Commentary: The "Foreign-Cubed" Equation

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Let me begin by calming the nerves of anyone who thinks "foreign-cubed" is a long-forgotten high school algebra equation. I promise there will be no math in this column. "Foreign-cubed" refers to a securities class action brought in the United States by (1) foreign investors, against (2) a foreign issuer, regarding securities purchased or sold on (3) a foreign exchange or a foreign securities market. Plaintiffs in foreign-cubed actions seek to bring their claims in the United States courts to take advantage of relatively liberal U.S. class action law and the potentially larger damage awards here than in their home countries.

Foreign-cubed litigation gained notoriety earlier this year when the U.S. Supreme Court heard a prime example of such a case, *Morrison v. National Australia Bank*. The *Morrison* case highlights the myriad legal and public policy questions raised by foreign-cubed cases, and a surprising proposal made by the SEC may offer a workable solution.

In *Morrison*, Australian investors sued the National Australia Bank (NAB) for losses suffered through trading on the ASX, an Australian exchange. The plaintiffs allege that fraudulent financial reporting by the bank artificially inflated its stock price, which later dropped when the fraud finally was revealed. The investors claim that the fraud took place in the United States, through intentionally misleading financial statements prepared by the bank's Florida subsidiary, thereby implicating U.S. law. The bank argues that any potential wrongdoing took place in Australia, where the financial statements were compiled and reviewed, and that the case should be thrown out of the U.S. courts.

Like most foreign-cubed cases, the original *Morrison* plaintiff class included both U.S. and foreign investors. Courts generally agree with the common sense notion that claims by U.S. investors who purchased securities on a U.S. exchange should be subject to U.S. law, even though the defendant may be a non-U.S. resident. Courts often utilize something called the "effects test" to determine whether the United States has enough of an interest in a case for domestic law to apply— when the fraudulent activity has an effect on domestic investors purchasing securities on domestic exchanges, then the courts allow U.S. law to be used to protect U.S. citizens and markets.

In *Morrison*, the named plaintiff was a U.S. investor who purchased the bank's ADRs on the New York Stock Exchange. NAB never questioned U.S. jurisdiction over Mr. Morrison's own case, but his claim was dismissed early in the proceedings

on other grounds. That left only foreign plaintiffs complaining about losses on a foreign exchange. With no U.S. investors or exchanges any longer involved, the effects test did not apply.

That left the courts with the job of determining whether the allegedly fraudulent conduct in Florida was significant enough to warrant the United States' exercise of its jurisdiction. That determination is typically called the "conduct test," where courts evaluate how much of the conduct contributing to the fraud actually occurred in the United States. Nationally, judicial interpretations of the conduct test have been inconsistent. The two lower courts that heard *Morrison* interpreted the conduct test to mean that U.S. jurisdiction exists "if activities in this country were more than merely preparatory to a fraud and culpable acts or omissions occurring here directly caused losses to investors abroad." Not exactly a clear or easy standard for courts to follow. Both lower courts then concluded that the conduct in Florida was "merely preparatory" and ultimately was not the "direct" cause of the fraudulent activity.

The Supreme Court must now evaluate the lower courts' application of the conduct test and weigh the competing public policy concerns. The Supreme Court will be asked to consider whether the conduct test was the proper standard, or whether the lower courts should have applied some other method of determining whether U.S. jurisdiction was warranted. If the Court decides that the conduct test was the right test, then it will have to determine whether the lower courts properly interpreted and applied the conduct test.

Both sides believe they have strong public policy arguments in their favor, and both presented suitably eloquent legal arguments to the Supreme Court. Plaintiffs' supporters asserted that when an issuer lists its securities on a U.S. exchange, subject to stringent U.S. disclosure requirements, investors have a heightened level of confidence that leads to an increase in the issuer's stock price. Confidence that U.S. law protects shareholders attracts more investors to the U.S. markets, which in turn benefits the U.S. economy. Thus, they argued that if the Supreme Court rules that foreign-cubed claimants are not entitled to the protection of U.S. law, foreign investors may flee from our markets, taking much-needed capital with them. Moreover, the U.S. courts' dismissing foreign-cubed cases would embolden international criminals to commit fraud in the United States, knowing that they likely will not be subject to U.S. legal action.

NAB's supporters countered that subjecting an issuer in a foreign-cubed case to potential U.S. securities liability will cause foreign companies to delist from U.S. exchanges and to cease their U.S. business operations, which could devastate the U.S. economy. They argued that United States involvement in foreign-cubed cases would frustrate foreign governments' efforts to enforce their own securities laws, and would allow foreign plaintiffs to circumvent the laws of their home countries by forum-shopping for plaintiff-friendly regulatory regimes. Several nations filed

briefs with the Supreme Court in support of NAB's position, including Great Britain, France and, appropriately, Australia.

The SEC, on behalf of the U.S. government, has also taken an active role in *Morrison*, but its position took a peculiar turn as the case worked its way to the Supreme Court. In the lower courts, the SEC supported the plaintiffs, arguing that the conduct in Florida was substantial enough to warrant U.S. jurisdiction. That viewpoint surprised no one, as the SEC would understandably wish to have jurisdiction to bring its own legal action against similar frauds in the future.

At the Supreme Court, however, the SEC reversed its position and surprisingly supported NAB. The SEC's new and more nuanced argument supports the dismissal of *Morrison*, while simultaneously advocating for SEC jurisdiction over similar cases in the future. The SEC reasoned that for private lawsuits, such as a class action by investors in a foreign-cubed case, something similar to the version of the conduct test used by the lower courts in *Morrison* should apply. Under that test, the SEC agreed with the courts below that the *Morrison* claim should not be tried in the United States because the plaintiffs cannot show that their losses were "directly" caused by any fraudulent activity that took place in Florida.

However, the SEC also proposed a new, more relaxed version of the conduct test for determining whether the type of fraud alleged in *Morrison* violates Section 10(b) of the Exchange Act. The SEC believes that such fraud violates Section 10(b) if "significant conduct material to the fraud's success occurs in the United States." The SEC's test may be just as subjective and difficult to apply as the "more than merely preparatory" and "direct cause" interpretations used by the lower courts in *Morrison*, but it seems clear that the SEC's "significant and material" standard would lower the bar in applying U.S. jurisdiction for enforcement actions by the SEC.

The SEC maintained that the alleged fraudulent conduct by NAB in Florida meets the "significant and material" test, which would allow for an enforcement action against NAB. Moreover, the SEC argued that applying different standards to private lawsuits than to SEC enforcement actions would address the competing public policy concerns presented by the parties and their *amicus curiae* supporters.

Addressing the concerns of those siding with the *Morrison* plaintiffs, the SEC argued that a more lenient jurisdictional standard for SEC enforcement actions would provide assurance to foreign investors that the SEC could protect against U.S.-based fraud. Thus reassured, foreign investors would continue to invest in foreign companies listed on U.S exchanges and in foreign companies with U.S. subsidiaries, saving the U.S. markets and U.S. economy from ill effects. The SEC's solution also would tend to deter potential fraudsters from engaging in unsavory conduct in the United States, because they would fear the enforcement might of the SEC.

On the other hand, *Morrison*'s dismissal also would ease the public policy concerns of NAB's supporters. Secure that the United States would not grab jurisdiction over a foreign-cubed private class actions like *Morrison*, foreign issuers would continue to list securities on U.S. exchanges and to operate U.S. subsidiaries. Foreign investors could not circumvent issuer-friendly regulatory regimes in their home countries by bringing securities cases in the more investor-friendly environment of the United States.

The SEC's solution might just work, provided that the SEC actually is vigilant about enforcing U.S. laws against fraudulently activity that affects foreign investors. The policy in favor of private rights of action recognizes that the SEC can't do it all: directly affected individuals can assist the government's overall goal of compliance with the securities laws, and increase the total amount of resources applied to the prosecution of fraud claims, if they are allowed to bring their own suits against fraudsters at their own expense. However, forum-shopping is a problem, and the standards applicable to foreign-cubed claims have long been dangerously unclear. Parties to these litigations, including legitimately aggrieved plaintiffs, have spent countless legal dollars arguing over U.S. jurisdiction without ever getting to the merits of their cases. While not without its flaws, the SEC's proposal in *Morrison* may be the most equitable solution put forth yet. The Supreme Court will soon provide its solution to the foreign-cubed equation.