CHAPTER XVIII

INVESTOR NATION REGULATION OF PORTFOLIO INVESTMENT

Regulation of portfolio investment–investment typically carried out through purchase of corporate stocks and bonds–has followed a very different path from that of bank lending. Following the stock market collapse of 1929, the United States enacted two statutes, the Securities Act of 1933[1] and the Securities Exchange Act of 1934,[2] designed to reassure investors and restore confidence in the stock market.

These statutes rely primarily upon disclosure through registration statements and prospectuses filed with the Securities and Exchange Commission (SEC) and, under certain circumstances, made available to the investor. The material disclosed in these statements, which must meet standards defined by the SEC, is designed to enable investors and financial analysts to obtain accurate information about the issuer of the securities. With this information available, the quality of the securities offerings should be self-regulating, and there should be no need for the government directly to regulate the terms of securities offerings, as it does in a few states.[3]

The securities industry[4] generally operates through "underwriters," securities firms that facilitate the distribution of an issuer's securities by organizing a selling effort to institutional investors and the public, or by buying a block of securities from issuer and then reselling the securities to the public through a national network.[5] Thus, when *X Corp*. wishes to raise new capital in the securities market, it authorizes a stock offering through its own corporate procedures, and then it might sell the entire package of securities to a group of underwriters, which passes the securities on to institutional investors (*e.g.*, insurance companies, investment funds, banks) and the public. The entire arrangement is carefully negotiated in advance–part of the expertise of the underwriters lies in accurately estimating the likelihood that the securities will actually sell at a specific price.

After the distribution of the securities is completed,[6] the securities enter the"second-

1. 15 U.S.C. §§ 77a-77aa.

2. *Id*. §§ 78a-78bb.

3. This practice of regulating the terms of securities offerings, sometimes called "merit review," is also followed in a few states of the United States. It is also followed in the federal regulation of the issuance of securities by national banks, *see, e.g.*, 12 U.S.C. § 51, and securities of federally chartered savings associations under *id*. § 1464. For analysis of merit review of securities of national banks and federal savings associations, see MICHAEL P. MALLOY, BANKING LAW AND REGULATION §§ 5.1 *et seq*. (1994).

4. The industry itself is subject to supervision and substantive regulation by the SEC under the 1934 Act and other federal securities statutes, in addition to SEC regulation of particular securities activities like underwriting under the 1933 Act. *See, e.g.*, 15 U.S.C. §§ 78h, 78o, 78s (providing for regulation of national securities exchanges and broker-dealers); *id*. §§ 80a *et seq*. (providing for regulation of investment companies); *id*. §§ 80b *et seq*. (providing for regulation of investment advisers).

5. *See id*. § 77c(a)(11) (defining "underwriter" for purposes of 1933 Act).

6. This point is usually referred to as the securities "coming to rest" with the public.

ary market," the market in which investors buy and sell securities among themselves. Thus, an initial purchaser of X Corp. securities from the underwriters may eventually resell them, either on a stock exchange, through the NASDAQ system, or through some other less organized market.[7] These markets serve speculative functions, but also contribute to initial investment. Investors are much more likely to purchase securities in an initial offering–which usually directly supports the acquisition of productive resources–if they can reasonably expect to be able to resell the securities in the secondary market should they later wish to do so.

The situations in which the disclosures must be made are identified in the federal securities statutes and implementing regulations in quite technical ways–and these requirements are particularly difficult to follow, because they place many of the important criteria and standards in definitional provisions, rather than obviously substantive ones.[8] In general, however, we may say that the securities laws are designed primarily to govern a "public offering" of securities, *i.e.*, one in which the securities are offered to more than a very few individuals or institutions who are well informed about the specific firm. Typically, a public offering will made either by or on behalf of the issuer itself, selling a large package of securities for the sake of raising capital, or by or on behalf of the issuer's inside investors, entrepreneurs, and executives who hold large blocks of stock that they wish to resell to the public. In either case a registration statement must be prepared, filed with the SEC and declared effective by the SEC before the securities can be offered and sold.[9] In addition, if the securities are listed on a national stock exchange, or are otherwise widely traded in the securities markets, various periodic disclosure statements and other rules of disclosure and SEC reporting must be satisfied by the issuer of the securities, for the continuing protection of investors in the secondary market.[10] The SEC has direct statutory authority to enforce these statutory requirements,[11] and private rights of action are also provided for purchasers of securities in the process of distribution.[12] In addition, the stock exchanges and NASD also have their own standards and rules governing securities activities and practices of their respective members, and compliance with these rules and standards are enforced both by the exchanges and NASD and by the SEC, which has the power to approve such rules and standards and to modify, suspend or eliminate them in the interest of the public.[13]

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7. Resellers must be careful about offering the securities too quickly after their initial purchase; otherwise, the SEC may consider them one of the "underwriters" of the original offering, since they appear to be facilitating the distribution of the securities. *See, e.g.*, 17 C.F.R. §§ 230.144, 230.145 (setting forth SEC rules about resale of securities).

8. In this sense, federal securities regulation–like many areas of federal regulatory law such as banking–is often said to be "definitionally driven." Attention to "mere" definitional provsions is therefore crucial to a mastery of these areas of regulatory law.

9. 15 U.S.C. §§ 77e, 77h, 77j.

10. *Id*. § 78*l*(a), (g).These disclosure and reporting requirements include registration of the securities under section 12 of the 1934 Act (15 U.S.C. § 78*l*); periodic reports about the issuer under section 13 (§ 78m), proxy statements and tender offer disclosures under section 14 (§ 78n); and reporting of trading in the securities by insiders of the issuer under section 16 (§ 78p).

11. *See, e.g., id*. § 77h (providing authority for SEC to stop the sale of securities in initial offering).

12. *Id*. §§ 77k-77*l*.

13. *Id*. § 78s.

A. INTERNATIONAL ASPECTS OF REGISTRATION REQUIREMENTS AND THEIR ANALOGUES

If they are to protect U.S. investors, the registration and disclosure requirements must extend to at least some international transactions. Consider the following situations:

1. A U.S. firm, listed on a U.S. stock exchange or otherwise publicly traded in the United States, makes an offering of securities in Europe to raise additional capital.
2. A European firm makes a public offering in the United States or seeks listing on a U.S. stock exchange.
3. A European firm sells a few shares of a European public offering to U.S. citizens who are living in Europe and who purchase the securities in Europe through brokers in Europe.
4. A very few of the shares purchased in Europe, as in example 3, are resold by the initial purchasers to persons in the United States.
5. The pattern of example 4 continues and reaches the point where there are a significant number of U.S. shareholders. (Note that this can happen relatively easily with respect to Canada and securities purchased on the Toronto Stock Exchange.)

In each of the five cases, the question is whether or not registration under U.S. law should be required–and this question itself is ambiguous, because there are two distinct "registration" processes that must be considered. One is registration, under the 1933 Act, of an issuance of securities being offered to the market by the firm, its underwriters, insiders or affiliates. The second is registration, under the 1934 Act, of the securities of a firm that are listed on a national securities exchange or that are otherwise widely traded in the market. The SEC has answers to each of these questions, but they are not the *same* answers for each situation.

1. Registration under the 1933 Act

The only explicit jurisdictional limitation on registration under the 1933 Act is that there must be use of the statutory "jurisdictional means" in offering, selling, or delivering the securities–*i.e.*, by the use "directly or indirectly . . . of any means or instruments of transportation or communication in interstate commerce or of the mails."[1] Obviously, these jurisdictional means could be met either in a domestic transaction or one that was non-domestic in whole or in part or otherwise had a transnational aspect to it. Assuming that the core objective of the federal securities laws is to protect U.S. markets and U.S. investors, one might expect the SEC to seek some limits to the full potential reach of the 1933 Act. The SEC did not definitively address this issue, however, until 1990, with the promulgation of Regulation S. The SEC continued to monitor the situation, and in 1995 it issued an interpretive release expressing concern that some issuers were using the regulation as an end-run around the registration requirement while still distributing securities into the U.S. market. Regulation S was amended in 1997, to tighten the scope of its application and to align it with Rule 144, which restricts the resale of unregistered securities. Consider the regulatory excerpts

1. 15 U.S.C. § 77e(a)(1).

below and then answer the questions that follow at ▬, *infra*.

SECURITIES AND EXCHANGE COMMISSION
17 C.F.R. PART 230

§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.

Preliminary Note:

Rule 144 is designed to implement the fundamental purposes of the Act, as expressed in its preamble, "To provide full and fair disclosure of the character of the securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof * * *" The rule is designed to prohibit the creation of public markets in securities of issuers concerning which adequate current information is not available to the public. At the same time, where adequate current information concerning the issuer is available to the public, the rule permits the public sale in ordinary trading transactions of limited amounts of securities owned by persons controlling, controlled by or under common control with the issuer and by persons who have acquired restricted securities of the issuer.

Certain basic principles are essential to an understanding of the requirement of registration in the Act:

1. If any person utilizes the jurisdictional means to sell any nonexempt security to any other person, the security must be registered unless a statutory exemption can be found for the transaction.

2. In addition to the exemptions found in Section 3 [15 U.S.C. § 77c], four exemptions applicable to transactions in securities are contained in section 4 [*id*. § 77d]. Three of these section 4 exemptions are clearly not available to anyone acting as an "underwriter" of securities. (The fourth, found in section 4(4) [*id*. § 77d(4)], is available only to those who act as brokers under certain limited circumstances.) An understanding of the term "underwriter" is therefore important to anyone who wishes to determine whether or not an exemption from registration is available for his sale of securities.

The term underwriter is broadly defined in section 2(11) of the Act [*id*. § 77b(a)(11)] to mean any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates, or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. The interpretation of this definition has traditionally focused on the words "with a view to" in the phrase "purchased from an issuer with a view to * * * distribution." Thus, an investment banking firm which arranges with an issuer for the public sale of its securities is clearly an "underwriter" under that section. Individual investors who are not professionals in the securities business may also be "underwriters" within the meaning of that term as used in the Act if they act as links in a chain of transactions through which securities move from an issuer to the public. Since it is difficult to ascertain the mental state of the purchaser at the time of his acquisition, subsequent acts and circumstances have been considered to determine whether such person took with a view to distribution at the time of his acquisition. Emphasis has been placed on factors such as the length of time the person has held the securities and whether there has been an unforeseeable change in circumstances of the holder. Experience has shown, however, that reliance upon such factors as the above has not assured adequate protection of

investors through the maintenance of informed trading markets and has led to uncertainty in the application of the registration provisions of the Act.

It should be noted that the statutory language of section 2(11) is in the disjunctive. Thus, it is insufficient to conclude that a person is not an underwriter solely because he did not purchase securities from an issuer with a view to their distribution. It must also be established that the person is not offering or selling for an issuer in connection with the distribution of the securities, does not participate or have a direct or indirect participation in any such undertaking, and does not participate or have a participation in the direct or indirect underwriting of such an undertaking.

In determining when a person is deemed not to be engaged in a distribution several factors must be considered.

First, the purpose and underlying policy of the Act to protect investors requires that there be adequate current information concerning the issuer, whether the resales of securities by persons result in a distribution or are effected in trading transactions. Accordingly, the availability of the rule is conditioned on the existence of adequate current public information.

Secondly, a holding period prior to resale is essential, among other reasons, to assure that those persons who buy under a claim of a section 4(2) [*id.* § 77d(2)] exemption have assumed the economic risks of investment, and therefore are not acting as conduits for sale to the public of unregistered securities, directly or indirectly, on behalf of an issuer. It should be noted that there is nothing in section 2(11) which places a time limit on a person's status as an underwriter. The public has the same need for protection afforded by registration whether the securities are distributed shortly after their purchase or after a considerable length of time.

A third factor, which must be considered in determining what is deemed not to constitute a "distribution", is the impact of the particular transaction or transactions on the trading markets. Section 4(1) [*id.* § 77d(1)] was intended to exempt only routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions. Therefore, a person reselling securities under section 4(1) of the Act must sell the securities in such limited quantities and in such a manner as not to disrupt the trading markets. The larger the amount of securities involved, the more likely it is that such resales may involve methods of offering and amounts of compensation usually associated with a distribution rather than routine trading transactions. Thus, solicitation of buy orders or the payment of extra compensation are not permitted by the rule.

In summary, if the sale in question is made in accordance with all of the provisions of the section as set forth below, any person who sells restricted securities shall be deemed not to be engaged in a distribution of such securities and therefore not an underwriter thereof. The rule also provides that any person who sells restricted or other securities on behalf of a person in a control relationship with the issuer shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof, if the sale is made in accordance with all the conditions of the section.

(a) Definitions. The following definitions shall apply for the purposes of this section.

(1) An "affiliate" of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.

(2) The term "person" when used with reference to a person for whose account

securities are to be sold in reliance upon this section includes, in addition to such person, all of the following persons:

(i) Any relative or spouse of such person, or any relative of such spouse, any one of whom has the same home as such person;

(ii) Any trust or estate in which such person or any of the persons specified in paragraph (a)(2)(i) of this section collectively own 10 percent or more of the total beneficial interest or of which any of such persons serve as trustee, executor or in any similar capacity; and

(iii) Any corporation or other organization (other than the issuer) in which such person or any of the persons specified in paragraph (a)(2)(i) of this section are the beneficial owners collectively of 10 percent or more of any class of equity securities or 10 percent or more of the equity interest.

(3) The term restricted securities means:

(i) Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering;

(ii) Securities acquired from the issuer that are subject to the resale limitations of [certain exemptive provisions of the SEC regulations promulgated under section 3(b) of the 1933 Act, 15 U.S.C. § 77c(b)]. . . .

(b) Conditions to be met. Any affiliate or other person who sells restricted securities of an issuer for his own account, or any person who sells restricted or any other securities for the account of an affiliate of the issuer of such securities, shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter thereof within the meaning of section 2(11) of the Act if all of the conditions of this section are met.

(c) Current public information. There shall be available adequate current public information with respect to the issuer of the securities. Such information shall be deemed to be available only if either of the following conditions is met:

(1) Filing of reports. The issuer has securities registered pursuant to section 12 of the Securities Exchange Act of 1934 [15 U.S.C. § 78*l*], has been subject to the reporting requirements of section 13 of that Act [*id*. § 78m] for a period of at least 90 days immediately preceding the sale of the securities and has filed all the reports required to be filed thereunder during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports), other than Form 8-K reports (§ 249.308 of this chapter); or has securities registered pursuant to the Securities Act of 1933, has been subject to the reporting requirements of section 15(d) of the Securities Exchange Act of 1934 [*id*. § 78o] for a period of at least 90 days immediately preceding the sale of the securities and has filed all the reports required to be filed thereunder during the 12 months preceding such sale (or for such shorter period that the issuer was required to file such reports), other than Form 8-K reports (§ 249.308 of this chapter). The person for whose account the securities are to be sold shall be entitled to rely upon a statement in whichever is the most recent report, quarterly or annual, required to be filed and filed by the issuer that such issuer has filed all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the issuer was required to file such reports), other than Form 8-K reports (§ 249.308 of this chapter), and has been subject to such filing requirements for the past 90 days, unless he knows or has reason to believe that the issuer has not complied with such requirements. Such person shall also be entitled to rely upon a written statement from the issuer that it has complied with such reporting requirements unless he knows or has reasons to believe that the issuer has not complied with such

requirements.

(2) Other public information. If the issuer is not subject to section 13 or 15(d) of the Securities Exchange Act of 1934, there is publicly available the information concerning the issuer specified in paragraphs (a)(5)(i) to (xiv), inclusive, and paragraph (a)(5)(xvi) of Rule 15c2-11 (§ 240.15c2-11 of this chapter) under that Act or, if the issuer is an insurance company, the information specified in section 12(g)(2)(G)(i) of that Act.

(d) Holding period for restricted securities. If the securities sold are restricted securities, the following provisions apply:

(1) General rule. A minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities. If the acquiror takes the securities by purchase, the one-year period shall not begin until the full purchase price or other consideration is paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer. . . .

(3) Determination of holding period. The following provisions shall apply for the purpose of determining the period securities have been held: . . .

(viii) Rule 145(a) transactions. The holding period for securities acquired in a transaction specified in Rule 145(a) [*i.e.*, a reclassification of securities, merger, consolidation or acquisitions of assets] shall be deemed to commence on the date the securities were acquired by the purchaser in such transaction. This provision shall not apply, however, to a transaction effected solely for the purpose of forming a holding company.

(e) Limitation on amount of securities sold. Except as hereinafter provided, the amount of securities which may be sold in reliance upon this rule shall be determined as follows:

(1) Sales by affiliates. If restricted or other securities are sold for the account of an affiliate of the issuer, the amount of securities sold, together with all sales of restricted and other securities of the same class for the account of such person within the preceding three months, shall not exceed the greater of

(i) One percent of the shares or other units of the class outstanding as shown by the most recent report or statement published by the issuer, or

(ii) The average weekly reported volume of trading in such securities on all national securities exchanges and/or reported through the automated quotation system of a registered securities association during the four calendar weeks preceding the filing of notice required by paragraph (h), or if no such notice is required the date of receipt of the order to execute the transaction by the broker or the date of execution of the transaction directly with a market maker, or

(iii) The average weekly volume of trading in such securities reported through the consolidated transaction reporting system contemplated by Rule 11Aa3-1 under the Securities Exchange Act of 1934 (§ 240.11A3-1) during the four-week period specified in paragraph (e)(1)(ii) of this section.

(2) Sales by persons other than affiliates. The amount of restricted securities sold for the account of any person other than an affiliate of the issuer, together with all other sales of restricted securities of the same class for the account of such person within the preceding three months, shall not exceed the amount specified in paragraphs (e)(1)(i), (1)(ii) or (1)(iii) of this section, whichever is applicable, unless the conditions of paragraph (k) of this rule are satisfied. . . .

(f) Manner of sale. The securities shall be sold in "brokers' transactions" within the

meaning of section 4(4) of the Act or in transactions directly with a "market maker," as that term is defined in section 3(a)(38) of the Securities Exchange Act of 1934, and the person selling the securities shall not (1) solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transaction, or (2) make any payment in connection with the offer or sale of the securities to any person other than the broker who executes an order to sell the securities. The requirements of this paragraph, however, shall not apply to securities sold for the account of the estate of a deceased person or for the account of a beneficiary of such estate provided the estate or beneficiary thereof is not an affiliate of the issuer; nor shall they apply to securities sold for the account of any person other than an affiliate of the issuer provided the conditions of paragraph (k) of this rule are satisfied. . . .

(h) Notice of proposed sale. If the amount of securities to be sold in reliance upon the rule during any period of three months exceeds 500 shares or other units or has an aggregate sale price in excess of $10,000, three copies of a notice on Form 144 shall be filed with the Commission at its principal office in Washington, D.C.; and if such securities are admitted to trading on any national securities exchange, one copy of such notice shall also be transmitted to the principal exchange on which such securities are so admitted. The Form 144 shall be signed by the person for whose account the securities are to be sold and shall be transmitted for filing concurrently with either the placing with a broker of an order to execute a sale of securities in reliance upon this rule or the execution directly with a market maker of such a sale. Neither the filing of such notice nor the failure of the Commission to comment thereon shall be deemed to preclude the Commission from taking any action it deems necessary or appropriate with respect to the sale of the securities referred to in such notice. The requirements of this paragraph, however, shall not apply to securities sold for the account of any person other than an affiliate of the issuer, provided the conditions of paragraph (k) of this rule are satisfied.

(i) Bona fide intention to sell. The person filing the notice required by paragraph (h) of this section shall have a bona fide intention to sell the securities referred to therein within a reasonable time after the filing of such notice.

(j) Non-exclusive rule. Although this rule provides a means for reselling restricted securities and securities held by affiliates without registration, it is not the exclusive means for reselling such securities in that manner. Therefore, it does not eliminate or otherwise affect the availability of any exemption for resales under the Securities Act that a person or entity may be able to rely upon.

(k) Termination of certain restrictions on sales of restricted securities by persons other than affiliates. The requirements of paragraphs (c), (e), (f) and (h) of this section shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer at the time of the sale and has not been an affiliate during the preceding three months, provided a period of at least two years has elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer. The two-year period shall be calculated as described in paragraph (d) of this section.

Regulation S–Rules Governing Offers and Sales Made Outside the United States Without Registration under the Securities Act of 1933

§ 230.901 General statement.

For the purposes only of section 5 of the Act (15 U.S.C. § 77e), the terms offer, offer to sell, sell, sale, and offer to buy shall be deemed to include offers and sales that occur

within the United States and shall be deemed not to include offers and sales that occur outside the United States.

§ 230.902 Definitions.

As used in Regulation S, the following terms shall have the meanings indicated.

(a) Debt securities. "Debt securities" of an issuer is defined to mean any security other than an equity security . . . , as well as the following:

(1) Non-participatory preferred stock, which is defined as non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer; and

(2) Asset-backed securities, which are securities of a type that either:

(i) Represent an ownership interest in a pool of discrete assets, or certificates of interest or participation in such assets (including any rights designed to assure servicing, or the receipt or timeliness of receipt by holders of such assets, or certificates of interest or participation in such assets, of amounts payable thereunder), provided that the assets are not generated or originated between the issuer of the security and its affiliates; or

(ii) Are secured by one or more assets or certificates of interest or participation in such assets, and the securities, by their terms, provide for payments of principal and interest (if any) in relation to payments or reasonable projections of payments on assets meeting the requirements of paragraph (a)(2)(i) of this section, or certificates of interest or participations in assets meeting such requirements.

(iii) For purposes of paragraph (a)(2) of this section, the term "assets" means securities, installment sales, accounts receivable, notes, leases or other contracts, or other assets that by their terms convert into cash over a finite period of time.

(b) Designated offshore securities market. "Designated offshore securities market" means:

(1) The Eurobond market, as regulated by the International Securities Market Association; the Alberta Stock Exchange; the Amsterdam Stock Exchange; the Australian Stock Exchange Limited; the Bermuda Stock Exchange; the Bourse de Bruxelles; the Copenhagen Stock Exchange; the European Association of Securities Dealers Automated Quotation; the Frankfurt Stock Exchange; the Helsinki Stock Exchange; The Stock Exchange of Hong Kong Limited; the Irish Stock Exchange; the Istanbul Stock Exchange; the Johannesburg Stock Exchange; the London Stock Exchange; the Bourse de Luxembourg; the Mexico Stock Exchange; the Borsa Valori di Milan; the Montreal Stock Exchange; the Oslo Stock Exchange; the Bourse de Paris; the Stock Exchange of Singapore Ltd.; the Stockholm Stock Exchange; the Tokyo Stock Exchange; the Toronto Stock Exchange; the Vancouver Stock Exchange; the Warsaw Stock Exchange and the Zurich Stock Exchange; and

(2) Any foreign securities exchange or non-exchange market designated by the Commission. Attributes to be considered in determining whether to designate an offshore securities market, among others, include:

(i) Organization under foreign law;

(ii) Association with a generally recognized community of brokers, dealers, banks, or other professional intermediaries with an established operating history;

(iii) Oversight by a governmental or self-regulatory body;

(iv) Oversight standards set by an existing body of law;

(v) Reporting of securities transactions on a regular basis to a governmental or self-regulatory body;

(vi) A system for exchange of price quotations through common communications media; and

(vii) An organized clearance and settlement system.

(c) Directed selling efforts.

(1) "Directed selling efforts" means any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes). Such activity includes placing an advertisement in a publication "with a general circulation in the United States" that refers to the offering of securities being made in reliance upon this Regulation S.

(2) Publication "with a general circulation in the United States":

(i) Is defined as any publication that is printed primarily for distribution in the United States, or has had, during the preceding twelve months, an average circulation in the United States of 15,000 or more copies per issue; and

(ii) Will encompass only the U.S. edition of any publication printing a separate U.S. edition if the publication, without considering its U.S. edition, would not constitute a publication with a general circulation in the United States.

(3) The following are not "directed selling efforts":

(i) Placing an advertisement required to be published under U.S. or foreign law, or under rules or regulations of a U.S. or foreign regulatory or self-regulatory authority, provided the advertisement contains no more information than legally required and includes a statement to the effect that the securities have not been registered under the Act and may not be offered or sold in the United States (or to a U.S. person, if the advertisement relates to an offering under Category 2 or 3 (paragraph (b)(2) or (b)(3)) in § 230.903) absent registration or an applicable exemption from the registration requirements;

(ii) Contact with persons excluded from the definition of "U.S. person" pursuant to paragraph (k)(2)(vi) of this section or persons holding accounts excluded from the definition of "U.S. person" pursuant to paragraph (k)(2)(i) of this section, solely in their capacities as holders of such accounts;

(iii) A tombstone advertisement in any publication with a general circulation in the United States, provided:

(A) The publication has less than 20% of its circulation, calculated by aggregating the circulation of its U.S. and comparable non-U.S. editions, in the United States;

(B) Such advertisement contains a legend to the effect that the securities have not been registered under the Act and may not be offered or sold in the United States (or to a U.S. person, if the advertisement relates to an offering under Category 2 or 3 (paragraph (b)(2) or (b)(3)) in § 230.903) absent registration or an applicable exemption from the registration requirements; and

(C) Such advertisement contains no more information than:

(1) The issuer's name;

(2) The amount and title of the securities being sold;

(3) A brief indication of the issuer's general type of business;

(4) The price of the securities;

(5) The yield of the securities, if debt securities with a fixed (non-contingent) interest provision;

(6) The name and address of the person placing the advertisement, and whether such person is participating in the distribution;

(7) The names of the managing underwriters;

(8) The dates, if any, upon which the sales commenced and concluded;

(9) Whether the securities are offered or were offered by rights issued to security holders and, if so, the class of securities that are entitled or were entitled to subscribe, the subscription ratio, the record date, the dates (if any) upon which the rights were issued and expired, and the subscription price; and

(10) Any legend required by law or any foreign or U.S. regulatory or self-regulatory authority;

(iv) Bona fide visits to real estate, plants or other facilities located in the United States and tours thereof conducted for a prospective investor by an issuer, a distributor, any of their respective affiliates or a person acting on behalf of any of the foregoing;

(v) Distribution in the United States of a foreign broker-dealer's quotations by a third-party system that distributes such quotations primarily in foreign countries if:

(A) Securities transactions cannot be executed between foreign broker-dealers and persons in the United States through the system; and

(B) The issuer, distributors, their respective affiliates, persons acting on behalf of any of the foregoing, foreign broker-dealers and other participants in the system do not initiate contacts with U.S. persons or persons within the United States, beyond those contacts exempted under § 240.15a-6 of this chapter; and

(vi) Publication by an issuer of a notice in accordance with § 230.135 or § 230.135c.

(vii) Providing any journalist with access to press conferences held outside of the United States, to meetings with the issuer or selling security holder representatives conducted outside the United States, or to written press-related materials released outside the United States, at or in which a present or proposed offering of securities is discussed, if the requirements of § 230.135e are satisfied.

(d) Distributor. "Distributor" means any underwriter, dealer, or other person who participates, pursuant to a contractual arrangement, in the distribution of the securities offered or sold in reliance on this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes).

(e) Domestic issuer/Foreign issuer. "Domestic issuer" means any issuer other than a "foreign government" or "foreign private issuer" (both as defined in § 230.405). "Foreign issuer" means any issuer other than a "domestic issuer."

(f) Distribution compliance period. "Distribution compliance period" means a period that begins when the securities were first offered to persons other than distributors in reliance upon this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes) or the date of closing of the offering, whichever is later, and continues until the end of the period of time specified in the relevant provision of § 230.903, except that:

(1) All offers and sales by a distributor of an unsold allotment or subscription shall be deemed to be made during the distribution compliance period;

(2) In a continuous offering, the distribution compliance period shall commence upon completion of the distribution, as determined and certified by the managing underwriter or person performing similar functions;

(3) In a continuous offering of non-convertible debt securities offered and sold in identifiable tranches, the distribution compliance period for securities in a tranche shall commence upon completion of the distribution of such tranche, as determined and certified by the managing underwriter or person performing similar functions; and

(4) That in a continuous offering of securities to be acquired upon the exercise of warrants, the distribution compliance period shall commence upon completion of the distribution of the warrants, as determined and certified by the managing underwriter or person performing similar functions, if requirements of § 230.903(b)(5) are satisfied.

(g) Offering restrictions. "Offering restrictions" means:

(1) Each distributor agrees in writing:

(i) That all offers and sales of the securities prior to the expiration of the distribution compliance period specified in Category 2 or 3 (paragraph (b)(2) or (b)(3)) in § 230.903, as applicable, shall be made only in accordance with the provisions of § 230.903 or § 230.904; pursuant to registration of the securities under the Act; or pursuant to an available exemption from the registration requirements of the Act; and

(ii) For offers and sales of equity securities of domestic issuers, not to engage in hedging transactions with regard to such securities prior to the expiration of the distribution compliance period specified in Category 2 or 3 (paragraph (b)(2) or (b)(3)) in § 230.903, as applicable, unless in compliance with the Act; and

(2) All offering materials and documents (other than press releases) used in connection with offers and sales of the securities prior to the expiration of the distribution compliance period specified in Category 2 or 3 (paragraph (b)(2) or (b)(3)) in § 230.903, as applicable, shall include statements to the effect that the securities have not been registered under the Act and may not be offered or sold in the United States or to U.S. persons (other than distributors) unless the securities are registered under the Act, or an exemption from the registration requirements of the Act is available. For offers and sales of equity securities of domestic issuers, such offering materials and documents also must state that hedging transactions involving those securities may not be conducted unless in compliance with the Act. Such statements shall appear:

(i) On the cover or inside cover page of any prospectus or offering circular used in connection with the offer or sale of the securities;

(ii) In the underwriting section of any prospectus or offering circular used in connection with the offer or sale of the securities; and

(iii) In any advertisement made or issued by the issuer, any distributor, any of their respective affiliates, or any person acting on behalf of any of the foregoing. Such statements may appear in summary form on prospectus cover pages and in advertisements.

(h) Offshore transaction.

(1) An offer or sale of securities is made in an "offshore transaction" if:

(i) The offer is not made to a person in the United States; and

(ii) Either:

(A) At the time the buy order is originated, the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States; or

(B) For purposes of:

(1) Section 230.903, the transaction is executed in, on or through a physical trading floor of an established foreign securities exchange that is located outside the United States; or

(2) Section 230.904, the transaction is executed in, on or through the facilities of a designated offshore securities market described in paragraph (b) of this section, and neither the seller nor any person acting on its behalf knows that the transaction has been pre-arranged with a buyer in the United States.

(2) Notwithstanding paragraph (h)(1) of this section, offers and sales of securities specifically targeted at identifiable groups of U.S. citizens abroad, such as members of the U.S. armed forces serving overseas, shall not be deemed to be made in "offshore transactions."

(3) Notwithstanding paragraph (h)(1) of this section, offers and sales of securities to

persons excluded from the definition of "U.S. person" pursuant to paragraph (k)(2)(vi) of this section or persons holding accounts excluded from the definition of "U.S. person" pursuant to paragraph (k)(2)(i) of this section, solely in their capacities as holders of such accounts, shall be deemed to be made in "offshore transactions."

(i) Reporting issuer. "Reporting issuer" means an issuer other than an investment company registered or required to register under the 1940 Act that:

(1) Has a class of securities registered pursuant to Section 12(b) or 12(g) of the Exchange Act (15 U.S.C. 78*l*(b) or 78*l*(g)) or is required to file reports pursuant to Section 15(d) of the Exchange Act (15 U.S.C. 78o(d)); and

(2) Has filed all the material required to be filed pursuant to Section 13(a) or 15(d) of the Exchange Act (15 U.S.C. 78m(a) or 78o(d)) for a period of at least twelve months immediately preceding the offer or sale of securities made in reliance upon this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes) (or for such shorter period that the issuer was required to file such material).

(j) Substantial U.S. market interest.

(1) "Substantial U.S. market interest" with respect to a class of an issuer's equity securities means:

(i) The securities exchanges and inter-dealer quotation systems in the United States in the aggregate constituted the single largest market for such class of securities in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation; or

(ii) 20 percent or more of all trading in such class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States and less than 55 percent of such trading took place in, on or through the facilities of securities markets of a single foreign country in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation.

(2) "Substantial U.S. market interest" with respect to an issuer's debt securities means:

(i) Its debt securities, in the aggregate, are held of record (as that term is defined in § 240.12g5-1 of this chapter and used for purposes of paragraph (j)(2) of this section) by 300 or more U.S. persons;

(ii) $1 billion or more of: The principal amount outstanding of its debt securities, the greater of liquidation preference or par value of its securities described in § 230.902 (a)(1), and the principal amount or principal balance of its securities described in § 230.902(a)(2), in the aggregate, is held of record by U.S. persons; and

(iii) 20 percent or more of: The principal amount outstanding of its debt securities, the greater of liquidation preference or par value of its securities described in § 230.902 (a)(1), and the principal amount or principal balance of its securities described in § 230.902(a)(2), in the aggregate, is held of record by U.S. persons.

(3) Notwithstanding paragraph (j)(2) of this section, substantial U.S. market interest with respect to an issuer's debt securities is calculated without reference to securities that qualify for the exemption provided by Section 3(a)(3) of the Act (15 U.S.C. 77c(a)(3)).

(k) U.S. person.

(1) "U.S. person" means:

(i) Any natural person resident in the United States;

(ii) Any partnership or corporation organized or incorporated under the laws of the United States;

(iii) Any estate of which any executor or administrator is a U.S. person;

(iv) Any trust of which any trustee is a U.S. person;

(v) Any agency or branch of a foreign entity located in the United States;

(vi) Any non-discretionary account or similar account (other than an estate or trust)

held by a dealer or other fiduciary for the benefit or account of a U.S. person;

(vii) Any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and

(viii) Any partnership or corporation if:

(A) Organized or incorporated under the laws of any foreign jurisdiction; and

(B) Formed by a U.S. person principally for the purpose of investing in securities not registered under the Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in § 230.501(a)) who are not natural persons, estates or trusts.

(2) The following are not "U.S. persons":

(i) Any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-U.S. person by a dealer or other professional fiduciary organized, incorporated, or (if an individual) resident in the United States;

(ii) Any estate of which any professional fiduciary acting as executor or administrator is a U.S. person if:

(A) An executor or administrator of the estate who is not a U.S. person has sole or shared investment discretion with respect to the assets of the estate; and

(B) The estate is governed by foreign law;

(iii) Any trust of which any professional fiduciary acting as trustee is a U.S. person, if a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settlor if the trust is revocable) is a U.S. person;

(iv) An employee benefit plan established and administered in accordance with the law of a country other than the United States and customary practices and documentation of such country;

(v) Any agency or branch of a U.S. person located outside the United States if:

(A) The agency or branch operates for valid business reasons; and

(B) The agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located; and

(vi) The International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans.

(*l*) United States. "United States" means the United States of America, its territories and possessions, any State of the United States, and the District of Columbia.

§ 230.903 Offers or sales of securities by the issuer, a distributor, any of their respective affiliates, or any person acting on behalf of any of the foregoing; conditions relating to specific securities.

(a) An offer or sale of securities by the issuer, a distributor, any of their respective affiliates, or any person acting on behalf of any of the foregoing, shall be deemed to occur outside the United States within the meaning of § 230.901 if:

(1) The offer or sale is made in an offshore transaction;

(2) No directed selling efforts are made in the United States by the issuer, a distributor, any of their respective affiliates, or any person acting on behalf of any of the foregoing; and

(3) The conditions of paragraph (b) of this section, as applicable, are satisfied.

(b) Additional Conditions--

(1) Category 1. No conditions other than those set forth in § 230.903(a) apply to securities in this category. Securities are eligible for this category if:

(i) The securities are issued by a foreign issuer that reasonably believes at the commencement of the offering that:

(A) There is no substantial U.S. market interest in the class of securities to be offered or sold (if equity securities are offered or sold);

(B) There is no substantial U.S. market interest in its debt securities (if debt securities are offered or sold);

(C) There is no substantial U.S. market interest in the securities to be purchased upon exercise (if warrants are offered or sold); and

(D) There is no substantial U.S. market interest in either the convertible securities or the underlying securities (if convertible securities are offered or sold);

(ii) The securities are offered and sold in an overseas directed offering, which means:

(A) An offering of securities of a foreign issuer that is directed into a single country other than the United States to the residents thereof and that is made in accordance with the local laws and customary practices and documentation of such country; or

(B) An offering of non-convertible debt securities of a domestic issuer that is directed into a single country other than the United States to the residents thereof and that is made in accordance with the local laws and customary practices and documentation of such country, provided that the principal and interest of the securities (or par value, as applicable) are denominated in a currency other than U.S. dollars and such securities are neither convertible into U.S. dollar-denominated securities nor linked to U.S. dollars (other than through related currency or interest rate swap transactions that are commercial in nature) in a manner that in effect converts the securities to U.S. dollar-denominated securities.

(iii) The securities are backed by the full faith and credit of a foreign government; or

(iv) The securities are offered and sold to employees of the issuer or its affiliates pursuant to an employee benefit plan established and administered in accordance with the law of a country other than the United States, and customary practices and documentation of such country, provided that:

(A) The securities are issued in compensatory circumstances for bona fide services rendered to the issuer or its affiliates in connection with their businesses and such services are not rendered in connection with the offer or sale of securities in a capital-raising transaction;

(B) Any interests in the plan are not transferable other than by will or the laws of descent or distribution;

(C) The issuer takes reasonable steps to preclude the offer and sale of interests in the plan or securities under the plan to U.S. residents other than employees on temporary assignment in the United States; and

(D) Documentation used in connection with any offer pursuant to the plan contains a statement that the securities have not been registered under the Act and may not be offered or sold in the United States unless registered or an exemption from registration is available.

(2) Category 2. The following conditions apply to securities that are not eligible for Category 1 (paragraph (b)(1)) of this section and that are equity securities of a reporting foreign issuer, or debt securities of a reporting issuer or of a non-reporting foreign issuer.

(i) Offering restrictions are implemented;

(ii) The offer or sale, if made prior to the expiration of a 40-day distribution compliance period, is not made to a U.S. person or for the account or benefit of a U.S. person (other than a distributor); and

(iii) Each distributor selling securities to a distributor, a dealer, as defined in section 2(a)(12) of the Act (15 U.S.C. 77b(a)(12)), or a person receiving a selling concession, fee or other remuneration in respect of the securities sold, prior to the expiration of a 40-day distribution compliance period, sends a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to a distributor.

(3) Category 3. The following conditions apply to securities that are not eligible for Category 1 or 2 (paragraph (b)(1) or (b)(2)) of this section:

(i) Offering restrictions are implemented;

(ii) In the case of debt securities:

(A) The offer or sale, if made prior to the expiration of a 40-day distribution compliance period, is not made to a U.S. person or for the account or benefit of a U.S. person (other than a distributor); and

(B) The securities are represented upon issuance by a temporary global security which is not exchangeable for definitive securities until the expiration of the 40-day distribution compliance period and, for persons other than distributors, until certification of beneficial ownership of the securities by a non-U.S. person or a U.S. person who purchased securities in a transaction that did not require registration under the Act;

(iii) In the case of equity securities:

(A) The offer or sale, if made prior to the expiration of a one-year distribution compliance period, is not made to a U.S. person or for the account or benefit of a U.S. person (other than a distributor); and

(B) The offer or sale, if made prior to the expiration of a one-year distribution compliance period, is made pursuant to the following conditions:

(1) The purchaser of the securities (other than a distributor) certifies that it is not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person or is a U.S. person who purchased securities in a transaction that did not require registration under the Act;

(2) The purchaser of the securities agrees to resell such securities only in accordance with the provisions of this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes), pursuant to registration under the Act, or pursuant to an available exemption from registration; and agrees not to engage in hedging transactions with regard to such securities unless in compliance with the Act;

(3) The securities of a domestic issuer contain a legend to the effect that transfer is prohibited except in accordance with the provisions of this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes), pursuant to registration under the Act, or pursuant to an available exemption from registration; and that hedging transactions involving those securities may not be conducted unless in compliance with the Act;

(4) The issuer is required, either by contract or a provision in its bylaws, articles, charter or comparable document, to refuse to register any transfer of the securities not made in accordance with the provisions of this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes), pursuant to registration under the Act, or pursuant to an available exemption from registration; provided, however, that if the securities are in bearer form or foreign law prevents the issuer of the securities from refusing to register securities transfers, other reasonable procedures (such as a legend described in paragraph (b)(3)(iii)(B)(3) of this section) are implemented to prevent any transfer of the

securities not made in accordance with the provisions of this Regulation S; and

(iv) Each distributor selling securities to a distributor, a dealer (as defined in section 2(a)(12) of the Act (15 U.S.C. 77b(a)(12)), or a person receiving a selling concession, fee or other remuneration, prior to the expiration of a 40-day distribution compliance period in the case of debt securities, or a one-year distribution compliance period in the case of equity securities, sends a confirmation or other notice to the purchaser stating that the purchaser is subject to the same restrictions on offers and sales that apply to a distributor. . . .

§ 230.904 Offshore resales.

(a) An offer or sale of securities by any person other than the issuer, a distributor, any of their respective affiliates (except any officer or director who is an affiliate solely by virtue of holding such position), or any person acting on behalf of any of the foregoing, shall be deemed to occur outside the United States within the meaning of § 230.901 if:

(1) The offer or sale are made in an offshore transaction;

(2) No directed selling efforts are made in the United States by the seller, an affiliate, or any person acting on their behalf; and

(3) The conditions of paragraph (b) of this section, if applicable, are satisfied.

(b) Additional conditions.

(1) Resales by dealers and persons receiving selling concessions. In the case of an offer or sale of securities prior to the expiration of the distribution compliance period specified in Category 2 or 3 (paragraph (b)(2) or (b)(3)) of § 230.903, as applicable, by a dealer, as defined in Section 2(a)(12) of the Act (15 U.S.C. 77b(a)(12)), or a person receiving a selling concession, fee or other remuneration in respect of the securities offered or sold:

(i) Neither the seller nor any person acting on its behalf knows that the offeree or buyer of the securities is a U.S. person; and

(ii) If the seller or any person acting on the seller's behalf knows that the purchaser is a dealer, as defined in Section 2(a)(12) of the Act (15 U.S.C. 77b(a)(12)), or is a person receiving a selling concession, fee or other remuneration in respect of the securities sold, the seller or a person acting on the seller's behalf sends to the purchaser a confirmation or other notice stating that the securities may be offered and sold during the distribution compliance period only in accordance with the provisions of this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes); pursuant to registration of the securities under the Act; or pursuant to an available exemption from the registration requirements of the Act.

(2) Resales by certain affiliates. In the case of an offer or sale of securities by an officer or director of the issuer or a distributor, who is an affiliate of the issuer or distributor solely by virtue of holding such position, no selling concession, fee or other remuneration is paid in connection with such offer or sale other than the usual and customary broker's commission that would be received by a person executing such transaction as agent.

§ 230.905 Resale limitations.

Equity securities of domestic issuers acquired from the issuer, a distributor, or any of their respective affiliates in a transaction subject to the conditions of § 230.901 or § 230.903 are deemed to be "restricted securities" as defined in § 230.144. Resales of any of such restricted securities by the offshore purchaser must be made in accordance with this Regulation S (§ 230.901 through § 230.905, and Preliminary Notes), the registration

requirements of the Act or an exemption therefrom. Any "restricted securities," as defined in § 230.144, that are equity securities of a domestic issuer will continue to be deemed to be restricted securities, notwithstanding that they were acquired in a resale transaction made pursuant to § 230.901 or § 230.904.

NOTES AND QUESTIONS

1. Assume that Considerable Corporation, incorporated under the laws of Delaware, creates a subsidiary, Considerate Company, S.A., under the laws of France. All of the shares issued by Considerate are acquired by Considerable and Mr. MacGuffin, Considerable's principal shareholder and chief executive officer. The Considerate shares would not be required to be registered under the 1933 Act, because they were issued in a "non-public offering" exempted from registration by section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2). If MacGuffin sells his shares in the over-the-counter market in the United States eight months later, has the 1933 Act been violated? What if he waits thirteen months before he sells? What if he waits 25 months? *See* Rule 144, *supra*.

2. Considerate issued 1 million shares and lists them on the *Bourse de Paris*; all of the shares are purchased by nationals of EU member states, principally French citizens. Must this issuance of securities be registered under section 5 of the 1933 Act?

3. Assume that 10 percent of the shares issued in question 2, *supra*, were purchased by MacGuffin. He has homes in Flapstack, Arizona, where Considerable has its corporate headquarters, and in the Principality of Monaco. Must these securities be registered pursuant to section 5 of the 1933 Act?

4. MacGuffin has incurred a large debt to a Monegasque lender to cover his whirlwind gambling spree at the casinos in Monaco. In order to pay the debt, MacGuffin sells half of his Considerate shares in the over-the-counter market in the United States eight months after the acquisition described in question 3, *supra*. Has the 1933 Act been violated?

5. Three years after Considerate was first listed on the *Bourse de Paris*, Considerable decides that it wants to take Considerate private, by acquiring all outstanding shares of its subsidiary. It offers 2 shares of Considerable common stock for each share of Considerate stock that it does not already own. Must the 2 million shares of Considerable common stock be registered under section 5 of the 1933 Act?

6. Reconsider the five situations outlined *supra* at ▬. In light of Regulation S, which of these require registration under section 5 of the 1933 Act?

7. Assuming that the key purpose of the federal securities laws is to protect U.S. investors, the intuitive answers to those five situations should be relatively obvious. The most difficult regulatory problem may be drawing the line between situation 4 and situation 5 in a way that does not penalize the foreign firm that accidentally has a few U.S. shareholders but does not open the door to effective evasion of U.S. law. How well does the SEC draw the lines involved?

8. If you were a U.S. issuer seeking funds in European capital markets, how would you assure yourself that the securities did not find their way back to the United States? For a sample approach, a "90-day lockup," based on temporary certificates along with certifications that the purchaser is not a U.S. national or resident, see Nathan, *Special Problems Arising as a Result of Trading in Multiple Markets*, 4 J. COMP. CORP. L. &. SEC. REG. 225 (1982). What would Regulation S require the U.S. issuer to do?

9. How comfortable would you be if you represented the board of a European firm

that had large numbers of bearer shares outstanding (shares circulating without any central registry, so that the firm does not know who its shareholders are)?

10. Rule 144(c)-(f) impose significant restrictions on the issuer and the holders of "restricted securities," particularly public information requirements. Under Regulation S, securities sold in offshore transactions remain restricted securities subject to Rule 144 requirements. Rule 905. Under these circumstances, why would an issuer opt to comply with Regulation S rather than simply register the offering under the 1933 Act? As treasurer of a foreign private firm, when would you prefer to comply with Regulation S, or to approach the U.S. capital market by selling securities under the registration procedures of the 1933 Act, or to take out a bank loan under the procedures described in the previous chapter? Are the differences rationally related to the various economic and institutional differences in the risks involved?

2. Registration under the 1934 Act

Under the 1934 Act, if an issuer lists its securities for trading on a national securities exchange, it must register them with the SEC. 15 U.S.C. § 78*l*(a), (b). Until 1964, that was the only basis on which registration under the 1934 Act was compelled. In that year the statute was amended to require registration by issuers who were otherwise publicly traded. *Id*. § 78*l*(g). Since "publicly traded" for these purposes simply meant a certain minimum number of shareholders and a specified assets size, the jurisdictional issue arose as a practical matter for the first time with the amendment of the statute.[1] The practical consequences of registration are considerable. The registration filing under section 12 of the 1934 Act must be completed, a task no less formidable than preparing a registration statement for a public offering under the 1933 Act. Furthermore, registered companies are subject to periodic reporting requirements– quarterly, annually, and event-driven–under section 13 of the 1934 Act, 15 U.S.C. § 78m. They are also required to comply with filing, disclosure and procedural rules whenever they solicit proxies from their shareholders under section 14(a) of the act, *id*. § 78n(a). Section 14 also imposes filing, disclosure, procedural and substantive requirements if they are involved in tender offers, *id*. § 78n(d), (e). Finally, the directors, officers, and principal shareholders[2] of registered companies are required to publicly report their purchases and sales of issuer securities under section 16(a) of the 1934 Act, *id*. § 78p(a), and they risk liability for any profit derived from such purchases and sales occurring within six months of each other. *Id*. § 78p(b).[3]

Foreign issuers will therefore be understandably concerned about the possibility that they may be subjected to the 1934 Act, despite their possibly minimal contact with the U.S. jurisdiction. Section 27 of the 1934 Act, *id*. §78aa, gives federal district courts exclusive jurisdiction over all "actions at law brought to enforce any liability or duty created by [the act] or the rules and regulations thereunder." While it has long been

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1. That is, prior to 1964, if a non-U.S. issuer chose to list its securities for trading on a U.S. exchange, it would hardly be surprising that it would thereby subject itself to the jurisdiction of the Securities Exchange Act of 1934. Only after the amendment could the possibility of inadvertent or unexpected subjection to the act.

2. *I.e.*, holders of more than 10 percent of any class of shares. 15 U.S.C. § 78p(a).

3. This potential liability for "insider trading" is quite distinct from liability under section 10(b) of the 1934 Act, *id*. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Liability under section 10(b) may apply whether or not the securities are registered. *See* 15 U.S.C. § 78j(b) (referring to "any security"). This potential liability is discussed in § B, *infra*.

recognized that the 1934 Act is silent as to its extraterritorial application,[4] the courts have nevertheless held that, at least under some circumstances, the act has significant extraterritorial reach.[5] The SEC has offered some relief, at least as to registration requirements, as the following excerpt will illustrate.

SECURITIES AND EXCHANGE COMMISSION
17 C.F.R. PART 240

§ 240.12g3-2 Exemptions for American Depositary Receipts and certain foreign securities

(a) Securities of any class issued by any foreign private issuer shall be exempt from [the registration requirements of] section 12(g) (15 U.S.C. 78*l*(g)) of the Act if the class has fewer than 300 holders resident in the United States. This exemption shall continue until the next fiscal year end at which the issuer has a class of equity securities held by 300 or more persons resident in the United States. For the purpose of determining whether a security is exempt pursuant to this paragraph:

(1) Securities held of record by persons resident in the United States shall be determined as provided in [the ownership rules of] § 240.12g5-1 except that securities held of record by a broker, dealer, bank or nominee for any of them for the accounts of customers resident in the United States shall be counted as held in the United States by the number of separate accounts for which the securities are held. The issuer may rely in good faith on information as to the number of such separate accounts supplied by all owners of the class of its securities which are brokers, dealers, or banks or a nominee for any of them.

(2) Persons in the United States who hold the security only through a Canadian Retirement Account . . . shall not be counted as holders resident in the United States.

(b)(1) Securities of any foreign private issuer shall be exempt from section 12(g) of the Act if the issuer, or a government official or agency of the country of the issuer's domicile or in which it is incorporated or organized:

(i) Shall furnish to the Commission whatever information in each of the following categories the issuer since the beginning of its last fiscal year (A) has made or in required to make public pursuant to the law of the country of its domicile or is which it is incorporated or organized, (B) has filed or is required to file with a stock exchange on which its securities are traded and which was made public by such exchange, or (C) has distributed or is required to distribute to its security holders;

(ii) Shall furnish to the Commission a list identifying the information referred to in paragraph (b)(1)(i) of this section and stating when and by whom it is required to be made public, filed with any such exchange, or distributed to security holders;

(iii) Shall furnish to the Commission, during each subsequent fiscal year, whatever information is made public as described in (A), (B) or (C) of paragraph (b)(1)(i) of this section promptly after such information is made or required to be made public as described therein;

(iv) Shall, promptly after the end of any fiscal year in which any changes occur in the kind of information required to be published as referred to in the list furnished under

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4. *See, e.g., Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir.) (citing 15 U.S.C. § 78aa), *cert. denied*, 502 U.S. 1005 (1991); *Itoba Limited v. Lep Group PLC*, 54 F.3d 118 (2d Cir. 1995).

5. The exact contours of that extraterritorial reach is the subject of § B, *infra*.

paragraph (b)(1)(ii) of this section or any subsequent list, furnish to the Commission a revised list reflecting such changes; and

(v) Shall furnish to the Commission in connection with the initial submission the following information to the extent known or which can be obtained without unreasonable effort or expense: the number of holders of each class of equity securities resident in the United States, the amount and percentage of each class of outstanding equity securities held by residents in the United States, the circumstances in which such securities were acquired, and the date and circumstances of the most recent public distribution of securities by the issuer or an affiliate thereof.

(2) The information required to be furnished under paragraphs (b)(1)(i) and (b)(1) (ii) of this section shall be furnished on or before the date on which a registration statement under section 12(g) of the Act would otherwise be required to be filed. Any issuer furnishing information under paragraph (b)(1)(i) of this section shall notify the Commission that it is furnished under that paragraph.

(3) The information required to be furnished under this paragraph (b) is information material to an investment decision such as: the financial condition or results of operations; changes in business; acquisitions or dispositions of assets; issuance, redemption or acquisitions of their securities; changes in management or control; the granting of options or the payment of other remuneration to directors or officers; and transactions with directors, officers or principal security holders.

(4) Only one complete copy of any information or document need be furnished under paragraph (b)(1) of this section. Such information and documents need not be under cover of any prescribed form and shall not be deemed to be "filed" with the Commission or otherwise subject to the liabilities of section 18 of the Act. Press releases and all other communications or materials distributed directly to securityholders of each class of securities to which the exemption relates shall be in English. English versions or adequate summaries in English may be furnished in lieu of original English translations. No other documents need be furnished unless the issuer has prepared or caused to be prepared, English translations, versions, or summaries of them. If no English translations, versions, or summaries have been prepared, a brief description in English of any such documents shall be furnished. Information or documents in a language other than English are not required to be furnished. If practicable, the Commission file number shall appear on the information furnished or in an accompanying letter. Any information or document previously sent to the Commission under cover of Form 40-F or Form 6-K need not be furnished under paragraph (b)(1) of this section.

(5) The furnishing of any information or document under paragraph (b) of this rule shall not constitute an admission for any purpose that the issuer is subject to the Act.

(c) Depositary Shares registered on Form F-6 (§ 239.36 of this chapter), but not the underlying deposited securities, are exempt from section 12(g) of the Act under this paragraph (c).

(d) The exemption provided by paragraph (b) of this rule shall not be available for the following securities:

(1) Securities of a foreign private issuer that has or has had during the prior eighteen months any securities registered under section 12 of the Act or a reporting obligation (suspended or active) under section 15(d) of the Act (other than arising solely by virtue of the use of Form F-7, F-8, F-9, F-10 or F-80) ;

(2) Securities of a foreign private issuer issued in a transaction (other than a transaction registered on Form F-8, F-9, F-10 or F-80) to acquire by merger, consolidation, exchange of securities or acquisition of assets, another issuer that had securities

registered under section 12 of the Act or a reporting obligation (suspended or active) under section 15(d) of the Act; and

(3) Securities quoted in an "automated inter-dealer quotation system" or securities represented by American Depositary Receipts so quoted unless all the following conditions are met:

(i) Such securities were so quoted on October 5, 1983 and have been continuously traded since;

(ii) The issuer is in compliance with the exemption in paragraph (b) of this section on October 5, 1983 and has continuously maintained the exemption since; and

(iii) After January 2, 1986, the issuer is organized under the laws of any country except Canada or a political subdivision thereof.

NOTES AND QUESTIONS

1. Auslander GmbH, a German corporation, has securities listed on the New York stock exchange. Is it exempt from the registration requirements of the 1934 Act if it complies with Rule 12g3-2?

2. Recall that Considerable Corporation, incorporated under the laws of Delaware, has a subsidiary, Considerate Company, S.A., organized under French law. If all of the shares issued by Considerate are acquired by Considerable and Mr. MacGuffin, Considerable's principal shareholder and chief executive officer, will Considerate be required to register under section 12 of the 1934 Act?

3. Recall that Considerate issued 1 million shares and listed them on the *Bourse de Paris*; all of the shares were purchased by nationals of EU member states, principally French citizens. Must Considerate register under section 12 of the 1934 Act? If not, is there anything that Considerate should do at this stage to maintain this status?

4. Recall that MacGuffin has sold half of his Considerate shares in the over-the-counter market in the United States. Must Considerate register under the 1934 Act? Do you need any other information to answer this question?

5. How comfortable would you be if you represented the board of a European firm that had large numbers of bearer shares outstanding (shares circulating without any central registry, so that the firm does not know who its shareholders are)?

6. Rule 10g3-2(b) imposes significant information disclosure requirements on the issuer. Why would an issuer opt to comply with this rule, rather than simply register under the 1934 Act?

B. EXTRATERRITORIAL APPLICATION OF JUDICIALLY ENFORCED PROVISIONS

The securities acts include not only registration and disclosure requirements but also substantive law enforced by private civil actions and SEC enforcement actions in the regular federal courts.[1] Among the key provisions are the following statute and rule

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1. SEC enforcement actions involving foreign-based defendants, particularly in the antifraud areas, can be quite dramatic. *See, e.g., SEC v. Banca Della Svizzera Italiana*, 92 F.R.D. 111 (S.D.N.Y. 1981) (requring disclosure by Swiss bank of identities of principals for whom bank purchased stock and stock options); *SEC v. Tome*, 833 F.2d 1086 (2d Cir. 1987), *cert. denied sub nom. Lombardfin S.p.A. v. SEC*, 486 U.S. 1014 (1988) (upholding service of process against unknown defendants who allegedly participated in insider trading scheme).

adopted under it:

SECURITIES AND EXCHANGE ACT OF 1934
15 U.S.C. §78j

§ 10. Regulation of the use of manipulative and deceptive devices

It shall be unlawful for 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–

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, 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.

(b) 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.

SECURITIES AND EXCHANGE COMMISSION
17 C.F.R. PART 240

§ 240.l0b-5. Employment of manipulative and deceptive devices

It shall he unlawful for 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,

(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

(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.

You have already seen this section in *Gaines* and *Fitzpatrick v. Haughton*, Chapter XII, *supra* at ▬. The section has given rise to a "federal common law" of corporations in which civil actions are available to an investor who has lost money and can bring his or her complaint under the ambit of Rule l0b-5. The idea of fraud and deceit in this context is very broad, so the potential scope of this section is also broad, and it becomes a way to bring a number of corporate issues into federal court. At the same time, concerns for federalism have led the Supreme Court to exercise special care in defining the scope of rights under this provision.

Although Rule 10b-5 is the leading example, there are a number of other comparable provisions that can lead to parallel forms of lawsuit, including, for example, the requirements of 1934 Act § 16(b), 15 U.S.C. § 78p(b), that profits made by corporate insiders on purchases and sales made within a six-month period must be given to the company for the benefit of all investors, but section 16(b) applies only to purchases and sales of securities registered under section 12 of the 1934 Act. At the time that these

provisions were enacted, their domestic impact may not have been fully realized–and their international impact was considered only indirectly and opaquely. This impact lay dormant until the following case. In analyzing the case, note that two separate jurisdictional tests are involved. One–raising issues that should by now be familiar–goes to United States jurisdiction over a transaction with mixed domestic and foreign elements. The other–spelled out in the securities laws in terms of use of the means of interstate commerce, transportation, or the mails (the "jurisdictional means")–goes to the domestic question of jurisdiction in the federal courts as opposed to the state courts. On a rehearing *en banc*, the district court was reversed. That decision is set out following the first.

SCHOENBAUM v. FIRSTBROOK (I)

405 F.2d 200 (2d Cir. 1968)

LUMBARD, J.:

Plaintiff, an American shareholder of Banff Oil Ltd., a Canadian corporation, brought this shareholder derivative action to recover under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1967), for damages to the corporation resulting from the sales, in Canada, of Banff treasury stock to defendants Aquitaine of Canada, Ltd., and Paribas Corporation. Plaintiff alleged that the defendant corporations and Banff's directors, who are the individual defendants in this action, conspired to defraud Banff by making Banff sell treasury shares at the market price which the defendants, who had inside information not yet disclosed to the public, knew did not represent the true value of the shares.

Defendants moved pursuant to Rules 12(c) and 56, Fed. R. Civ. P., for summary judgment, and under Rule 12(b) to dismiss the complaint on the ground that the Court lacked jurisdiction over the subject matter. Judge Cooper, refusing to permit plaintiff to carry out a program of discovery, entered judgment for defendants, holding that the Court lacked jurisdiction because the Securities and Exchange Act does not have extraterritorial application, and that plaintiff failed to state a cause of action under § 10(b) and Rule 10b-5. . . .

We find that the district court had subject matter jurisdiction but affirm the judgment below because, while plaintiff's complaint alleges a breach of fiduciary duty by Banff's directors in authorizing sales of treasury shares at too low a price, these allegations fail to state a cause of action under § 10(b) of the Exchange Act.

The Facts

Banff is a Canadian corporation and conducts all of its operations within Canada. Its common stock is registered with the SEC and traded upon both the American Stock Exchange and the Toronto Stock Exchange. In February 1964, Aquitaine Company of Canada, Ltd., acquired control of Banff through a tender offer to Banff shareholders in the United States and Canada. Aquitaine is a wholly owned subsidiary of a French corporation, Societe National des Petroles d'Aquitaine, which in turn is a subsidiary of Enterprises for Research and Activities in Petroleum (ERAP), a French governmental oil agency.

In March 1964, Banff and Aquitaine entered into an agreement to conduct joint oil explorations. In October 1964, Banff entered into a "farmout agreement" with Socony Mobil under which Banff and Aquitaine would receive a 50% interest in 160,000 acres in the Rainbow Lake area of Alberta, Canada, in return fox- paying the total cost of

drilling two exploratory wells. The Rainbow area is a desolate wilderness region over 100 miles from the nearest all-weather road or railway. At least sixteen wells had previously been drilled in the general vicinity by six different oil companies, and all had been aban•. doned as failures, Because of the difficulty of conducting exploratious in this region and the highly speculative prospects for success Socony Mobil was willing to give up a half interest merely for drilling two test wells.

Banff received a 5% interest and Aquitaine received a 45% interest, pursuant to their joint exploration agreement, with the drilling costs to be paid 10% by Banff and 90% by Aquitaine. On December 11, 1964 Banff's Board of Directors, the three Aquitaine representatives abstaining, voted to offer to sell 500,000 shares of Banff treasury stock to Aquitaine at the current market price allegedly for the purpose of financing Banff's share of the exploration expenses. On January 5, 1965, Aquitaine's president wrote to Banff that "our Chairman and Managing Director . . . has agreed to your... proposal." On January 26, Banff issued a press release announcing that Aquitaine "intended to purchase" 500,000 shares of common stock at the price of $1.35 per share, the closing price on the Toronto Stock Exchange on December 11, 1964. Actual delivery of the shares took place March 16, 1965.

Exploration in the Rainbow area commenced toward the end of 1964. On February 6, 1965, the test well flowed oil to the surface on a drillstem test. This information was released to the public on February 8. The well reached total depth on March 17, 1965, the day after delivery on the Aquitaine purchase. On March 18, Banff issued a press release indicating that the discovery well was completed and that no further information would be disclosed in the immediate future. A further release on April 20 explained that the company was taking advantage of the Alberta law permitting it to withhold information on its discovery for one year to reduce competition from other companies in on government oil lands in the discovery area. The release stated "The Board feels that this discovery is of great significance to the company but it is too early to have any idea of the real extent."

After the discovery, further exploration activity was undertaken. In September 1965, a press release announced the formation of a company, in which Banff has a 3⅓% interest and. Aquitaine has a 30% interest, to build a pipeline into the area. To finance its activities, Banff's Board of Directors authorized negotiation of sales of treasury shares of common stock at $6.75 per share or more. Paribas Corporation–a Delaware corporation doing business in New York and a wholly owned subsidiary of Banque de Paris et des Pays-Bas, a French banking institution–negotiated a purchase of 270,000 shares of Banff Common at $7.30 per share, the current price on the Toronto Stock Exchange, on behalf of Banque de Paris et des Pays-Bas pour le Grand Duche de Luxembourg, another subsidiary of Banque de Paris. The issue was to be placed with "ten European professional investors." A verbal offer was made by Paribas on November 19, 1965. A written offer was mailed by Paribas from New York and was accepted by Banff in Canada on November 22. Payment and delivery took place in Canada January 24, 1966.

The Allegations in the Complaint

The complaint alleged that "For some time prior to February 6, 1965, Aquitaine and the other defendants knew Banff had exceptionally valuable oil properties located in the Rainbow Lake area in Alberta, Canada." It alleged that the Aquitaine purchase of 500,000 treasury shares at $1.35 per share took place March 15, 1965, and that the Paribas purchase of 270,000 shares at $7.30 on January 24, 1966 was on behalf of "affiliates, business associates and friends" of Aquitaine and its parent companies, and

that defendants withheld information until March 16, 1966 in order to purchase the treasury shares at an artificially low market price, paying to Banff about $10,000,000 less than the stock's fair market value.[1]

The individual defendants are all of Banff's directors. They allegedly conspired with the corporate defendants and approved of, participated in or acquiesced in the transactions with the corporate defendants.

Subject Matter Jurisdiction

Plaintiff predicated subject matter jurisdiction upon Section 27 of the Securities and Exchange Act, 15 U.S.C. §78aa, which gives the district courts exclusive jurisdiction over all "actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder." The district court concluded that the Act has no extraterritorial application, and that therefore no liability arose under the Act with regard to the sales in question, which took place in Canada between foreign buyers and sellers. The court found nothing to rebut the presumption that the Act was intended to apply only to transactions within the territorial limits of the United States. It also stated that the presumption was reinforced by the "specific mandate" of Section 30(b), 15 U.S.C. § 78dd(b), which provides that the Act does not apply "to any person insofar as he transacts a business in securities without the jurisdiction of the United States. . . ."

We disagree with the district court's conclusion. We believe that Congress intended the Exchange Act to have extraterritorial application in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities. In our view, neither the usual presumption against extraterritorial application of legislation nor the specific language of Section 30(b) show Congressional intent to preclude application of the Exchange Act to transactions regarding stocks traded in the United States which arc effected outside the United States, when extraterritorial application of the Act is necessary to protect American investors.

Section 2 of the Exchange Act, 15 U.S.C. §78b, states that because transactions in securities are affected with "a national public interest" it is "necessary to provide for regulation and control of such transactions and of practices and matters related thereto, . . . necessary to make such regulation and control reasonably . . . complete state commerce and to insure the maintenance of fair and honest markets in such transactions."

The Act seeks to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges...

Banff common stock is registered and traded on the American Stock Exchange. To protect United States shareholders of Banff common stock, Banff is required to comply with the provisions of the Securities Exchange Act concerning financial reports to the SEC, §13, 15 U.S.C. §78m; proxy solicitation, §14, 15 U.S.C. §78n, and reports of insider holdings, §16, 15 U.S.C. §78p. Similarly, the anti-fraud provision of §10(b), which enables the Commission to prescribe rules "necessary or appropriate in the public interest or for the protection of investors" reaches beyond the territorial limits of the United States and applies when a violation of the Rules is injurious to United States investors. "Acts done outside a jurisdiction, but intended to produce and producing detrimental effects within it, justify a state in punishing the cause of the harm as if [the actor] had been present at the [time of the detrimental] effect, if the state should succeed

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1. Banff common stock traded at prices as high as $18 per share in 1966.

in getting him within its power." *Strassheim v. Daily*, 221 U.S. 280, 285 (1911).

The Commission has recognized the broad extraterritorial applicability of the Act and has specifically exempted certain foreign issuers from the operation of Sections 14 and 16 of the Act, when enforcement would be impractical. . . .

The provision contained in Section 30(b) does not alter our conclusion that the Exchange Act has extraterritorial application. In our view, while section 30(b) was intended to exempt persons conducting a business in securities through foreign securities markets from the provisions of the Act, it does not preclude extraterritorial application of the Exchange Act to persons who engage in isolated foreign transactions.

Section 30, entitled "Foreign Securities Exchanges,"[3] deals with the extent to which the Act applies to persons effecting securities transactions through foreign exchanges. Section 30(a) empowers the SEC to regulate all brokers and dealers who use the mails or interstate commerce, for the purpose of effecting a transaction in American securities on exchanges outside the United States. 2 LOSS, SECURITIES REGULATION, 1170 n.2 (2d ed. 1961). It was intended to prevent evasion of the Act through transactions on foreign exchanges. *See Hearings on S. Res. 89 (72d Cong.), and S. Res. 56 and S. R.es. 97 (73d Cong.) before the Committee on Banking and Currency*, 73d Cong., 2d Sess. part 15, pp.6569, 6578-79 (1934).

Section 30(b) states that the Act does not apply in the absence of SEC rule to prevent evasion of the Act to "any person insofar as he transacts a business in securities without the jurisdiction of the United States." The language of §30(b) must he construed in light of the purpose of the subsection, and the definitions of terms contained in §3(a) of the Act.

The purpose of this subsection is to permit persons in the securities business to conduct transactions in securities outside of the United States without complying with the burdensome reporting requirement of the Act and without being subject to its regulatory provisions, except insofar as the Commission finds it necessary and appropriate to regulate such transactions to prevent evasion of the Act. It is also designed to take the Commission out of the business of regulating foreign security exchanges unless the Commission deems regulation necessary to prevent evasion of the domestic regulatory scheme. The exemption relieves the Commission of the impossible task of enforcing American securities law upon persons whom it could riot subject to the sanctions of the Act for actions upon which it could not bring its investigatory powers to bear.

If §30(b) had been meant to exempt every transaction by any person outside of the United States it would have been drafted to state that the Act does not apply to "any transaction in any security outside the jurisdiction of the United States," a phrase used in §30(a). The drafters used the phrase "any person insofar as he transacts a business in securities without the jurisdiction of the United States" in §30(b) because it is a terni which would exempt the business transactions not only of brokers and dealers but also

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3. "Section 30. (a) It shall be unlawful for any broker or dealer, directly or indirectly, to make use of the mails or of any means or instrumentality of interstate commerce for the purpose of effecting on an exchange not within or subject to the jurisdiction of the United States, any transaction in any security the issuer of which is a resident of or is organized under the laws of, or has its principal place of business in, a place within or subject to the jurisdiction of the United States, 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 or to prevent the evasion of this title.

"(b) The provisions of this title or of any rule or regulation thereunder shall riot apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title."

of banks. The term "brokers and dealers," used in §30(a), could not be used because the definitions of "broker" and "dealer" in §§3(a) (4) and 3(a) (5), 15 U.S.C. §78c(a)(4) and (5), specifically exclude "banks" as defined in §3(a) (6), I5 U.S.C. §78c(a) (6). It is precisely the terminology that appears in §30(b), when construed in light of §3(a)(4) and (5) that exempts brokers and dealers and banks otherwise subject to the Act insofar as they conduct transactions not subject to §30(a) outside the United States, even though their United States transactions are subject to the Act.

In *Kook v. Crang*, 182 F. Supp. 388 (S.D.N.Y. 1960) the Court properly held that §30(b) exempted from the margin requirements of Section 7(c) of the Act, 15 U.S.C. §78g(c), sales to a United States citizen of Canadian stock in Canada by a Canadian broker, since the transactions were outside of the United States and part of the Canadian finn's business in securities. 2 Loss, Sec. Reg. 1292 n.15 (2d ed. 1961). The Court found in §30(b) a Congressiona.l intent to exempt from application of the Act transaction of a business in securities outside the United States.

This holding was extended in *Ferraioli v. Cantor*, C.C.H. Fed. Sec. L. Rep. ¶91, 615 (S.D.N.Y. 1965) to exempt an isolated transaction, not part of a business in securities, the private sale in Canada of controlling shares of a New York corporation in which plaintiff was a minority shareholder, on the ground that the Exchange Act does not have extraterritorial application. The Court reasoned that if Congress specifically exempted foreign business in securities it intended to exempt isolated transactions as well. We disagree with this reasoning.

We find that the language and purpose of §30(b) show that it was not meant to exempt transactions that are conducted outside the jurisdiction of the United States unless they are part of a "business in securities." Indeed, since Congress found it necessary to draft an exemptive provision for certain foreign transactions and gave the Commission power to make rules that would limit this exemption, the presumption must be that the Act was meant to apply to those foreign transactions not specifically exempted.

We hold that the district court has subject matter jurisdiction over violations of the Securities Exchange Act although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors. *See Ford v. United States*, 273 U.S. 593, 619-624 (1927); *United States v. Pizzarusso*, 388 F.2d8 (2dCir.Jan. 9,1968); *United States v. Aluminum Company of America*, 148 F.2d 416, 443-444 (2d Cir. 1945).

However, the district court found that the only harm alleged was to the foreign corporation on whose behalf plaintiff brought the action. We do not agree. A fraud upon a corporation which has the effect of depriving it of fair compensation for the issuance of its stock would necessarily have the effect of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices hid for the shares on the domestic stock market. This impairment of the value of American investments by sales by the issuer in a foreign country, allegedly in violation of the Act, has in our view, a sufficiently serious effect upon United States commerce to warrant assertion of jurisdiction for the protection of American investors and consider-ation of the merits of plaintiff's claim.

Use of Interstate Commerce

There can be no violation under Section 10 unless a rule of the Commission is contravened "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. *See generally* 3 Loss, Sec. Reg. 1519-1524 (2d ed. 1961). The trial court found that the transactions in question were essentially Canadian, with insufficient contacts with the United States to fall within §10(b) of the Act. We are uncertain, whether the Court's finding was directed at the issues of extraterritorial application of the Exchange Act or at the jurisdictional requirements of §10. In either case we disagree with its conclusion. We have already discussed the reasons why a foreign purchase or sale of treasury shares by a corporation has sufficient efièct upon interstate commerce to warrant extraterritorial application of the Exchange Act.

The present question is not whether this limited use of the mails and the facilities of interstate commerce would be a sufficient basis for subject matter jurisdiction over a foreign transaction which would otherwise be exempt from the Act, *see Kook v. Crang, supra*, but whether, once it has been determined that the Act applies to a particular foreign transaction, there is a use of the mails or interstate commerce sufficient to meet the requirement of § 10(b). We find that defendant's affidavits show a use of interstate commerce or the mails sufficient to bring both transactions within the scope of Section 10(b).

Since defendants admit that the Aquitaine purchase was delayed pending the successful conclusion of negotiations with the Treasury Department regarding tax rulings and negotiations with the American Stock Exchange regarding the listing of the additional shares, we find, on this record, that these negotiations were a part of the scheme for the sale of treasury stock to Aquitaine. And since it appears that, as plaintiff alleges, these negotiations with United States government and stock exchange officials must have made some use of the mails or other facilities of interstate commerce, there was at the very least use of interstate commerce[7] or the mails sufficient to bring the sales transactions within the scope of Section 10(b). *Hooper v. Mountain States Securities Corp*., 282 F.2d 195, 204 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

The Paribas transaction likewise involved negotiations which must have taken place in part in the United States or made some use of the mails or interstate commerce. Furthermore, the purchase agreement was mailed from Paribas in New York to Banff in Canada; this in itself would establish a use of the mails sufficient to meet the requirement of Section 10.

Rule 10b-5

Plaintiff's theory of its cause of action is that "Banff was defrauded by its directors and controlling shareholder who combined to force it to sell treasury shares at the prevailing market price when they knew that the price was an artificially low one." In other words, plaintiff contends that defendants violated §10(b) and Rule 10b-5 by causing Banff to issue shares to defendant corporations at the current market price at a time when all the defendants knew that Banff had made an oil discovery which, if known to the public, would have raised the market price considerably. For purposes of the motion the court below rejected plaintiff's claim of the existence of a conspiracy and defendants' claims that at the time of the transaction they did not have material information and assumed that at the time of the sales in question the buyers and Banff's directors all knew that Banff had made a valuable discovery. We agree with the district court's conclusion that plaintiff failed to state a cause of action under Rule 10b-5 because there was no fraud and the allegations amounted to nothing more than breach

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7. The term 'interstate commerce," as used in the Exchange Act, encompasses commerce "between any foreign country and any State." §3(a)(17), 15 U.S.C. §l5c(a)(l7).

of fiduciary duty by the controlling shareholder and directors. . . .

We do not see how Banff's directors, in authorizing sales of treasury stock in arm's length transactions in which all parties possessed the same information, can properly be characterized as participating in a "manipulative or deceptive device or contrivance" in connection with a sale so as to fit within §10(b) merely because some shareholders now consider the sale price too low. Plaintiff's claim fails to state a cause of action under §10(b) because it does not show that the corporation was deceived. The directors, who were authorized to act on behalf of the corporation in these transactions, were all concededly in full possession of the material information, and we find no basis, on the facts before us, for refusing to impute their knowledge to the corporation.

A corporation can act only through its agents and officers and can know only what its agents and officers know. . . . If the persons entitled in the ordinary course to participate in authorizing a securities transaction on behalf of the corporation have not been fully informed, it may he said that the corporation has not been frilly informed. . . . In general, if the corporation's agents have not been deceived, neither has the corporation. However, as in other situations governed by agency principles, knowledge of the corporation s officers and agents is not imputed to it when there is a conflict between the interests of the officers and agents and the interests of the corporate principal. . . . Therefore, a corporation may be defrauded in a stock transaction even when all of its directors know all of the material facts, if the conflict between the interests of one or more of the directors and the interests of the corporation prevents effective transmission of material information to the corporation, in violation of Rule 10b-5(2).

While the purchaser in the Aquitaine transaction had three representatives on Banff's board of directors and was Banff's controlling shareholder, the Aquitaine representatives on the Banff board abstained from the authorization vote and shareholder ratification by Aquitaine was not required for the sale. Under these circumstances, we cannot refuse to impute the directors' knowledge to the corporation on the ground that directors participating in the corporate decision had a conflicting personal interest in the transaction. . . . Since the directors were all fully informed and since only the non-interested directors participated in the vote authorizing the sale, there is no deception of the corporation and no violation of §10(b) and Rule 10b-5 even though it may be that the directors, by authorizing sales of shares for inadequate consideration, may have breached their fiduciary duty to the corporation.

Section 10(b) does not encompass all corporate wrongs involving securities transactions. . . .

HAYS, J. (concurring in part and dissenting in part):

I concur in Judge Lumbard's distinguished opinion on the issue of jurisdiction.

I am constrained to dissent on the point of the applicability to the facts of this case of the provisions of Section 10(b) and, more particularly, Rule 10b-5.

Defendants are alleged to have caused Banff to sell treasury shares at a price far below the fair price of such shares. In doing so defendants took advantage of their special relationship to Banff by reason of which they knew of Banff's discovery of extremely valuable oil reserves,–information which was clearly material to the purchase of the securities.

The complaint alleges a scheme to defraud the corporation by transferring corporate property to the corporation's majority stockholder and to an affiliate of the majority stockholder for a vastly inadequate consideration. My brothers do not absolve the

defendants of fraud by calling their action a breach of fiduciary duty. There is no reason for making that distinction since such a breach of fiduciary duty as is here alleged clearly constitutes fraud.

The majority "do not see how Banff's directors ... can properly be characterized as participating in a 'manipulative or deceptive device or contrivance' in connection with a sale so as to fit within §10(b) merely because some shareholders now consider the sale price too low." This statement completely disregards allegations of the complaint which are based upon matters of record and which establish that the treasury stock was sold at a price which did not reflect in any way the value of the recently discovered oil reserves. Whatever reason there may be for denying plaintiffs' recovery in this case it certainly cannot be because their complaint is deficient in its allegation that Banff was bilked of some millions of dollars by the transactions in question. . . .

The acts in which defendants are alleged to have engaged clearly fall within the literal language of [Rule 10b-5(1) and (3)].

The purpose of Section 10(b) and Rule 10b-5 is apparent from their language. That purpose is simply to prevent in interstate commerce the perpetration of fraud in connection with the sale of securities.

"Quite obviously the broad purpose of this legislation was to keep the channels of interstate commerce, the mail, and national security exchanges pure from fraudulent schemes, tricks, devices, and all forms of manipulation." . . .

Reluctance to see the federal courts involved in this broad field cannot justify rejection of a case that comes so clearly within the antit of the statute as does the case which we are now considering.

The majority believe that the complaint fails to "state a cause of action under §10(b) because it does not show that the corporation was deceived" since the directors "who were authorized to act on behalf of the corporation in these transactions, were all concededly in full possession of the material information" and the knowledge of the directors is to be "imputed to the corporation."

Endowing a corporation with a fictitious "personality," so that, for example, it has "knowledge," is a useful device for the analysis of many problems. But it can also constitute a trap for the unwary when they ascribe reality to the fictions. What the majority is actually saying is that since the directors were the corporation for the purposes of the questioned transactions the corporation must have known what the directors knew, or, in other words, the directors knew what the directors knew. There is of course, no justification for interposing the corporate fiction between the directors and the minority stockholders who were the victims of the directors' fraudulent actions. In order to establish fraud it is surely not necessary to show that the directors deceived themselves. It must be enough to show that they deceived the shareholders, the real owners of the property with which the directors were dealing. Deception of the shareholders (with the exception of the majority stockholder which was a party to the transactions) is established by showing that the directors withheld from them information that would have revealed the true value of the treasury stock.

The directors cannot take refuge behind the law permitting the information as to the discovery of the reserves to be withheld for one year. Such a law does not constitute a license to the directors to deal with the property as if no such discovery had been made. To argue to the contrary would he to argue that the directors could give the oil reserves away, as they in fact did in part, by selling the treasury stock at a price which did not reflect the value of the reserves.

What we have here then is a scheme by which the directors of Banff gave to the

controlling stockholder[2] and an affiliated corporation some millions of dollars worth of the corporation's property. A plainer case of fraud would be hard to find.

SCHOENBAUM v. FIRSTBROOK (II)

405 F.2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969)

HAYS, J.

After a panel opinion in this case was issued a petition for rehearing en hanc was granted. Additional briefs were submitted including an amicus brief by the Securities arid Exchange Commission. On consideration by the full court the order of the district court granting summary judgment for the defendants is affirmed as to the defendant Paribas Corporation and reversed as to the other defendants.

The petition for rehearing sought reconsideration only of the issue of whether the defendants were entitled to summary judgment under Rules 12(c) and 56 of the Federal Rules of Civil Procedure. The court en banc has not reviewed the decision announced by Chief Judge Lumbard on the issue of jurisdiction over the subject matter and that decision stands as the holding of the court. . . .

Plaintiff's Cause of Action Under Section 10-b And Rule 10b-5 of The Securities Exchange Act of 1934 . . .

In the present case it is alleged that Aquitaine exercised a controlling influence over the issuance to it of treasury stock of Banff for a wholly inadequate consideration. If it is established that the transaction took place as alleged it constituted a violation of Rule 10b-5, subdivision (3) because Aquitaine engaged in an "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." Moreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine). . . .

NOTES AND QUESTIONS

1. How did the stock sale to Aquitaine hurt any U.S. investors?

2. What is the court's standard for the extraterritorial application of U.S. law? Does it appear reasonable?

3. Does the court's decision appear to infringe on the right of Canada to regulate its own corporations in the way it reasonably chooses? Is it fair for a Canadian firm to have to consider both Canadian and U.S. views of the rights of minority shareholders?

4. Is the impact of the Aquitaine sale on minority shareholders something likely to be reasonably permitted by any nation's corporate law? What about the practices permitted by the Alberta law described in *Schoenbaum* (I)?

5. Are you satisfied with the way the court read Section 30(b)?

6. What about the way the court read Rule 10b-5?

7. On the basis of *Schoenbaum* (I) and (II), the courts–particularly the Second Cir-

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2. The abstention of the "Aquitaine directors'' on the vote km the sale to Aquitaine is hardly worthy of mention As I said in my dissenting opinion in *Alleghany Corporation v. Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed as improvidently granted*, 384 U.S. 28 (1966): "No one who knows anything about the conduct of corporate enterprise considers that the major stockholder's withdrawal from the room when a vote is taken amounts to anything more than an empty ceremonial."

cuit– quickly built an elaborate structure, generally regarded as well summarized in the following case, *Leasco Data*, which extended *Schoenbaum* (I) and (II) to reach a situation in which, according to the complaint, part of the fraud occurred in the United States, and the defrauded party, a corporation, was U.S. owned, even though the sale occurred abroad and the defrauded corporation was technically not a U.S. firm.

LEASCO DATA PROCESSING EQUIPMENT CORP. v. MAXWELL

468 F.2d 1326 (2d Cir. 1972)

FRIENDLY, J.

I. The Facts Claimed by Leasco

The gist of the complaint is that the defendants conspired to cause Leasco to buy stock of Pergamon Press Limited ("Pergamon"), a British corporation controlled by defendant Robert Maxwell, a British citizen, at prices in excess of its true value, in violation of § 10(b) of the Securities Exchange Act and the SEC's sufficiently known Rule 10b-5. According to Leasco, and–as we shall not always repeat–we here state only Leasco's version, the first contact occurred early in 1969 when Maxwell came to Great Neck, N.Y., where Leasco then had its principal office, and proposed to Saul Steinberg, Chairman of Leasco, that Pergamon and Leasco engage in a joint venture in Europe. Maxwell falsely told Steinberg that Pergamon had a computerized typesetting plant in Ireland and gave Steinberg the most recent Pergamon annual report, which contained untruthfhl and misleading statements of Pergamon's affairs. Steinberg telephoned Maxwell in London to decline the joint venture; Maxwell invited him to come there to discuss areas of possible cooperation. . . .

. . . On what is now before us it is impossible to say that conduct in the United States was not an "essential link," *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970), in leading Leasco into the contract of June 17, 1969. And that contract, signed in the United States, was "an essential link" in inducing Leasco to make the open-market purchases, whether these were triggered by a call from London to New York, as Leasco contends, or by a conversation in England, as defendants assert. Putting the matter in another way, if defendants' fraudulent acts in the United States significantly whetted Leasco's interest in acquiring Pergamon shares, it would be immaterial from the standpoint of foreign relations law, that the damage resulted, not from the contract whose execution Maxwell procured in this country, but from interrelated action which he induced in England or, for that matter, which Leasco took there on its own, As said in a leading English case, "In order to establish a coherent chain of causation it is not necessary that the precise details leading up to the accident [here the loss] should have been reasonably foreseeable," *Hughes v. Lord Advocate*, [1963] A.C. 837, 852. We have approved this with the qualification, doubtless intended, that the damage was within the area where the defendant had unlawfully created a risk of loss. . . .

Up to this point we have established only that, because of the extensive acts alleged to have been performed in the United States, considerations of ihreign relations law do not preclude our reading §10(b) as applicable here. The question remains whether we should. Appellants have three lines of defense: they claim (1) that §10(b) has no application to transactions in foreign securities not on an organized American market; (2) that if it does, it has no application when such transactions occur outside the United

States; and (3) that in any event it can have no application when the purchaser is not a citizen of the United States. . . .

Since Congress . . . meant §10(b) to protect against fraud in the sale or purchase of securities whether or not these were traded on organized United States markets, we cannot perceive any reason why it should have wished to limit the protection to securities of American issuers. The New Yorker who is the object of fraudulent misrepresentations in New York is as much injured if the securities are of a mine in Saskatchewan as in Nevada. Defendants have pointed to nothing in the legislative history which would indicate an intention that the language of §10(b) should be narrowed so as not to protect him.

We likewise cannot see any sound reason for believing that, in a case like that just put, Congress would have wished protection to he withdrawn merely because the fraudulent promoter of the Saskatchewan mining security took the buyer's check back to Canada and mailed the certificate from there, In the somewhat different yet closely related context of choice of law, the mechanical test that, in determining the *locus delicti*, "The place of wrong is in the state where the last event necessary to make an actor liable for an alleged tort takes place," Restatement of the Conflict of Laws §377 (1934), has given way, in the case of fraud and misrepresentation, to a more extensive and sophisticated analysis. *See* Restatement (Second) of the Conflict of Laws §148 (1971).

Our case, however, is not the simple one thus hypothesized. In that instance not only the fraudulent misrepresentation but the issuance of the check and the receipt of the securities occurred in the United States, although the check was deposited and the security mailed in Canada. Here it was understood from the outset that all the transactions would be executed in England. 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–a purpose which its words can fairly be held to embrace. While, as earlier stated, we doubt that impact on an American company and its shareholders would suffice to make the statute applicable if the misconduct had occurred solely in England, we think it tips the scales in favor of applicability when substantial misrepresentations were made in the United States.

This brings us to appellants' third line of defense, namely, that the purchaser was not an American but a Netherlands Antilles corporation. . . .

It seems quite arguable from all this that Leasco N.V. is holding the shares merely as trustee for Leasco, which has the beneficial interest arid is bound to reimburse Leasco N.V. for the latter's expenditures. If that were so, defendants' contention that the true purchaser was a foreigner would he drained of force. But even if Leasco N.V. is the beneficial owner, it would be elevating form over substance to hold that this entails a conclusion that the purchases did not have a sufficient effect in the United States to make § 10(b) apply. Whether Leasco N.V. is merely a financial conduit, as plaintiffs assert, or was planned to conduct an active business, as some of the SEC filings indicate, it was wholly-owned and its debt securities were guaranteed by Leasco and were convertible with Leasco common stock. We see no need to enter into the debate whether, as defendants contend and plaintiffs deny, Leasco obtained substantial tax and other advantages through the incorporation of Leasco N.V. and the use of the latter to acquire the Pergamon shares. Whatever may' be the rule where the defrauded American investor chooses, deliberately and unilaterally, to have the purchase consummated abroad by a foreigner, here the situation was quite different. The Maxwell group

expressly agreed in its written contract that Leasco could "at its election" have the offer made "by a wholly-owned subsidiary of Leasco or a wholly-owned subsidiary of such subsidiary," "providing Leasco shall remain responsible for the due performance" of the obligation to acquire the shares. This clause specifically covered Leasco N.V., which was part and parcel of Leasco in every realistic sense. In acceding to this provision the defendants themselves recognized that Leasco, the United States company, remained at all times intimately involved in the transaction; the foreign entity was accepted by both sides as the alter ego of the American. The case is quite different from another hypothetical we posed at argument, namely, where a German and a Japanese businessman met in New York for convenience, and the latter fraudulently induced the former to make purchases of Japanese securities on the Tokyo Stock Exchange. . . .

We therefore hold that the motions to dismiss for lack of subject matter jurisdiction were properly denied.

QUESTIONS

How much and what kind of "conduct" is enough under the Second Circuit's conduct test? What if the alleged fraud was directly about shares related to the purchased securities that are the subject of a securities fraud action, so that when the value of the former drops so does the value of the latter? What if allegedly fraudulent SEC filings are prepared *outside* the United States by an issuer operating in a foreign country? What if the fraudulent statements occurred in the United States, but the plaintiff's purchase occurred on a foreign stock exchange? In answering these questions, consider the following cases.

BERSCH v. DREXEL FIRESTONE, INC.

519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975)

FRIENDLY, J.

These appeals from orders of Judge Carter in an action in the District Court for the Southern District of New York again bring before us the question of the territorial reach of the federal securities laws with which we have previously dealt in *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir.), *rev'd on the merits*, 405 F.2d 215 (2d Cir. 1968) (en hanc), *cert. denied sub nom., Manley v. Schoenbaum*, 395 U.S. 906 (1969), and *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972). Apart from differences in the facts, there is the added complexity that whereas *Scboenbaum* was a derivative action by stockholders of a Canadian corporation and *Leasco* an action by two corporate plaintiffs, the suit here is a class action on behalf of thousands of plaintiffs[2] preponderantly citizens and residents of Canada, Australia, England, France,

2. The exact size of the plaintiff class has not yet been determined with any precision. In his original complaint, plaintiff Bersch, on the basis of an "estimate' that the average class member purchased tOO shares, alleged that there were approximately 100,000 potential class members. Apparently based on the alleged fact, revealed by discovery, that the average American purchaser bought 3,906 shares, and certain other information derived from the settling defendants, Bersch has now lowered his estimate of the size of the potential class to 25,000. On the record before us it is not possible to ascertain whether this new estimate is reasonable. On its face, if one were to assume that foreign purchasers on average subscribed for as many

Germany, Switzerland, and many other countries in Europe, Asia, Africa, and South America.

I. The Basic Facts

The securities transactions giving rise to this litigation go back to 1969. The securities were the common stock of defendant I.O.S., Ltd. (IOS), an international sales and financial service organization principally engaged in the sale and management of mutual funds and complementary financial activities organized under the laws of Canada, having had its main business office in Geneva, Switzerland. It is now in the hands of liquidators appointed in November, 1973, by the Supreme Court of New Brunswick pursuant to the Canadian Winding-Up Act, Revised Statutes of Canada, 1970, ch. W-l0.[4]

Prior to 1968 the stock of IOS and its subsidiaries had been held by its organizer, defendant Bernard Cornfeld, his associates, and their employees. Although Cornfeld had always been free to sell his IOS shares, and in fact had disposed of significant amounts of these over the prior nine year period, his employees had been denied the right to sell their holdings and no organized market for IOS shares existed. Within the company the price of the stock was set by a theoretical formula value; the stock was used as a means of partial compensation and was granted to employees as a performance incentive, it being commonly understood by the employees that the company would eventually be taken public and they might then "cash in". A plan was developed wherein each of IOS's principal subsidiaries would first separately be taken public; finally common shares of IOS itself would be sold. In 1968 IOS floated 600,000 shares of one of its principal subsidiaries, IOS Management Ltd., a Canadian registered concern. The shares were offered at $12.50; trading opened at $75; and by March 1969 they had reached a peak of around $180. Subsequent to this sale, no doubt in part due to the success of this offering and more importantly to growing salesman dissatisfaction in light of a successful offering by a recently created competitor, the decision was made to abandon the original plan and to take IOS public as soon as appeared feasible. The planning of this offering was constrained by the framework set out in an Order Accepting Offer of Settlement entered by the SEC on May 23, 1967. Paragraph 4 of this order provided in pertinent part:

> Upon entry of the Order based on this Stipulation, IOS and all its affiliates shall cease all sales of securities to United States citizens or nationals wherever located, except for (i)

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shares as discovery allegedly has revealed with respect to Americans, then even the 25,000 figure would be a significant overestimate. However, plaintiff's 3,906 average purchase estimate is based in part upon an erroneously high computation of the total number of shares allegedly purchased by Americans. Elimination of an apparently inadvertent double counting error with respect to one major purchaser lowers the total shares purchased by the alleged 386 American purchasers from 1,507,578 to 844,683. Moreover, even after elimination of this error, the average purchase figure is still deceptively high since one of the American purchasers which plaintiff lists in support of his allegations–the IOS Foundation of Delaware–purchased some 662,895 shares. Exclusion of these shares from the averaging would reduce the average American purchase to around 200 shares, and extrapolation of this to the foreign purchasers would result in a class of some 50,000.

4. The liquidation proceedings against IOS were initiated on August 30. 1973, before Mr. Justice Dickson of the Supreme Court of New Brunswick, Canada, on the petition of the Public Trustee of the Province of Ontario, as creditor of IOS. Subsequently two additional petitions for the liquidation of IOS were filed, one by another creditor, and one by a shareholder. See In re I.O.S., Ltd., 7 N.B.R.(2d) 316 (S. Ct. 1973), *amended on appeal, 7,* N.B.R.(2d) 311 (S. Ct. App. Div. 1973). We are told that the filing of the first petition "followed and was in great measure the result of conferences among the governments of Canada and the Provinces of Quebec and Ontario, the regulatory authorities of Luxembourg and of the United States Securities and Exchange Commission." Affidavit of Herbert M. Wachtell, p.4 n.*, April 16, 1974. During those conferences it was apparently agreed, *inter alia*, that liquidation of the various interconnected business entities that made up the multi-national IOS complex would he sought by or with the assistance of the relevant government or regulatory authorities of the corporate domiciles of the various key corporations. We are further told that it was agreed at the conference that an informal international committee made up of representatives of the various governments and regulatory authorities referred to above "would periodically meet and generally oversee the liquidation process."

offers and sales outside of the United States (and its territories, possessions or commonwealth subject to the jurisdiction of the United States) to officers, directors and full-time personnel of IOS and its subsidiaries.

Three separate distributions of IOS common stock were proposed. The largest was to be a primary offering of 5,600,000 newly issued shares underwritten by six of the defendants (hereafter the Drexel group)–two American banking houses, Drexel Firestone, Inc. and Smith, Barney & Co., having their principal offices in the United States but also having offices in Europe, and four foreign underwriting houses, Banque Rothschild; Hill Samuel & Co. Limited; Guinness Mahon & Co. Limited; and Pierson Heldring & Pierson, having their principal offices abroad. The 5,600,000 shares were to be and were in fact sold under a prospectus outside the United States to foreign nationals residing in Europe, Asia and Australia. Prospectuses were printed abroad in English, French, and German and delivered to the purchasers outside the United States. A secondary offering of 1,450,000 shares, underwritten by defendant J. H. Crang & Co., a Toronto investment house (Crang), was made in Canada by a prospectus conforming to the laws of Canada and its provinces; all of these shares were sold in Canada and none was sold to Americans resident there. The third distribution, whence this action springs, was a secondary offering of 3,950,000 shares by defendant Investors Overseas Bank Limited of Nassau, the Bahamas, an IOS subsidiary (IOB). The prospectus stated, as had that of the Drexel Group, that the shares "are not being offered in the United States of America or any of its territories or possessions or any area subject to its jurisdiction" and was "being made to approximately 25,000 persons who are either (1) employees or sales associates of the Company, (2) certain clients presently holding investments in managed funds or other products of the Company, or (3) persons who have had a long-standing professional or business relationship with the Company."

The offerings were made at the same price, $10 per share, and at approximately the same time. Each prospectus referred to the two other offerings. Reference was made to plans to list the IOS stock on various stock exchanges, none of these being in the United States. The Drexel Group and IOB prospectuses were substantially identical. Although the Crang prospectus was somewhat different insofar as compliance with particular Canadian securities regulations was sought, all three contained balance sheets of IOS arid various subsidiaries as of December 31, 1968, and income statements for the five years then ended, and a report of defendant Arthur Andersen & Co. (Andersen), an international accounting firm with its principal office in the United States that, subject to usual qualifications, the statements fairly presented the financial condition of the company as of December 31, 1963, and for the five years then ended. The Drexel and IOB prospectuses stated that the offerings had not been registered under United States securities laws. The offerings were successful in the limited sense of being frilly subscribed, but after stabilizing briefly at $14 the price of the shares drifted downward until April 1970 when it collapsed through the $10 level and three weeks later the shares apparently were virtually unsaleable. The plight of the purchasers was further aggravated when control of IOS passed into the hands of Robert L. Vesco, currently a resident of Costa Rica, and a defendant in a substantial number of actions for fraud pending in this circuit.

II. The Proceedings in The District Court and this Court

The complaint in this action alleging violations of the Securities Act of 1933 and the Securities Exchange Act of 1934, and also containing allegations which can be read as charging common law fraud, was filed in December 1971 by Howard Bersch, a United

States citizen living in New York, who had purchased 600 shares of IOS common distributed as part of the IOB underwriting. Characterizing the three underwritings as the "IOS Public Offering", Bersch alleged he was bringing the action individually and on behalf of all persons who purchased stock in each of the offerings, estimated to approximate 100,000. The complaint contained the allegations usual when a plaintiff desires designation of his action as a class action under Fed. it Civ. P. 23(b)(3), It alleged that the underwriters "impliedly represented to the public that IOS was a suitable company for public ownership" when, in part as a result of the refusal of other investment houses to participate, they should have known that it was not. It also contained more particularized charges, *e.g.*, that the prospectuses failed to reveal illegal activities by IOS arid its officers which had seriously damaged the company, that the books and records of IOS and its subsidiaries and affiliates were in such a chaotic condition that it was impossible to determine from them an accurate picture of IOS's financial position, and that during the months preceding the offering various IOS officials, including Cornfeld, had touted IOS' prospects. It charged that the underwriters in the Drexel Group had failed to use due diligence with regard to their prospectus, and that Andersen had failed to observe generally accepted accounting principles in connection with its audit with the result that the financial statements were false and misleading in various respects unnecessary to detail here.

The district court rendered its opinion on November 26, 1974. The first question it addressed was whether the 1969 IOS Public Offering fairly could be viewed as one, two, or three distinct offerings. Depending upon whether one focused "on the purposes of the offering and the interaction of its prime movers, upon the character of the offerings themselves, or upon the structure of the selling arrangement and the identity and locus of the purchasers," each of these views was considered at least arguable. The court concluded that the three offerings were sufficiently integrated that they should be considered as one for the purpose of determining subject matter jurisdiction. It then found subject matter jurisdiction because of three factors:

> (1) The amount of activity in the United States, almost entirely in connection with the Drexel offering, by the underwriters, their counsel and accountants (Price Waterhouse & Co.), and IOS.
>
> (2) Sales to Americans, estimated at 386 individuals, even though "the defendants appear to have made an attempt to prevent any sales to Americans" and none occurred through the Drexel Group or Crang offerings.
>
> (3) Generally adverse effects upon the American securities markets from the collapse in the price of the IOS shares offered.

With this background we turn to the three elements a combination of which led the district judge to conclude that subject matter jurisdiction existed with respect not only to the relatively few Americans who had purchased IOS shares hut to the many thousands of foreign purchasers whom plaintiff sought to represent. We think it will be useful to consider the first and third elements on which the court relied before we take up the second.

Assuming that there were no American purchasers and that the underwriting related, for example, to a large foreign industrial company clearly identified with a foreign country rather than with the United States, *e.g.*, Rolls-Royce, Mercedes-Benz or Fiat, we do not believe the activities in the United States would justify an American court in taking jurisdiction in a suit for damages by foreign plaintiffs. The fraud, if there was one,

was committed by placing the allegedly false and misleading prospectus in the purchasers' hands. Here the final prospectus emanated from a foreign source– London or Brussels in the case of the Drexel offering, Toronto in the case of the Crang offering, and apparently the Bahamas and Geneva in the case of the IOB offering. Not only do we not have the case where alt the misrepresentations were communicated in the nation whose law is sought to be applied as in Illustration 2 of § 17 of the Restatement (2d) of Foreign Relations Law at 45, *see Leasco*, 468 F.2d at 1334 n.3, or the case where a substantial part of them were, as in *Leasco* itself, hut we do not even have the oft-cited case of the shooting of a bullet across a state line where the state of the shooting as well as of the state of the hitting may have an interest in imposing its law. At most the acts in the United States helped to make the gun whence the bullet was fired from places abroad; alternatively proper action in the United States would have prevented the gun's ever being sent abroad. We are indeed holding in *IIT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975) decided this day, that Congress did not mean the United States to be used as a base for fraudulent securities schemes even when, the victims are foreigners. at least in the context of suits by the SEC or by named foreign plaintiffs. But as we there point out, that holding itself goes beyond any case yet decided, and we see no reason to extend it to cases where the United States activities are merely preparatory or take the font of culpable nonfeasance and are relatively small in comparison to those abroad. We thus conclude that the action and inaction which here occurred in the United States would not of itself confer subject matter jurisdiction with respect to foreign plaintiffs even if we assume *arguendo* that the three underwritings may be considered for this purpose as one.

We turn next to the third ground on which the district court predicated subject matter jurisdiction–the adverse general effect of the collapse of IOS in the United States. This was based on an affidavit by Morris Mendelson, Associate Professor of Finance at the Wharton School of the University of Pennsylvania. Professor Mendelson's principal conclusions were that:

> (1) The aftermath of the Drexel offering "was a debacle of monumental proportions which resulted in a deterioration of investor confidence in American underwriters at home and, particularly, abroad," and increased the problems of United States corporations in seeking to raise capital abroad.
>
> (2) "The false and misleading prospectus issued in connection with the Public Offering impaired investors' confidence and trust and contributed to a steep decline in the purchase of United States securities by foreigners" with attendant adverse effects on the balance of payments and the price of American securities generally.
>
> (3) Loss of investor confidence in IOS led to large redemption of shares in the mutual funds controlled by it, notably Fund of Funds Limited, which required the funds to sell substantial parts of their portfolios, mainly United States securities, with consequent depression of prices.
>
> (4) Part of the attraction of American securities to foreigners has been the superior disclosures afforded by SEC registration requirements. The collapse of IOS after the offering undermined this confidence since IOS was "identified as an American company in the minds of investors", the Drexel underwriting was led by an American firm and the accountants, Andersen, were American.
>
> (5) The collapse of IOS after the offering "contributed to a breakdown in the entire structure of building up an offshore investing industry whereby funds of European investors were channeled into American securities markets."

Although appellants attack certain of Professor Mendelson's conclusions as erroneous or exaggerated, we do not doubt that the collapse of IOS after the offering had an

unfortunate financial effect in the United States. Nevertheless we conclude that the generalized effects described by Professor Mendelson would not be sufficient to confer subject matter jurisdiction over a damage suit by a foreigner under the anti-fraud provisions of the securities laws.

This branch of plaintiff's arguments goes back to Mr. Justice Holmes' statement in *Strassheim v. Daily*, 221 U.S. 280, 284-85 (1911), which was relied on by Judge L. Hand in *United States v. Aluminum Co. of America*, 148 F.2d 416, 443 (2d Cir. 1945), and by Chief Judge Lumbard in *Schoenbaum, supra*, 405 F.2d at 206:

> Acts done outside a jurisdiction, but intended to produce and producing detrimental effects within it, justify a state in punishing the cause of the harm as if he had been present at the effect, if the state should succeed in getting him within its power.

See Restatement (2d) of Foreign Relations Law §18, "Jurisdiction to Prescribe with Respect to Effect within Territory". The statement, however, must be read in context. The indictment at issue in *Strassheim v. Daily* charged that Daily, in Illinois, had connived with the warden of a Michigan prison to defraud the prison's Board of Control by substituting worn and second-hand machinery for the new machinery that had been ordered, and the Court declined to upset, on a petition for habeas corpus, an order extraditing Daily from Illinois to Michigan. This principle would. support subject matter jurisdiction if a defendant, even though acting solely abroad, had defrauded investors in the United States by mailing false prospectuses into this country, *see* ALI Proposed Federal Securities Code (Draft No. 3, April, 1974) §1604(a)(1)(A) & Comment (3)(b) at 165-66, or if, as in *Schoenbawn*, the number of shares of a company traded on American exchanges was increased by a sale to insiders without adequate consideration at least when this is imperfectly disclosed, *cf. Popkin v. Bishop*, 464 F.2d 714 (2d Or, 1972). But it does not support subject matter jurisdiction if there was no intention that the securities should be offered to anyone in the United States, simply because in the long run there was an adverse effect on this country's general economic interests or on American security prices. Moderation is all. This, we think, is what Judge Hand had in mind in the remarks in his [*Alcoa*] opinion quoted in the margin.[33] These considerations are particularly pertinent in view of the limitations in §17(a) of the 1933 Act to acts in "the offer or sale of any securities" and in § 10(b) of the 1934 Act to acts "in connection with the purchase or sale of any security." This means to us that there is subject matter jurisdiction of fraudulent acts relating to securities which are committed abroad only when these result in injury to purchasers or sellers of those securities in whom the United States has an interest, not where acts simply have an adverse effect on the American economy or American investors generally. Also we do not think that a combination of the district court's first and third grounds, neither sufficient in itself, supports a result different from that which would be proper if each subsisted alone.

IV. Subject Matter Jurisdiction–Americans

We find it rather strange that this large record, with appendices alone running to more than 1200 pages, leaves us in serious doubt about one simple fact that seemingly could

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33. There may be agreements made beyond our borders not intended to affect imports, which do affect them, or which affect exports. Almost any limitation of the supply of goods in Europe, for example, or in South America, may have repercussions in the United States if there is trade between the two. Yet when one considers the international complications likely to arise from an effort in this country to treat such agreements as unlawful, it is safe to assume that Congress certainly did not intend the Act to cover them.

have been established quite readily. That is how plaintiff Bersch came to buy 600 shares of IOS that were part of the 3,950,000 share IOB offering.

Bersch was Vice-President and Secretary of Saja Associates Ltd., a privately-held business management and consulting firm, whose principal client was IOS, having an office in a building on Madison Avenue in New York City.

If the record is thus murky on how Bersch came to subscribe, it is even murkier about how other American residents did. Appellant Andersen repeatedly says that the only information on this is a statenmnt in an affidavit of Bersch:

> I was not the only American residing here who purchased IOS stock. . . . Among the New Yorkers purchasing the IOS securities were: Christine Cullen, Naydyne Nelson, Claire Fipolo, David Elmer, Elliott Adler, Robin Leach, Robert Sutner, Raymond Grant, Simme Arthur, Hyman Feld, and Morton Schiowitz.

But this is simply not so. Much more information is furnished in a series of letters from IOS to the SEC in the fall of 1970. These indicate that sales aggregating 41,936 shares were made to 22 American residents, all having relationships with IOS or its affiliates as employees, lawyers, directors or consultants. Although Andersen loudly claims that Bersch and other American residents bought the shares when they knew they should not have, we find nothing in the record to support this. The IOB prospectus does not exclude American employees residing in the United States and, as indicated above, *see* note 7 and accompanying text, the SEC 1967 order does not clearly do so. We note also that several of the subscribers were members of law firms that had represented IOS or its affiliates; it is scarcely to be thought that they would have subscribed for shares which they knew were not intended to and could not lawfully be made available to them.

We see no reason why there would not be subject matter jurisdiction with respect to such persons on the part of defendants IOS and Cornfeld who were responsible for the IOB offering. This type of situation–the dispatch from abroad of misleading statements to United States residents–would be closely analogous to that in which jurisdiction was upheld in *Strassheim v. Daily, supra,* and in the [*Alcoa*] case and one which would be considered an appropriate subject of United States jurisdiction under §18 of the Restatement (2d). To be sure, it may turn out that particular individuals never saw the statements or, because of their knowledge, were not misled. But at the present stage we must assume that there was some mailing of' prospectuses into the United States and some reliance on them. The same result should also follow with respect to Andersen; action in the United States is not necessary when subject matter jurisdiction is predicated on a. direct etkct here and Andersen allowed its report on the 1968 financial statements to be used in the IOB offering as much as in the two others. Subject matter jurisdiction with respect to the Drexel Group defendants is more debatable; this depends on whether their activities, whether in the United States or abroad, can be considered as essential to the carrying out of the JOB offering and thus of the purchases here at issue. On the material before the district judge we think they can properly be, although this would he open to disproof at a trial. *Cf. Leasco,* 468 F.2d at 1330. Whether the same is true with respect to Crang is more debatable since the IOB offering was far more dependent on the large Drexel offering throughout the world than on the much smaller Canadian offering by Crang, but in view of our approval of the court's holding of lack of in personam jurisdiction over Crang, we need not decide this.

Plaintiff asserts that, in addition to purchases by Americans resident in the United States, there were significant purchases by Americans resident abroad. Whether

Congress intended that such persons should be entitled to obtain damages for violation of the securities laws is a different and closer question from that on which we have just ruled, We think the answer would he in the negative if none of the defendants engaged in significant activities within the United States, as defendants, with apparent soundness, claim to be the case with respect to the IOB offering considered alone, Congress surely did not mean the securities laws to protect the many thousands of Americans residing in foreign countries against securities frauds by foreigners acting there, and we see no sufficient reason to believe it would have intended otherwise simply because an American participated so long as he had done nothing in the United States. However, in Judge Carter's view the IOB offer to American citizens residing abroad would not have occurred but for the primary offering which invoked the many documented activities of most of the defendants in the United States. There was enough basis for this to justify a holding of subject matter jurisdiction as regards American citizens residing abroad, with respect to IOS and Andersen, Despite the paucity of physical acts on its part in the United States, the head and front of its alleged offending was its decision to allow its 1968 report to he used in all three prospectuses, including the IOB prospectus, and this must have emanated from its headquarters in the United States. We are of the same view with respect to the Drexel group. While merely preparatory activities in the United States are not enough to trigger application of the securities laws for injury to foreigners located abroad, they are sufficient when the injury is to Americans so resident. We here assume that, for reasons stated in the preceding paragraph . . . proof will disclose a significant causal relationship between the Drexel offering and the IOB offering. The case with respect to Crang is weaker but, since we sustain the judges ruling of lack of *in personam* jurisdiction, we need not reach it. This leaves Cornfeld; the question of how far the alleged defrauding of American citizens abroad resulted from acts which he did or caused in the United States had best be left for development at a trial. We again invite attention to our observation in *Leasco:*

> We add that if a trial should disclose that the allegedly fraudulent acts of any of the defendants within the United States were non-existent or so minimal as not to be material, the principles announced in this opinion should be applied to the proven facts; the issue of subject matter jurisdiction persists.

468 F.2d at 1330.

We have thus concluded that the anti-fraud provisions of the federal securities laws:

> (1) Apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country; and
>
> (2) Apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but
>
> (3) Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.

Other fact situations, such as losses to foreigners from sales to them within the United States, are not before us. We freely acknowledge that if we were asked to point to language in the statutes, or even in the legislative history, that compelled these conclusions, we would be unable to respond. The Congress that passed these extra-

ordinary pieces of legislation in the midst of the depression could hardly have been expected to foresee the development of offshore funds thirty years later. We recognize also that reasonable men might conclude that the coverage was greater, or less, than has been outlined in this opinion and in *IIT v. Vencap, Ltd.*, 519 FM 1001 (2d Cir. 1975) this day decided, Our conclusions rest on case law and commentary concerning the application of the securities laws and other statutes to situations with foreign elements and on our best judgment as to what Congress would have wished if these problems had occurred to it.

ITOBA LIMITED v. LEP GROUP PLC

54 F.3d 118 (2d Cir. 1995)

VAN GRAAFEILAND, CIRCUIT JUDGE:

[A wholly owned Channel Islands subsidiary of a Bermuda holding company with a U.S. subsidiary brought a securities fraud action against a British issuer and its U.S.-based officers. The District Court dismissed the suit, and the subsidiary appealed. The Second Circuit reversed and remanded, holding that material issues of fact, precluding summary judgment, existed as to whether the British issuer had committed securities fraud by making false and misleading statements in its SEC Form 20-F reports filed in connection with the deposit of some of its shares with a U.S. depository and U.S. trading in related American Depository Shares (ADSs) on U.S. markets.]

The corporate defendant in this case, Lep Group PLC, is a London-based holding company with some fifty subsidiaries operating in thirty countries. It is a true conglomerate, owning businesses in freight forwarding, home security systems, biotechnology, travel services, and real estate speculation. Lep's "ordinary shares", the British equivalent of common stock, are registered in the United Kingdom, obligating the company to comply with United Kingdom securities laws. The primary trading market for Lep's ordinary shares is the International Stock Exchange of the United Kingdom and the Republic of Ireland Ltd. (the "London Exchange").

To create a United States market for its ordinary shares, Lep deposited 12,842,850 of its approximately 136 million shares in an American depository in 1988. The depository in turn issued an American Depository Receipt (ADR) for each five ordinary shares of Lep on deposit. Because these ADRs trade in the form of [ADSs] on the National Association of Securities Dealers Automated Quotation System ("NASDAQ"), Lep is subject to the reporting and disclosure requirements of United States securities law.

A.D.T. Limited ("ADT") is a transnational holding company based in Bermuda. Its shares are listed on the New York Stock Exchange and approximately fifty percent of its shareholders of record reside in the United States. Itoba, a Channel Islands company, is a wholly-owned subsidiary of ADT. ADT also is the corporate parent of A.D.T. Securities Systems, Inc., a Delaware-based firm and one of America's largest suppliers of security and protection services.

In mulling over expansion plans for A.D.T. Securities Systems, ADT considered the possible acquisition of one of A.D.T. Securities Systems' largest competitors in the American security market, National Guardian. ADT already owned a small interest in that corporation through shares it held of Lep, the parent company of National Guardian. Because ownership of Lep would lead to control of National Guardian, ADT considered increasing its Lep holdings.

At the same time, Canadian Pacific was interested in expanding into the freight forwarding business and also was pondering a sizeable investment in Lep. Learning of their mutual interest, the companies agreed to explore a joint purchase of Lep. Canadian Pacific hired S.G. Warburg, a London investment bank, to evaluate Lep's business operations. Nicholas Wells, ADT's in-house financial analyst, was directed by Michael Ashcroft, ADT's chairman, to perform a valuation of Lep.

In December 1989, S.G. Warburg issued an extensive report assessing Lep's prospects. The analysis in this report was based on Lep's U.K. annual reports, the Form 20-F that Lep filed with the United States Securities and Exchange Commission for the year ended December 31, 1988, Lep's shareholder register, and broker reports. Shortly after the Warburg report was issued, Canadian Pacific abandoned the proposed joint venture.

ADT's interest, on the other hand, did not diminish. Wells continued his examination of Lep, relying heavily on the Warburg report. To supplement his research, he obtained from Canadian Pacific a copy of Lep's Form 20-F for 1988. Wells frequently discussed his analyses of these documents with David Hammond, ADT's vice chairman and the person in charge of acquisitions.

Based on Wells' analyses and their own review of the Warburg report, Hammond and Ashcroft decided to acquire Lep. Soon thereafter, Hammond formulated a plan to increase ADT's Lep holdings by making anonymous purchases on the market through one of ADT's offshore companies, in this case Itoba. Hammond contacted the board members of Itoba and recommended that they approve his purchase plan.

As expected, Itoba's board approved the plan. Itoba's board then requested one of ADT's employees to commence share purchases in Itoba's name; these purchases were made according to Hammond's plan and paid for by ADT. During the second half of 1990, Itoba executed a number of significant purchases on the London Exchange pursuant to the plan. By November 1990, Itoba had acquired over 37 million Lep ordinary shares for approximately $114 million.

Before ADT could complete its planned acquisition, however, Lep disclosed a series of business reversals that decimated its share value; Lep's stock price plummeted 97% and the value of Itoba's Lep holdings declined by nearly $111 million. Lep wrote off approximately $522 million from its books for the fiscal year ended December 31, 1991.

Itoba sued Lep and its officers in the District of Connecticut, asserting violations of sections 10(b) and 20 of the Securities Exchange Act of 1934 (the "Act") and of Rule 10b-5. According to Itoba, the defendants were subject to liability because they failed to disclose material matters in statements filed with the SEC. Specifically, Itoba alleged that Lep made high risk investments and engaged in speculative business ventures without informing the investing public. Itoba claimed that had these matters been properly disclosed, it would not have purchased Lep's stock at artificially inflated prices.

Itoba also asserted claims against Lep director William Berkley for alleged violations of sections 10(b) and 12(2) of the Act and of Rule 10b-5. Berkley, a United States citizen and a resident of Connecticut, had sold a large block of Lep ordinary shares in the United States on the same day that Itoba purchased a large block of shares in London. Itoba alleged that had Berkley properly complied with his duty to disclose material, nonpublic information before trading, it would not have made that purchase.

. . . The district court . . . dismissed Itoba's action on [jurisdictional] grounds. . . . This, we conclude, was error.

It is well recognized that the Securities Exchange Act is silent as to its extraterritorial application. *See, e.g., Alfadda v. Fenn,* 935 F.2d 475, 478 (2d Cir.) (citing 15 U.S.C. §

78aa), *cert. denied*, 502 U.S. 1005 (1991). However, in determining whether Congress intended that the "precious resources of United States courts" be devoted to a specific transnational securities fraud claim, we are not without guidance. Two jurisdictional tests have emerged under this Court's decisions: the "conduct test", as announced in *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1336-37 (2d Cir.1972), and the "effects test", as announced in *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206-09 (2d Cir.), *rev'd with respect to holding on merits*, 405 F.2d 215 (2d Cir.1968) (in banc), *cert. denied sub nom. Manley v. Schoenbaum*, 395 U.S. 906 (1969). There is no requirement that these two tests be applied separately and distinctly from each other. Indeed, an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court. It is in this manner that we address the issue of jurisdiction in the instant case. Because we believe that the allegations are sufficient to support jurisdiction, we reverse.

Under the conduct test, a federal court has subject matter jurisdiction if (1) the defendant's activities in the United States were more than "merely preparatory" to a securities fraud conducted elsewhere, *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 987 (2d Cir.), *cert. denied*, 423 U.S. 1018, (1975), and (2) these activities or culpable failures to act within the United States "directly caused" the claimed losses, *Alfadda, supra*, 935 F.2d at 478. Inherent in the conduct test is the principle that Congress does not want "'the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners.'" *Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1045 (2d Cir.1983) (quoting *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir.1975)).

The magistrate judge[,who recommended dismissal to the District Court,] correctly stated the conduct test when she said that Itoba must prove that Lep's United States-based activities directly caused Itoba's financial losses. However, whether she correctly applied the test is an entirely different matter. The magistrate judge based her recommendation to deny jurisdiction on the following findings:

> First, Itoba and ADT did not read the SEC filing and rely on them; it was an investment bank hired by ADT which had reviewed the documents. And second, the SEC filings were filed in connection with LEP's ADS's and ADR's, not the ordinary shares purchased by Itoba, for which annual reports and press releases were generated from England.

The magistrate judge's first finding–that ADT and Itoba did not read and rely on the SEC filing in making their purchase decision–must be rejected in view of the clearly-established fact that the executives of Itoba and ADT based their investment decision on the Warburg report. The analyses and conclusions in this report were predicated on information found in the Form 20- F that Lep filed with the SEC. Nicholas Wells, the ADT executive responsible for assessing investment prospects, made the Warburg report the centerpiece of his Lep valuation. Moreover, he not only relied on the discussion of the SEC filing as contained in the Warburg report, he also used his own copy of the 1988 Form 20-F to formulate his purchase recommendations. According to the affidavit of ADT's vice chairman, the decision to acquire Lep was based upon these recommendations.

The fact that Itoba's board members did not read the SEC filing is not of controlling significance. A party need not personally have read a misleading financial report to establish reliance; derivative reliance is a well-established basis for liability in a Rule

10b-5 action. *See, e.g., Austin v. Loftsgaarden,* 675 F.2d 168, 177-78 & n. 19 (8th Cir.1982), *appeal after remand,* 768 F.2d 949 (8th Cir.1985), *rev'd on other grounds sub nom. Randall v. Loftsgaarden,* 478 U.S. 647 (1986); *Garfinkel v. Memory Metals, Inc.,* 695 F.Supp. 1397, 1404 (D.Conn.1988); *Kronfeld v. Trans World Airlines, Inc.,* 104 F.R.D. 50, 53-54 (S.D.N.Y.1984); *Walsh v. Butcher & Sherrerd,* 452 F.Supp. 80, 84 (E.D.Pa.1978); *In re Ramada Inns Sec. Litig.,* 550 F.Supp. 1127, 1131 (D.Del.1982). The acquisition plan that Itoba's directors approved was formulated and funded by ADT, which in turn relied on its financial officer's analysis of the Warburg report and Lep's SEC filing. The contents of Lep's 1988 Form 20-F were thus a "substantial" and "significant contributing cause" to Itoba's purchase decision. There is no requirement, as suggested by the magistrate judge's decision, that Itoba read Lep's filing before it could rely on it.

The magistrate judge's second reason for denying jurisdiction, *i.e.*, that the SEC filings were made in connection with Lep's ADSs and ADRs, not its ordinary shares, is only fifty percent correct and therefore is one hundred percent wrong. The ADRs were simply a grouping into one security of five ordinary shares. Inevitably, there was a direct linkage between the prices of the ADRs representing five ordinary shares and the prices of the single ordinary shares themselves. If the ordinary share price fell on the London Exchange, the market price of an ADR would decrease in similar manner, and *visa versa* [*sic*].

Finally, a Rule 10b-5 action is not barred because a false and misleading statement in an SEC filing pertains to a security that is not the security purchased. *See In re Ames Dep't Stores Inc. Stock Litig.,* 991 F.2d 953, 961-62 (2d Cir.1993). So long as the fraudulent device employed is of the type that would cause reasonable investors to rely thereon and, so relying, cause them to purchase or sell the corporation's securities, a Rule 10b-5 action may lie. *See SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 860 (2d Cir.1968) (in banc), *cert. denied sub nom. Coates v. Securities & Exchange Comm'n,* 394 U.S. 976 (1969). SEC filings generally are the type of "devices" that a reasonable investor would rely on in purchasing securities of the filing corporation. When these United States filings include substantial misrepresentations, they may be a predicate for subject matter jurisdiction. *See Psimenos, supra,* 722 F.2d at 1045 (citing *Leasco, supra,* 468 F.2d at 1337).

The fact that the Lep ordinary shares were issued and purchased in England does not change our conclusion. "The conduct test does not center its inquiry on whether domestic investors or markets are affected, but on the nature of conduct within the United States as it relates to carrying out the alleged fraudulent scheme...." *Psimenos, supra,* 722 F.2d at 1045; *see Leasco, supra,* 468 F.2d at 1337.

Moreover, the making of the allegedly false and misleading filings with the SEC was not "merely preparatory to the fraud." Although the magistrate judge refrained from forthrightly stating as much, she tiptoed around that statement as follows:

> It is beyond dispute that SEC filings and press releases are the type of information on which an investor relies in making his or her investment decisions. *Securities & Exchange Comm'n v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 862 (2d Cir.1968), *cert. denied sub nom. Coates v. Securities & Exchange Comm'n,* 394 U.S. 976 . . . (1969). Even beyond the issue of whether the SEC filings were "merely preparatory to the fraud," plaintiff cannot demonstrate that the alleged acts within the United States "directly caused [its] losses" for two reasons.

She then propounded the two reasons we have rejected in the preceding paragraphs and cited two cases whose application here is questionable at best, *Koal Industries Corp. v. Asland, S.A.*, 808 F.Supp. 1143, 1153-55 (S.D.N.Y.1992) and *Nathan Gordon Trust v. Northgate Exploration, Ltd.*, 148 F.R.D. 105, 107-08 (S.D.N.Y.1993). In *Koal Industries*, a Panamanian corporation acquired two Netherlands Antilles corporations which owned interests in an Arkansas mining company. The entire transaction took place in Switzerland and the financing was obtained from outside the United States. The only contact with the United States other than the location of the mine was a telephone call seeking additional funds for the acquisition. *Northgate* involved a motion for class certification. The defendant was a Canadian corporation which owned an interest in a gold mine located in northern Canada, concerning which the defendant filed allegedly false SEC statements. The proposed class was to consist of all persons who purchased Northgate stock on the Toronto, Montreal, London and New York Exchanges. The defendant requested that the class be limited to those who purchased on the New York Exchange, and the district court granted its request. In contrast to the discretionary nature of the district court's class certification ruling and the "fraud on the market" class issues of *Northgate*, the instant case involves a single plaintiff asserting direct individual fraud.

Appellees address the issue of "preparatory conduct" more directly. They assert that the mere filing of a document with the SEC should not trigger jurisdiction in United States courts. In support of this contention, they point out that Lep's financial statements were prepared in England and contend that the act of filing alone should not confer subject matter jurisdiction in the United States. They say further that the filing was "incidental or preparatory conduct" in whatever wrongdoing may have occurred. With respect to the first contention, we hold that the situs of preparations for SEC filings should not be determinative of jurisdictional questions. Otherwise, the protection afforded by the Securities Exchange Act could be circumvented simply by preparing SEC filings outside the United States. We find no support in the Act for such a result.

The second half of appellees' argument overlooks a basic purpose of the securities law, which is fair disclosure of material facts. A material fact that is undisclosed in an SEC filing remains undisclosed absent public enlightenment. This may bring into play a concomitant duty, *i.e.*, the duty to correct. *See* 2 Bromberg & Lowenfels, *Securities Fraud & Commodities Fraud* § 6.11, at 138.401-.509 (2d ed. 1994). Lep's uncorrected nondisclosure played as much a role in Itoba's purchases as the price listings on the London Exchange and NASDAQ. In view of the deleterious effect this continued nondisclosure had on the thousands of ADT shareholders in the United States, it cannot be described correctly as incidental or preparatory.

This argument, of course, combines pertinent principles of both the conduct and effects tests, the latter one being based on fraud which takes place abroad which impacts on "stock registered and listed on [an American] national securities exchange and [is] detrimental to the interests of American investors." *Schoenbaum, supra,* 405 F.2d at 208. Here, we have fraud occurring on an American exchange and persisting abroad that has impacted detrimentally upon thousands of United States shareholders in the defrauded company, *i.e.*, over $100 million lost in the shareholders' corporate equity.

The magistrate judge held that "if ADT were the plaintiff, the 'effects test' would be met, in that ADT's stock is traded on the New York Stock Exchange and approximately fifty percent (50%) of its shares are held in this country." *See generally Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252, 262-63 (2d Cir.), *amended on other grounds,* 890 F.2d 569 (2d Cir.), *cert. dismissed,* 492 U.S. 939 (1989); *Matter of Marc*

Rich & Co. A.G., 707 F.2d 663, 666-67 (2d Cir.), *cert. denied*, 463 U.S. 1215 (1983); *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 443 (2d Cir.1945); *Restatement (Second) of Law of Foreign Relations* § 18(b), cmt. d. We believe this reasoning applies with equal effect where, although Itoba, ADT's wholly-owned subsidiary, was the nominal purchaser and owner of the Lep stock, it was ADT which financed the deal and which, with its shareholders, ultimately must bear the loss. This is not a case in which Lep's acts "simply [had] an adverse affect [*sic*] on the American economy or American investors generally." *See Bersch, supra*, 519 F.2d at 989. In short, we hold that a sufficient combination of ingredients of the conduct and effects tests is present in the instant case to justify the exercise of jurisdiction by the district court. *See generally Leasco, supra*, 468 F.2d at 1338.

For some reason that is not clear to us, the magistrate judge did not consider it necessary to address specifically Itoba's causes of action against any of the individual defendants. She simply recommended a blanket dismissal of the complaint as to all defendants, which recommendation was adopted without discussion by the district court. We find this particularly troublesome with respect to the defendant Berkley.

On October 8, 1990, Berkley, a United States resident and a Lep director, sold 7,300,000 ordinary shares of Lep to his United States-based broker, New York & Foreign Securities Corporation, which in turn sold these shares for its own account on the London Exchange. Berkley received almost $24 million for his shares. That same day, Itoba purchased 7,500,000 shares on the London Exchange through its London-based broker. Whether the close temporal relationship of these two transactions is or is not coincidental presents an interesting question. After executing this purchase, Itoba and ADT executives learned that the shares they had acquired were owned previously by Berkley. When Itoba brought the instant action, it asserted a separate claim against Berkley based on this Court's "disclose or abstain" rule, which imposes on insiders a duty to disclose material information before trading in their company's securities. *See SEC v. Texas Gulf Sulphur Co., supra*, 401 F.2d at 848. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237 (2d Cir.1974), we held that an insider who fails to comply with his duty to disclose or abstain can be held liable "not only to the purchasers of the actual shares sold by [the insider,] but to all persons who during the same period purchased [the corporation's] stock in the open market without knowledge of the material inside information which was in the possession of [the insider]."

Although we do not presently rule on the issue, it would seem that Berkley's failure to disclose material, nonpublic information prior to selling his Lep shares is the type of behavior that falls under this Rule 10b-5 rubric. Because antifraud provisions are designed to prevent corporate insiders from taking unfair advantage of uninformed outsiders, *Shapiro v. Merrill Lynch, supra*, 495 F.2d at 235 (citing *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir.1972)), Berkley's alleged nondisclosure during a sales transaction executed by two parties within the United States–Berkley and his broker–is the type of conduct that should trigger jurisdiction. *See Roth v. Fund of Funds, Ltd.*, 279 F.Supp. 935, 936-37 (S.D.N.Y.), *aff'd*, 405 F.2d 421 (2d Cir.1968), *cert. denied*, 394 U.S. 975 (1969).

Moreover, it is not clear that Itoba is disabled from asserting its claim because it purchased its shares on a foreign market–the London Exchange. In *Shapiro v. Merrill Lynch, supra*, we held that an inside trader is subject to liability to all purchasers of his corporation's stock on the "open market." 495 F.2d at 237. Whether the "open market" encompasses foreign exchanges is an issue we leave for remand.

NOTES AND QUESTIONS

1. Why are these cases brought in the United States rather than elsewhere?

2. Do these cases help you in advising a foreign corporate client as to when it should be careful not only to avoid fundamental fraud but also to comply with more technical U.S. requirements?

3. *Bersch* dealt with a global fraud affecting plaintiffs all over the world, and presents the current standards for taking jurisdiction on the basis of effects on the United States. (Another case, discussed in Bersch but not presented here, *ITT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975), involved the inverse question–jurisdiction over a securities fraud originating in the United States and affecting foreign plaintiffs.) For additional background on the extraterritoriality issue, see the Restatement of the Foreign Relations Law of the United States (Third) §416. But you should treat cases like *Bersch* not only as raising the classical issues of extraterritoriality but also as raising a practical question: how can the courts and enforcement authorities of different nations cooperate in stopping a global fraud and in providing as equitable a recovery as possible to those who were defrauded?

4. Are the Second Circuit's conduct test and effects test two distinct tests to be separately applied, or are they to be applied cumulatively in any given case involving transnational securities fraud? In answering this question, consider *Itoba, supra*, and the following case.

KAUTHAR SDN BHD v. STERNBERG

149 F.3d 659 (7th Cir. 1998)

RIPPLE, CIRCUIT JUDGE.

[A foreign shareholder brought an action against several defendants, alleging securities fraud, violations of the Racketeer Influenced and Corrupt Organizations Act (RICO), and state law claims arising from its investment in a satellite communications services company. The Northern District of Indiana dismissed the complaint and granted summary judgment for the defendants, and the shareholder appealed. The Seventh Circuit affirmed, holding *inter alia* that jurisdiction over the securities fraud claims involving a transnational transaction existed, since the conduct directly causing the plaintiff's alleged loss occurred in the United States, but that on appeal the shareholder had waived its securities claims relating to fraudulent interstate transactions, public offerings, and control person liability, and that the unwaived securities fraud claims were time barred.]

I
BACKGROUND

A. Facts

This case centers on a $38 million investment made by [Kauthar SDN BHD] in a company called Rimsat, Ltd. Kauthar is a Malaysian corporation with its principal place of business in Kuala Lumpur, Malaysia. Rimsat, whose principal place of business is in Fort Wayne, Indiana, was incorporated in the Caribbean island nation of Nevis for the purpose of providing satellite communications services to customers within the Pacific Rim region. These satellite communications were to be provided using satellites that Rimsat had contracted to purchase from a Russian satellite company. The satellites were

to be placed in geosynchronous (or geostationary) orbit positions ("GSOs") that were leased to Rimsat by a company called Friendly Islands Satellite Communications, Ltd., doing business as "Tongasat." Tongasat is incorporated in the Pacific Rim Kingdom of Tonga.

Apparently, there is a limited number of GSOs available in the world because satellites may not be put in too close proximity to one another or else communications interference occurs. Satellites in geosynchronous orbit, by definition, stay essentially in the same spot over the earth and on the same equatorial plane. Consequently, the number of these spots in space is finite and, as with all scarce resources for which there is demand, they are valuable. The International Telecommunications Union ("ITU") and the International Frequency Registration Board, agencies of the United Nations, coordinate the registration and regulation of GSO positions. Only sovereign nations may apply to the ITU for rights to a GSO position for operation of a satellite. In this case, the Kingdom of Tonga obtained seven GSOs which it leased out to others through its company Tongasat. Rimsat's apparent plan was to make its fortune by buying relatively inexpensive Russian communications satellites, leasing GSOs from Tongasat and selling satellite communications services.

Not surprisingly, such a venture is highly capital-intensive. Rimsat and various of the individual defendants involved in forming Rimsat and Tongasat sought investors for this project. Kauthar allegedly was convinced, on the basis of various communications and meetings, that Rimsat was a worthy investment, and it sank $38 million into the venture through a purchase of Rimsat stock. Kauthar effected this purchase by wiring funds to Rimsat's bank in Fort Wayne, Indiana.

In January 1995, several of Rimsat's creditors forced Rimsat into bankruptcy by filing a petition for involuntary bankruptcy in the United States Bankruptcy Court for the Northern District of Indiana. Six weeks later, when Kauthar realized that its equity stake in Rimsat was worthless, it brought this suit. Essentially, Kauthar alleged in its complaint that all of the parties involved in soliciting its investment in Rimsat intentionally misled Kauthar about the investment. Kauthar specifically points to a document that it terms a "prospectus" that was disseminated by Rimsat to outline the company's investment and business plans. In its 113-page amended complaint, Kauthar identifies alleged misrepresentations contained in the prospectus in addition to other misrepresentations and omissions it alleges were made in the course of dealings. . . .

II

DISCUSSION . . .

A. Securities Fraud Claims

Kauthar alleged in Counts I and II of its complaint violations of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, which relate to fraud in the purchase or sale of a security.[3] In Counts III and IV of its complaint, Kauthar alleged additional securities fraud claims predicated on violations of § 17(a) of the 1933 Act, 15 U.S.C. § 77q, and of § 12(2) of the 1933 Act, 15 U.S.C. § 77l. Before we address the specifics of each claim, we first consider a problem common to all of them.

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3. In addition to the § 10(b) violations, Kauthar's Counts I and II reference violations of § 20(a) of the 1934 Act. Specifically, Kauthar's complaint alleges in Counts I and II "Federal Securities Fraud in Violation of Sections 10(b) and 20(a) of the 1934 Act, 15 U.S.C. §§ 78j(b) & 78(s)." This is puzzling as § 78(s) deals with "Registration, responsibilities, and oversight of self-regulatory organizations," none of which is at issue here. We think that Kauthar means to allege control person liability under § 20(a) of the 1934 Act, as codified at 15 U.S.C. § 78t(a). To the extent that the complaint so alleges, Kauthar's claims for control person liability were dismissed by the district court and we address that decision below.

1. Extraterritorial Application of the Antifraud Securities Statutes

The district court determined that the securities violations alleged by Kauthar in Counts I-IV of its complaint were beyond the ambit of statutory protection because they involved transnational securities transactions without a sufficient connection to the United States. Specifically, the district court held that Kauthar's allegations satisfied neither the "effects" nor the "conduct" analyses employed by federal courts to decide whether the securities acts cover a particular transnational securities transaction. We review this question of law de novo.

Courts have struggled for many years to define with meaningful precision the extent to which the antifraud provisions of the securities laws apply to securities transactions that are predominantly extraterritorial in nature but have some connection to the United States. The courts that have addressed the issue have noted that the question is a difficult one because Congress has given little meaningful guidance on the issue.[5] In addition, resort to the legislative history of the securities acts does little to illuminate Congress' intent in this area. *See, e.g., Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 30 (D.C.Cir.1987) ("If the text of the 1934 Act is relatively barren, even more so is the legislative history. Fifty years ago, Congress did not consider how far American courts should have jurisdiction to decide cases involving predominantly foreign securities transactions with some link to the United States. The web of international connections in the securities market was then not nearly as extensive or complex as it has become.").[a] In fact, some courts have admitted candidly that, in fashioning an approach to the issue of extraterritorial application of the securities laws, policy considerations and the courts' best judgment have been utilized to determine the reach of the federal securities laws.[6]

In dealing with this difficult area we begin, as we always do in matters of statutory interpretation, with the words of the statute. Although the statutory language gives us little guidance, it does give us some clue of the direction we must take. Congress did leave some indication in the language of the securities laws about their intended application to foreign commerce. Section 10(b) prohibits fraud by the "use of any means or instrumentality of interstate commerce or of the mails" in "connection with the purchase or sale of any security." 15 U.S.C. § 78j & (b). "Interstate commerce" is defined to include "trade, commerce, transportation, or communication ... between any foreign country and any State." 15 U.S.C. § 78c(a)(17). A single passage in the statute addresses foreign transactions explicitly. As the District of Columbia Circuit noted in

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5. *See, e.g., Robinson v. TCI/US West Communications, Inc.*, 117 F.3d 900, 904-05 (5th Cir.1997) ("[W]ith one small exception the Exchange Act does nothing to address the circumstances under which American courts have subject matter jurisdiction to hear suits involving foreign transactions."); *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 121 (2d Cir.1995) ("It is well recognized that the Securities Exchange Act is silent as to its extraterritorial application."), *cert. denied*, 516 U.S. 1044 (1996); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 30 (D.C.Cir.1987) (stating that provisions of 1934 Act furnish "no specific indications of when American federal courts have jurisdiction over securities law claims arising from extraterritorial transactions"). *But see SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir.) ("[T]he anti-fraud laws suggest that such [extraterritorial] application is proper. The securities acts expressly apply to 'foreign commerce,' thereby evincing a Congressional intent for a broad jurisdictional scope for the 1933 and 1934 Acts." (citing the preambles to the Acts)), *cert. denied*, 431 U.S. 938 (1977).

a. *Zoelsch* is excerpted *infra* at ▬.

6. *See Robinson*, 117 F.3d at 905 (describing the court's task of determining jurisdiction as " 'fill[ing] the void' created by a combination of congressional silence and the growth of international commerce since the Exchange Act was passed"); *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 416 (8th Cir.1979) (recognizing that its decision "in favor of finding subject matter jurisdiction is largely based upon policy considerations"); *Kasser*, 548 F.2d at 116 (stating that "it should be recognized that this case in a large measure calls for a policy decision"); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir.) ("The Congress that passed these extraordinary pieces of legislation in the midst of the depression could hardly have been expected to foresee the development of offshore funds thirty years later.... Our conclusions rest on ... our best judgment as to what Congress would have wished if these problems had occurred to it."), *cert. denied*, 423 U.S. 1018 (1975).

Zoelsch, 824 F.2d at 30, § 30(b) states that the 1934 Act "shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this chapter." 15 U.S.C. § 78dd(b). The Supreme Court has said that "[i]t 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.'" *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991) (quoting *Foley Bros., Inc. v. Filardo*, 336 U.S. 281, 285 (1949)). But, as some courts have noted,[7] this statutory language suggests that the antifraud provisions were intended to apply to some transnational securities transactions.

Although the circuits that have confronted the matter seem to agree that there are some transnational situations to which the antifraud provisions of the securities laws are applicable, agreement appears to end at that point. Identification of those circumstances that warrant such regulation has produced a disparity in approach, to some degree doctrinal and to some degree attitudinal, as the courts have striven to implement, in Judge Friendly's words, "what Congress would have wished if these problems had occurred to it." *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975).

These efforts have produced two basic approaches to determining whether the transaction in question ought to be subject to American securities fraud regulation. These two approaches (we think that "test" is too inflexible a term to characterize the present state of the case law) focus on whether the activity in question has had a sufficient impact on or relation to the United States, its markets or its citizens to justify American regulation of the situation. Specifically, one approach focuses on the domestic conduct in question, and the other focuses on the domestic effects resulting from the transaction at issue.[8]

When focusing on the effects, the courts seek to determine whether actions "'occurring in foreign countries ha[ve] caused foreseeable and substantial harm to interests in the United States.'" *Mak v. Wocom Commodities Ltd.*, 112 F.3d 287, 289 (7th Cir.1997) (quoting *Tamari v. Bache & Co. (Lebanon) S.A.L.*, 730 F.2d 1103, 1108 (7th Cir.), *cert. denied*, 469 U.S. 871 (1984)). Several cases have examined the type and severity of the harm that must be suffered domestically in order to enable an exercise of jurisdiction.[9] This case, however, affords us no occasion to explore this approach; the record does not reveal sufficient effect on domestic interests to justify its invocation here.

In contrast with the effects analysis, which examines actions occurring outside of the United States, the conduct analysis focuses on actions occurring in this country as they "relate[ ] to the alleged scheme to defraud." *Tamari*, 730 F.2d at 1107. The chronic

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7. *See Continental Grain*, 592 F.2d at 416 & n. 9; *Kasser*, 548 F.2d at 114 & n. 21.

8. The general approach of the courts has been to assume that the securities laws are applicable if either approach so indicates. *See Robinson*, 117 F.3d at 905; *Zoelsch*, 824 F.2d at 30; *Tamari v. Bache & Co.* (Lebanon) S.A.L., 547 F.Supp. 309, 311 (N.D.Ill.1982). We note, however, that the Second Circuit, from which these analytical approaches of conduct and effects originated, has recently stated that they need not "be applied separately and distinctly from each other" and that, in fact, "an admixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court." *Itoba Ltd.*, 54 F.3d at 122. Since the aim of this inquiry is to measure the degree of United States involvement in the transaction in question, the joint assessment of conduct and effects seems appropriate because it permits a more comprehensive assessment of the overall transactional situation.

9. *See generally* George K. Chamberlin, Annotation, *Subject Matter Jurisdiction of Securities Fraud Action Based on Foreign Transactions, under Securities Exchange Act of 1934*, 56 A.L.R. Fed. 288 (1982).

difficulty with such a methodology has been describing, in sufficiently precise terms, the sort of conduct occurring in the United States that ought to be adequate to trigger American regulation of the transaction. Indeed, the circuits that have confronted the matter have articulated a number of methodologies.

The predominant difference among the circuits, it appears, is the degree to which the American-based conduct must be related causally to the fraud and the resultant harm to justify the application of American securities law. At one end of the spectrum, the District of Columbia Circuit appears to require that the domestic conduct at issue must itself constitute a securities violation. *See Zoelsch*, 824 F.2d at 31 ("[J]urisdiction will lie in American courts where the domestic conduct comprises all the elements of a defendant's conduct necessary to establish a violation of section 10(b) and Rule 10b-5.").[10] At the other end of the spectrum, the Third, Eighth and Ninth Circuits, although also focusing on whether the United States-based conduct caused the plaintiffs' loss, to use the Fifth Circuit's words, "generally require some lesser quantum of conduct." *Robinson v. TCI/US West Communications, Inc.*, 117 F.3d 900, 906 (5th Cir.1997). In *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977), the Third Circuit stated that the conduct came within the scope of the statute if "at least some activity designed to further a fraudulent scheme occurs within this country." The Eighth Circuit, in *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 421 (8th Cir.1979), held that the antifraud provisions were applicable when the domestic conduct "was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment." The Ninth Circuit adopted the Continental Grain approach in *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 425 (9th Cir.1983).

Our colleagues in the Second and Fifth Circuits have set a course between the two extremes that we have just discussed. That approach requires a higher quantum of domestic conduct than do the Third, Eighth and Ninth Circuits. *See Robinson v. TCI/US West Communications Inc.*, 117 F.3d 900, 905-06 (5th Cir.1997). The Second Circuit has stated that foreign plaintiffs' suits[11] under the antifraud provisions of the securities laws, such as Kauthar's, will be "heard only when substantial acts in furtherance of the fraud were committed within the United States." *Psimenos v. E.F. Hutton & Co., Inc.*, 722 F.2d 1041, 1045 (2d Cir.1983).[12] Furthermore, if the United States-based activities were merely preparatory in nature, or if the " 'bulk of the activity was performed in

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10. Indeed, in *Zoelsch*, the court expressed doubt "that an American court should ever assert jurisdiction over domestic conduct that causes loss to foreign investors." 824 F.2d at 32. In adopting this restrictive approach, the District of Columbia Circuit claimed to adopt expressly the Second Circuit's methodology. *See id.* at 33. We share the reservations of the Fifth Circuit as to whether the District of Columbia Circuit accurately portrayed the Second Circuit's jurisprudence. *See Robinson*, 117 F.3d at 905 n. 10. Rather, we believe that the Fifth Circuit more accurately mirrored the Second Circuit's approach, which it articulated as: "Where (as here) the alleged fraud is in connection with a sale of securities to a foreigner outside the United States, the federal securities laws apply only if acts or culpable failures to act within the United States directly caused the plaintiff's loss." *Robinson*, 117 F.3d at 905.

11. The Second Circuit had distinguished the conduct analysis' requirements with respect to the residence and citizenship of the security purchasers in its earlier decision in *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir.), cert. denied, 423 U.S. 1018 (1975).

12. In *Psimenos*, a case brought under the Commodity Exchange Act, the Greek plaintiff alleged fraud in the defendant's managers' handling of his commodities transactions. Although the court noted that "most of the fraudulent misrepresentations alleged in the complaint occurred outside the United States," it found the conduct analysis was satisfied because a pamphlet emanating from the defendant's New York office indicated that the managers would be supervised and because the alleged fraud was completed "by trading domestic futures contracts on American commodities exchanges." 722 F.2d at 1044, 1046. Other cases have indicated that effecting transactions on exchanges in America is sufficient conduct in the United States to satisfy the conduct test. *See, e.g., Tamari*, 730 F.2d at 1108 (adopting district court's analysis that wiring of orders for commodity transactions to the United States and execution of those orders on Chicago exchanges was sufficient conduct to satisfy the conduct test).

foreign countries,' " jurisdiction will not exist. *Id*. at 1046 (quoting *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1018 (2d Cir.1975)). In addition, only "where conduct 'within the United States directly caused' the loss will a district court have jurisdiction over suits by foreigners who have lost money through sales abroad." *Id.* (quoting *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975)); *see also Vencap,* 519 F.2d at 1018.

Although this court has not had occasion to articulate an approach to the extraterritorial application of the securities laws, we have employed these concepts with respect to analogous actions brought under the Commodity Exchange Act. *See Mak*, 112 F.3d at 288-89; *Tamari*, 730 F.2d at 1107 & n. 11. In that context, we have stated that "[w]hen the conduct occurring in the United States is material to the successful completion of the alleged scheme, jurisdiction is asserted based on the theory that Congress would not have intended the United States to be used as a base for effectuating the fraudulent conduct of foreign companies." *Tamari*, 730 F.2d at 1108. We think that our approach under the Commodities Act ought to be followed with respect to the securities laws and, although stated more generally, that it represents the same midground as that identified by the Second and Fifth Circuits. In our view, the absence of all but the most rudimentary Congressional guidance counsels that federal courts should be cautious in determining that transnational securities matters are within the ambit of our antifraud statutes. Nevertheless, we would do serious violence to the policies of these statutes if we did not recognize our Country's manifest interest in ensuring that the United States is not used as a "base of operations" from which to "defraud foreign securities purchasers or sellers." *Kasser*, 548 F.2d at 116. This interest is amplified by the fact that we live in an increasingly global financial community. The Second and Fifth Circuit's iterations of the test embody a satisfactory balance of these competing considerations. This analytical pattern will enable the courts to address situations in which the United States is being used as a launching pad for fraudulent international securities schemes. At the same time, it will cause us to refrain from adjudicating disputes which have little in the way of a significant connection to the United States.

We believe, therefore, that federal courts have jurisdiction over an alleged violation of the antifraud provisions of the securities laws when the conduct occurring in the United States directly causes the plaintiff's alleged loss in that the conduct forms a substantial part of the alleged fraud and is material to its success. This conduct must be more than merely preparatory in nature; however, we do not go so far as to require that the conduct occurring domestically must itself satisfy the elements of a securities violation.

We turn now to an application of these principles to Kauthar's allegations. Kauthar argues that a host of alleged general activities undertaken by various of the defendants constitutes conduct that was part of the scheme to defraud Kauthar and to solicit Kauthar's investment in Rimsat. Kauthar alleges that various documents containing fraudulent misrepresentations and omissions were prepared in the United States and were sent to it by wire and by the United States mail in an effort to obtain Kauthar's investment. Kauthar also alleges that phone calls were made from Fort Wayne, Indiana, and from San Diego, California, for the same purpose. Kauthar further alleges that the defendants had meetings and phone conversations in the United States to discuss the deceptive information contained in the prospectus and to "ultimately agree upon a plan to obtain equity funding from Kauthar by means of false and deceptive statements of fact." . . . Thus, according to the complaint, the United States was utilized as a base of operations from which to launch the defendants' fraudulent scheme to defraud Kauthar.

Moreover, Kauthar also alleges a set of specific acts that, in combination with those already mentioned, satisfy the conduct analysis. Specifically, Kauthar alleges that it wired the payment for the Rimsat securities, over $38 million, in six installments to Rimsat's bank account in Fort Wayne, Indiana. Therefore, Kauthar has alleged that the defendants conceived and planned a scheme to defraud Kauthar in the United States, that they prepared materials in support of the scheme to solicit the payment in the United States and sent those materials from the United States via the United States mail, and that they received in the United States the fraudulently solicited payment for the securities–the final step in the alleged fraud. We think these allegations sufficient to bring the alleged conduct within the ambit of the securities laws. We are therefore constrained to disagree respectfully with the district court's contrary conclusion. . . .

C. MODIFYING THE SCHOENBAUM DOCTRINE

Several pressures have worked to modify the *Schoenbaum* doctrine of relatively extensive extraterritorial jurisdiction for securities fraud. First of all, this area has *not* had a *Timberlane* to convert into a balancing test the (relatively) sharp-edged tests just described. Second, the Supreme Court has sought to restrict the expansion of 10b-5 in places where it arguably infringes on state law. These issues are both posed in the following case, *IIT v. Cornfeld*. To understand *Cornfeld,* it is useful to begin by noting that, as already mentioned, the Second Circuit decided still a third case, *IIT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975), at roughly the same time as *Leasco* and *Bersch*. This case held that the security laws reached to the "manufacturing of fraudulent securities devices for export." This concept, the reverse of protecting the U.S. investor, provides the underlying basis for jurisdiction in *Cornfeld.*

But *Cornfeld* also raises the substantive issues that troubled the Supreme Court, issues close to those that divided the original panel opinion from the en banc opinion in *Schoenbaum*, and the key case is *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), in which minority shareholders were held unable to use 10b-5 to attack a domestic transaction somewhat similar to that of *Schoenbaum.* In *Santa Fe Industries*, the Supreme Court relied on the absence of a misrepresentation in the case before it:

> [T]he cases do not support the proposition, adopted by the Court of Appeals below and urged by respondents here, that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule.

Shareholders in such a position are thus remanded to state law remedies. Nevertheless, the Second Circuit sought to narrow the impact of *Santa Fe Industries* by defining "deception" quite broadly in *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1978), *cert. denied*, 434 U.S. 1069. Under *Goldberg*, there can be a 10b-5 action if the insiders harm a group of shareholders and there is nondisclosure or misleading disclosure. There may also have to be reliance on the misrepresentation; this typically means that the harmed shareholders would have had a chance to vote on the corporate action or bring a suit against it, had they known what was being done.

IIT v. CORNFELD

619 F 2d 909 (2d Cir. 1980)

FRIENDLY, J.

I. IIT's Transactions in King-Related Securities

Many members of the cast of characters in this case are not new to our courtroom. Plaintiff-appellant IIT, an International Investment Trust, was organized under the laws of the Grand Duchy of Luxembourg in 1961. Before it and its liquidators were forced to spend most of their time in court,[3] IIT provided an investment vehicle by which fundholders could participate in a portfolio of securities chosen and managed by allegedly "[q]ualified professional investment counsel." IIT was controlled and managed by IIT Management Company, S.A. (Management), a Luxembourg corporation, which was in turn controlled by its parent Investors Overseas Services. Ltd. (IOS). first a Panamanian and then a Canadian corporation whose "troubled existence", *see* 519 F.2d at 1003, has spawned many actions besides the present one. Both Management and IOS were operated out of Geneva, Switzerland, although plaintiffs allege that "all the top persons" controlling the once vast financial empire were Americans, notably Bernard Cornfeld and Edward M. Cowett. The transactions which form the basis of IIT's complaint occurred before Cornfeld lost control of IOS to Robert Vesco.

IIT currently has 144,496 fundholders residing in 154 countries. Some 218 reside in the United States, although it is unclear how many of these are American citizens. At the height of its prosperity in the late I 960s and early 1970s, ITT held assets worth $375 million, about forty percent of which were in American securities. This prosperity, however, was short-lived. Late in 1972 the Securities and Exchange Commission charged that Vesco was looting the assets of the IOS funds and, in the wake of the resulting scandal, the Grand Duchy of Luxembourg placed all Luxembourg investment funds under supervision of the Bank Control Commissioner. One year later, upon petition of that Commissioner, the Luxembourg district court declared IIT an involuntary bankrupt. Georges Baden, Jacques Delvaux, and Ernest Lecuit were appointed liquidators of the fund and are co-plaintiffs in this action.

The transactions giving rise to the present case, which occurred between January 16 and October 26, 1969, involved three series of acquisitions by IIT of securities related to a complex of companies controlled by one John M. King, an American oil and gas entrepreneur based in Denver. King allegedly controlled King Resources Company (KRC), a publicly traded Maine corporation, and The Colorado Corporation (TCC), a private company largely owned by him. Both the public side of the King complex (KRC) and the private side (TCC) bought and sold natural resource properties and offered a variety of investments in the nature of tax shelters. The two companies had numerous subsidiaries. One of these, King Resources Capital Corporation, N.V. (KRCC), a wholly-owned Netherlands Antilles subsidiary of KRC, figures prominently in this case. Like IIT, King and his companies have fallen on hard times, but were not named as defendants in this action because stays were issued by courts in bankruptcy proceedings involving them.

IIT's first acquisition of King-related securities occurred between January 16 and October 26, 1969, during which period IIT bought about $8 million face value of KRCC

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3. . . . The liquidators of IIT list no less than thirteen actions which they have litigated or are litigating on IIT's behalf in federal district courts from Puerto Rico to Colorado.

subordinated convertible debentures. The debentures had been issued in Europe on November 27, 1968, to raise $15 million in the eurodollar market. This offering was closely coordinated with a domestic offering of an additional $25 million in debentures of KRC which occurred on November 26. The KRCC debentures were guaranteed by KRC and convertible into KRC common stock. The bulk of IIT's purchases were made abroad, although IIT alleges it purchased $50,000 face value of the debentures through defendant Arthur Lipper Corporation (Lipper) in the United States. IIT sold its KRCC debentures between July 28, 1970 and February 5,1971 at a loss of $8,765,698.

IIT's second acquisition of King-related securities was the purchase between January 16 and March 20, 1969, of 200,000 shares of KRC common stock. IIT purchased its shares in the United States over-the-counter market for $16.8 million, availing itself of the brokerage services Lipper performed for IIT and the other members of the IOS complex. These shares were sold between October 6 and November 4, 1970, at a loss of approximately $14 million.

IIT's final acquisition of King-related securities was a July, 1969 purchase of a $12 million 15 year convertible note from TCC. . . . TCC defaulted on the note and has never paid any principal or interest to IIT. As noted, TCC is now in bankruptcy. . . .

According to the complaint and various affidavits and memoranda submitted by plaintiffs in the district court, the three . . . transactions outlined above were the result of a conspiracy to defraud IIT between those in control of IOS and Management, together with Lipper and those in control of the King complex. The King empire allegedly required "continuous injections of vast sums of cash to survive," some of which it obtained from IIT's purchases. For their part, the IOS and Management defendants received personal kickbacks, opportunities to join in KRC tax avoidance schemes, and the ability to over-value King-related assets so as to increase their management fees and performance bonuses. Lipper, the United States broker for the IOS complex, was allegedly involved in all three transactions. Its recompense included not only the sizable commissions it gained from the IOS brokerage business but also a special right, allegedly given in connection with the TCC note transaction, to purchase 10,000 shares of TCC stock at what was thought to be a bargain price. Lipper and individuals at Lipper also allegedly partook of KRC investment and tax avoidance schemes involving projects as diverse as the development of Sinai oil properties and the leasing of jet aircraft. . . .

III. The District Court's Reasons For Finding Lack of Subject-Matter Jurisdiction

Judge Goettel began his discussion of subject-matter jurisdiction by rejecting the argument that Rule 10b-5 applied to the transactions here in question because of their effects within the United States. Distinguishing *Schoenbaum, supra,* because the victim in that case was a corporation whose shares were listed on the American Stock Exchange, with a substantial minority *of* American shareholders, he cited *Bersch, supra,* as holding that an unparticularized. deleterious effect on the American economy from lessened ability to attract offshore investment funds did not provide the necessary effect, . . . and *Vencap, supra,* as holding that such effect was not provided "simply because half of one percent" of the shares of the allegedly defrauded fund were "held by Americans." . . . In this the judge was clearly right, and we need say no more about "effects" as a basis of subject-matter jurisdiction save in one respect noted in Part V below.

Turning to jurisdiction based on acts within the United States, the judge focused on the complicity of Management in all the fraudulent transactions. He thought that "[s]o long as the derivative action is one alleging total cornplicity on the part of foreign

management, the ultimate focus of the theory remains a deception of foreign fundholders by foreign 'directors'." . . . "Since virtually all the fundholders were foreign nationals residing in foreign countries, the deception, if it could be proved, *must* have occurred outside of the United States." . . . (emphasis in original). Furthermore, insofar as our decision in *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir, 1977), *cert. denied*, 434 U.S. 1069 (1978), relied, as regards causation, on the ability of the deceived shareholders to have sought injunctive relief if they had known the facts, the court thought this case to differ from "a domestic case", . . . because, for reasons not clearly stated and somewhat contradicted [elsewhere in the opinion], it assumed that any such suit would have had to be brought in Luxembourg. This would place "the plaintiffs in a curious position in that by establishing their right to an injunction under Luxembourg law, they could prove 10b-5 materiality; simultaneously, however, they would be offering a good reason not to apply Rule 10b-5 to the transactions, since the availability of relief under foreign law would then be at least partially evident." Viewing the action as one that had "its genesis abroad . . . with a group of foreign managers of a foreign investment trust violating what would appear to be their fiduciary duties to their fundholders, and the foreign managers merely enlisting the aid of American aiders and abettors", . . .the court found no basis for subject-matter jurisdiction, even as to transactions consummated within the United States. . . .

We see no sufficient ground for this characterization of the transactions here at issue. Our decision in *Goldberg v. Meridor, supra*, did not find the nub of the action to be the directors' breach of fiduciary duty to the shareholders, *see* 567 F.2d at 221; indeed, that was the very ground that had been ruled out by *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977). The holding rather was that, as we said in speaking of *Schoenbaum*, an action under Rule 10b-5 can lie if "there is deception of the corporation (in effect, of its minority shareholders) when the corporation is influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests (in effect, the minority shareholders' interests) and there is nondisclosure or misleading disclosures as to the material facts of the transaction." 567 F.2d at 217. The basic principle was that where the directors are parties to the fraud, deception, as stated by Chief Judge Seitz in *Pappas v. Moss*, 393 F.2d 865, 869 (3d Cir. 1968), "is fairly found by viewing this fraud as though the 'independent' stockholders were standing in the place of the defrauded corporate entity. . . ." The relevance of the wrongdoing of the directors and managers is in relieving the corporation of having their knowledge attributed to it. The judge was thus mistaken in viewing all the American participants, even including the King group, as mere aiders and abettors of Management in perpetrating a fraud on IIT. While that is a fair description of the asserted role of Andersen, the underwriter defendants and perhaps even Upper, the members of the King complex and other defendants were claimed to have been perpetrators of a fraud upon the fundholders, and the three sets of defendants here before us could be held, on proper allegations, for aiding and abetting a deception originating in the United States. An actual participant in a fraud is no less a principal because someone else originated the plan. IIT and its liquidators are complaining of deception practices on IIT by both the King complex, whose acts were primarily in the United States, and Management, whose acts were mainly outside it, both allegedly aided and abetted by the defendants here before us, without any attribution to IIT of knowledge on the part of Management. The ability of such a victim to maintain such an action was decided in *Goldberg*, we see no reason to depart from that decision, and we shall discuss subject-matter jurisdiction in that light.

IV. Subject-Matter Jurisdiction: The King Resources Common and TCC

Convertible Note Transactions

So viewing the case, we have no difficulty in finding subject-matter jurisdiction with respect to IIT's purchases of the KRC common stock and the TCC convertible note. Apart from the fact that these were securities of American corporations, the transactions were fully consummated within the United States. . . . We see nothing foreign in this transaction except that the purchaser was a foreigner and the orders were transmitted from abroad, by a devious method whereby Management advised the Montreal Trust Company in Toronto, the custodian of IIT's securities, to receive the KRC common stock through its sub-custodian, with payment to Lipper's London office to ne made by IIT's cash custodian, Credit Suisse. None of our cases or any others intimate that foreigners engaging in security purchases in the United States are not entitled to the protection of the anti-fraud provisions of the securities laws.

V. Subject-Matter Jurisdiction: The KRCC Convertible Debentures

The defendants stress that IIT purchased its KRCC eurodollar convertible debentures, except perhaps for the $50,000 purchased from Lipper, in the European after-market. They argue that lack of jurisdiction over these purchases follows from our conclusion in *Bersch, supra*, . . . that the anti-fraud provisions of the federal securities laws "[d]o not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses", since with the exception noted all purchases were made abroad. When the quoted statement is read in the context of the facts in *Bersch*, it does not have the effect contended.

The first difference is that in *Bersch* we were dealing wholly with foreign securities. All three of the offerings were of common stock of IOS, Ltd., a Canadian corporation having its center of activities in Geneva, Switzerland. The prospectuses for the primary offering of the shares underwritten by the Drexel group for the 5,600,000 share offering and for the secondary 3,950,000 share offering by IOB, of which the shares involved in the action were a part, stated that the shares "are not being offered in the United States of America or any of its territories or possessions or any area subject to its jurisdiction"; the secondary offering of 1,450,000 shares underwritten by J.H. Crang & Co. of Toronto was sold entirely in Canada. Here the primary offering was of $25,000,000 of KRC debentures, United States securities offered in the American market. The offering of $15,000,000 of KRCC eurodollar' bonds was, in substance, an integral part of this financing. There is abundant evidence that the United States and foreign offerings were closely coordinated; while this was also true of the three offerings in *Bersch*, . . . there none of the offerings was of an American security or was made domestically to anywhere near the same extent as the coordinated debenture offerings, $25,000,000 in the United States and $15,000,000 abroad, in this case. Although the eurodollar debentures were nominally the obligations of a wholly owned Netherlands Antilles subsidiary of KRC, this corporation was inserted into the total offering simply because European investors were reluctant to purchase debentures issued directly by an American corporation, since interest payments would then be subject to United States withholding tax. The Netherlands Antilles corporation had no operating assets, the debentures issued by it were guaranteed by KRC, and they were convertible into KRC common stock. We have previously refused to be deterred from considering the real facts by the interposition of a foreign subsidiary of this kind. *Leasco, supra*. . . .

The fact that we are dealing here with debentures which in substance were American rather than foreign securities has bearings of several sorts. The first goes back to the effects test. We think Congress would have been considerably more interested in

assuring against the fraudulent issuance of securities constituting obligations of American rather than purely foreign business. Our statement in *Vencap, supra,* . . . : "We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners" applies with even greater force when, as here, the securities are essentially American. Our very next sentence, . . . "This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States" reads with particular strength on a situation where the securities are essentially of the pourer's own nationals. This concern is only partially diminished by the fact that the prospectus for the eurodollar offering stated that the securities were not registered under the Securities Act of 1933 and were not being offered within the United States or to Americans, and by the SEC's grant of no-action treatment under the 1933 Act. None of this amounts to saying that if fraud had been committed in the United States in connection with the issuance of the debentures, American courts would look away. *See Bersch, supra.* . . .

Here there was also greater relative American participation than in *Bersch* in other respects. While two of the six underwriters of the primary offering in *Bersch* were American banking houses, these had European offices from which they apparently did much of their work, and all the others and the underwriters of the two secondary offerings were foreigners. Here Dempsey-Tegeler & Company, Inc., an American firm, was the sole lead underwriter of the dollar offering and co-lead underwriter of the eurodollar offering along with a Luxembourg bank.

Perhaps most important of all, a consequence of the KRCC debentures being essentially of an American security is that the activities occurring in the United States, which on their surface may appear similar to those held in *Bersch* to be "merely preparatory" and thus insufficient to have "directly caused" loss to foreigners, assume a different aspect. The fact that the drafting of the final prospectus in *Bersch* was done in Europe was not just "a formal or ultimate act . . . staged in Europe", as the *Bersch* district court found. . . . The *Bersch* prospectus was mainly drafted in Europe because that was where IOS' records and principals were. Here the prospectus was wholly drafted in the United States because the offering, for largest part in form and for all in substance, was of securities of an American based corporation. Similarly while there was some domestic accounting work in *Bersch,* . . . most of the field work was and in the nature of things had to be done abroad. Here all the accounting work was and had to be done in the United States. Similarly the fact that the prospectuses in *Bersch* were printed in Europe while those in this case (including the prospectus for the eurodollar offering) were printed in the United States, while not of particular significance in and of itself, reflects the fact that in *Bersch* the work on the prospectuses had mainly been done in Europe, so that Europe was the natural place for printing, whereas here most of the work had been done in the United States and there was no reason to ship the prospectus elsewhere for printing. In sum while many of the acts in the United States in this case were similar to those in *Bersch,* the relativity is entirely different because of the lack here of the foreign activity so dominant in *Bersch* . . . ("We see no reason to extend [jurisdiction] to cases where the United States activities . . . are relatively small in comparison to those abroad.") Determination whether American activities "directly" caused losses to foreigners depends not only on how much was done in the United States but also on how much (here how little) was done abroad.

We see little force in defendants' argument that sustaining jurisdiction here will somehow affront Luxembourg. The problem of conflict between our laws and that of a

foreign government is much less when the issue is the enforcement of the anti-fraud sections of the securities laws than with such provisions as those requiring registration of persons or securities. The primary interest of Luxembourg is in the righting of a wrong done to an entity created by it. If our anti-fraud laws are stricter than Luxembourg's, that country will surely not be offended by their application, If they are weaker–which is not seriously suggested–the liquidators made their choice, doubtless at least in part because of difficulty in securing personal jurisdiction in Luxembourg, and after Andersen attacked their capacity, . . . they obtained a second order from the Luxembourg district court reaffirming their right, so far as Luxembourg was concerned, to bring suit on behalf of the fundholders. The defendants with whom we are here concerned acted in the United States and cannot fairly object to having their conduct judged by its laws. . . .

NOTES AND QUESTIONS

1. Is *Cornfeld* consistent with *Leasco* and *Bersch*? Implied by them? This extension (to manufacturing securities frauds for export) has often been criticized. Is this criticism reasonable?

2. If the more refined analysis of *Cornfeld* were applied back to the *Schoenbaum* (I) facts, would it still be appropriate for the U.S. court to take jurisdiction?

3. All questions of technical jurisdiction aside, is it not reasonable for a U.S. court to give jurisdiction to the representative of a foreign court that has undeniable jurisdiction over some aspects of the cases and a plausible claim to have the right and duty to marshal assets from throughout the world?

4. Is there any sense in taking rules written to draw a line between federal and state jurisdiction and applying them to derive a line between federal and foreign jurisdiction? What about the possibility of a foreign action in a U.S. state court?

5. Would a reasonable rule (or perhaps the actual rule being applied covertly) be to take jurisdiction in a securities fraud case wherever any remaining assets can be found? For an example implicitly suggesting such a rule, *see* SEC v. Kasser, 548 F.2d 109 (3d Cir, 1977), *cert. denied sub nom. Churchill Forest Industries (Manitoba) v. SEC*, 431 U.S. 938 (1977).

6. Why is the U.S. extension of extraterritorial jurisdiction in this area producing much less international conflict than in the antitrust area?

7. What kinds of cooperation would you propose for dealing with future securities fraud? How much are the forms administrative rather than judicial?

8. Suppose the parties to a securities transaction specify application of foreign law and decision in a foreign court. When should a U.S. court decline jurisdiction? *See AVC Nederland B.V. v. Atrium Investment Partnership*, 740 F.2d 148 (2d Cir, 1984).

9. Suppose that AMSUB is the Panamanian subsidiary of a multinational U.S. manufacturing firm, ZEECO. As is typical of Panamanian subsidiaries, this subsidiary holds profits from various foreign operations to protect them from U.S. taxes. In what may be a somewhat unusual pattern, AMSUB has been investing these funds in Eurobonds issued by developing nations. One of these nations, Guatador, has recently faced severe difficulties in making payments on its bonds, and the value of the bonds has fallen sharply. There are strong indications that Guatador misrepresented its financial situation at the time of' the Eurobond borrowing and that the prospectus circulated by the European underwriter firm from whom AMSUB bought the bonds contained significant misrepresentations. (The bonds, of course, were not registered in the United

States.) ZEECO has approached you to ask about a 10b-5 suit by AMSUB and ZEECO in the United States against Guatador and the European underwriter (assuming that *in personam* jurisdiction will be available against the latter). What would you say?

10. Assume that the international controversy over the Westinghouse Uranium litigation continues to become nastier and nastier. Several key congressmen, incensed over various foreign efforts to keep evidence away from U.S. courts and to avoid the effects of U.S. treble-damage judgments, have introduced a new bill. This proposed legislation would amend the U.S. securities legislation to require that any foreign firm that is named as a defendant in any public or private U.S. antitrust litigation and fails to produce evidence that it is directed to provide by the U.S. court shall be required to file the information publicly as a condition of registration (ot of exemption from the duty to register, where that is the wording of the security laws) of its securities for sale in the United States. In short, the legislation proposes making access to the U.S. securities market conditional on compliance with the information requests of U.S. courts.

You are chairperson of a special study group for the New York Bar Association, whose task is to comment on this legislative proposal. That study group's preliminary discussions make it clear that the memorandum, if it is to have any political weight at all, will have to deal with both the wisdom of the specific legislative proposal and the underlying problem of evidence in the e extraterritorial application of U.S. antitrust law. What would you say?

11. Andersen-Nusquam is a Nusquami subsidiary of H.C. Andersen (HCA), a U.S. accounting firm. One of Andersen-Nusquam's clients is Uppan Komin, Ltda. (Uppan), a Nusquami corporation in the fluff business. Business is good, and Uppan has decided to go public by offering Ø10 million[1] worth of newly issued common stock to citizens of countries in the Greater Nusquami Economic Union, a regional group that includes Nusquam. No shares will be offered in the United States or to U.S. citizens. Business may be good, but Anderson-Nusquam cannot make the financial data reflect this. It electronically transmits data to HCA's international division for advice. The division head transmits back "adjusted" financial data reflecting Uppan's successful operations. Andersen-Nusquam prepares the final version of the data, which is included in Uppan's prospectus, based entirely upon the advice received from HCA. It turns out that business in fact is not so good; Uppan is liquidated by government receivers shortly after the offering is completed. Since the proceeds of the public offering had been consumed in a vain effort to meet Uppan's debt obligations, its public investors are likely to receive nothing from the liquidation. One such investor has asked you whether a suit against HCA in federal district court alleging securities fraud, might be successful. In considering how to advise the investor, consider the following case.

ZOELSCH v. ARTHUR ANDERSEN & CO.

824 F.2d 27 (D.C. Cir. 1987)

BORK, CIRCUIT JUDGE:

I.

The transactions that led to this lawsuit involved four principal participants. Dr. Loescher und Co. KG ("Loescher") is a West German limited partnership. First American International Real Estate Limited Partnership ("FAIR") is an American limited

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1. The official exchange rate of the Nusquami Slug is US$ 1 = Ø 10.

partnership based in Miami, Florida. Arthur Andersen & Co. GmbH ("GmbH") is a West German limited liability corporation. Arthur Andersen & Co. ("AA-USA"), the sole defendant in this case, is an American general partnership organized under the laws of Illinois.

Zoelsch and the other West Germans invested in an intricate investment and tax shelter plan. Under the plan, their funds were placed either directly with Loescher, or indirectly with another West German entity that is a limited partner of Loescher. In either case, the investors understood that their funds would be channeled through these entities to FAIR. FAIR, in turn, would invest the funds in property and condominium conversions in Memphis, Tennessee, and Atlanta, Georgia.

In April of 1981, Loescher and FAIR entered into an investment agreement. In September of 1981, Loescher commissioned GmbH to prepare an audit report on the entire plan, including an analysis of FAIR's written description of the American investments. Within the month, GmbH issued its report. Loescher then solicited investors by distributing a package of materials to them, which included GmbH's audit report and FAIR's materials. It is undisputed that FAIR's materials were prepared in the United States, that the audit report was prepared in West Germany, and that the package of materials was distributed only in West Germany to West German investors. The investments were not successful, and Zoelsch's complaint alleges that he and the other investors detrimentally relied on a number of false representations and material omissions in the audit report.[1] . . .

Zoelsch's complaint alleged that AA-USA provided false and misleading information to GmbH with ample reason to know that this information would be incorporated in GmbH's audit report and would be relied on by investors such as Zoelsch. . . . Zoelsch alleged fraud in connection with the sale of securities and the aiding and abetting of securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934 and its attendant Rule 10b-5. *See* 15 U.S.C. § 78j(b) (1982); 17 C.F.R. § 240.10b-5 (1985). . . .

II.

A.

The issue, not previously addressed in this circuit, is American court jurisdiction over securities law claims against a defendant who acted in the United States when the securities transaction occurred abroad and there was no effect felt in this country.

Congress can, of course, prescribe the extent of federal jurisdiction over actions to enforce the federal securities laws, so long as it does not overstep the broad limits set by the due process clause. *See, e.g., Leasco Data Processing Equip. Corp. v. Maxwell,* 468 F.2d 1326, 1334 (2d Cir.1972). But in the Securities Exchange Act of 1934, Congress said little that bears on this issue. The explicit purposes of the Act are:

> to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and

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1. Among the misrepresentations and omissions alleged by Zoelsch are the following: that his investment would be registered as a silent investment; that FAIR had a $2 million paid-in equity; that FAIR's capitalization was sufficient to assure successful implementation of the investment plan; that FAIR was the actual owner of certain apartments in Memphis; that FAIR had purchased a particular building for $8 million; and that the building purchased was leased and economically viable. . . .

> make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions.

15 U.S.C. § 78b (1982). The relevant language of section 10(b) prohibits "any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails" from using "in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance" proscribed by the SEC. *Id.* § 78j(b). "Interstate commerce" is broadly defined to include "trade, commerce, transportation, or communication ... between any foreign country and any State." *Id.* § 78c(a)(17). And the federal district courts are given exclusive jurisdiction of suits brought to enforce the securities laws. *See id.* § 78aa. These provisions frame a fairly broad grant of jurisdiction, but they furnish no specific indications of when American federal courts have jurisdiction over securities law claims arising from extraterritorial transactions.

A single passage in the statute addresses this issue explicitly. Section 30(b) states that the 1934 Act "shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this chapter." 15 U.S.C. § 78dd(b) (1982). But AA-USA is not alleged to have transacted a business in securities anywhere. Nevertheless, as will be seen, . . . section 30(b) gives some reinforcement to the conclusion that there is no jurisdiction to entertain Zoelsch's claims.

If the text of the 1934 Act is relatively barren, even more so is the legislative history. Fifty years ago, Congress did not consider how far American courts should have jurisdiction to decide cases involving predominantly foreign securities transactions with some link to the United States. The web of international connections in the securities market was then not nearly as extensive or complex as it has become. In this state of affairs, our inquiry becomes the dubious but apparently unavoidable task of discerning a purely hypothetical legislative intent. As Judge Friendly candidly put it in a very similar case:

> We freely acknowledge that if we were asked to point to language in the statutes, or even in the legislative history, that compelled these conclusions, we would be unable to respond. The Congress that passed these extraordinary pieces of legislation in the midst of the depression could hardly have been expected to foresee the development of offshore funds thirty years later.... Our conclusions rest on ... our best judgment as to what Congress would have wished if these problems had occurred to it.

Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 993 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975).

B.

The courts have not confined federal jurisdiction to securities transactions consummated in the United States. They have deviated from this position in two respects. First, they have asserted jurisdiction over extraterritorial conduct that produces substantial effects within the United States, such as effects on domestic markets or domestic investors. *See, e.g., Schoenbaum v. Firstbrook*, 405 F.2d 200, 206-08 (2d Cir.), *partially rev'd on other grounds*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969). Second, they have asserted jurisdiction in some cases over acts done in the United States that "directly caused" the losses suffered by investors outside this country.

See, e.g., Bersch, 519 F.2d at 991-93.

Zoelsch concedes that jurisdiction in this case cannot be premised on domestic "effects" of predominantly foreign conduct, . . . and "[j]urisdiction may not be sustained on a theory that the plaintiff has not advanced." *Merrell Dow Pharmaceuticals Inc. v. Thompson,* 478 U.S. 804 (1986). Zoelsch relies on AA-USA's domestic conduct as the basis for jurisdiction.

Several tests have been devised for determining when American courts have jurisdiction over domestic conduct that is alleged to have played some part in the perpetration of a securities fraud on investors outside this country. The Second Circuit has set the most restrictive standard. It has declined jurisdiction over alleged violations of the securities laws based on conduct in the United States when the conduct here was "merely preparatory" to the alleged fraud, that is, when the conduct here did not "directly cause" the losses elsewhere. *See, e.g., Bersch,* 519 F.2d at 992-93; *IIT v. Vencap, Ltd.,* 519 F.2d 1001, 1018 (2d Cir.1975). In later cases, the line between domestic conduct that is "merely preparatory" and conduct that "directly causes" the losses elsewhere has been significantly clarified. The Second Circuit's rule seems to be that jurisdiction will lie in American courts where the domestic conduct comprises all the elements of a defendant's conduct necessary to establish a violation of section 10(b) and Rule 10b-5: the fraudulent statements or misrepresentations must originate in the United States, must be made with scienter and in connection with the sale or purchase of securities, and must cause the harm to those who claim to be defrauded, even though the actual reliance and damages may occur elsewhere. *See IIT v. Cornfeld,* 619 F.2d 909, 920-21 (2d Cir.1980); *cf. Vencap,* 519 F.2d at 1018 (finding of jurisdiction "is limited to the perpetration of fraudulent acts themselves"); *Leasco,* 468 F.2d at 1335 ("if defendants' fraudulent acts [occurred] in the United States ... it would be immaterial ... that the damage resulted, not from the contract ... procured in this country, but from interrelated action which he induced in England").

The Third, Eighth, and Ninth Circuits appear to have relaxed the Second Circuit's test. They too have asserted jurisdiction only when the conduct in this country "directly causes" the losses elsewhere. *See SEC v. Kasser,* 548 F.2d 109, 115 (3d Cir.), *cert. denied,* 431 U.S. 938 (1977); *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc.,* 592 F.2d 409, 418-20 (8th Cir.1979); *Grunenthal GmbH v. Hotz,* 712 F.2d 421, 424 (9th Cir.1983). But in *Continental Grain* the court explicitly repudiated the Second Circuit's requirement that "domestic conduct constitute the elements of a rule 10b-5 violation," 592 F.2d at 418, in favor of a test that would find jurisdiction whenever the domestic conduct "was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment." *Id.* at 421. The Third Circuit's formulation seems more permissive, allowing subject matter jurisdiction "where at least some activity designed to further a fraudulent scheme occurs within this country." *Kasser,* 548 F.2d at 114. The consequence of these approaches has been a loosening of the jurisdictional requirements: any significant activity undertaken in this country–or perhaps any activity at all–that furthers a fraudulent scheme can provide the basis of American jurisdiction over the domestic actor.

C.

We believe that a more restrictive test, such as the Second Circuit's, provides the better approach to determining when American courts should assert jurisdiction in a case such as this. There is no doubt, of course, that Congress could confer jurisdiction over activity like that alleged to have been engaged in by AA-USA. Moreover, considerations of comity, which will often cause a court to stay its hand, appear to be minimal or

nonexistent here. Appellants do not seek to have us assert jurisdiction over West German parties, nor would a judgment about AA-USA's conduct in the United States necessarily or even probably require a pronouncement on the propriety of the behavior of the West German parties. The case going forward in the Federal Republic would likely be unaffected by this case. Nevertheless, we think we should not assert jurisdiction.

We begin from the established canon of construction that "legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States," which "is based on the assumption that Congress is primarily concerned with domestic conditions." *Foley Bros. v. Filardo,* 336 U.S. 281, 285 (1949); *see also Sandberg v. McDonald,* 248 U.S. 185, 195 (1918); *Commodity Futures Trading Comm'n v. Nahas,* 738 F.2d 487, 493 (D.C.Cir.1984); *FTC v. Compagnie de Saint-Gobain-Pont-A-Mousson,* 636 F.2d 1300, 1322-23 (D.C.Cir.1980). And even aside from this presumption, it is quite clear that the Securities Exchange Act of 1934 had as its purpose the protection of American investors and markets. *See, e.g.,* H.R.Rep. No. 1383, 73d Cong., 2d Sess. 1-16 (1934); S.Rep. No. 792, 73d Cong., 2d Sess. 1-13 (1934). That is the inference to be drawn from section 30(b) as well, for it states that the statute does not apply to persons transacting business in securities abroad unless the Securities and Exchange Commission issues rules and regulations making the statute applicable to such persons because that is "necessary or appropriate to prevent the evasion" of the statute. That rather clearly implies that Congress was concerned with extraterritorial transactions only if they were part of a plan to harm American investors or markets. The Commission has never issued such rules or regulations and there is no allegation in this case that AA-USA's conduct was engaged in to evade American law.

Courts have also been concerned to preserve American judicial resources for the adjudication of domestic disputes and the enforcement of domestic law. *Bersch,* 519 F.2d at 985 ("When, as here, a court is confronted with transactions that on any view are predominantly foreign, it must seek to determine whether Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted to them rather than leave the problem to foreign countries."). It is far from clear that these resources would be well spent on all the potential disputes in which domestic conduct makes a relatively small contribution to securities fraud that occurs elsewhere.[2]

Were it not for the Second Circuit's preeminence in the field of securities law, and our desire to avoid a multiplicity of jurisdictional tests, we might be inclined to doubt that an American court should ever assert jurisdiction over domestic conduct that causes loss to foreign investors. It is somewhat odd to say, as *Bersch* and some other opinions do, that courts must determine their jurisdiction by divining what "Congress would have wished" if it had addressed the problem. A more natural inquiry might be what jurisdiction Congress in fact thought about and conferred. Congress did not think about conduct here that contributes to losses abroad in enacting the Securities Exchange Act

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2. Given this concern, it would also seem counterproductive to adopt a balancing test, or any test that makes jurisdiction turn on a welter of specific facts. *See, e.g., Restatement (Second) of the Foreign Relations Law of the United States* § 403(2) (2d draft 1981). As we know from our experience in the extraterritorial application of antitrust law, such tests are difficult to apply and are inherently unpredictable. *See, e.g., Laker Airways Ltd. v. Sabena, Belgian World Airlines,* 731 F.2d 909, 948-53 (D.C.Cir.1984). They thus present powerful incentives for increased litigation on the jurisdictional issue itself, which inevitably tends to defeat efforts to protect limited American judicial resources. A strong argument has also been made that balancing tests "are not faithful to the principle of comity among nations," for in practice they tend to deemphasize foreign sovereign interests and almost never lead a court to decline jurisdiction. *See* Note, *Predictability and Comity: Toward Common Principles of Extraterritorial Jurisdiction,* 98 Harv.L.Rev. 1310, 1323-25 (1985).

of 1934; it could easily provide such jurisdiction if that seemed desirable today. But, for the reasons just given, we defer to *Bersch* and the later Second Circuit cases and adopt the Second Circuit's approach. We are not persuaded by the reasoning of those circuits that have broadened federal court jurisdiction for reasons that are essentially legislative. In *Continental Grain*, the court said, "[w]e frankly admit that the finding of subject matter jurisdiction in the present case is largely a policy decision." 592 F.2d at 421. Yet Congress is available to make any policy decisions that are required. In *Kasser*, similarly, the court justified its approach in part because "[f]rom a policy perspective, and it should be recognized that this case in a large measure calls for a policy decision, we believe that there are sound rationales for asserting jurisdiction." 548 F.2d at 116 (footnote omitted). Three rationales were offered. "First, to deny such jurisdiction may embolden those who wish to defraud foreign securities purchasers or sellers to use the United States as a base of operations." *Id.* Second, "[b]y finding jurisdiction here, we may encourage other nations to take appropriate steps against parties who seek to perpetrate frauds in the United States." *Id.* Finally, the court's action "will enhance the ability of the SEC to police vigorously the conduct of securities dealings within the United States." *Id.; see also Continental Grain*, 592 F.2d at 421-22 (approving and employing these same policy rationales). *Kasser* concluded: "We are reluctant to conclude that Congress intended to allow the United States to become a 'Barbary Coast,' as it were, harboring international securities 'pirates.'" 548 F.2d at 116.

We, too, are reluctant to conclude that Congress intended any such thing, but we are less reluctant to conclude that Congress in 1934 had no intention at all on the subject because it was concerned with United States investors and markets. That being so, *Kasser's* policy arguments may provide very good reasons why Congress should amend the statute but are less adequate as reasons why courts should do so. As the Supreme Court has said in another context, "[t]he responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones: 'Our Constitution vests such responsibilities in the political branches.'" *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 866 (1984) (quoting *TVA v. Hill*, 437 U.S. 153, 195 (1978)). This is particularly the case since such an amendment providing jurisdiction over aspects of predominantly foreign transactions should take into account considerations of comity and foreign affairs. Those factors do not weigh heavily in this case but they may in others.[3]

For these reasons we adopt what we understand to be the Second Circuit's test for finding jurisdiction based on domestic conduct: jurisdiction is appropriate when the fraudulent statements or misrepresentations originate in the United States, are made with scienter and in connection with the purchase or sale of securities, and "directly cause" the harm to those who claim to be defrauded, even if reliance and damages occur elsewhere. Indeed, we believe this test is only a slight recasting, if at all, of the traditional view that jurisdiction will lie in American courts only over proscribed acts

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3. In this connection, there may be more reason to find jurisdiction in a case like *Kasser*, which was brought by the SEC, than in a case like the present one, brought by foreign private individuals. The SEC, while an independent agency, is a responsible governmental agency and will surely take into account in framing its enforcement actions any foreign policy concerns communicated to it by the Department of State. A private individual need not and often will not. A court can feel more comfortable asserting jurisdiction if it knows that foreign policy concerns can be accommodated by the plaintiff and are not left entirely to the court's untutored evaluation. Whether or not that consideration should be sufficient to allow jurisdiction in an SEC action that would not lie in a private action we need not decide.

done in this country.[4]

III.

The application of these principles to Zoelsch's claims is not difficult. . . . [I]t is clear that any actual defrauding of investors took place in West Germany, so that reliance and damages would have occurred there. We are therefore left to consider whether Zoelsch alleges any tenable theory of liability according to which AA-USA committed acts in this country that are "punishable" in the sense that they satisfy the other elements needed to establish liability under section 10(b) or Rule 10b-5.

One possible theory of liability that can be gleaned from the complaint is that AA-USA and GmbH are "branch establishments," parts of a single world-wide organization, so that one could be held liable for the other's fraudulent misrepresentations. . . . But Zoelsch has not raised this argument on appeal, and appears not to dispute that AA-USA and GmbH are completely separate legal entities. . . .

The only other theory of liability that we find in the complaint, and the essence of Zoelsch's position on appeal, is that AA-USA acted willfully or recklessly by either misrepresenting or omitting to state material facts that it knew, in response to inquiries made by GmbH. . . . The complaint indicates that AA-USA could foresee that its misrepresentations or omissions might affect future purchasers of securities. . . . Zoelsch also alleges that those misrepresentations or omissions were in fact one of the causes of the damage he and the other investors suffered when they were defrauded. These actions by AA-USA from the basis of Zoelsch's claims of securities fraud under section 10(b) and Rule 10b-5 and for aiding and abetting such fraud. . . .

These allegations, even if true, are insufficient to support jurisdiction under the test we have enunciated. At the most, they establish that AA-USA made misrepresentations to GmbH that GmbH credited in drawing up its audit report. AA-USA's statements were not themselves made for distribution to the public, and were not transmitted to the public. AA-USA was merely one of the sources GmbH consulted in conducting the investigations which culminated in its audit report. That report, which was circulated to investors as part of the larger package of materials distributed by Loescher, was prepared and certified by GmbH alone. . . .

On these allegations, any misrepresentations made by AA-USA would not have been made "in connection with the purchase or sale of any security" as required for liability by section 10(b) and Rule 10b-5. The Ninth Circuit confronted a similar situation in *Wessel v. Buhler*, 437 F.2d 279 (9th Cir.1971). An accountant prepared financial statements for a corporation. The corporation later issued prospectuses that became the grounds for claims of securities fraud. Those prospectuses did not include as part of the package the financial statements that had been prepared by the accountant, though

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4. Although at first glance this approach might be thought to collapse the jurisdictional issue together with the merits, it does not. Instead, it merely recognizes that the issue of federal jurisdiction over extraterritorial conduct, like other threshold issues, "in no way depends on the merits of the plaintiff's contention that particular conduct is illegal, ... [but] often turns on the nature and source of the claim asserted." *Warth v. Seldin*, 422 U.S. 490, 500 (1975). And indeed, as the Supreme Court said in *Warth* about standing to sue, "the source of the plaintiff's claim to relief assumes critical importance with respect to the prudential rules of [judicial self-restraint] that, apart from Art. III's minimum requirements, serve to limit the role of the courts in resolving public disputes." *Id. See also Vencap*, 519 F.2d at 1011-14, 1016-18 (considering jurisdiction in light of the several theories of liability arguably proposed by the plaintiff). *Cf. Hagans v. Lavine*, 415 U.S. 528, 536-43 (1974) (federal courts may consider the substance of a claim for relief in order to decide whether it is too insubstantial to support federal question jurisdiction).

It is also worth noting, of course, that the test we adopt here does provide jurisdiction whenever any individual is defrauded in this country, regardless of whether the offer originates somewhere else, for the actual consummation of securities fraud in the United States in and of itself would constitute domestic conduct that satisfies all the elements of liability.

apparently some of the figures in the prospectuses were based on figures contained in those financial statements. Plaintiffs sought to fasten liability upon the accountant by claiming either that his financial statements were made in connection with the purchase and sale of a security or that he knew or should have known the statements would be used in preparing later prospectuses. *Id.* at 281.

The court rejected both theories, noting that although the "in connection with" requirement has been broadly construed, "its reach is not boundless." 437 F.2d at 282. The court found that the accountant's statements were not publicly disseminated or made in any way to influence investors, but were merely prepared in response to requests by the client corporation. Thus they were not made at the time "in connection with" any later sale. *Id.* The court also refused to make liability turn on whether the accountant could have known that his figures might be used in some later prospectus. Instead, the court held that the accountant could not be held liable for securities fraud where he did not prepare any part of the later prospectus, and therefore was not responsible for its contents. *Id.* at 282- 83.

The same reasoning applies here. AA-USA is not alleged to have prepared or certified any part of the audit report that was distributed to the investors. None of its statements are alleged to have reached those investors. We decline to find the "in connection with" requirement satisfied by statements made privately to an accounting firm that it may have credited later when it put together an audit report that was distributed to investors. *Cf. SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 862 (2d Cir.1968) ("Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, *e.g.,* by means of the financial media"), *cert. denied,* 394 U.S. 976 (1969).[5]

To put the matter in the Second Circuit's terminology, AA-USA's alleged misrepresentations to GmbH were "merely preparatory" to any fraud perpetrated on West German investors, and did not "directly cause" their losses. *Bersch,* 519 F.2d at 992-93. *Bersch*'s facts are very like the facts in this case. . . . The biggest difference between the two cases, however, and one which makes Zoelsch's claim of jurisdiction much weaker even than that in *Bersch,* is that here AA-USA did not even prepare or audit the financial statements for the prospectus that was distributed to the West German investors. . . .

The *Wessel* decision also forecloses Zoelsch's claim that AA-USA aided and abetted securities fraud. That decision specifically denied that such liability could attach when the accountant defendant was not in any way responsible for including misleading figures in prospectus materials that were distributed to investors. *See* 437 F.2d at 283. Nor was the court willing to find liability based on the accountant's failure to disclose to investors that the prospectus contained misleading figures. "On the contrary, the exposure of independent accountants and others to such vistas of liability, limited only

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5. Another way to express this point is in terms of causation. The Second Circuit has held that to recover under § 10(b) a plaintiff must show not only that the fraud caused economic harm, or "loss causation," but also that the fraud caused the plaintiff to engage in the transaction in question, which is "transaction causation." Under the Second Circuit's test, GmbH's audit report may have "induc[ed] the plaintiff to enter into a transaction," but AA-USA's statements, which were never distributed to investors, did not. *Manufacturers Hanover Trust Co. v. Drysdale Securities Corp.,* 801 F.2d 13, 20 (2d Cir.1986), *cert. denied,* 479 U.S. 1066 (1987); *see also Chemical Bank v. Arthur Andersen & Co.,* 726 F.2d 930, 943 (2d Cir.), *cert. denied,* 469 U.S. 884 (1984); *First Fed. Sav. & Loan Ass'n v. Oppenheim, Appel, Dixon & Co.,* 629 F.Supp. 427, 440-41 (S.D.N.Y.1986). However the point is categorized, the central distinction for our purposes is that between an auditor who certifies an audit report or issues financial statements for public use, thereby assuming a peculiarly public status, and individuals who answer private inquiries without thereby establishing any particular relationship with the investing public. *See, e.g., Drake v. Thor Power Tool Co.,* 282 F.Supp. 94, 104 (N.D.Ill.1967); *Reingold v. Deloitte Haskins & Sells,* 599 F.Supp. 1241, 1259 (S.D.N.Y.1984).

by the ingenuity of investors and their counsel, would lead to serious mischief." *Id.*

We endorse these principles. The Supreme Court has stated that to aid and abet another it is necessary that a defendant "'in some sort associate himself with the venture, that he participate in it as something that he wishes to bring about, that he seek by his action to make it succeed.'" *Nye & Nissen v. United States*, 336 U.S. 613, 619 (1949) (quoting *United States v. Peoni*, 100 F.2d 401, 402 (2d Cir.1938) (Hand, J.)). The Third Circuit, applying this approach to liability for securities fraud, has held that defendants are not liable under Rule 10b-5 where there is no allegation that they "proposed to bring about the publication of the false financials and the consequent fraud upon the stock purchasers." *Landy v. FDIC*, 486 F.2d 139, 164 (3d Cir.1973), *cert. denied*, 416 U.S. 960 (1974). Likewise, in this case AA-USA is not alleged to have played any part in publishing misleading statements to the public. As for liability for passive failure to disclose, other courts have held that inaction cannot create liability as an aider and abettor unless the defendant recklessly violates an independent duty to act or manifests a conscious intention to further the principal violation, *see Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777-79 (1st Cir.1983); *Harmsen v. Smith*, 693 F.2d 932, 944 (9th Cir.1982), *cert. denied*, 464 U.S. 822 (1983); *Cornfield*, 619 F.2d at 926-27; *Woodward v. Metro Bank*, 522 F.2d 84, 96-97 (5th Cir.1975), none of which has been alleged here.

Zoelsch offers one final argument that comes at jurisdiction from a very different angle. He asserts that we should consider all the activity that surrounds any given securities transaction as a single mass, and exercise subject matter jurisdiction over any individual defendant if we find that the sum of all the domestic activities by all participants in a string of transactions seems large enough to support jurisdiction in American federal courts. Thus we should take account of FAIR's domestic conduct in deciding whether to assert jurisdiction over AA-USA, even though FAIR is not even a party to this case, and there is no allegation that AA-USA acted in concert with FAIR to perpetrate a securities fraud. It is obvious that this suggestion is completely antithetical to the approach we have adopted here. It bears no relation to the tests for determining jurisdiction that have been adopted by any of the federal appellate courts. It is a novel theory and appears not to relate to the statute's purpose to protect American investors and securities markets. There seems nothing to recommend it. . . .

NOTES AND QUESTIONS

1. In light of the objectives of the federal securities law, which approach to jurisdiction over private securities litigation makes the most sense–the Second Circuit's restrictive standard? The Third Circuit's "some activity" test? The Eighth Circuit's "furtherance of a fraudulent scheme" test? Where does the D.C. Circuit stand on this issue? It was here that Chief Judge Wald parted company with the *Zoelsch* majority, explaining:

> I agree with the majority that the District Court properly dismissed this action for lack of subject matter jurisdiction. In reaching that result, I find it unnecessary, however, to adopt the Second Circuit's restrictive test for determining the extent of federal jurisdiction over securities law claims involving international transactions. It seems clear that, even under the less strict approach adopted by the Third, Eighth, and Ninth Circuits, AA-USA's alleged misrepresentations or omissions of material fact were so insignificant and so indirectly related to the overall fraudulent scheme as set out in the complaint that no federal jurisdiction would exist over Zoelsch's claims.
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> Furthermore, I cannot accept the majority's rationale for rejecting the jurisdictional

> standard adopted by the Third, Eighth, and Ninth Circuits. The majority characterizes those courts as having improperly engaged in judicial activism by "broaden[ing] federal court jurisdiction for reasons that are essentially legislative." . . . Those courts were faced, as we are, with a question of statutory interpretation for which the language of the statute and its legislative history provide little guidance. It is clear that "[f]ifty years ago, Congress did not consider how far American courts should have jurisdiction to decide cases involving predominantly foreign securities transactions with some link to the United States." . . . In such circumstances, courts properly look to the overall purposes of the statute in resolving an issue of statutory construction. The majority may disagree with the policy rationales offered by the other circuits, but its criticism of them as engaging in *ad hoc* judicial legislation is misplaced. The decisions cited by the majority as examples of judicial lawmaking clearly indicate that the policies adopted are those the court perceives as most consistent with the intent of Congress in enacting the federal securities laws. *See, e.g., SEC v. Kasser*, 548 F.2d 109, 116 (3d Cir.) ("the antifraud provisions of the 1933 and 1934 Acts were designed to insure high standards of conduct in securities transactions within this country in addition to protecting domestic markets and investors from the effects of fraud"), *cert. denied*, 431 U.S. 938 (1977). I therefore wish to distance myself from the majority's labeling of these courts' efforts as an attempt to usurp the role of Congress.

Zoelsch, 824 F.2d at 36-37 (Wald, C.J., concurring).

2. Consider note 3 of the *Zoelsch* opinion. Does it make sense to find jurisdiction where the SEC is the plaintiff, if in the same case brought by foreign private individuals the court would not find jurisdiction?

3. If all the conduct in *Zoelsch*, including the alleged fraudulent statements, had occurred in Germany, but one of the purchasers was an American citizen in New York, would there be jurisdiction? *See* note 4 of the *Zoelsch* opinion.

4. Would it have made any difference to the analysis or outcome in *Zoelsch* if GmbH had been a branch of Andersen, rather than a separately incorporated entity?

5. Was it necessary for the court to reach the jurisdictional issue in *Zoelsch*? A securities fraud claim under Rule 10b-5 requires that the fraud be "in connection with" the purchase or sale of a security, but Andersen did not prepare or certify the audit report that was distributed to the investors. Nor did any of its statements reach the investors.

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