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# SECURITIES CLASS ACTIONS AGAINST FOREIGN ISSUERS

Merritt B. Fox\*

*This Article addresses the fundamental question of whether, as a matter of good policy, it is ever appropriate that a foreign issuer be subject to the U.S. fraud-on-the-market private damages class action liability regime, and, if so, by what kinds of claimants and under what circumstances. The bulk of payouts under the U.S. securities laws arise out of fraud-on-the-market class actions—actions against issuers on behalf of secondary market purchasers of their shares for trading losses suffered as a result of issuer misstatements in violation of Rule 10b-5. In the first decade of this century, foreign issuers became frequent targets of such actions, with some of these suits yielding among the very largest payouts in securities law history.*

*The law determining the reach of the U.S. fraud-on-the-market liability regime against foreign issuers has since been thrown into flux. The Supreme Court's recent decision in the Morrison case adopted an entirely new approach for determining the reach of Rule 10b-5 in situations with transnational features. This new approach focused on whether the purchase was of a security listed on a U.S. exchange or occurred in the United States, in contrast to the previous focus on whether either conduct or effects of sufficient importance occurred in the*

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United States. In almost immediate response, Congress, in the Dodd-Frank Act, reversed the Court's decision with respect to actions by the government and mandated that the SEC prepare a report concerning the desirability of doing the same with respect to private damages actions.

*This Article goes back to first principles to look at the basic policy concerns that are implicated by the reach of fraud-on-the-market class actions for damages, and to determine who, under a variety of circumstances relating to the nationality of the purchasers, the place of the trade, and the place of the issuer's misconduct, is ultimately affected by imposition of this liability regime on foreign issuers. The resulting analysis suggests a simple, clear rule likely to both maximize U.S. economic welfare and, by also promoting global economic welfare, foster good foreign relations. The U.S. fraud-on-the-market class action liability regime should not as a general matter be imposed upon any genuinely foreign issuer, even where the claimant is a U.S. investor purchasing shares in a U.S. market or where the issuer engages in significant conduct in the United States relating to the misstatement. The only exception would be a foreign issuer that has agreed, as a form of bonding, to be subject to the U.S. regime.*

*This Article then charts a practical path to reform based on this simple rule. It assesses the attractions of, and problems with, the two competing alternatives—using the Morrison rule and returning to the conduct/effects test—and explores the possibilities for reform through the courts, SEC rulemaking, and legislation.*

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## INTRODUCTION

Fraud-on-the-market class actions allow buyers in secondary securities markets to recover losses that they incur from purchasing at prices inflated by misstatements of the issuing corporation. These actions, based on alleged violations of section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder,<sup>1</sup> give rise to the bulk of all the damages paid out in settlements and judgments pursuant to private litigation under the U.S. securities laws.<sup>2</sup> With

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1. A fraud-on-the-market action is a form of an implied right of action for civil damages based on a misstatement made in violation of section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78j (2006), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2011), promulgated thereunder. The nature and development of the fraud-on-the-market cause of action is described more fully in Part II.A below. Fraud-on-the-market class actions are also available for sellers who claim to be injured by losses resulting from a falsely negative misstatement that depresses prices in the secondary market. For convenience, it will be assumed throughout this Article that, as is more commonly the case, the plaintiffs are purchasers who claim to be injured from losses resulting from a falsely positive misstatement.

2. This view of the dominance of fraud-on-the-market claims is universally shared by the many practitioners in the area with whom the author has spoken. The accuracy of the proposition can also be inferred from the following data: In terms of initial complaints, in 2008, 75% of securities class actions alleged Rule 10b-5 claims and less than a third of these

securities trading becoming globalized,<sup>3</sup> foreign issuers became increasingly frequent targets of such actions, with one in six being against a foreign issuer in 2009 compared to only one in fifteen a decade earlier.<sup>4</sup> Two of the seven largest payouts in the history of private U.S. securities litigation were made in settlements of suits against foreign-issuer defendants: Nortel Networks (over \$2 billion) and Royal Ahold, NV (over \$1 billion).<sup>5</sup> A judgment estimated in the press to be worth over \$9 billion, an amount larger than any payout yet made in

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included a claim of insider trading (the only other Rule 10b-5 claim besides a fraud-on-the-market claim likely to be pursued by class action). For the same year, 23% of all securities class actions complaints included a claim under section 11 of the Securities Act of 1933 (Securities Act), and 19% contained a claim under section 12(a)(2) of the Securities Act. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2008 A YEAR IN REVIEW 21 (2009), available at [http://securities.stanford.edu/clearinghouse\\_research/2008\\_YIR/20090106\\_YIR08\\_Full\\_Report.pdf](http://securities.stanford.edu/clearinghouse_research/2008_YIR/20090106_YIR08_Full_Report.pdf). As for securities class action settlements, section 11 and/or section 12(a)(2) were involved in only 22% of securities class action settlements from 1996 through 2008. The inclusion of a section 11 or section 12(a)(2) claim did not result in a statistically significant increase in the size of settlements (after adjusting for the presence of underwriters). ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2008 REVIEW AND ANALYSIS 10 (2009), available at [http://securities.stanford.edu/Settlements/REVIEW\\_1995-2008/Settlements\\_Through\\_12\\_2008.pdf](http://securities.stanford.edu/Settlements/REVIEW_1995-2008/Settlements_Through_12_2008.pdf). Finally, complaints containing only Securities Act claims constituted 11% of the securities class actions settled in the first nine months of 2009, but provided only 1.5% of the amounts paid out in such settlements. See NERA Econ. Consulting, Federal Securities Class Action Cases Settled January 1, 2009 Through September 30, 2009 (unpublished manuscript) (on file with author) (providing proprietary data on securities class action settlements).

3. Foreign equities as a share of the stock portfolios of U.S. investors increased from less than 1% in the 1950s to approximately 10% by 1999. Alan G. Ahearne et al., *Information Costs and Home Bias: An Analysis of U.S. Holdings of Foreign Equities* fig.1 (Bd. of Governors of the Fed. Reserve Sys., Int'l Fin. Discussion Paper No. 691, 2000), available at <http://www.federalreserve.gov/pubs/ifdp/2000/691/ifdp691.pdf>. Since 1994, U.S. holdings of foreign equities have grown from approximately \$567 billion to more than \$2.7 trillion in 2008. *U.S. Portfolio Holdings of Foreign Securities Historical Data*, DEP'T TREASURY (Oct. 31, 2011), <http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/shchistdat.html>; see also Carol C. Bertaut et al., *Understanding U.S. Cross-Border Securities Data*, 92 FED. RES. BULL. A59, A59 fig.1 (2006), available at [http://www.federalreserve.gov/pubs/bulletin/2006/cross\\_border\\_securities.pdf](http://www.federalreserve.gov/pubs/bulletin/2006/cross_border_securities.pdf). In 2009, there were 495 foreign issuers listed on the NYSE and 283 listed on the NASDAQ. *Equity—1.3 Number of Listed Companies*, WORLD FED'N EXCHANGES, <http://www.world-exchanges.org/files/statistics/excel/EQUITY309.xls> (last visited May 11, 2012).

4. Federal securities class actions against foreign issuers represented 17% of all actions filed in both 2007 and 2008. PRICEWATERHOUSECOOPERS, 2008 SECURITIES LITIGATION STUDY 6, 43 (2009). In contrast, for the period 1996 through 2002, they averaged about 7% of all actions filed. Reeta Alanko, *Private Securities Litigations Against Foreign Firms: Empirical Findings* 44 (April 2004) (unpublished M.A. thesis, Tufts University), available at [http://dl.tufts.edu/view\\_pdf.jsp?pid=tufts:UA015.012.DO.00064](http://dl.tufts.edu/view_pdf.jsp?pid=tufts:UA015.012.DO.00064).

5. U.S. CHAMBER INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION: THE PROBLEM, ITS IMPACT, AND THE PATH TO REFORM 8 n.21 (2008), available at [http://www.instituteforlegalreform.com/get\\_ilr\\_doc.php?docId=1213](http://www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213).

any U.S. securities case, was rendered in early 2010 against another foreign corporation, Vivendi.<sup>6</sup>

The law behind these actions against foreign issuers has since been thrown into flux, however, with the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*<sup>7</sup> and Congress's response to *Morrison* in provisions of the subsequently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>8</sup> The *Morrison* case and the congressional reaction to it put the United States at a critical moment of decision. We face the fundamental question of whether, as a matter of good policy, it is ever appropriate that a foreign issuer be subject to the U.S. fraud-on-the-market class action damages liability regime, and, if so, by what kinds of claimants and under what circumstances.

How the United States answers this question will have important effects on where the shares of the world's issuers trade, who invests in them, and what these issuers disclose to the public. Fear of fraud-on-the-market suits, for example, appears to have been the single most important deterrent in recent years to foreign issuers offering or listing their shares in the United States.<sup>9</sup> More fundamentally, the United States' decision concerning the reach of these suits will have a significant impact around the world on both the overall efficiency of securities trading and the quality and cost of corporate governance. The decision will also materially affect U.S. economic relations with other countries.<sup>10</sup> This Article goes back to first principles to look at the basic policy con-

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6. *Court Finds Vivendi Liable for Misleading Investors*, N.Y. TIMES, Jan. 30, 2010, at B3.

7. 130 S. Ct. 2869 (2010).

8. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code).

9. Howell E. Jackson, *Summary of Research Findings on Extra-Territorial Application of Federal Securities Laws*, in GLOBAL CAPITAL MARKETS & THE U.S. SECURITIES LAWS 2009, at 1243, 1246 (PLI Corp. Law & Practice, Course Handbook Ser. No. B-1743, 2009) (citing data from interviews with leading practitioners conducted by Harvard Law School students under the direction of Howell Jackson, which addressed foreign issuers' concerns about entry into U.S. capital markets).

10. One indication of the difficulties that fraud-on-the-market class actions against foreign issuers can pose is the reaction of public officials abroad to the plaintiffs' appeal of the Second Circuit's decision in *Morrison v. National Australia Bank Ltd.*, 547 F.3d 167 (2d Cir. 2008). See Brief of the Government of the Commonwealth of Australia as Amicus Curiae in Support of the Defendant-Appellees, *Morrison*, 130 S. Ct. 2869 (No. 08-1191), 2010 WL 723006 (arguing that Australia regulated its securities market to reflect its policy choices and that the U.S. Supreme Court should follow precedent regarding comity and international conflict of laws); Brief for the Republic of France as Amicus Curiae in Support of Respondents, *Morrison*, 130 S. Ct. 2869 (No. 08-1191), 2010 WL 723010 (arguing that principles of international comity preclude extraterritorial application of the antifraud rules of the U.S. securities laws because the foreign interest is paramount and the U.S. interest is attenuated); Brief of the United Kingdom of Great Britain and Northern Ireland as Amicus Curiae in Support of Respondents, *Morrison*, 130 S. Ct. 2869 (No. 08-1191), 2010 WL

cerns that are implicated by the reach of fraud-on-the-market class actions. The resulting analysis suggests a simple, clear rule likely to both maximize U.S. economic welfare and, by also promoting global economic welfare, foster good foreign relations. The American law based class action fraud-on-the-market liability regime, I conclude, should not as a general matter be imposed upon any genuinely foreign issuer, even where the purchaser making the claim is a U.S. investor purchasing the share in a U.S. market or where significant conduct contributing to the misstatement occurs in the United States. An issuer is genuinely foreign if it has its economic center of gravity as an operating firm outside the United States.<sup>11</sup> The only exception would be a foreign issuer that has agreed, as a form of bonding, to be subject to the U.S. liability regime, in which case all such claims against the issuer should be allowed, regardless of the nationality and residence of the purchasing plaintiff, the place where she executes the transaction, and the place or places where conduct contributing to the misstatement occurs.

A claim of injury based on a secondary market securities purchase at a price inflated by the issuer's misstatement has potential connections with particular countries along a number of dimensions. In addition to the nationality of the issuer, these dimensions would include the nationality and the residence of the purchaser, the place where the purchase order was executed, the place of each of the exchanges where the security is listed, and the place or places where conduct relating to the misstatement occurred. The concern here is with a claim that is connected with more than one country in terms of these different dimensions. Consider each country that has such a connection with the claim and that under its law has a cause of action would arise if the claim had instead been entirely domestic. Such a country is faced with deciding whether to still include the claim within the reach of its cause of action despite the claim's foreign elements. The issue is which connection or connections with other coun-

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723009 (arguing in part that foreign purchasers in foreign markets should have no such private right of action against foreign issuers). Also instructive is foreign official reaction to provisions in the Dodd-Frank Act, both as it made its way through Congress and after enactment. See, e.g., Helen Thomas & Tom Braithwaite, *Europe Expresses Concern over US Laws on Investor Protection*, FIN. TIMES, Nov. 23, 2009, at 14 (quoting an unnamed EU official concerned with provisions of the bill relating to the reach of U.S. antifraud laws as stating, "We've been in contact and are keeping a close interest in the situation"). This reaction extended to section 929Y of the Dodd-Frank Act as enacted, which requires the SEC to submit a report to Congress concerning the reach of private actions against foreign issuers. Ives Mamou, *Washington veut réautoriser le retour des "class actions" étrangères [Washington Wants to Reauthorize the Return of Foreign "Class Actions"]*, LE MONDE, July 21, 2010, at 11 ("This report . . . frightens a number of foreign capitals, including Paris, who fear the United States becoming the financial policeman for countries that chose to forego private class actions.") (translation by author).

11. For further discussion concerning how U.S. issuers are distinguished from genuinely foreign issuers, see Part IV.C.4 below.



tries, if any, will nevertheless allow the claim to remain within the reach of the country's cause of action.

Until very recently, development of the U.S. approach to the reach of its fraud-on-the-market class action was, by default, entirely the province of the lower federal courts. Congress had not specified the reach of section 10(b), the statute whose violation gives rise to the cause of action. The language of section 10(b) makes no distinctions between the United States and elsewhere in the world with respect to any of these dimensions of connection. Read literally, it authorizes the SEC to promulgate rules that govern the whole world.<sup>12</sup> The SEC had not spoken either: the language of Rule 10b-5 is as sweeping as that of the underlying statute in terms of its possible reach,<sup>13</sup> and the SEC has not promulgated any other rules relevant to determining the reach of the Rule. The Supreme Court also had not addressed the issue.

The approach developed by the lower courts was that in transnational situations, the prohibitions of section 10(b) and Rule 10b-5 reached conduct, and their violation could be the basis of a fraud-on-the-market cause of action under either of two circumstances: where conduct in connection with the violation occurred in the United States (the "conduct test"), or where effects from the violation were experienced in the United States (the "effects test").<sup>14</sup> The na-

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12. Section 10(b) provides in relevant part:

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 . . . [t]o 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.

15 U.S.C. § 78j (2006).

13. Rule 10b-5 provides:

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 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.

17 C.F.R. § 240.10b-5 (2011).

14. This lower court jurisprudence is reviewed briefly below in Part V.C. For more extensive reviews, see Hannah L. Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 46 COLUM. J. TRANSNAT'L L. 14 (2007); Stephen J. Choi & Linda J. Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465; Stuart M. Grant & Diane Zilka, *The Role of Foreign Investors in Federal Securities Class Actions*, in SECURITIES LITIGATION &

ture and importance of the conduct or effects necessary to satisfy these tests were subject to a variety of different, often vague, formulations. Overall, the body of cases sketching out the conduct/effects test were widely recognized by commentators, and sometimes even the courts themselves, as lacking sufficient consistency and coherence to permit reliable predictions as to what transnational situations would give rise to a valid fraud-on-the-market claim.<sup>15</sup>

The use of the conduct/effects test also seriously impeded well-articulated judicial consideration of many of the important issues of public policy at stake. This was in part because the framework encouraged courts to conflate two issues with quite different policy implications: first, what connections with the United States must a transaction in a foreign issuer's shares have for the issuer's misstatement to potentially constitute a violation of section 10(b) and Rule 10b-5, and, second, assuming a violation, whether these connections are sufficient to justify imposing on the issuer civil liability for the share-trading losses suffered by any given purchaser who paid an inflated price as a result of the violation.

The legal landscape changed dramatically in the summer of 2010. In *Morrison*,<sup>16</sup> the Supreme Court threw out the whole lower court jurisprudence built on the conduct/effects test, concluding instead that section 10(b) reached only situations where the securities were listed on a U.S. exchange or where their purchase or sale was effected in the United States.<sup>17</sup> The Court joined commentators in criticizing the unpredictability of the lower courts' jurisprudence.<sup>18</sup> The Court stated that, in contrast, its approach "preserv[ed] a stable background against which Congress can legislate."<sup>19</sup> Congress did not wait long. Within days, it enacted the Dodd-Frank Act, which included provisions relating to the reach of section 10(b). For suits instituted by public entities—the SEC and the U.S. Department of Justice—the new legislation essentially reverses the Court's *Morrison* decision and reimposes a particular articulation of the con-

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ENFORCEMENT INSTITUTE 2004, at 91 (PLI Corp. Law & Practice, Course Handbook Ser. No. B-1442, 2004).

15. *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 665 (7th Cir. 1998) ("Although the circuits . . . seem to agree that there are some transnational situations to which the anti-fraud provisions of the securities laws are applicable, agreement appears to stop at that point."); Buxbaum, *supra* note 14, at 17; Kun Young Chang, *Multinational Enforcement of U.S. Securities Laws: The Need for the Clear and Restrained Scope of Extraterritorial Subject-Matter Jurisdiction*, 9 FORDHAM J. CORP. & FIN. L. 89, 106-08, 115-16 (2003); Choi & Silberman, *supra* note 14, at 467.

16. *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869 (2010).

17. *Id.* at 2888.

18. *Id.* at 2880-81.

19. *Id.* at 2881.

duct/effects approach.<sup>20</sup> For private antifraud actions—the realm that includes the fraud-on-the-market suits that are the subject of this Article—the new legislation requires the SEC to solicit public comment and conduct a study concerning the extent to which the reach of private actions should follow the approach established in the legislation for suits brought by public entities, and to report back to Congress within eighteen months.<sup>21</sup> These dramatic moves by the Court and Congress suggest the need for a serious analysis of the full range of possible approaches to determining the reach of the fraud-on-the-market class action liability system.

## I. OVERVIEW

This Article has two objectives. The first is to determine which approach to the reach of fraud-on-the-market actions would best further the twin goals of maximizing U.S. economic welfare and fostering good foreign relations through the promotion of global economic welfare. The second objective is to chart a practical path to reform.

Parts II-IV of this Article are devoted to the first objective and Parts V-VII to the second. Part II lays the initial groundwork by describing the origins of the fraud-on-the-market class action within the U.S. legal system. Parts III and IV form the Article's theoretical core and address the question of what would be best if the United States were able to write on a clean slate as to how this action should be applied to foreign issuers. The answer is the simple rule set out above.

The determination of the ideal approach begins by identifying the seven policy concerns that appear potentially most relevant to deciding the reach of fraud-on-the-market class actions. Each is analyzed to see what it implies in terms of the reach of the action. Four important policy concerns arguably justify imposing U.S. fraud-on-the-market class action liability against an issuer for the benefit of secondary market purchasers of its shares who suffer losses because the price was inflated by the issuer's misstatements: (1) providing compensation in order to correct for the unfairness of these losses or to spread their risk; (2) deterring issuers subject to a mandatory disclosure regime from making misstatements, in order to increase issuers' transparency and thereby improve their corporate governance and liquidity; (3) permitting issuers not automatically subject to this regime of mandatory disclosure and liability for misstatements to opt in, as a bond that they will maintain high transparency;

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20. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P, 124 Stat. 1376, 1864-65 (2010) (codified as amended at 15 U.S.C. § 77v (2006 & Supp. IV 2010)).

21. *Id.* § 929Y.

and (4) assuring that exchanges located in the United States are places where only the shares of high-transparency issuers trade.

The first and fourth concerns—providing compensation to cover investor trading losses, and assuring that U.S. exchanges are places where only high-transparency issuers are traded—are shown to be poor justifications for imposing fraud-on-the-market liability on any issuer, and thus they should not play a role in determining the reach of the U.S. regime. The second concern—improving transparency in order to enhance corporate governance and liquidity—can justify imposition of a fraud-on-the-market type of liability regime on any country's issuers if the social benefits from the resulting enhancements in corporate governance and liquidity are judged to exceed the liability regime's social costs. But the issuer's home country is shown to be the one that will experience most of the benefit from this judgment being made correctly, with other countries being little affected. The government of the issuer is best positioned to make this judgment both in terms of its incentives and its local knowledge. So this second concern points toward not imposing the U.S. liability regime on any genuinely foreign issuer. The third concern—relating to foreign issuers whose private calculations suggest that the corporate governance and share liquidity benefits from being subject to the U.S. liability regime exceed the costs—calls for allowing a foreign issuer to voluntarily agree to be subject to the U.S. liability regime with respect to all purchases of its shares.

Three additional policy concerns are otherwise potentially affected by imposition of such liability on an issuer: (1) assuring that the issuer's shareholders receive corporate benefits on a pro rata basis; (2) avoiding unnecessary distortions in the market choices of the world's issuers as to where to list their shares, and of the world's investors as to where to trade; and (3) promoting the economies of scale and consistency of treatment that result from similar claims being heard in one place. Each of these additional considerations is shown to be served better, or at least as well, by barring American-law-based fraud-on-the-market claims against all genuinely foreign issuers (except those choosing the U.S. regime) as they are by any other rule.

In sum, putting the properly analyzed implications of these seven policy concerns together turns out to be surprisingly straightforward. There are no difficult tradeoffs in terms of what rule would best promote both U.S. and global economic welfare.

The United States is not writing on a clean slate, however. Charting a path toward adoption of the simple rule proposed here requires an assessment of the attractions of, and the problems with, each of the likely competing approaches, and an exploration of each of the possible pathways to reform—judicial decisionmaking, SEC rulemaking, and legislation.

One competing approach, explored in Part V, is to return to the conduct/effects test. Congress has already chosen this approach for actions brought

by public officials. Making the same choice for the reach of fraud-on-the-market class actions has the comfortable allure of the familiar, but would be a mistake. It would impose this liability regime on many foreign issuers when doing so would not serve either U.S. or global economic welfare. It also proved in the pre-*Morrison* era to be very difficult to administer judicially. The problem is that the approach was originally developed to determine the reach of traditional reliance-based fraud actions, where it worked reasonably well, and was then applied to the later-developed fraud-on-the-market action. The difference between the two actions in terms of the causal link between the misstatement and the damage to the purchaser—inducing the purchaser to enter into the transaction versus increasing the price the purchaser pays—makes the approach a very poor transplant.<sup>22</sup>

Another alternative, explored in Part VI, would be to use the Supreme Court's approach in *Morrison*. The Court ruled that section 10(b) only reaches situations where the securities involved were listed on a U.S. exchange or where their purchase or sale was effected in the United States.<sup>23</sup> Because there can be no cause of action without an underlying violation of the statute, this ruling concerning the reach of the statute sets an outer limit on the reach of the private fraud-on-the-market cause of action as well. Using the *Morrison* approach would take the reach of the private action to this outside limit. Compared to restoring the conduct/effects test, using the *Morrison* test would reduce confusion and likely lead to more consistent court decisionmaking. Again, however, it would impose the U.S. fraud-on-the-market liability regime on many foreign issuers when doing so would not enhance U.S. economic welfare and would diminish welfare abroad. The proposals of certain other prominent commentators are also considered in Part V and are found to have, to one extent or another, similar defects.<sup>24</sup>

Part VII explores the different possible pathways to reform. *Morrison* repudiated the conduct/effects test and so, absent legislation or SEC rulemaking, the courts have no choice but to start afresh the task of defining the reach of the fraud-on-the-market cause of action. The Supreme Court did not address this issue because it found there was no violation of the statute in the first place.<sup>25</sup>

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22. See *infra* Part V.D.

23. *Morrison*, 130 S. Ct. at 2888.

24. See Buxbaum, *supra* note 14, at 68 (proposing that claims against foreign issuers be allowed only by investors, whether U.S. or foreign, who purchased their shares on a U.S. market); Choi & Silberman, *supra* note 14, at 506 (using presumptions instead of bright line rules to the same effect); John C. Coffee, Jr., *Global Class Actions*, NAT'L L.J., June 11, 2007, at 12, 13 (arguing that claims against foreign issuers should be allowed only by investors, whether U.S. or foreign, who purchased their shares on a U.S. market and by U.S. investors who purchased abroad).

25. *Morrison*, 130 S. Ct. at 2882-83.

The cause of action is implied, meaning that it is entirely a creation of the courts.<sup>26</sup> The courts thus define its metes and bounds and can do so in accordance with their conception of good public policy,<sup>27</sup> something the Supreme Court has shown its continued willingness to do in a number of recent, prominent cases.<sup>28</sup> The courts could conclude, as demonstrated here, that imposing fraud-on-the-market actions on foreign issuers does not enhance U.S. interests and may actually reduce global economic welfare, and therefore decide as a matter of good public policy not to include claims against foreign issuers within the reach of the action. Alternatively, the SEC could act. Section 36 of the Exchange Act<sup>29</sup> grants the SEC broad exemptive authority, and the full adoption of the simple rule recommended here is clearly within its power. Finally, there is the possibility of congressional action. Congress, by the provision in the Dodd-Frank Act mandating the SEC to prepare within eighteen months a report and recommendations concerning the reach of private actions, has already indicated possible future interest in legislating in the area.<sup>30</sup>

The ideas set out in this Article have the potential to animate reform through each of these routes. The decisionmaking of each of these institutions over the last few decades suggests increased receptivity to such ideas. Even if these ideas fail to spark immediate full adoption of the rule advocated here, they can help move the law in the Article's direction. Moreover, as detailed in the Conclusion, time is on the side of this Article's proposal. Further globalization will create pressures that will both increase, and make unavoidably self-evident, the inadequacies of the competing alternatives.

## II. THE ORIGINS OF THE FRAUD-ON-THE-MARKET CLASS ACTION

The fraud-on-the-market cause of action, which is the basis of class action claims for secondary market trading losses caused by issuer misstatements, evolved from the common law fraud action based on traditional reliance con-

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26. *See infra* Part II.A.2.

27. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). *See* Parts II.B and VII.A below for further discussion of this point.

28. *See Janus Capital Grp. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) (defining narrowly the range of persons potentially liable for misstatements in a Rule 10b-5 fraud-on-the-market class action for damages); *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (holding that a showing of loss causation is not required for plaintiffs to acquire class certification of a Rule 10b-5 fraud-on-the-market action for damages); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (holding that the fraud-on-the-market presumption of reliance does not extend to misstatements made by an issuer's vendor).

29. Securities Exchange Act of 1934 (Exchange Act) § 36, 15 U.S.C. § 78mm (2006).

30. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929Y, 124 Stat. 1376, 1871 (2010).

cepts. A brief review of this evolution is a necessary introduction to a discussion of the appropriate reach of this cause of action, and a crucial first step in understanding the confusion that occurred when the conduct/effects test, which was developed in the context of a traditional reliance action, was extended to determine the reach of this new, very different, fraud-on-the-market cause of action.

A. *The Development of a Claim for Damages for Corporate Misstatements Where the Issuer Does Not Trade*

Consider, within an entirely domestic context, a hypothetical established U.S. issuer whose shares trade in an efficient market. The issuer makes with scienter a positive material misstatement to the public. Such a statement would be a clear violation of Rule 10b-5 if the issuer were selling its shares at the same time.<sup>31</sup> Assume, however, that neither the issuer nor its insiders engage in any selling of such shares at the time of the misstatement.

For much of the history of the U.S. securities laws, the ordinary portfolio investor who suffered a loss from buying shares of this hypothetical issuer in the secondary market at a price inflated by the misstatement would not, as a practical matter, have been able to recover damages for any resulting losses. Three principles needed to be established before this situation could change: (1) Rule 10b-5 needed to be interpreted as prohibiting an issuer from making such a statement even though the issuer and its insiders are not selling any securities; (2) such a violation needed to be determined to give rise to a private right of action for damages on behalf of those injured by the violation; and (3) the investor needed to be able to establish this cause of action without having the burden of affirmatively showing that he relied on the misstatement, a burden that makes impractical the certification of a class action brought on behalf of investors who are similarly situated.

1. *The illegality of corporate misstatements*

Rule 10b-5 provides in part:

It shall be unlawful for any person, directly or indirectly, . . . [t]o 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 . . . *in connection with the purchase or sale of a security.*<sup>32</sup>

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31. See *infra* note 32 and accompanying text.

32. 17 C.F.R. § 240.10b-5 (2011) (emphasis added).

On the face of the Rule, it is not obvious that an issuer that makes a material misstatement but does not sell any securities commits a violation. The issuer could reasonably argue that the misstatement was not made “in connection with the purchase or sale of a security.” In 1968, however, in *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit rejected this argument and held that any issuer statement that is “reasonably calculated to influence the investing public”—for example, by being made to the media—satisfies Rule 10b-5’s requirement that it be “in connection with the purchase or sale of a security.”<sup>33</sup> This is the case even if neither the issuer nor its officials buy or sell shares themselves.<sup>34</sup> The court’s reasoning as to why such a statement satisfies the “in connection with” requirement is that the issuer would know that the misstatement would influence persons trading in the secondary market.<sup>35</sup>

## 2. *Private right of action*

Rule 10b-5 does not explicitly provide for a private right of action in the event of its violation. Nevertheless, as early as 1946, in the seminal case *Kardon v. National Gypsum Co.*,<sup>36</sup> a court found the existence of an implied private right of action available to those persons intended to be protected by the rule who suffer an injury to the interest intended to be protected.<sup>37</sup> The theory behind this finding was that under the common law, a violation of a legislative enactment is a tort against a person suffering such an injury.<sup>38</sup>

## 3. *Presumption of reliance on the integrity of the market and the possibility of class actions*

By the end of the 1960s, a positive material misstatement made publicly with scienter by a corporate issuer that did not trade would have been considered a violation of Rule 10b-5, and would have given rise to a private right of action. This potential liability had not yet become a serious threat to the misbehaving issuer in most situations, however. The stumbling block for plaintiffs was the requirement that they show “reliance” as the term was traditionally un-

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33. 401 F.2d 833, 859-62 (2d Cir. 1968).

34. *Id.* at 860.

35. *Id.* at 860-61.

36. 69 F. Supp. 512 (E.D. Pa. 1946).

37. *Id.* at 513-14.

38. *Id.* at 513. The Supreme Court ultimately affirmed the existence of this right twenty-five years later in *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 & n.9 (1971).



derstood.<sup>39</sup> A large portion of the secondary market purchasers of the issuer's shares would not have "relied" on the issuer's misstatement in the sense that the misstatement induced them to buy. Even for those whose purchases were induced by the misstatement, demonstrating this fact is an individualized inquiry and so the reliance requirement made a class action against an issuer impractical.<sup>40</sup>

a. *The traditional reliance requirement*

The seminal case defining traditional reliance is the Second Circuit's 1965 opinion in *List v. Fashion Park, Inc.*<sup>41</sup> The district court in *List* found that the plaintiff, with regard to one of his allegations, would have sold his stock even if he had known the true situation.<sup>42</sup> The district court dismissed the claim relating to this allegation and the Second Circuit affirmed.<sup>43</sup> Citing common law authorities, the court found that "the test of 'reliance' is whether 'the misrepresentation is a substantial factor in determining the *course of conduct* which results in [the recipient's] loss.'"<sup>44</sup> The court stated, "The reason for this

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39. See, e.g., Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 437 (1984) ("[C]ourts have sought to streamline securities fraud litigation to make it an appropriate vehicle for class actions. Thus, individual issues of proof, such as reliance, which would make an action inappropriate for class action certification, are minimized." (footnote omitted)).

40. See *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 745 (5th Cir. 1996) ("[A] fraud class action cannot be certified when individual reliance will be an issue."); *In re Scientific-Atlanta, Inc. Sec. Litig.*, 571 F. Supp. 2d 1315, 1337 (N.D. Ga. 2007) ("[P]laintiffs who are proceeding under a traditional fraud theory must usually prove actual, individualized reliance on the material misstatement or omission, thereby precluding resolution of their claims through a class action.").

41. 340 F.2d 457 (2d Cir. 1965). *List* was a nondisclosure case where the plaintiff claimed injury because an insider stayed silent when he allegedly had a duty to speak, not a case based on an affirmative misleading statement. *Id.* at 460-61. The court's analysis, however, drew upon affirmative-misleading-statement cases in the common law, as shown by its references to the Restatement of Torts, well-known torts treatises, and to prior Rule 10b-5 affirmative-misleading-statement cases. See *id.* at 462-63 (citing *Kohler v. Kohler Co.*, 208 F. Supp. 808, 823 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963); *Speed v. Transamerica Corp.*, 5 F.R.D. 56, 60 (D. Del. 1945)). Moreover, the *List* court's definition of reliance has been regularly cited as controlling in subsequent Rule 10b-5 affirmative-misleading-statement cases. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (citing *List*, 340 F.2d at 462)).

42. *List*, 340 F.2d at 464.

43. *Id.* at 464-65.

44. *Id.* at 462 (alteration in original) (emphasis added) (quoting RESTATEMENT OF TORTS § 546 (1938)).

requirement . . . is to certify that the conduct of the defendant actually *caused* the plaintiff's injury."<sup>45</sup>

b. *The fraud-on-the-market theory of reliance*

The fraud-on-the-market theory of reliance was first enunciated by some lower courts in the 1970s and was affirmed by the Supreme Court in *Basic Inc. v. Levinson* in 1988.<sup>46</sup> Under this theory, a material public misstatement by an official of an issuer whose shares trade in an efficient market will affect the issuer's share price.<sup>47</sup> This effect on price provides a plaintiff with an alternative way of showing "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury."<sup>48</sup> Unlike traditional reliance, the plaintiff no longer needs to show that she would have acted differently (i.e., not purchased the security) if the defendant had not made the misstatement.<sup>49</sup>

c. *Availability of class actions*

Allowing the plaintiff to establish reliance in this alternative way—by a showing that the misstatement caused the plaintiff to pay too much rather than by a showing that the misstatement induced the plaintiff to enter into what turned out to be an unfavorable transaction—thereby eliminates the need to make particularized claims of reliance for each purchaser. All purchasers who buy during the period when the price is inflated by the misstatement pay too much. Thus common issues of fact predominate and class actions become possible.

Given the high costs of securities litigation, the ordinary portfolio investor will rarely find the prospective recovery of her own damages sufficient to justify the cost of bringing suit. Class actions bundle together many claims against the same issuer for the same misstatement, permitting realization of very substantial economies of scale. With this reduction in the cost relative to prospective recovery, bringing suit was more often worthwhile. Thus the fraud-on-the-market presumption of reliance, by making class actions possible, made practical for the first time the pursuit of the claims of ordinary portfolio investors

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45. *Id.* (emphasis added).

46. 485 U.S. 224.

47. *Id.* at 245.

48. *Id.* at 243.

49. The Court insisted in *Basic* that its ruling maintained the need for the plaintiff to show reliance, just in the form of a rebuttable presumption of "reliance on the integrity of [the market] price." *Id.* at 247.

who suffer losses from share transactions at prices unfavorably influenced by issuer misstatements.

B. *Lessons from the History of the Two Causes of Action*

This history of the development of the fraud-on-the-market cause of action contains two important lessons for the discussion that follows. First, compared to the traditional reliance-based action, this newer action arises from a distinctly different claim of injury, and the injury typically occurs in a very different setting. Second, the way that the courts developed the implied right of action under Rule 10b-5 reflects, whether for good or for bad, a very open and creative process.

1. *Differences in injury and setting*

An action based on a showing of traditional reliance typically grows out of a face-to-face purchase of shares of a non-publicly traded issuer or a purchase at or about the time of an initial public offering (IPO). These are the only situations where investors are likely to be able to show that they would have acted differently but for the misstatement. The focus on the effect of the misstatement on the plaintiff's decision whether to enter into the transaction, rather than on the price, is appropriate in these situations because the price that the plaintiff pays is not established in an efficient secondary market. As a consequence, the value of the security is much more subjective and the relationship between the misleading statement and the plaintiff's purchase price is unclear.<sup>50</sup>

In a fraud-on-the-market action, the plaintiff has engaged in an impersonal secondary market transaction on an exchange and is typically an individual portfolio investor or an institution doing index investing. The individual plaintiff often was not even aware of the misstatement. Even if she was, the misstatement was unlikely to have weighed heavily on her decision to purchase, since the misstatement, while making the stock appear more attractive than it really was, would also have made it commensurately more expensive. Thus, whether she was aware of the misstatement or not, she likely would have made the purchase even if the misstatement had not been made. Consequently, the misstatement is not likely to be a "but for" cause of her purchase. As for the index-investing institution, it is by definition purchasing for reasons other than the misstatement.

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50. As one district court, quoted in *Basic*, 485 U.S. at 244, put it, "In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor." *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980).

As will be discussed in Part V, this difference will turn out to strongly suggest the undesirability of a return to the conduct/effects test, which was originally developed for determining the reach of the traditional action, as a way of determining the reach of the subsequently developed fraud-on-the-market action. Even independent of the policy analysis supporting the simple rule advocated here, the case for using the location of the actors associated with the making of the misstatement, the place of the trade, and the nationality of the purchaser as the factors determining the reach of the new action is, as will be developed in Part V, much less compelling than it is for the traditional rule.

## 2. *Open process by which the courts develop the cause of action*

The creation of the fraud-on-the-market class action discussed here and the pre-*Morrison* decisions of the lower courts discussed in Part V are each part of the court-driven development of the implied right of action under Rule 10b-5. There was nothing inevitable about the courts' choice to ignore major differences between the two actions and to extend the use of the conduct/effects test to determine the reach of its later-developed fraud-on-the-market cause of action. The fact that this particular approach turns out to be what the courts chose is not a persuasive reason for Congress to mandate a return to it, particularly since the clearly reasoned policy analysis offered here now reveals a wiser alternative. This lesson also suggests, as discussed in Part VII, the availability of the courts themselves as a pathway for the reforms suggested by this analysis.

### III. UNDERSTANDING THE SOCIAL FUNCTIONS OF FRAUD-ON-THE-MARKET CLASS ACTION LIABILITY

The first step in determining the appropriate reach of a U.S. fraud-on-the-market class action liability regime with respect to foreign issuers is to analyze, as a general matter, what the consequences of having such a liability regime are within an entirely domestic context: whose behaviors are changed and in what ways, whose wealth positions are changed, and what scarce resources are consumed in the system's operation. The answers to these questions will guide the determination, undertaken in Part IV, of which circumstances, if any, give the United States an interest in imposing this liability regime not just on U.S. issuers—as it has clearly chosen to do—but on foreign issuers as well.

Stripped down to its bare essentials, the fraud-on-the-market cause of action works as follows. Neither the issuer nor its insiders are selling any of the issuer's shares, and the issuer makes a material misstatement that violates Rule 10b-5. For a period of time, the misstatement inflates the price at which the issuer's shares trade in the secondary market. Because of the existence of the fraud-on-the-market cause of action, the issuer is presumptively liable to all

those who purchase its shares during the period of inflated prices for any losses that those purchasers can establish that they suffered as a result.

This liability regime potentially can be justified on either fairness or efficiency grounds. An analysis of these justifications requires consideration of both the regime's compensation aspect—the wealth transfers involved in the payments to share purchasers from the issuers that make misstatements—and its deterrence effects, arising from the threat of the need to make such payments. The analysis below suggests that the compensation provided by this cause of action does not redistribute wealth in a way that effectively corrects for any unfairness generated by the issuer's behavior. Nor does such compensation enhance efficiency by effectively reallocating the risks generated by the possibility of issuer misstatements in a way that lessens the disutility in society caused by these risks.

The threat of liability does, however, help deter issuers from making such misstatements in the first place. The resulting increase in their transparency improves both their corporate governance and the liquidity of their shares. These improvements may sufficiently enhance efficiency in the economy that the cause of action is socially worthwhile notwithstanding its substantial costs of operation. The balance between these social benefits and costs is a matter of debate, but the fact that the United States maintains this cause of action within its larger system of laws represents, for now at least, an implicit determination that within the entirely domestic context the benefits are greater than the costs.

#### A. *Fairness-Based Compensation Rationales*

Consider an issuer that makes a price-inflating misstatement in violation of the law and a purchaser of the issuer's shares who, as a result, pays more than she otherwise would. Even if neither the issuer nor any of its insiders sells shares during the period that the price is inflated, any resulting losses suffered by the purchaser would appear unfair. Paying damages equal to these losses would rectify this apparent unfairness. What, though, is the exact nature of this unfairness? And to the extent that this unfairness is real, will issuer-provided compensation make the world less unfair, or just move the unfairness around?

##### 1. *The ex ante perspective*

The first thing to note in a fairness analysis is that an issuer misstatement has no effect on the aggregate wealth of outside investors who are trading the issuer's shares in the secondary market.<sup>51</sup> If a misstatement increases an issu-

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51. This analysis assumes that neither the issuer nor its insiders are selling and thereby making trading gains as a result of the misstatement, a situation that in the United States

er's share price by \$5, every buyer pays \$5 more per share than if there had been no misstatement. But every seller receives \$5 more per share. For every share traded, the buyer's loss is exactly counterbalanced by the seller's gain. More generally, the overall effect of a misstatement on outside investors trading in the secondary market is a zero sum game: the winners' winnings just equal the losers' losses.

This is a very important observation because it means that on an expected basis, outsider secondary market traders are, in terms of their trading profits, no worse off transacting in the shares of an issuer that makes misstatements from time to time, than in the shares of one that never makes misstatements. An investor purchasing the shares of the misstatement-making issuer faces a certain percentage chance that she will overpay. This risk, however, is counterbalanced by an equal chance that she will be overpaid at the time of sale (the time when the rewards from her original purchase decision are determined).<sup>52</sup> The neutrality of the expected impact on an investor's wealth from the share price effects of an issuer's misstatement is highly relevant because the underlying rationale for fraud-on-the-market actions relates to the misstatement's effect on price. It is not, as with the traditional reliance-based action, based on the misstatement inducing the investor into a transaction she later regrets.<sup>53</sup>

In sum, even though issuer misstatements add another element of risk to the purchasing of equity,<sup>54</sup> they do not change the overall odds of winning. Investing in issuers that make misstatements is not like playing a game using dice loaded in an opponent's favor. Compensation, therefore, cannot be justified on the grounds that it is needed to correct what would otherwise be a diminution in the expected wealth position of the purchasers of misstatement-making issuers.

## 2. *The ex post perspective*

Another way of looking at unfairness is from the ex post perspective. The unlucky purchaser who in fact does pay too much because of an issuer misstatement is unlikely to feel mollified by the fact that the practice of issuer mis-

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would give rise to a different kind of Rule 10b-5 claim for civil damages based on insider trading. The analysis goes to investor wealth positions in terms of trading profits. It does not account for the misstatement's negative wealth effects, considered below in Part III.D, from the decline in corporate governance and liquidity due to lessened transparency.

52. For an analysis of why this proposition still holds in the case of a purchaser who is planning to hold her shares for a significant period of time and thus is looking to receive part or all of her return through the receipt of dividends, see Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 302-03 n.5.

53. See Part II.A.3.a above for a discussion of the traditional reliance-based cause of action for fraud.

54. See Part III.B below for a discussion of whether this imposition of additional risk justifies requiring compensation.

statements creates no unfairness *ex ante*. Her view will be that she is entirely innocent and that her loss would not have occurred but for the wrongdoing of another. She will not be impressed that the issuer's misstatement, equally by chance, made some other innocent investor a winner. Nor will she necessarily be comforted by the fact that she herself, over time or across investments, might be a gainer as often as she is a loser as the result of the more general practice of issuer misstatements. Her position will be that it is unfair that the wrongdoing of someone else forced upon her a gamble that, while having equal upside and downside odds, ended up leaving her with a loss.

Even if one finds this *ex post* perspective more congenial, compensation paid by the issuer is not an effective cure. The damages are ultimately paid for by a mix of the very same purchasers who suffered the losses (to which extent they do not, on a net basis, alleviate the unfairness of these losses at all) and of other equally innocent investors (to which extent the unfairness has simply been moved around).

The following simplified example illustrates these points. XYZ Inc. has five million shares outstanding. It makes a misstatement on June 1 that inflates its share price by \$10, so that it trades at \$70 instead of \$60. The share price remains inflated by \$10 until December 1 and no other news comes out about the issuer. The price thus stays at \$70 throughout this period. On December 1, the truth comes out and the \$10 inflation in price disappears entirely. Assume that on December 1, three million of the XYZ shares are in the hands of persons who already held them on June 1 and thus did not pay an inflated price at the time they purchased their shares. The other two million shares changed hands one or more times between June 1 and December 1. The holders on December 1 of these two million shares paid \$10 per share more than they would have but for the misstatement and, because the price is no longer overinflated, will not be able to recoup this overpayment. (For those of the two million shares that changed hands more than once during this six month period, the earlier purchaser or purchasers during the period suffered no damages because the price was still inflated at the time of their sales, thereby permitting each such purchaser to recoup her overpayment entirely.)

Suppose that a cause of action exists that allows each of the holders of these two million shares, free of transaction costs, instantly to receive from XYZ \$10 per share in compensation (a \$20 million payout in total).<sup>55</sup> The price of the shares will drop on December 1 from \$70 to \$56. Ten dollars of this price drop reflects the dissipation of the inflation when the truth comes out and the

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55. In reality, it takes time for an injured party to recover damages through a lawsuit. The simplifying assumption can be justified, however, because the market will anticipate the need for the issuer to make such payments once it becomes aware of the misstatement, and will discount the price accordingly.

additional \$4 reflects the payout to the injured shareholders of \$20 million (\$4 per share spread over the five million shares outstanding). Thus a portion of the damages received by the injured shareholders is indeed “circular,” as many critics suggest.<sup>56</sup> The injured shareholders, because of the drop in share price attributable to the payout, themselves fund \$4 of the \$10 in damages that they receive per share. The remaining portion of the damages ultimately comes from the shareholders who had acquired their shares prior to June 1. They also suffer a \$4 per share loss. Because these longer term holders are just as innocent of the wrongdoing as the parties receiving the payout, this reallocation between the two groups does not correct the unfairness suffered by the injured shareholders; it simply moves it around.

### B. *The Risk-Reallocation-Based Compensation Rationale*<sup>57</sup>

A second argument for providing compensation to traders who suffer losses from purchasing the issuer’s shares at prices inflated by its misstatements is efficiency-based rather than fairness-based. The argument is that providing compensation reduces the amount of disutility in society arising from the risk of suffering such a loss. Compensation will in fact have this effect to a limited extent because the shift of the losses from the purchasers to the whole group of the issuer’s shareholders will spread these losses over a larger number of people. Given the high rate of turnover of shares, however, this is not typically a much larger number and so the improvement in risk allocation is very minor.<sup>58</sup> At the same time, these suits consume substantial amounts of legal fees and other real resources in society.<sup>59</sup> With such a small gain for such a substantial cost, this is insurance that few, if any, persons who realize the cost would want to buy.

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56. See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1556-66 (2006); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 632 (1992). Both authors express skepticism concerning the compensation rationale for requiring issuers to pay damages to those who trade in the secondary market at disadvantageous prices due to issuer misstatements.

57. I have considered these points in detail in Fox, *supra* note 52, at 304-09.

58. “Of the 688 securities class actions filed from 2002 to 2008 that have settled or been dismissed, the class period has averaged about 1.5 years.” *Id.* at 305 n.10. Based on NYSE figures for share turnover, in the average case, 79% of the shares would have been sold at least once during this 1.5-year period of time, and so the losses associated with these 79% would be spread over 100% of the shares. *Id.* at nn.10-11.

59. Available data suggests that in recent years average legal expenses for the two sides associated with securities class actions (the defense’s legal fees ultimately being paid by shareholders and the plaintiff’s legal fees coming out of the recovery) totaled about \$2.5 billion per year, while total settlements averaged about \$4.1 billion per year. *Id.* at 306 n.15. Other costs include the executive time involved in litigation and the use of judicial resources.



Equally important, there is a far less costly, far more effective, alternative way of dealing with this risk: investor portfolio diversification. Unlike compensation from the issuer, diversification can fully eliminate both the risk from the possibility of issuer misstatements and all other firm-specific (i.e., unsystematic) risks as well.<sup>60</sup> Thus fraud-on-the-market suits are far less effective at eliminating the disutility in society generated by the risk of issuer misstatements, and consume more of society's scarce resources.

### C. *The Investor Protection Deterrence Rationale*

The threat of a fraud-on-the-market suit will tend to deter a corporate manager from making material misstatements. Everything else being equal, she will be worse off if her company needs to pay out a large damages award. The argument that this deterrence is needed to enhance investor protection is weak, however, for reasons closely related to the fairness and risk allocation reasons discussed above. Many provisions in the securities laws, including major parts of broker-dealer regulation, have important investor protection purposes. Investor protection is not, however, a persuasive rationale for the regulation of the disclosure of established issuers trading in efficient markets. Disclosure by such issuers is not necessary to protect investors against either unfair prices or risk.<sup>61</sup> This is because the market discounts all issuers for the possibility that they may be making falsely positive statements. The market, however, does not know, at least for sure, which issuers are making misstatements and which are not. Thus the issuers that are actually making falsely positive statements are priced too high, and ones that actually are not are priced too low. According to the efficient market hypothesis, the discount for the possibility that any given issuer is making a false statement reflects all publicly available information relating to the likelihood that it is doing so, and so the price of its shares is unbiased. In other words, the price is as likely to be below the share's actual value as above.

The share price will be unbiased in this way whether the issuer is operating in a legal environment that makes the likelihood of such a misstatement very low or one that allows the likelihood to be much higher. In other words, improving transparency is not necessary to protect investors from buying shares at

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60. See RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 168-70 (10th ed. 2011) (noting that diversification fully eliminates all firm-specific risks). Diversifying a portfolio over as few as twenty randomly selected stocks can eliminate almost all the firm-specific risk associated with each. See *id.* at 169-70. Complete diversification can be attained at low cost by purchasing an index fund.

61. I have considered the points discussed here in significantly more detail elsewhere. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2532-44 (1997).

prices that are, on average, unfair (i.e., greater than their actual values). Such an improvement, by reducing the likelihood that an issuer makes a false statement and thus avoiding later surprises, may reduce risk—on average bringing the price closer, on one side or the other, to its actual value—but the only kind of risk that it reduces is *unsystematic* risk.<sup>62</sup> Again, simply by being diversified, investors can protect themselves from this unsystematic risk much more effectively and at less social cost than by improvements in issuer transparency.

Though a large portion of equity is held by investors that are diversified, a not-insignificant portion of equity is held by undiversified investors despite diversification's advantages as a way of reducing the risk from any lack of issuer transparency.<sup>63</sup> The existence of these undiversified investors, and the resulting risks that they face, might suggest, contrary to the analysis above, a strong investor protection justification for enhancing transparency through the fraud-on-the-market liability regime. For a number of reasons, however, this suggestion is unpersuasive.

The first thing to note is that many undiversified investors are aware of the advantages of diversifying but still choose not to. In some such cases, the investor is investing simply to gamble. Such an investor rationally seeks to invite risk, not to avoid it, and so any expenditure of social resources to reduce the

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62. See *supra* note 60 and accompanying text.

63. As of the end of the third quarter of 2011, institutional investors (mutual funds, closed-end funds, exchange-traded funds, brokers and dealers, federal government retirement funds, state and local government retirement funds, private pension funds, life and property casualty insurance companies, savings institutions, and U.S.-chartered commercial banks), which can be assumed generally to be highly diversified, held 49.2% of the value of U.S. equities. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS THIRD QUARTER 2011 (2011) 94 tbl.L.213, available at <http://www.federalreserve.gov/releases/z1/20111208/z1.pdf>.

When U.S. individuals invest in equities directly, most do so in an undiversified portfolio. A study of the 2001 Survey of Consumer Finance found that about 80% of individual portfolios held the stocks of five or fewer companies and about 90% held the stocks of ten or fewer companies. Valery Polkovnichenko, *Household Portfolio Diversification: A Case for Rank-Dependent Preferences*, 18 REV. FIN. STUD. 1467, 1476 (2005). However, because of the skewness of shareholdings, the aggregate wealth invested through undiversified equity portfolios was not as large. Only about 40% of the aggregate value of equities directly held by individuals was held in portfolios with ten or fewer stocks, which, again, represented 90% of all portfolios. *Id.* at 1477 fig.1. Furthermore, the 40% figure likely overestimates the aggregate value of equities held by individual investors who are undiversified across all of their investments because some investors who hold equities directly in undiversified portfolios also hold equities indirectly through diversified funds, such as mutual funds. In 2001, the median individual investor indirectly held 60% of the value of his or her total equity holdings, leaving 40% in direct portfolios, with the direct portfolios having a median of three different stocks. *Id.* at 1476 tbl.2. Finally, it appears that many individuals who invest in equities directly choose to do so, knowing the risk of attempting to choose stocks and balancing their direct equity holdings according to their risk tolerances. *Id.* at 1481.

risk that he faces hurts him, rather than protects him. In other cases, the investor (or the person advising the investor or managing her money) knows the advantages of diversification but is speculating that the market price of a particular security in which she is concentrating her portfolio is below its actual value. Such speculation, when it is based on the hard work of gathering and subjecting to shrewd analysis publicly available information not yet appreciated by the market, can serve a useful social purpose. It increases price accuracy, which, as discussed in Part III.D immediately below, increases economic efficiency by improving the operation of existing projects and the selection of proposed new investment projects in the economy. While this concern may be a valid reason to expend social resources to enhance an issuer's transparency, the end purpose of doing so would not be to protect the investor; it would be to promote more of an activity that enhances the efficiency of the economy as a whole. This undiversified investor is not in need of special solicitude: she concentrates her portfolio in the security that she views as undervalued only to the extent that the increased risk from lack of diversification is justified by the speculative gain that she expects.<sup>64</sup>

What, though, about unsophisticated investors whose lack of diversification is due to ignorance of its benefits? A number of alternative policies could significantly reduce the number of such individuals: (1) a public campaign of investor education, (2) changes to broker-dealer regulations that would require the broker to explain to the customer the benefits of diversification and put the burden on the broker to justify any recommendations that result in a concentrated portfolio, and (3) Employee Retirement Income Security Act (ERISA) reforms that discourage employer-run employee retirement funds from concentrating their investments in the employers' shares. Such programs would not be inordinately expensive and would be far more effective at reducing risk for those investors that these programs actually convert into diversified securities holders. Admittedly, the latter two policies would likely face stiff resistance from those with vested interests in the old way of doing things, but the first policy would probably face less resistance. And, relative to enhancing transparency by imposing fraud-on-the-market liability, all three alternative policies, for the investors that they convert, are so superior in terms of risk reduction benefit versus cost that they are almost certainly the more appropriate focus of regulatory efforts at investor protection. Still, some unsophisticated undiversified investors will remain even after any efforts to promote these three alternative policies. The difficulty in justifying imposing fraud-on-the-market liability just to reduce the unsystematic risk faced by these remaining unsophisticated undiver-

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64. This point is established in a more rigorous fashion in MERRITT B. FOX, *FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY* 36-43 (1987).

sified investors is that the cost of the regime is borne pro rata by all shareholders even though most are sufficiently diversified not to receive significant risk reduction benefits. Thus imposing liability might well work a larger unfairness than that suffered by the remaining unsophisticated undiversified investors if liability is not imposed.

D. *Deterring Misstatements to Promote Corporate Governance and Liquidity*<sup>65</sup>

While the investor protection arguments for imposing liability on an issuer to deter misstatements are weak, the corporate governance and liquidity arguments for doing so can be much stronger. The starting point for understanding these arguments is to note that they rest on the threat of liability increasing an issuer's transparency, and that the power of this threat to increase transparency is much greater when the issuer operates within a regulatory environment requiring significant periodic disclosure. In such a situation, the issuer has no choice but to make many material statements relevant to predicting future cash flows available to its shareholders. Imposing the threat of liability, therefore, will not deter the issuer from making statements about the required matter in the first place; it has no choice but to do so. The threat just deters the issuer from making these statements in a false or misleading way. Thus fraud-on-the-market liability should be viewed primarily as an enforcement mechanism for mandatory periodic disclosure. This means that the corporate governance and liquidity arguments for involuntarily imposing on issuers this liability regime are inextricably tied up with the underlying rationale for mandatorily imposing periodic disclosure requirements. The chain of logic is as follows: fraud-on-the-market liability for misstatements leads to more truthful compliance with mandatory disclosure rules, which in turn increases issuer transparency, thereby improving corporate governance and liquidity.

1. *The rationale for mandatory disclosure*

This Article primarily concerns what circumstances, if any, justify mandatorily imposing the U.S. fraud-on-the-market regime on a foreign issuer. This requires an analysis of why such a regime would be mandatorily imposed on any issuer, even within an entirely domestic context. Because, as just noted, this liability regime is best viewed as a private enforcement mechanism for a system of mandatory periodic disclosure, the justification for mandatorily im-

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65. A more detailed account of these efficiency-enhancing effects of issuer transparency can be found in Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 252-60, 264-67 (2009).

posing this liability regime on an issuer must in the first instance rest on the justification for mandatorily imposing a periodic disclosure regime on the issuer.

The most persuasive rationale for mandatory periodic disclosure for established issuers trading in efficient markets arises from the fact that such issuers, if left unregulated, are likely to choose a level of disclosure that is less than socially optimal. This is because each issuer's private costs of disclosure are greater than the social costs of disclosure, while its private benefits are less than the social benefits.<sup>66</sup>

With regard to the divergence between private and social costs for each individual issuer, a disclosure involves two different kinds of costs: operational costs and interfirm costs. Operational costs are the out-of-pocket expenses and the diversions of management and staff time that issuers incur to provide the information. Interfirm costs arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers, and major customers. Operational costs are costs both to the individual firm and to society as a whole. Interfirm costs are costs only to the individual firm. They are not social costs because the disadvantages to the issuer from the disclosure are counterbalanced by the advantages they confer on the other firms. Thus, at all levels of disclosure, an issuer's private marginal cost of disclosure will exceed its social marginal cost by an amount equal to these interfirm costs.

With regard to the divergence between private and social benefits, information disclosed by one issuer does not just improve its corporate governance and reduce the illiquidity of its own shares. The information can be useful as well in analyzing other issuers, and thus has beneficial effects on those other issuers' governance and liquidity. One issuer's disclosures could, for example, reveal something about possible trends for its industry as a whole.<sup>67</sup> In particular, if one has detailed information about one issuer's performance, it is easier to detect shirking by the managers of its competitors, who face a similar external business environment. The disclosing issuer's share price will only capture transparency-induced improvements in its own corporate governance and liquidity, not the corporate governance and liquidity improvements of other firms that become more transparent as the result of the disclosing firm's disclosure. Therefore, the private benefit to the disclosing issuer and its shareholders will be less than the social benefit.

Because an issuer's disclosure involves both social costs and social benefits, each issuer has some socially optimal level of disclosure. Because the pri-

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66. See generally Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999).

67. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 685 (1984).

vate costs of an issuer's disclosure exceed the social costs and the private benefits fall short of the social benefits, even managers who completely identify with existing shareholders—managers who seek to maximize share value—would, if free to choose a disclosure level to which to bind the firm, choose a level below the social optimum.<sup>68</sup> Mandatory disclosure can be viewed, in important part, as an effort to correct this shortfall, and its ability to do so is its primary advantage over relying on firms voluntarily committing to be bound by such a regime as a form of bonding. In this connection, it should be noted that if all issuers in an economy are required to increase their disclosures up to the socially optimal level, the effects of the interfirm costs that give rise to the divergence between private and social cost would likely be a wash for each firm. Each firm would lose as a result of its own increased disclosure, but gain from the disclosures of its competitors, major suppliers, and major purchasers. At the same time, the higher level of disclosure would reduce agency costs of management and improve liquidity.

2. *Detering misstatements makes mandatory disclosure more effective at promoting transparency*

A comprehensive system of mandatory periodic disclosure will require issuers to make disclosures concerning a wide range of information relevant to predicting their future cash flows, and to make most of their material public statements (either initially or quickly thereafter) in forms filed pursuant to the system's requirements. Fraud-on-the-market class actions are a form of private enforcement of the truthfulness of these disclosures. By deterring misstatements in connection with such disclosures, they make the system more effective and hence promote transparency.<sup>69</sup>

Mandatorily imposing the fraud-on-the-market regime, if it were found to be a cost-effective form of enforcement, can therefore be viewed as complementary to mandatorily imposing the periodic disclosure regime. Without enforcement, the mandatory disclosure regime cannot perform its intended correction of the market failure arising from unregulated issuers disclosing at

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68. I have considered in more detail elsewhere the divergence of the private and social costs and benefits of issuer disclosure and the consequent tendency of unregulated issuers to disclose below their socially optimal level. See Fox, *supra* note 66, at 1343-46; see also Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1490-91 (1992); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Easterbrook & Fischel, *supra* note 67, at 684-85; Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 846-74 (1995).

69. See Coffee, *supra* note 68, at 725-37.

suboptimal levels because of the divergence of social and private costs and benefits.

### 3. *Greater transparency contributes to better corporate governance*

Greater transparency enhances efficiency by improving the selection of proposed new investment projects in the economy and the operation of existing projects. A corporation is well governed if it makes these decisions in ways that maximize share value. Transparency has beneficial effects on the workings of both the legal mechanisms for assuring the quality of corporate governance, and the existing market mechanisms that help align managerial interests with those of shareholders. Transparency thus prompts managers to make share-value-maximizing decisions.

In terms of legal mechanisms, transparency strengthens the effective exercise of the shareholder franchise: a better-informed shareholder is more likely to vote for share-value-maximizing choices with regard to all matters, including the selection of directors. Transparency also enhances the effectiveness of derivative-suit enforcement of management's fiduciary duties, because managers are unlikely to voluntarily provide information concerning their breaches of these duties. And by making the existence of conflicts more easily detected, it makes more meaningful those corporate law provisions that require special procedures in connection with the authorization of transactions in which management has an interest.

In terms of market mechanisms, transparency has beneficial effects on the operation of three of the economy's key market-based mechanisms for controlling managerial behavior: (1) the market for corporate control, (2) share-price-based managerial compensation, and (3) the terms at which new funding is available to the corporation.

Transparency strengthens the effectiveness of the market for corporate control by increasing the threat of a hostile takeover when incumbent managers act in a non-share-value-maximizing way. A potential acquirer must assess what a target would be worth in its hands. Greater transparency reduces the risk of inaccuracy in this assessment. Because typically the managers of the potential acquirer (like most individuals) are risk averse, this reduction in the risk of inaccuracy means that a smaller apparent deviation between incumbent target management decisionmaking and what would maximize share value will impel the potential acquirer into action. This reduction in the size of the apparent deviation needed to impel action, by increasing the threat of takeover, better motivates incumbent managers to maximize share value. For incumbent managers who nevertheless fail to maximize share value, it increases the likelihood of their replacement.

Transparency strengthens the usefulness of share-price-based compensation as a way of motivating management by inducing management to accept a larger portion of its total compensation in share-price-based form. Compared to straight salary with the same expected value, the problem for managers with share-price-based compensation is the undiversifiable, unsystematic risk that holding a large amount of a single company's shares or options imposes on the manager. More transparency makes share prices more accurate, which, by eliminating surprises, reduces this unsystematic risk. More accurate share prices also make such compensation more effective at spurring effort because managers expect a higher likelihood that good results will be accompanied by a higher share price and bad results by a lower one.

Transparency, by improving share price accuracy, also improves the allocation of scarce capital among the proposed real investment projects in the economy. This is clearest when a firm is considering funding a project through the issuance of new equity. Transparency affects the terms at which such funds can be obtained. An inaccurately high price may encourage managers to invest in negative net present value projects (i.e., projects with prospects inferior to the prospects of some proposed projects in the economy that do not get funding). An inaccurately low price may discourage investments in positive net present value projects (i.e., projects with prospects better than some project proposals in the economy that do get funding). There is evidence that share price affects the terms demanded by other available external sources of funds as well.<sup>70</sup> Share price also appears to affect management's willingness to use internal funds to implement a new project.<sup>71</sup>

#### 4. *Greater transparency contributes to liquidity*

Transparency also enhances efficiency by increasing the liquidity of an issuer's stock through the reduction in the bid-ask spread demanded by the makers of the markets for these shares. More transparency thus reduces illiquidity in the secondary market for an issuer's shares. Insiders and their tippees can make supernormal profits by engaging in trades based on nonpublic information. Since market makers, specialists, and other providers of liquidity have difficulty knowing whether they are dealing with traders acting on inside information or with uninformed outsiders, they cover the expected costs of being on the other side of trades with informed traders through the "bid-ask" spread that they offer all traders (i.e., the difference between the lower price at which they accept seller orders and the higher price at which they accept buyer

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70. See HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 123 (1979).

71. See FOX, *supra* note 64, at 282-87.



orders).<sup>72</sup> The bigger the spread, the less liquid are the issuer's shares, and the less valuable they are to hold. Greater transparency reduces the amount of non-public information and hence the opportunities for insiders and tippees to engage in trades based on such information, thereby reducing bid-ask spreads, increasing liquidity, and, as a consequence, reducing the cost of capital.<sup>73</sup>

#### IV. USING FIRST PRINCIPLES TO DETERMINE THE APPROPRIATE TRANSNATIONAL REACH OF FRAUD-ON-THE-MARKET ACTIONS

Assume that the United States could start from scratch in determining the reach of fraud-on-the-market class actions with significant transnational elements. How should it design a rule that would maximize U.S. economic welfare, and by also promoting global economic welfare, foster good foreign relations?

Four important policy concerns arguably justify imposing U.S. fraud-on-the-market class action liability against an issuer for the benefit of secondary-market purchasers of its shares who suffer losses because the price was inflated by the issuer's misstatements: (1) providing compensation in order to correct for the unfairness of these losses or to spread their risk; (2) deterring issuers subject to a mandatory disclosure regime from making misstatements, in order to increase their transparency and thereby improve their corporate governance and liquidity; (3) permitting issuers not automatically subject to this regime of mandatory disclosure and liability for misstatements to opt in, as a bond that they will maintain high transparency; and (4) assuring that exchanges located in the United States are places where only the shares of high-transparency issuers trade.

Three other policy concerns are otherwise potentially impacted by imposition of such liability on an issuer: (1) assuring that the issuer's shareholders receive corporate benefits on a pro rata basis; (2) avoiding unnecessary distortions in the market choices of the world's issuers as to where to list their shares and of the world's investors as where to trade; and (3) promoting the economies of scale and consistency of treatment that result from similar claims being heard in one place.

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72. LARRY HARRIS, TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 287-91, 299-302 (2003); Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985).

73. For models working these points out more rigorously, see David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553 (2004) (explaining that disclosure reduces information asymmetries and lowers a firm's cost of capital); Robert E. Verrecchia, *Essays on Disclosure*, 32 J. ACCT. & ECON. 91 (2001) (same).

Putting the properly analyzed implications of these seven policy concerns together will suggest that as a general rule, U.S. fraud-on-the-market-based claims should not be imposed on genuinely foreign issuers, even if the claimants are U.S. residents or have effected their purchases on U.S. markets. The exception to this general rule would be where a foreign issuer voluntarily agrees to be subject to the U.S. liability regime.

A. *Policy Concerns Arguably Justifying Imposition of Liability*

1. *The illusory compensation concern*

Providing investor protection through compensation is the policy rationale given most frequently by the courts<sup>74</sup> and by public officials<sup>75</sup> for imposing fraud-on-the-market liability. Providing compensation is supposed to reduce investor risk, and to reverse any purportedly unfair trading losses suffered by investors.

If this rationale were sound, it would point toward a rule allowing claims against foreign issuers when brought by U.S. investors, especially when the issuer promoted trading by U.S. residents in its shares through listing them on a U.S. exchange or otherwise sponsoring their trading among U.S. residents. The analysis in Part III, however, shows that providing such compensation does not cost-effectively reduce risk and is not justified on fairness grounds<sup>76</sup>—a view widely shared by thoughtful commentators on the issue.<sup>77</sup> Compensation concerns, therefore, should not play a role in terms of determining the optimal rule concerning the reach of the U.S. liability regime. In other words, while the United States is particularly interested in the welfare of its own residents, this interest is not a good reason to put weight on the national residency of a purchaser in determining whether a class action fraud-on-the-market claim may be brought. This conclusion is important because much of the pre-*Morrison* discussion relating to the reach of the fraud-on-the-market cause of action against

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74. *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997); *Fogarazzo v. Lehman Bros.*, 232 F.R.D. 176, 186-87 n.87 (S.D.N.Y. 2005); *Simon v. Am. Power Conversion Corp.*, 945 F. Supp. 416, 425 (D.R.I. 1996); *Grossman v. Waste Mgmt., Inc.*, 589 F. Supp. 395, 406 (N.D. Ill. 1984).

75. President Clinton, for example, articulated this rationale when he wrote to the House, requesting that it amend the Private Securities Litigation Reform Act (PSLRA), saying, “[I]t is also true that there are innocent investors who are defrauded and who are able to recover their losses only because they can go to court. . . . [I]t is not appropriate to erect procedural barriers that will keep wrongly injured persons from having their day in court.” 141 CONG. REC. S19048 (daily ed. Dec. 21, 1995).

76. *See supra* Part III.A-C.

77. *See, e.g., Coffee, supra* note 56, at 1556-66; *Mahoney, supra* note 56, at 632.

foreign issuers is based on this investor protection concern and accordingly tends to privilege claims by U.S. residents.<sup>78</sup>

2. *Deterring misstatements to promote corporate governance and liquidity, and the scope of U.S. interest*

The threat of fraud-on-the-market liability deters issuer misstatements and as a consequence enhances transparency, especially if the issuer is subject to a rigorous set of periodic disclosure requirements. This enhanced transparency limits the extent to which the managers of a public corporation place their own interests above those of their shareholders (i.e., the agency costs of management).<sup>79</sup> Thus, as we have seen, class action fraud-on-the-market suits can be properly considered a corporate governance device. The transparency-enhancing effects of the threat of such actions also reduce information asymmetries in the market and hence improve the liquidity of an issuer's shares.<sup>80</sup> Along with the liability regime's social benefits, however, come its social costs. The key question is whether, for a foreign issuer, U.S. legal decisionmakers are better positioned than legal decisionmakers in the issuer's home country in terms of their incentives and the information in their possession to determine whether the benefits of applying the U.S. liability regime to the foreign issuer exceed the costs. The analysis below demonstrates that the legal decisionmakers of the issuer's home country are better positioned to make this decision.

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78. *In re SCOR Holding (Switzerland) AG Litig.*, 537 F. Supp. 2d 556, 562 (S.D.N.Y. 2008) (“The effects test was developed ‘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’ based on an assumption that Congress intended the securities laws to have extraterritorial application ‘when a violation of the Rules is injurious to United States investors.’” (citation omitted) (quoting *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir.), *rev’d in part en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968))); *see also* Buxbaum, *supra* note 14, at 53 (“Judicial treatment of multinational class actions reveals one core assumption: courts are not willing to deprive U.S. investors who purchase securities on U.S. markets of a remedy under U.S. law. . . . [I]t is true even if the conduct in question caused significantly *more* harm to foreign investors than to U.S. investors.”). The role that purchaser residency played in determining the reach of the action is further explored in the review of pre-*Morrison* case laws in Part V.C below.

79. *See supra* Part III.D.3.

80. *See supra* Part III.D.4.

a. *Corporate governance*

The extent of the corporate governance benefits from the transparency-enhancing effects of the threat of fraud-on-the-market suits will vary across countries depending on their issuers' typical ownership structures and their overall systems of corporate governance.

The ownership pattern of the typical publicly traded corporation in the United States is dispersed, with no single controlling shareholder.<sup>81</sup> The primary corporate governance problem with dispersed ownership is the divergence of interests between management and shareholders. As discussed in Part III, truthful disclosure ameliorates these agency costs of management.<sup>82</sup> Divergences between the private and social costs of issuer disclosure, as well as between its private and social benefits, can justify imposing mandatory disclosure requirements on an economy's issuers. Fraud-on-the-market liability is a method of privately enforcing truthful responses to these requirements. As noted earlier, the fact that the United States, within its larger system of laws, provides for such liability domestically represents an implicit determination that, at least for U.S. issuers, the corporate governance benefits from this private enforcement mechanism, when combined with the liquidity benefits, are greater than the costs.

In a substantial majority of other countries, most corporations are controlled by families, banks, or the state.<sup>83</sup> The agency problems associated with management are lower because shareholders with control positions can supervise managers more easily than can dispersed shareholders. Thus a high level of public disclosure is not as necessary to keep managers in line. As a result, in the many countries where concentrated share ownership is the norm, the corporate governance gains from the increased transparency prompted by imposing on its issuers a fraud-on-the-market type of liability regime can be expected to be smaller than in the United States.<sup>84</sup> Therefore, while it is possible that imposing such liability on the issuers from these countries will enhance economic welfare, everything else being equal, it is less likely.<sup>85</sup>

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81. Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-95 (1999).

82. See *supra* Part III.D.3.

83. See La Porta et al., *supra* note 81, at 496.

84. The social costs associated with promoting issuer transparency through mandatory disclosure requirements and fraud-on-the-market liability, unlike the benefits, are probably more similar across countries because the mechanisms involved work similarly everywhere.

85. The prime corporate governance problem in concentrated ownership firms is controlling shareholders taking private benefits in violation of the pro rata distribution rule, rather than the agency costs of management. See John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 3, 24 (2001). Increased transparency can also be helpful in discouraging this

An issuer's home country government is best positioned to weigh the benefits and costs of involuntarily imposing on the issuer a fraud-on-the-market type of liability regime. Ultimately, whether involuntarily imposing a fraud-on-the-market type of liability regime on an issuer enhances economic welfare depends on weighing the gains from the resulting increased transparency on the part of the issuer (and of other firms that become easier to analyze when the issuer becomes more transparent) against the very substantial amount of real resources that such a liability regime consumes. These include both the resources expended by issuers to try to comply in order to avoid liability and, when litigation nevertheless arises, the resources expended by both sides<sup>86</sup> and by the judiciary.

It will be argued here that the country where an issuer has its economic center of gravity is best positioned to weigh these benefits and costs. The issuer's home country is better informed because it has access to local knowledge. And it will be more motivated to do the weighing accurately because, as will be shown, ultimately most of the benefits from making the correct decision whether or not to involuntarily impose this liability regime on the issuer accrue to residents of the home country even if investors in the issuer are spread around the world.

The demonstration that the benefits from making the right decision on whether or not to impose the liability regime are concentrated in the issuer's home country starts with the observation that in an efficient market, an issuer's share price takes into account the effect on the issuer's future expected cash flow of the forces determining the quality of the issuer's corporate governance. If the issuer is subject to a fraud-on-the-market liability regime, these forces include the benefits and costs experienced by the issuer because it and the other issuers in the country's economy are subject to such regime. At the same time, because globalization makes capital relatively mobile internationally, competitive forces push capital toward receiving a single global expected rate of return (adjusted for risk). Thus investors in all the world's issuers tend to get the same risk-adjusted expected return even though the quality of corporate governance

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kind of misbehavior, but the extent of its effectiveness depends greatly on the specific situation. News of such behavior may depress share prices, but if those in control directly or indirectly determine the votes of a majority of the shares, such a decrease in price will not lead to a fear of being replaced by a hostile takeover. Whether increased transparency has some other kind of deterring effect on such behavior depends both on the overall social and business mores of the country and the extent to which such behavior, once revealed, can be meaningfully challenged in court.

86. For the United States, a reasonable estimate of the litigation costs for the legal and expert fees of both sides is \$2.5 billion per year. Fox, *supra* note 65, at 247-48 n.18. These figures do not include the value of the executive time devoted to defending the litigation.

and the costs of the devices used to promote it may vary widely from one country to the next.

Where, then, go the higher returns that result from a country's issuers being subject to an optimal mix of devices (including the correct decision as to whether or not to impose fraud-on-the-market liability) that prompt good corporate governance? They go largely to the suppliers of the issuers' less mobile factors of production. These are the country's entrepreneurs, who will get higher prices when they sell shares in the firms they founded, and labor, who are likely to enjoy higher wages in an economy where capital is allocated and used efficiently. Thus the persons in the world who primarily benefit from higher real returns from a country's issuers being subject to an optimal mix of corporate governance devices are the country's entrepreneurial talent and labor, who are residents of the country, not the investors in these issuers.<sup>87</sup>

This reasoning shows that if issuers with a U.S. economic center of gravity are subject to fraud-on-the-market suits, the ultimate impact of both the benefits of improved corporate governance and the expected costs will be concentrated in the United States, regardless of how globally dispersed their share-

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87. If a country's issuers represent only a small portion of all equities available to investors in the world, investors would share in almost none of these gains. The country would be analogous to a single small firm in a perfectly competitive industry. Such a firm's level of production has no effect on price. Following this analogy, what the country produces is investment opportunities—dollars of future expected cash flow—just like the small firm in a perfectly competitive industry produces products. A transparency improvement's positive effects on managerial motivation and choice of real investment projects will increase the number of dollars of future expected cash flow that the country has to sell. This benefits the country's entrepreneurs, who are selling the cash flow, and its labor, who gain from the overall increase in the country's economic efficiency. See Fox, *supra* note 61, at 2561-69. Because the country is like the small firm, however, the increase in the amount expected future dollars supplied to the world is not great enough to lower the price at which a dollar of future expected cash flow is sold. Thus there is no benefit to investors, the "buyers" of these dollars of expected future cash flow.

If a country's issuers represent a substantial portion of all equities available to investors, investors around the world will share in some of these gains. A movement toward the optimal mix of corporate governance devices would sufficiently increase the number of dollars of future expected cash flow that the country supplies to the world that the price at which a dollar of future expected cash flow is sold would be lowered, at least slightly. Thus investors—the persons who pay current dollars to buy future dollars—would gain from the improvement (i.e., the global risk-adjusted expected return on investment would increase). This is equally true of investors from every country in the world, however, because investors all around the world receive the same global expected rate of return (adjusted for risk). Thus, the fact that investors in an issuer are residents of a country other than the home country does not give the other country some special stake, relative to the rest of the world as a whole, in regulating the mix of corporate governance devices imposed on the issuer. For more detailed discussions of these points, see *id.* at 2552-80; and Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696, 732-33 (1998).

holders are. Similarly, the costs and benefits of the decision to impose fraud-on-the-market liability regime on an issuer with an economic center of gravity in another country are concentrated on residents of that country. The United States does not have a large stake in whether this foreign issuer is subject to such a regime or not, even if U.S. investors own substantial shareholdings in these issuers.<sup>88</sup> This same reasoning shows as well that the location where an issuer's shares are traded is simply irrelevant to where the ultimate impact of the benefits and costs of the mix of good corporate governance prompting devices is felt.

b. *Liquidity*

The transparency-enhancing impact on liquidity of an issuer being subject to a fraud-on-the-market liability regime leads to a similar conclusion. If an issuer's shares are more liquid, they are more valuable to hold. This transparency-induced gain in value must be aggregated with the social gains in the quality of corporate governance and then weighed against the social costs of an issuer being subject to such a liability system. The prospect of higher liquidity will boost the price of the issuer's shares at the time of their original public offering. The beneficiaries will be the entrepreneurs who take the firm public. Again, these entrepreneurs are likely to be located in the country where the issuer has its economic center of gravity. The initial and subsequent public holders of the shares will enjoy this superior liquidity, but they will have to pay a commensurate premium for it at the time of purchase.

c. *The limits of U.S. interest*

In sum, the policy concern with the transparency-enhancing impact of fraud-on-the-market suits on corporate governance and liquidity provides little justification for imposing the U.S. fraud-on-the-market class action liability regime on foreign issuers. This is true even in the case of claims by U.S.-resident purchasers who purchase the shares of such issuers in a U.S. market. For U.S. issuers, this liability regime is a corporate governance and liquidity-enhancing device that the United States, by the decision to impose it domestically, has im-

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88. To the extent that globalization has not yet proceeded far enough to fully result in a single global risk-adjusted expected rate of return on capital, the remaining market segmentation, which would reflect a home bias by investors, simply reinforces the point. The gains from a country's issuers being subject to an optimal mix of good-corporate-governance-prompting devices will be even more concentrated at home because any gain to investors from this imposition of an optimal mix would be disproportionately enjoyed by home-country investors rather than being spread evenly across all investors in the world. See Fox, *supra* note 61, at 2561-69; Fox, *supra* note 87.

PLICITLY determined to be worth its costs. But this device may not be worth its costs when imposed on issuers of another country. The foreign issuer's home country is the better judge of these costs and benefits and its residents will be the primary ones to feel the consequences from whether or not liability is imposed on the issuer. It is not surprising that foreign governments have protested the United States' imposition of its fraud-on-the-market liability regime on their issuers, since their decisions not to include this device as part of their own domestic systems imply that they have determined that, for their issuers, this device is not worth its costs.<sup>89</sup>

### 3. *Enhancing global welfare by facilitating foreign-issuer bonding*

Consider a foreign issuer whose home securities laws do not subject it to American-style fraud-on-the-market liability for material misstatements. The home-country laws may well reflect a determination that based on the social costs and benefits, for most of its issuers, imposing such a system of liability would not be a cost-effective component of their corporate governance. Suppose, however, the management of this particular issuer, after taking account of just its private costs and benefits, concludes, as a share-value maximizer, that it would be a net gainer under a U.S.-style system of periodic affirmative disclosure and fraud-on-the-market liability. In other words, management calculates that the value of the expected improvements in corporate governance and liquidity exceed the expected private costs of compliance and the expected costs from any possible litigation.<sup>90</sup> The individual firm's private calculations will, from a social point of view, overstate the costs and understate the benefits of the firm being subject to such a liability and disclosure regime, as we saw in the discussion of the market failure justification for mandatory disclosure.<sup>91</sup> Thus when a foreign firm's management voluntarily chooses to be bound by the U.S. disclosure and fraud-on-the-market liability regime, the expected economic gain to the world is unambiguously positive. Providing foreign issuers the option to be subject to the U.S. regime will therefore enhance global economic welfare.

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89. For examples of foreign governments that have expressed concerns about their issuers being subject to U.S. fraud-on-the-market liability, see note 10 above.

90. Litigation expenses would not include payments actually received by the share purchasers at the time of judgment or settlement. These transfers are distributions from the issuer to shareholders and the share price at the time of purchase should reflect the probabilistic chance of receiving such a payment. Litigation expenses would include the costs the issuer incurs defending the litigation. They would also include the fees and expenses paid to plaintiffs' lawyers, since the shareholders receive only the portion of the firm's total payout that remains after these fees and expenses are paid.

91. See *supra* Part III.D.1.



These gains in global economic welfare will likely be enjoyed primarily abroad. If the foreign issuer chooses to be subject to the U.S. disclosure and liability regime at the time it goes public, for example, the company's entrepreneurs and the home country's labor force will enjoy most of the gains.<sup>92</sup> Still, the United States can benefit from offering to foreign issuers the option of being subject to this regime. A practice that helps develop the global system of finance and promotes overall global wealth generation will also promote good economic relations abroad and create the potential for reciprocity in other matters.<sup>93</sup> It also serves the cosmopolitan values of the many Americans who have concern for the welfare of persons living outside the United States.

The idea that U.S. securities law can provide some kind of bonding mechanism for foreign issuers is not new. Ed Rock<sup>94</sup> and John Coffee<sup>95</sup> have each suggested that the reason that at least some foreign issuers cross-list on the New York Stock Exchange or NASDAQ is because doing so requires them to register their securities under the Exchange Act, and so subjects them to the U.S. periodic disclosure regime<sup>96</sup> and to the threat of private litigation should they commit violations of this regime.<sup>97</sup> Coffee, for example, argues that many large Latin American companies cross-listed in this way in the 1990s specifically as a way of bonding that they would be more transparent.<sup>98</sup>

There is significant empirical evidence that there have been gains from doing so. Hail and Leuz find that foreign issuers experience a price jump when

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92. *See supra* Part IV.A.2.

93. If a sufficiently large number of foreign firms took advantage of the option of subjecting themselves to the U.S. disclosure and liability regime, U.S. investors would enjoy at least a modest benefit. The increase in the expected future cash flow from the adopting issuers will drive down, at least slightly, the price of an expected future dollar. Investors are purchasers of future dollars. Thus investors worldwide, including those in the United States, would gain. *See supra* note 87.

94. Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 *CARDOZO L. REV.* 675, 686-87 (2002).

95. John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 *COLUM. L. REV.* 1757 (2002).

96. Exchange Act section 12(a) prohibits any trading of shares on a national securities exchange, which today includes both the NYSE and NASDAQ, unless the issuer has registered the shares pursuant to Exchange Act section 12(b). Such registration triggers mandatory periodic issuer disclosure obligations under Exchange Act section 13(a). 15 U.S.C. §§ 78l-78m (2006).

97. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 *U. PA. L. REV.* 229, 286 (2007). Coffee, who includes private class actions as part of U.S. enforcement mechanisms, states his belief that "the enforcement variable may be the underlying force that most drives issuers to improve their disclosure." *Id.* at 239 n.19.

98. Coffee, *supra* note 95, at 1773-76.

they cross-list on the NYSE or NASDAQ.<sup>99</sup> They analyze this price jump and find that it is the result of both an increase in the market's expectations of the firm's future cash flows—which can be related at least in part to the expectation of improved corporate governance<sup>100</sup>—and to a reduction in the rate at which the market discounts these cash flows (the firm's cost of capital),<sup>101</sup> which would be related to improved liquidity. They attribute this expectation of improved corporate governance and liquidity to the increase in the expected level of transparency that accompanies a U.S. cross-listing.<sup>102</sup> At least part of this increase in the expected level of transparency was likely due to the fact that the U.S. listing increased the chance that the issuer would face fraud-on-the-market liability if it made a misstatement.<sup>103</sup> Hail and Leuz find no comparable results for a foreign firm's over-the-counter (OTC) cross-listing in the United States, or for a Rule 144A<sup>104</sup> offering (under which unregistered shares of foreign issuers can be traded in the United States among large institutional investors).<sup>105</sup> Neither of these other U.S. secondary trading arrangements would have triggered the need to comply with the U.S. periodic disclosure requirements, nor would they likely have subjected the firm to a significant risk of fraud-on-the-market liability.

The proposal here would make clear that foreign issuers that choose to be subject to U.S. fraud-on-the-market class actions will be liable to all purchasers, wherever resident and wherever they purchased their shares, to the same extent that a U.S. issuer would be in an entirely domestic context. For reasons discussed more below, cross-listing on a U.S. exchange and being subject to

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99. Luzi Hail & Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-Listings*, 93 J. FIN. ECON. 428 (2009); see also Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. ACCT. RES. 485 (2006) (finding an inverse relationship between the effectiveness of a securities regime generally and the cost of capital in a cross-country comparison).

100. The market's anticipation of greater ongoing disclosure following the cross-listing can increase its expectations of the firm's future cash flows for two reasons. One reason is bonding: greater scrutiny will lead to changes in managers' or (where applicable) controlling shareholders' behavior, increasing *actual* future cash flows to noncontrolling shareholders. Hail & Leuz, *supra* note 99, at 431 (explaining effects of bonding on companies under increased U.S. disclosure requirements as well as threats of SEC enforcement and shareholder suits). The other reason is signaling: the firm's willingness to submit its claims of a bright future to greater scrutiny can lead to an increase in the outside market's *perception* of the level of the firm's future cash flow, even assuming no change in the future behavior of the firm and hence no change in actual cash flows.

101. *Id.* at 428.

102. *Id.*

103. See *infra* Part V.C-D.

104. 17 C.F.R. § 230.144A (2011).

105. Hail & Leuz, *supra* note 99, at 449-50.

this U.S. liability regime would be independent options, with neither being a condition for choosing the other.<sup>106</sup> For this proposal to be a fair deal for the United States, the sum of an issuer's fees for registration under the Exchange Act and the expected court fees from the issuer must equal or exceed the sum of the expected administrative costs of applying the U.S. disclosure regime to the issuer and the expected consumption of judicial resources.

4. *Assuring that only high-transparency issuers trade on U.S. exchanges*

Because imposing the U.S. fraud-on-the-market liability regime on an issuer enhances its transparency, assuring that exchanges located in the United States are places where only the shares of high-transparency issuers trade is another policy concern that is potentially relevant in determining the reach of the U.S. fraud-on-the-market liability regime. This concern, if sound, would point toward imposing the U.S. liability regime on any foreign issuer that lists its shares on a U.S. exchange. Sensible as this concern might appear, however, serious analysis shows it to be misplaced.

A requirement that all issuers listed for trading on a U.S. exchange, whether U.S. or foreign, be subject to the U.S. liability regime would mean that the simple fact that an issuer is listed on a U.S. exchange would send a clear shorthand signal to the market that the issuer is subject to this liability regime.<sup>107</sup> One argument for having such a requirement is that this clear shorthand signal enhances share price accuracy. With this signal, the argument goes, the market prices of the world's issuers would easily and accurately reflect which issuers are subject to the liability regime and which are not. With price accurately reflecting the status of each issuer, individual investors are protected from paying an unfairly high price for an issuer that is less transparent because it is not subject to the U.S. liability regime.

The problem with this first argument is that market prices do not need this shorthand signal in order to reflect each issuer's actual situation. Establishing that the market for an issuer's shares is efficient is a prerequisite for a purchaser to be able to bring a fraud-on-the-market claim,<sup>108</sup> and so only foreign

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106. *See infra* Parts IV.A.4, IV.B.2.

107. *See, e.g.,* James D. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition*, LAW & CONTEMP. PROBS., Autumn 1992, at 157, 192 ("The ever-present private sanctions for misleading statements adds [sic] further authenticity to the firm's disclosures and enhances the attractiveness of U.S. markets to foreign investors.").

108. The fraud-on-the-market action is premised on share prices moving in response to issuer announcements. *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988). Since *Basic*, the lower courts have moved toward a requirement that plaintiffs establish market efficiency.

issuers that meet this requirement are potential candidates to be subject to the U.S. regime in any event. Share prices in efficient markets reflect a broad variety of publicly available information, including information much less salient than the important fact of whether or not the issuer has publicly opted to be subject to the U.S. fraud-on-the-market regime.<sup>109</sup> And these share prices do so even if most individual investors are unaware of this information.

A second argument in favor of requiring all foreign issuers trading on a U.S. exchange to be subject to the U.S. fraud-on-the market liability regime relates to the investor-protection value of the clear shorthand signal of a U.S. listing. The greater transparency associated with a foreign issuer being subject to the liability regime would likely reduce the riskiness for an unsophisticated, undiversified investor for whom the issuer's shares constitute a substantial portion of her total investment portfolio. An unsophisticated individual investor is much more likely to know whether a foreign issuer is listed on a U.S. exchange than whether it is subject to the U.S. liability regime. With this requirement, the investor can know that by confining herself to U.S.-listed foreign issuers, she can protect herself against the extra risk associated with the lower-transparency foreign issuers that are not subject to the U.S. liability regime.<sup>110</sup>

The problem with this second argument is that this requirement—while it may provide some protection against the risk associated with an issuer that is more prone to make misstatements—bundles the decision to list on a U.S. exchange with the decision to be subject to the U.S. liability system, thereby distorting the market-based choices by the world's issuers of where to list their securities. These distortions create serious inefficiencies.<sup>111</sup> The risk of share mispricing due to issuer misstatements is firm specific, and so an alternative way to deal with it is for the investor to diversify the investments in her portfolio. Again, diversification is a strategy that costs very little to implement and fully eliminates not only this risk, but also the thousands of other firm-specific risks associated with investing in the issuer.<sup>112</sup> With the availability of this superior alternative for reducing risk, a rule bundling the listing and liability decisions together is hard to justify, given its associated distorting inefficiencies. An educational campaign urging unsophisticated individual investors to diversify, and the other policies discussed earlier to reduce the number of unsophis-

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For a more detailed discussion of this requirement, see Part II.A above, and note 231 and accompanying text below.

109. See BREALEY ET AL., *supra* note 60, at 317-18 (arguing that the prices of established issuers trading in liquid markets reflect all publicly available information).

110. See James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1234-35 (1999), where Cox makes a similar argument for applying the U.S. mandatory disclosure regime to foreign issuers that list on a U.S. exchange.

111. See *infra* Part IV.B.2.

112. See *supra* Part III.B-C.

ticated undiversified investors, are more promising public policies for reducing investor risk.<sup>113</sup> Indeed, a bundling rule may well be an obstacle, not an aid, to U.S. investors in minimizing their risks from equity investing. By discouraging foreign issuers from listing on U.S. exchanges, it makes including their shares in U.S. investors' portfolios more expensive and less convenient. This leaves U.S. investors exposed to greater risk, because diversifying globally attains more risk reduction than diversifying simply among U.S. stocks.

In sum, the fact that a foreign issuer's shares are listed on a U.S. exchange is not a connection that should determine whether the issuer should be within the reach of the U.S. fraud-on-the-market regime. This is so despite the great importance that courts have placed on such a listing in determining the reach of the action, both in the pre-*Morrison* era and even more since.<sup>114</sup> We saw earlier that the national residence of the persons who ultimately enjoy the benefits and incur the costs of a fraud-on-the-market liability regime is unrelated to the location of the trading venue, or venues, for the issuer's shares.<sup>115</sup> And here we have found unsound the arguments that it is necessary to bundle the U.S. listing decision of a foreign issuer with the U.S. liability regime in order to send a clear signal to the market—or to individual unsophisticated investors—concerning whether an issuer is subject to this regime.

## B. *Policy Considerations Otherwise Implicated by Imposition of Liability*

### 1. *Pro rata distribution of benefits to shareholders*

A core principle in corporate law around the world is that common shareholders should receive benefits arising from their status as common shareholders on a pro rata basis in accordance with the number of shares that they hold.<sup>116</sup> Thus, for example, dividends are paid on a per-share basis to all holders. One of the advantages of the pro rata rule is that it permits a single, more liquid, more efficiently priced market for the shares bought and sold in portfolio-investment amounts because the shares offer the same expected cash flow to all shareholders. The rule also prevents resources from being wasted in conflicts over corporate decisions that could affect the division of a distribution.

The right to receive fraud-on-the-market damages is a benefit related to an investor's status as a shareholder, and should conform to this rule. To see why, consider a regime where *all* shareholders are entitled to compensation from the

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113. *See supra* Part III.C.

114. *See infra* Parts V.C-D, VI.

115. *See supra* Part IV.A.2.

116. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 143-44 (1991).

corporate treasury for any losses they suffer if, unknowingly, they purchase a share at a price that has been inflated as a result of an issuer's material misstatement made with scienter. This regime essentially provides an insurance benefit that the investor acquires when she purchases each of her shares. The expected value of this insurance benefit is equal for all shareholders because each purchase has the same likelihood of having been made at a misstatement-inflated price. Whenever payment has to be made out of the treasury, all shareholders pay derivatively pro rata as well.

Now imagine a regime where only some shareholders—those who have a certain national residency or who purchase their shares in a market located in a certain country—are entitled to this benefit. Under this alternative regime, the insurance benefit is not distributed pro rata, because it is only received by those shareholders who reside in the designated country or purchase their shares in its markets. Yet whenever payment of compensation has to be made out of the treasury, all shareholders still derivatively pay pro rata.

The policy concern with pro rata distribution of benefits therefore implies that either no class action fraud-on-the-market claims should be allowed against a foreign issuer, or all claims should be allowed against the foreign issuer regardless of the nationality or residence of the purchaser and the place she executed the transaction.

2. *Promoting the efficient functioning of secondary trading markets through undistorted issuer and investor choices of venues*

Determining whether to impose U.S. fraud-on-the-market liability on foreign issuers based on whether the issuers list their shares on a U.S. exchange, whether the purchasers acquired their shares in the United States, or whether they are U.S. residents inefficiently distorts the choices of such issuers concerning where to offer and promote the trading of their shares. Market efficiency requires that these choices be made based on the quality of services that different potential trading venues offer buyers and sellers, and the costs of acquiring these services. Tying liability to the geographic location of the trading venues chosen by an issuer and the residency of traders in the issuer's shares introduces a consideration unrelated to service quality and cost.<sup>117</sup>

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117. Beyond the inefficiencies created by the distortions discussed in the text, the bundling rule also involves a second kind of social cost. Foreign issuers that do not find it advantageous to be subject to the U.S. fraud-on-the-market liability regime, but find that the advantages of a U.S. listing outweigh the disadvantage of being subject to the U.S. liability regime will decide to list. In so doing, however, they will have imposed on themselves a corporate governance device not well suited to their situations, with greater costs than benefits. See *supra* Part IV.A.2.

A securities-trading venue is a facility that allows a potential buyer and potential seller to find each other and engage in a trade that each side believes is beneficial to itself. The venue produces value by providing these potential traders with liquidity. Liquidity is a multidimensional concept relating to the cost that a party must expend to execute a trade of a given size at a given speed. The cost of doing a trade comes from the bid-ask spread, brokerage fees, trading venue fees, and clearance and settlement fees. There are tradeoffs and so, generally, the faster the trader wishes her trade executed and the larger the size of the trade, the more the trade will cost on a per-dollar basis.<sup>118</sup>

The choices made by an issuer as to what venue or venues to promote in terms of the trading of its shares, and by traders as to where to trade, are complicated ones. On the one hand, there are advantages to having all trades occur at one venue, because that maximizes the chances that buyers and sellers who are willing to trade at a certain price can find each other. On the other hand, there are a number of virtues to having multiple venues for trading an issuer's shares. Multiple venues can compete to be the meeting place for the traders engaging in the largest number of transactions in the issuer's stock. Such competition can eliminate what would otherwise be monopoly prices, reduce costs by spurring efficient operation, and provide both greater incentives for innovation and more diverse settings within which it can arise. Also, because traders' needs vary in terms of the different dimensions of liquidity, multiple venues can provide traders useful product differentiation, with each venue having its own strengths.

Promoting the efficiency with which trading in equities around the world occurs is important. To start, substantial real resources are devoted to operating the trading venues that facilitate these trades,<sup>119</sup> and the services that they provide are socially valuable. Equity is a more effective device for raising capital, for example, when the shares being offered are expected subsequently to trade in a liquid secondary market. This makes the shares a more convenient place for savers to store wealth because it can be easily and cheaply withdrawn when needed.<sup>120</sup> Liquid markets also facilitate hedging transactions and diversifying

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118. HARRIS, *supra* note 72, at 394.

119. A sense of the real resources involved comes from data concerning just one component of the world of trading venues, NYSE Euronext, which operates the New York Stock Exchange, NYSE Arca, and the Euronext exchanges in Paris and London. NYSE Euronext had revenue from operations of \$4.69 billion in 2009. NYSE Euronext, Annual Report 2009, at 74 (Form 10-K) (March 1, 2010).

120. A sense of the value of liquidity comes from studies of the market for securities that are not Securities Act-registered when initially sold and that therefore trade only on the restricted basis allowed under Rule 144 or Rule 144A. Some studies suggest that average discounts for such restricted stock range from thirteen to sixteen percent. Prior to 1997, when the SEC reduced the Rule 144 holding period from two years to one, studies suggested that average discounts ranged from the high teens to the low twenties. For a critical summary

portfolio adjustments that reduce the aggregate amount of risk in society to which individual investors are exposed directly or derivatively. And liquid markets make it more rewarding for professional investors to collect and analyze information in order to better predict an issuer's future cash flows and to speculate based on these predictions.<sup>121</sup> These activities make share prices more informed, which in turn makes them better guides for real economic activity.

Self-evidently, the way to avoid distortions in issuer choices as to where to promote trading of their shares, and by trader choices as to where to trade, is to prevent trading location from affecting liability. That is, to avoid distortion, none of the potentially distorting considerations—the place where the issuer lists its shares, the place where the purchase occurs, and the residency of the purchaser—should play a role in determining whether or not a claim by a purchaser of an issuer's shares is within the reach of the U.S. fraud-on-the-market liability regime. The United States has a particularly strong interest in avoiding such distortions because it has within its boundaries highly regarded trading venues offering low cost and high liquidity. The United States gains from having a larger percentage of the world's trading occur in its venues because there are U.S. residents in professions whose rents depend on the number of listings and volume of trading in the United States. It also has an interest in U.S. investors being able to reduce the risks of equity investing by diversifying cheaply and easily into the stocks of foreign issuers. If the United States permits fraud-on-the-market claims against foreign issuers, but only by investors who execute their purchases on a U.S. market or only by investors who are U.S. residents, fear of U.S. class action fraud-on-the-market liability will deter foreign issuers from offering their shares to U.S. residents and having their shares trade in U.S. markets.<sup>122</sup> This will hurt U.S. capital market competitiveness by reducing the number of U.S. offerings and listings.<sup>123</sup> And it will discourage international

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of relevant studies, see Robert Comment, *Revisiting the Illiquidity Discount for Private Companies: A New (and "Skeptical") Restricted-Stock Study*, J. APPLIED CORP. FIN., Winter 2012, at 80.

121. Michael J. Fishman & Kathleen M. Hagerty, *Insider Trading and the Efficiency of Stock Prices*, 23 RAND J. ECON. 106, 112 (1992); Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1238-43 (2001).

122. See Jackson, *supra* note 9, at 1246 (discussing survey data showing that fear of fraud-on-the-market suits is the single most important deterrent to foreign issuers offering or listing their shares in the United States).

123. The Committee on Capital Markets Regulation, also known as the "Paulson Committee," claims, for example, that there has been a reduction in the competitiveness of U.S. capital markets versus markets abroad as a result in part of the costs imposed on issuers by fraud-on-the-market class actions and the uncertainty that they create. The Committee calls for reforms that would effectively reduce or eliminate such actions on all issuers, foreign and



diversification by U.S. investors, because it is more costly and inconvenient for a U.S. investor to trade in a foreign market than in a domestic one.

### 3. *Advantages of resolving similar claims in one place*

There are economies of scale in resolving similar claims in one place at one time. It is also desirable that similar claims be treated in a similar fashion rather than dissimilarly, as can happen when multiple triers of fact and applicators of law adjudicate such claims. As a general matter, this policy concern would militate in favor of permitting class action status for all fraud-on-the-market claims against a foreign issuer that are determined to be within the United States' jurisdictional reach.

Current U.S. law, however, places constraints on class action treatment for some such claims. Federal Rule of Civil Procedure 23(b)(3) requires that a party seeking class certification demonstrate that "a class action is superior to other available methods for fairly and efficiently adjudicating the controversy."<sup>124</sup> Suppose that a member of a proposed class has the alternative of suing on the same claim in a foreign court and a judgment in the U.S. case would not be viewed by the foreign court as *res judicata* (i.e., as precluding the foreign court from ruling on the same claim in a subsequent foreign suit). This fact weighs against determining that a class action is the superior method of adjudication.<sup>125</sup> In any fraud-on-the-market case against a foreign issuer, this possibility of a relitigated claim is thus a potential issue.

A genuinely realistic prospect that a claim would be relitigated abroad after a U.S. judgment or court-approved settlement would clearly erode the economies-of-scale and adjudication-consistency rationales for inclusion of the claimant within the class. Unlike the United States, however, "opt-out only" class actions and contingent fee arrangements are generally not present in most other countries. The absence of these procedures, combined with the preva-

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domestic alike. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 81-82, 109-10 (2006), available at [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf) (calling for adoption of a rule that plaintiffs must show that the market price fully reflects *all* publicly available information, and calling for the SEC to permit issuer management, with the approval of shareholders, to adopt charter amendments barring shareholders from bringing fraud-on-the-market damage actions except individually in arbitration).

124. FED. R. CIV. P. 23(b)(3).

125. See *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 996 (2d Cir. 1975); *In re Alstom SA Sec. Litig.*, 253 F.R.D. 266, 287 (S.D.N.Y. 2008). Interestingly, research does not reveal any cases raising this concern where a proposed fraud-on-the-market class includes foreign purchasers of a U.S. issuer's shares, even though claims by such purchasers raise the same possibilities of relitigation abroad.

lence of “loser pay” rules,<sup>126</sup> means that the likelihood of a fraud-on-the-market type of claim being brought against a foreign issuer in a foreign court is in fact very low, except perhaps by an investor that has engaged in some significant portion of all the affected trading.<sup>127</sup> This likelihood is further reduced by the fact that payment to investors under a U.S. judgment or settlement can be conditioned upon agreement not to relitigate the claim abroad, thus forcing any foreign plaintiff considering relitigating the issue to turn down a sure thing.<sup>128</sup> In sum, this final policy concern suggests that class action status should be permitted for all claims against foreign issuers that are within the United States’ jurisdictional reach, again regardless of the nationality or residency of the plaintiff or the place of execution. This rule should apply whether or not there is a possibility of relitigation of any claims abroad, because even where there is, the probability is typically negligible.

### C. *Convergence on a Simple Rule*

Putting the properly analyzed implications of these seven policy concerns together turns out to be surprisingly straightforward. There are no difficult tradeoffs in terms of what rule would best promote both U.S. and global economic welfare.

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126. See Heather Smith, *Is America Exporting Class Actions to Europe?*, AM. LAW. (Feb. 28, 2006), available at <http://www.law.com/jsp/tal/PubArticleFriendlyTAL.jsp?id=900005448105>; *Class Actions*, GLOBAL DISP. RESOL. (Linklaters LP, London, U.K.), Feb. 2008, at 1, available at <http://linklaters.com/pdfs/publications/Litigation/Classactions.pdf>.

127. There is authority that even where a foreign court would likely not give a U.S. judgment preclusive effect, class certification should be granted if practical difficulties make relitigating it unlikely. See *Cromer Fin. Ltd. v. Berger*, 205 F.R.D. 113, 134-35 (S.D.N.Y. 2001); *Societe Generale de Banque v. Touche Ross & Co.* (*In re* U.S. Fin. Sec. Litig.), 69 F.R.D. 24, 52 (S.D. Cal. 1975).

128. See *In re* Lloyd’s Am. Trust Fund Litig., No. 96 CIV. 1262(RWS), 1998 WL 50211, at \*15 (S.D.N.Y. 1998). The argument for not precluding foreign purchasers when the claims process includes this condition is reinforced by the fact that as a practical matter, all purchasers, even in suits by U.S. purchasers in domestic markets against U.S. issuers, already have this possibility of choosing to turn down what would appear to be the final disposition in the class action and pursuing the matter in litigation. Most securities class actions are settled rather than litigated to final judgment. See PRICEWATERHOUSECOOPERS, 2010 SECURITIES LITIGATION STUDY: LOOKING BEYOND A DECADE OF FRAUD, CORRUPTION, AND TURMOIL 8, 22 (2011), available at [http://10b5.pwc.com/PDF/NY-11-0484%20sec%20lit%20study\\_V6bonline.pdf](http://10b5.pwc.com/PDF/NY-11-0484%20sec%20lit%20study_V6bonline.pdf). The Federal Rules of Civil Procedure provide that “the court may refuse to approve a settlement unless it affords a new opportunity to request exclusion to individual class members.” FED. R. CIV. P. 23(e)(4). It is a common practice for a settlement agreement to allow class members to opt out of the settlement, subject to the condition that the settlement is void if too many class members exercise this option. 4 NEWBERG ON CLASS ACTIONS § 12.12 (William Rubenstein et al. eds., 4th ed. 2011) (describing typical right-to-withdraw clause).

### 1. *Statement of the rule*

The U.S. class action fraud-on-the-market liability regime should not as a general matter be imposed on any genuinely foreign issuer (i.e., one with an economic center of gravity as an operating firm outside the United States). This rule shielding foreign issuers should apply even where the claimant is a U.S. investor purchasing shares in a U.S. market or where the issuer engages in significant conduct in the United States contributing to the misstatement. The only exception to the exclusion of genuinely foreign issuers from the reach of the action should be a foreign issuer that has agreed, as a form of bonding, to be subject to the U.S. liability regime. In such a case, claims against the issuer should be allowed and given class action status, regardless of the purchasing plaintiff's nationality and residence, the place where she executes the transaction, and the location of any conduct contributing to the misstatement.<sup>129</sup>

### 2. *Derivation from the seven policy concerns*

The simple rule is derived from the preceding analysis of the seven policy concerns as follows. The first and fourth policy concerns that potentially argue for imposing a fraud-on-the-market liability regime on an issuer—the need to provide compensation to cover investor trading losses, and to assure that U.S. exchanges are places for the trading of only high-transparency issuers—have been shown in fact to be poor justifications for imposing such liability, and thus should not play a role in determining the reach of the U.S. regime. The second policy concern—improving transparency in order to enhance corporate governance and liquidity—can justify imposition of a fraud-on-the-market type of liability regime on any country's issuers if the social benefits from the resulting enhancements in corporate governance and liquidity are judged to exceed the

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129. Wolf-Georg Ringe and Alexander Hellgardt, from a more European and comparative law perspective, have a proposal that overlaps somewhat with the rule suggested here. See Wolf-Georg Ringe & Alexander Hellgardt, *The International Dimension of Issuer Liability—Liability and Choice of Law from a Transatlantic Perspective*, 31 OXFORD J. LEGAL STUD. 23, 45-59 (2011). They too start with the premise that securities law liability serves a corporate governance purpose. *Id.* at 46. From this they suggest that an issuer be subject to the securities liability rules of its country of incorporation. *Id.* at 49-51. The proposal here differs from theirs in that it is focused only on fraud-on-the-market type liability and considers a corporation's nationality to be determined by its economic center of gravity as a firm. For a public firm with a U.S. economic center of gravity, it almost always would be subject to Exchange Act periodic disclosure requirements even if it were incorporated abroad. Fox, *supra* note 87, at 714-16. This is appropriate given the rationale suggested here for making periodic disclosure regulation mandatory. See *supra* Part III.D.1. Ringe and Hellgardt would also impose on the issuer the liability system associated with each other country in which the issuer cross-lists its shares—in other words, they would impose the bundling rule argued against here. See Ringe & Hellgardt, *supra*, at 56.

liability regime's social costs. But the government of an issuer's home country is best positioned to make this judgment, and so this second concern points toward not imposing the U.S. liability regime on any genuinely foreign issuer. The third concern—relating to foreign issuers whose private calculations suggest that the corporate governance and liquidity benefits from being subject to the U.S. liability regime exceed the costs—calls for an exception to this general rule where a foreign issuer voluntarily agrees to be subject to the U.S. liability regime with respect to all purchases of its shares.

The three additional policy concerns that are otherwise potentially impacted by imposition of this liability regime on an issuer—pro rata distribution of benefits, undistorted issuer and investor choices of where to list and trade, and adjudicatory consolidation—have been shown to be served better, or at least as well, by the simple rule barring American-law-based fraud-on-the-market claims against all genuinely foreign issuers (except those choosing the U.S. regime) as they are by any other rule concerning the reach of the action.

### *3. Effect of the rule on global and U.S. economic welfare*

The proposed simple rule maximizes global economic welfare because, for each of the world's established issuers trading in an efficient market, the decision of whether to subject the issuer to a fraud-on-the-market type of liability regime is placed in the hands of the government best positioned, in terms of incentives and the information it possesses, to weigh the social benefits versus the social costs of doing so, and to act accordingly.

The rule's maximization of global welfare does not come at the cost of infringing on U.S. economic welfare, which is relatively unaffected by other governments' decisions with respect to their home-country issuers. Indeed, relative to any other approach, the simple rule proposed here enhances U.S. economic welfare. It makes U.S. markets more attractive places for foreign issuers to offer and promote the trading of their shares, thereby making risk-reducing transnational portfolio diversification by U.S. investors easier and less expensive, while at the same time providing increased skills-based rents to those working in, or servicing, the U.S. financial industry. Also, by making global finance and corporate governance work better, the simple rule will raise the global return on capital, which will aid U.S. investors along with all others. Finally, it will improve U.S. economic relations with other countries, which encourages U.S.-welfare-enhancing reciprocity and cooperation by foreign governments with regard to other kinds of transnational economic interactions.

#### 4. *Operational considerations*

The “economic center of gravity” test for an issuer’s nationality would focus on the country where the issuer’s headquarters is located, where the greatest concentration of its physical capital and employees is located, and where its entrepreneurs at the time of founding resided. The issuer’s jurisdiction of incorporation would, because it has some effect on its corporate governance, be a consideration as well, but would at most serve only a secondary, tie-breaking role in the unusual case where the other factors pointed in different directions.

Many larger companies, of course, have production facilities located around the world. Most of the world’s issuers, even ones labeled “multinational,” however, still have a distinct nationality in this economic center of gravity sense (particularly if the European Union is for these purposes treated as a single country). What, though, about the remaining borderline cases as to whether or not an issuer is genuinely foreign? These determinations are, in my view, best resolved by courts through a case-by-case, precedent-building process guided by the underlying analysis set out in Parts III and IV. The workability of this approach is demonstrated by the existence of other areas of the law where courts must determine which single geographic location to assign to a corporation based on operationally related criteria. These include the continental European concept of “real seat”<sup>130</sup> for determining corporate nationality for choice of law purposes, and the “nerve center” approach recently enunciated by the U.S. Supreme Court for determining a corporation’s state of citizenship for federal court diversity jurisdiction purposes.<sup>131</sup>

If, in the view of others, case-by-case court determinations would result in too much uncertainty with respect to the status of too many of the world’s issuers to make such a procedure workable, a bright-line mechanical rule could be developed by legislation or by the SEC. Such a rule would inevitably involve some arbitrariness, but it could still define the reach of the U.S. liability regime in a way that is reasonably close to the ideal. For example, the current Exchange Act Rule 3b-4, which defines “foreign private issuer” for purposes of delineating the reach of U.S. periodic disclosure regulations for issuers not listed on a U.S. exchange,<sup>132</sup> could be the starting point for constructing a rule for the reach of the U.S. fraud-on-the-market liability regime. Eliminating Rule 3b-4’s criteria relating to the nationality of the issuer’s shareholders and the issuer’s jurisdiction of incorporation, but retaining the rest of the Rule’s criteria, would result in a rule for the reach of the U.S. liability regime that is roughly

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130. STEPHAN RAMMELOO, CORPORATIONS IN PRIVATE INTERNATIONAL LAW: A EUROPEAN PERSPECTIVE 11-13 (P.B. Carter ed., 2001).

131. *See* *Hertz Corp. v. Friend*, 130 S. Ct. 1181, 1185-86 (2010).

132. 17 C.F.R. § 240.3b-4(c) (2011).

consistent with what would be called for by the analysis in this Article. Under such a rule, the U.S. regime would reach any issuer that has more than 50% of its assets in the United States, has U.S. residents or citizens as a majority of its executive officers or directors, or is administered primarily in the United States. It would not reach any other nonbonding issuer in the world. Further refinement of the criteria quite possibly might come even closer to the ideal. The point here is simply to establish that a bright-line rule based on the components of a frequently applied rule currently in use could take us a long way in the right direction, thereby establishing the overall workability of the approach advocated in this Article.

#### V. COMPETING ALTERNATIVES: RETURN TO THE CONDUCT/EFFECTS TEST

We have established the rule for the reach of the U.S. fraud-on-the-market regime that would maximize U.S. economic welfare and—by promoting global economic welfare as well—best foster good foreign relations. There remains this Article's second task: to chart a practical path of reform toward this ideal. Undertaking this second task requires an awareness of the complications posed by the real-world context in which the U.S. decision will be made concerning the liability regime's reach. The first step is to assess the attractions of, and the problems with, the likely competing approaches to determining the regime's reach. This Part assesses returning to the conduct/effects test; Part VI assesses adopting the *Morrison* test and similar approaches suggested by other prominent commentators. The remainder of the task, undertaken in Part VII, explores the three institutional ways by which reform can occur: judicial decisionmaking, SEC rulemaking, and legislation.

One competing alternative to the rule proposed here is a return to the conduct/effects test used by the lower courts prior to *Morrison* to determine the transnational reach of the fraud-on-the-market cause of action. The Supreme Court in *Morrison* argued that its holding concerning the reach of section 10(b) “preserv[es] a stable background against which Congress can legislate.”<sup>133</sup> Thus, despite the Court's pointed rejection of the conduct/effects test, Congress has been left free to reinstate the test if it wishes to act affirmatively to do so. Indeed, in the Dodd-Frank Act, Congress has already done just that with respect to the reach of section 10(b) in cases brought by the SEC or the U.S. Department of Justice.<sup>134</sup> And in the same Act, Congress has required the SEC to solicit public comment and conduct a study concerning whether there should be a return to using the conduct/effects test for determining the reach of private

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133. *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2881 (2010).

134. Dodd-Frank Wall Street Reform and Consumer Protection Act § 929P(b), 15 U.S.C. §§ 77v(c), 78aa(b), 80b-14(b) (2006 & Supp. IV 2010).

actions as well.<sup>135</sup> Thus Congress has signaled that it will give the idea serious attention.

The conduct/effects test arose from a handful of seminal Second Circuit cases in the 1960s and 1970s. All of these cases concerned the reach of the traditional reliance-based Rule 10b-5 fraud cause of action for damages. In this traditional reliance-based action, it will be recalled, the causal connection between the misstatement of the defendant, typically the seller, and the purchaser-plaintiff's damage is that the misstatement induced the plaintiff to enter into what turned out to be a losing transaction.<sup>136</sup> The fraud-on-the-market cause of action was developed later.<sup>137</sup> When issues began to arise concerning its reach, the courts simply adopted the same test. This turned out to be problematic because the causal connection between the defendant's misstatement and the plaintiff's damage in this later-developed cause of action is very different. The theory is that the issuer, although not a seller, publicly made a material misstatement that damaged the purchaser-plaintiff by inflating the price at which she purchased the issuer's shares.<sup>138</sup> The conduct/effects test worked reasonably well for both the traditional fraud cause of action for which it was originally developed and for government antifraud enforcement actions. But, as will be shown below, the very different theory of causal connection that underlies the fraud-on-the-market action made this test a poor transplant for determining this new action's reach.

#### A. *The Origins of the Conduct/Effects Test*

Four seminal Second Circuit opinions, the latter three written by the securities law legend Judge Henry Friendly, form the origins of the conceptual framework that had been used prior to *Morrison* to determine the reach of all Rule 10b-5 actions for damages, both traditional reliance-based and fraud-on-the-market. The opinions in question were *Schoenbaum v. Firstbrook*,<sup>139</sup> *Leasco Data Processing Equipment Corp. v. Maxwell*,<sup>140</sup> *Bersch v. Drexel Firestone, Inc.*,<sup>141</sup> and *IIT v. Vencap, Ltd.*<sup>142</sup> These seminal cases each involved traditional reliance-based claims, and were decided prior to the development of the fraud-on-the-market action. Commentators and later court deci-

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135. *Id.* § 929Y.

136. *See supra* Part II.A.3.a.

137. *See supra* Part II.A.3.b.

138. *See supra* Part II.A.3.c.

139. 405 F.2d 200 (2d Cir.), *rev'd in part en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968).

140. 468 F.2d 1326 (2d Cir. 1972).

141. 519 F.2d 974 (2d Cir. 1975).

142. 519 F.2d 1001 (2d Cir. 1975).

sions subsequently distilled the results of these seminal cases down to two tests—the effects test and the conduct test—but the four seminal cases do not themselves use the terms. Each opinion provides a plausible rationale for its decision regarding the reach of the action in the particular transnational situation before the court. As will become clear, however, these rationales make little sense in the very different situation that characterizes a fraud-on-the-market case.

### 1. Schoenbaum

*Schoenbaum* involved a shareholder derivative suit filed on behalf of Banff Oil Ltd., a Canadian corporation whose shares traded on the Toronto Stock Exchange, against its controlling shareholder, Acquitaine of Canada, Ltd., also a Canadian corporation.<sup>143</sup> Banff's U.S. connections were that it was an Exchange Act-registered company and that its shares also traded on the American Stock Exchange.<sup>144</sup> Banff's officials and its controlling shareholder Acquitaine were aware of successful oil drilling operations by Banff, but the public was not.<sup>145</sup> Banff issued shares to Acquitaine at the then-market price, a price that allegedly did not reflect these successful drilling operations.<sup>146</sup> The suit claimed that this stock transaction was fraudulent in violation of Rule 10b-5.<sup>147</sup>

The defendants moved for summary judgment, arguing (among other things) that the Exchange Act did not apply extraterritorially to a stock transaction occurring in Canada between two Canadian corporations.<sup>148</sup> They argued that the district court lacked subject matter jurisdiction, as courts prior to *Morrison* generally used that language to describe whether a matter, notwithstanding its transnational elements, was within the reach of Rule 10b-5's prohibitions or the reach of the cause of action based on a violation thereof.<sup>149</sup> The Second Circuit held, contrary to the defendant's argument, that the court did

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143. *Schoenbaum*, 405 F.2d at 204.

144. *Id.* at 204.

145. *Id.* at 205.

146. *Id.*

147. *Id.* at 204.

148. *Id.*

149. Prior to *Morrison*, the lower courts consistently used the term "subject matter jurisdiction" to mean that the statute, or the private implied cause of action based on the statute's violation, reached the conduct in the case before them notwithstanding its transnational elements. Justice Scalia, in his opinion for the Court in *Morrison*, stated that this is an incorrect use of the term; subject matter jurisdiction instead "refers to a tribunal's power to hear a case." *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2877 (2010) (quoting *Union Pac. R.R. Co. v. Bhd. of Locomotive Eng'rs & Trainmen Gen. Comm. of Adjustment, Cent. Region*, 130 S. Ct. 584, 596 (2009)). Instead, the Court held, the reach of the statute in a case with transactional elements is a "merits question." *Id.*



have subject matter jurisdiction for transactions violating the Act that take place outside of 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."<sup>150</sup>

The Second Circuit stated as its rationale:

[T]he anti-fraud provision of § 10(b) . . . 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 . . . ."<sup>151</sup>

Although the corporation that was injured, Banff, was incorporated and located abroad, the court found that the defendant's behavior created harmful effects within the United States because it reduced the value of the corporation's shares held by U.S. investors and the price at which they were trading in the U.S. market.<sup>152</sup>

## 2. Leasco

According to the complaint in *Leasco*, the late British press mogul Robert Maxwell made material misstatements to executives of Leasco, a U.S. corporation, in connection with negotiations relating to the possible sale to Leasco of Pergamon Press, a U.K. corporation controlled by Maxwell.<sup>153</sup> Some of these misstatements were made during discussions in meetings in New York between Leasco and Maxwell or his representatives, and others during meetings in London.<sup>154</sup> These misstatements made Pergamon look more valuable than it was.<sup>155</sup> Leasco, at Maxwell's suggestion, purchased publicly traded shares of Pergamon on the London Stock Exchange at a price allegedly in excess of their value.<sup>156</sup>

Maxwell argued that there was no subject matter jurisdiction because the transaction was conducted abroad and, unlike *Schoenbaum*, involved shares of a foreign issuer that did not trade on an American exchange and were not regis-

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150. *Schoenbaum*, 405 F.2d at 208.

151. *Id.* at 206 (second and third alterations in original) (emphasis added) (quoting *Strassheim v. Daily*, 221 U.S. 280, 285 (1911)).

152. *Id.* at 208-09.

153. *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1330 (2d Cir. 1972).

154. *Id.* at 1330-33.

155. *Id.*

156. *Id.* at 1332.

tered under the Exchange Act.<sup>157</sup> The Second Circuit disagreed, but added in dicta that the result would have been different if all the misrepresentations had been made abroad.<sup>158</sup>

*Schoenbaum* and *Leasco* therefore each involve effects that occurred in the United States—the diminution in the wealth position of a United States person as the result of a securities transaction—but Judge Friendly indicated this alone would not have been sufficient. Each has an additional, though different, factor that Judge Friendly indicated in *Leasco* was essential. In *Schoenbaum*, the factor is registration under the Exchange Act.<sup>159</sup> In *Leasco*, the factor is that some of the conduct occurred in the United States.<sup>160</sup>

### 3. Bersch

*Bersch* involved a class action by purchasers in three simultaneous, coordinated public offerings of the shares of I.O.S., Ltd., a company that managed mutual funds.<sup>161</sup> Each of the offerings was aimed at a different set of offerees based on residency or employment status.<sup>162</sup> I.O.S., whose shares had not previously been publicly traded, had a somewhat blurred national identity: it was incorporated in Canada, headquartered in Switzerland, and founded and headed by a U.S. citizen, Bernard Cornfeld.<sup>163</sup> The funds it managed, while marketed to persons abroad, invested primarily in the shares of U.S. companies.<sup>164</sup> The offering of I.O.S. stock purported to be structured so as not to extend to residents of the United States, but twenty-two U.S.-resident Americans nevertheless acquired I.O.S. shares in one of the offerings and were included in the class.<sup>165</sup> The complaint alleged that the nearly identical prospectus in each of the three offerings contained material misstatements in violation of Rule 10b-5.<sup>166</sup>

A key defendant was Drexel, a U.S.-headquartered investment bank that was the managing underwriter for one of the offerings. Drexel undertook a number of activities in the United States associated with its offering, which

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157. *Id.* at 1335.

158. *Id.* at 1338-39.

159. There was no U.S. conduct in *Schoenbaum*, but Judge Friendly explicitly uses Banff's Exchange Act registration "to differentiate the problem here presented [in *Leasco*] from the point decided in [*Schoenbaum*]." *Id.* at 1333.

160. *Id.* at 1334-35.

161. *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 978-80 (2d Cir. 1975).

162. *Id.* at 979, 981.

163. *Id.* at 978.

164. *Id.* at 988.

165. *Id.* at 991.

166. *Id.* at 980-81.

plaintiffs contended was integrated with the other two offerings.<sup>167</sup> These U.S. activities included meetings with representatives of I.O.S. and their attorneys and accountants to organize and structure the offering, preliminary discussions concerning underwriting discounts and commissions, and drafting parts of the prospectus.<sup>168</sup> The place from which each offering's final prospectus was sent out to potential investors was abroad, however, as was the place where orders were received and where shares were exchanged for cash.<sup>169</sup>

Writing for the Second Circuit, Judge Friendly found that the court did *not* have subject matter jurisdiction with respect to the claims of the *non-U.S.*-resident, foreign members of the class against Drexel.<sup>170</sup> Clearly, with respect to these plaintiffs, the materially misleading statements had no effects in the United States. As for Drexel's conduct in the United States, Friendly stated, "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 . . ." <sup>171</sup> In his summary of his opinion, he states that "the federal securities laws . . . [d]o not apply to losses from sales of securities to foreigners outside the United States unless acts . . . within the United States *directly* caused such losses,"<sup>172</sup> which he found Drexel's U.S. conduct did not do.

Friendly found, however, that there *would* be subject matter jurisdiction with respect to the claims of the *U.S.*-resident investor plaintiffs against Drexel if Drexel's "activities, *whether in the United States or abroad*, can be considered as essential to the carrying out of" the offer in which these plaintiffs purchased their shares,<sup>173</sup> and if the *U.S.*-resident investors received in the United States prospectuses sent from abroad that induced them to purchase the *I.O.S.* shares.<sup>174</sup>

*Bersch* thus represents yet a third opinion confirming that despite a situation involving significant transnational elements, the diminution of the wealth

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167. *Id.*

168. *Id.* at 985 n.24.

169. *Id.* at 979-80.

170. *See id.* at 989-90.

171. *Id.* at 987. The court said it had no doubt that Drexel's activities in the United States were sufficient for the United States to have prescriptive jurisdiction under international law and, if the United States so wished, it could impose its rules as to whatever consequences might flow from such activities. *Id.* at 985. The court said that the question of jurisdictional reach, however, is one of statutory interpretation, and suggested that it would be a mistake to believe that the legislature necessarily intended the reach of its regulation to extend as far as would be permitted under international law. *Id.*

172. *Id.* at 993 (emphasis added).

173. *Id.* at 991-92 (emphasis added).

174. *Id.* at 991.

position of a U.S. person could bring conduct within the reach of a Rule 10b-5 cause of action. This time the additional factor is that the conduct, despite perhaps occurring abroad, results in a document containing the misstatement to be projected into the United States.<sup>175</sup> *Bersch* also contains dicta that conduct in the United States, if it is the direct cause of the harm, can give rise to a claim by a foreign investor purchasing abroad the shares of a foreign issuer.<sup>176</sup>

#### 4. Vencap

*Vencap* involved an appeal from a district court ruling appointing a receiver for IIT, an international investment trust, and enjoining certain defendants from utilizing the assets of IIT or those of certain corporations in which IIT had invested.<sup>177</sup> The suit seeking the appointment of the receiver was brought by the liquidators of IIT based on a claim that the defendants had fraudulently funneled funds from IIT in violation of Rule 10b-5.<sup>178</sup>

IIT was organized under the laws of Luxembourg and the liquidators were Luxembourg citizens appointed by the District Court of Luxembourg.<sup>179</sup> IIT was not registered under the Exchange Act.<sup>180</sup> IIT shares “apparently were not intended to be offered to American residents or citizens”<sup>181</sup> and only a tiny fraction of IIT’s investors were Americans.<sup>182</sup>

The “leading player” among the defendants was Richard Pistell,<sup>183</sup> a U.S. citizen who resided in the Bahamas. He was the organizer of the defendant Vencap Ltd., which purported to be a venture capital company organized under the laws of the Bahamas.<sup>184</sup> IIT invested in Vencap, and the funds were allegedly misused by Pistell and entities that he controlled.<sup>185</sup> It appears that IIT’s investment in Vencap was largely negotiated outside the United States and that the closing occurred in the Bahamas.<sup>186</sup> After Vencap obtained its financing, however, it appears to have used its law firm’s office in New York as its

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175. *Id.* at 990-91.

176. *Id.* at 993.

177. *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1004 (2d Cir. 1975).

178. *Id.* at 1003-04.

179. *Id.* at 1003.

180. *Id.* at 1003 & n.1.

181. *Id.* at 1017.

182. At most, Americans constituted 0.2% of IIT’s fundholders and their holdings constituted at most 0.5% of the total amount invested in IIT. *Id.* at 1016.

183. *Id.* at 1004.

184. *Id.* at 1005.

185. *Id.* at 1006, 1008.

186. *Id.* at 1005-07.

base.<sup>187</sup> The alleged funneling of funds occurred after Vencap's receipt of the IIT financing.<sup>188</sup>

Friendly held that this conduct in the United States could be sufficient by itself to be within the reach of a private Rule 10b-5 fraud action, despite the fact that the transaction occurred abroad and the ultimate effects were essentially entirely abroad.<sup>189</sup> Friendly's rationale that subject matter jurisdiction could be found solely on the basis of conduct in the United States was one of good neighborliness and the increased likelihood of reciprocal regulation by other countries of behavior abroad that would damage the United States:

We do not think that 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. 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. By the same token it is hard to believe Congress meant to prohibit the SEC from policing similar activities within this country . . . .<sup>190</sup>

#### 5. *Distillation into the conduct/effects test framework*

In a number of subsequent traditional reliance cases where courts considered Rule 10b-5's transnational reach, the jurisprudence developed in these four seminal cases was distilled into the effects test and the conduct test. In accordance with the effects test, U.S. courts have "asserted jurisdiction over extraterritorial conduct that produces substantial effects within the United States."<sup>191</sup> In accordance with the conduct test, U.S. courts have asserted jurisdiction in cases involving "acts done in the United States that 'directly caused' the losses suffered by investors outside this country."<sup>192</sup>

#### B. *Comparing Application of the Conduct/Effects Test to Traditional Fraud and to Fraud-on-the-Market Actions*

The conduct/effects test is vaguely articulated, and its use for determining the reach of even the traditional Rule 10b-5 reliance-based fraud action has not been straightforward. Nevertheless, the test has a certain core conceptual logic

187. *Id.* at 1018.

188. *Id.* at 1007-09.

189. *Id.* at 1018.

190. *Id.* at 1017.

191. *See, e.g.,* Zoelsch v. Arthur Andersen & Co., 824 F.2d 27, 30 (D.C. Cir. 1987) (citing Schoenbaum v. Firstbrook, 405 F.2d 200, 206-08 (2d Cir. 1968), *rev'd in part en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968)).

192. *Id.* (citing Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 991-93 (2d Cir. 1975)).

that, as the discussion of the seminal cases above illustrates, can, when applied in a nuanced and fact-sensitive way, provide a useful framework for deciding the reach of such actions. However, application of the test to fraud-on-the-market cases seems almost entirely lacking in any conceptual logic.

1. *Traditional reliance-based fraud actions*

Traditional reliance-based fraud cases, it will be recalled, typically involve a private one-on-one transaction in the shares of a non-publicly traded issuer, or a purchase in an IPO with the issuer being the primary defendant. In such cases, a misstatement is specifically placed in the hands of an investor and the statement induces the investor into making the purchase.

a. *Effects test*

Consider a situation where the message containing the misstatement—a prospectus in an IPO, or a communication directly to a specific potential investor in a one-on-one deal—is sent from abroad. The investor, who receives the message and is induced by it into purchasing, is a U.S. resident. A determination that this foreign conduct (sending the message) is within the reach of a Rule 10b-5 traditional fraud action because of its U.S. effects has a plausible rationale. The situation resembles the classic “shooting of a bullet across a state line” hypothetical, cited by Judge Friendly in *Bersch*,<sup>193</sup> which is a key illustration in the discussion that gives rise to the effects test in the international law prescriptive jurisdiction jurisprudence.<sup>194</sup> Sending the misstatement across a state line, like firing a bullet, is conduct that can only impose a deprivation, not a benefit, within the receiving jurisdiction. Unlike the case of a fraud-on-the-market action, there are no complications in the analysis arising from the investor ex ante being equally likely to benefit from such conduct, or from the market efficiently discounting the price to reflect the possibility of a misstatement so that on average investors do not lose from the practice. The purposes of the traditional fraud action within an entirely domestic context—to prevent such deprivations to U.S. residents from occurring by deterring such conduct, and to correct for the deprivations when such conduct nevertheless does occur—are equally well served by bringing within the reach of the cause of action a situation involving foreign conduct.

Finding such foreign conduct to be within the reach of a Rule 10b-5 action, while not free of complications, is also reasonably workable in terms of the interaction with other legal systems in the world. Even if the sender of the mes-

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193. 519 F.2d at 987.

194. *See id.*; RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW §§ 402-403 (1987).

sage is also potentially subject to an action for these damages under the laws of the country from which he is operating, the sender is likely to know the location of a person or persons to whom he is sending the message, and so he need be familiar with the relevant laws of at most two countries. With the universe confined to two legal systems, both the sender and the purchaser will be on clear notice as to the standards that will be used for determining whether the statements in the message are materially false or misleading and the legal consequences if they are. Moreover, imposing U.S. liability on the foreign sender is unlikely to create conflict with the other country in terms of discouraging behavior that the other country wishes to permit. Most countries' domestic legal systems provide for some kind of negative consequences for conduct that in the United States would give rise to a traditional reliance-based fraud action.<sup>195</sup> The transfer of wealth from the defendant to the plaintiff simply corrects for the earlier transfer from plaintiff to defendant that both the United States and the other country find inappropriate.

b. *Conduct test*

Consider a situation where the conduct placing the message in the investor's hands—typically sending out a prospectus, or a face-to-face meeting—occurs in the United States but the investor resides abroad. The negative effect flowing from this conduct that ultimately matters the most—the reduction in the investor's wealth position—is thus abroad. There is again a reasonable rationale for determining that this conduct, because it occurs in the United States, is within the reach of a Rule 10b-5 traditional fraud action. This rationale parallels Judge Friendly's reasoning in *Vencap*: extending the action to cover this situation is an act of good neighborliness toward the country where the effects are felt. Doing so deters conduct in the United States that causes deprivations to the other country's residents, and it corrects for such deprivations when such conduct nevertheless occurs. This encourages reciprocity: the other country, if it has a similar cause of action, will be more likely to extend it to include U.S. purchasers in cases where the misconduct occurs within its territory. This reciprocal favor could be valuable to such U.S. purchasers even if the U.S. cause of action were also available to them, because bringing the foreign action would likely facilitate obtaining personal jurisdiction over the defendant, obtaining evidence, and securing witnesses.

Finding U.S. conduct with effects abroad to be within the reach of a Rule 10b-5 action is again reasonably workable in terms of the interaction with other

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195. See Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 10-11, 15-16 (2006) (explaining that liability for losses due to misleading statements in a prospectus exists in many legal regimes).

legal systems in the world. This situation is the reciprocal of the traditional fraud action effects test situation discussed just above, and so again, in terms of putting the parties on notice, the universe will be confined to two legal systems. And providing residents of the other country with a cause of action—the same one the United States would provide similarly situated U.S. claimants against a similarly situated defendant—is very unlikely to create conflict with this other country given that it potentially enriches the other country’s residents.

## 2. *Fraud-on-the-market actions*

In contrast to the traditional reliance-based fraud action, the fraud-on-the-market plaintiff, it will be recalled, purchases the shares of an established, publicly traded issuer in an organized, highly liquid secondary market. The seller is not the defendant and is in no way involved in the litigation. The seller is instead just a person on the other side of an impersonal market transaction who by chance has the good luck to receive the prevailing, inflated market price for her shares. The defendant is the issuer, even though the issuer did not trade and thus could not make any trading profits from selling at the inflated price. Again, the theory of the action instead is that the issuer publicly made a material misstatement that led to the inflated price at which the plaintiff purchased. The plaintiff’s claim is that she has been injured as a result of purchasing at this inflated price, not, as in the traditional reliance case, that she was induced into the purchase by the misstatement.

### a. *Effects in the United States*

Consider a situation where a foreign issuer acting entirely outside the United States makes, with scienter, a material misstatement to the public media and the misstatement inflates the price at which the issuer’s shares trade. There are two ways that this conduct could be said to have effects in the United States. One way, if the issuer’s shares trade in the United States, is that the conduct affects the price at which the shares trade in the U.S. market. The other way is that U.S. residents purchase the issuer’s shares and their wealth positions are diminished because the misstatement inflated the price that they paid.

Consider first the effect on prices prevailing in the U.S. market. The effect of the issuer’s misstatement on its share price does not have a real geographic location. Because of arbitrage, the issuer’s shares will trade at essentially the same inflated price everywhere in the world. This, of course, includes the United States if the issuer’s shares trade there. To count this effect on prices in the U.S. market as an “effect” for jurisdictional-reach purposes is just another way of saying that purchases at a price inflated by the issuer’s misstatement that are executed in the United States should be covered by the cause of action and pur-



chases executed abroad at the same inflated prices should not. The fact that the misstatement has an effect on U.S. prices is not by itself a good reason, however, for making a distinction between purchases on U.S. markets and purchases abroad—including the first within the reach of the action and excluding the second—because the misstatement has the same effect on prices abroad.

Of course, there might be some reason other than effect on price to include purchases on U.S. markets as within the action's reach while excluding purchases made abroad. We have already seen that assuring that U.S. markets are places where only highly transparent issuers trade is not a good one, however. Moreover, the place where the investor's buy order is executed may be quite arbitrary. The misstatement did not induce the purchase and so it certainly did not induce it to occur in the United States rather than elsewhere. To the extent that the place of execution is not simply the product of the residency of the purchaser—the relevance of which is discussed immediately below—the choice of where to execute the purchaser's order is likely to be made by her broker, who simply tries to find the market where best execution is available at the moment.

It should also be noted that, in an age of electronic trading, the geographic location of a market, to the extent that it can be said to exist anywhere, is simply where the computer server processing the trades is located. The server could be located anywhere in the world and perform identically, without most traders caring, or even knowing, about its location. There is no obvious reason why the server's location should be an important factor in determining what claims should be within the reach of an American-law-based cause of action and which outside.<sup>196</sup>

Now consider the effect on U.S. investors. U.S. residents who purchase the issuer's shares at the inflated price are affected by the foreign issuer's conduct whatever the location of the market on which they execute their purchases. Regardless of purchase location, if they hold until the market realizes the truth and the inflation in price dissipates, they suffer the same diminution in wealth from having paid the inflated price. There is nothing arbitrary about U.S. law being more concerned with the effects of foreign-issuer conduct on U.S. residents than with its effects on residents of other countries. Thus, unlike effect on price, effect on the wealth position of U.S. residents is a coherent basis for making a distinction concerning the reach of the action, even if it is ultimately not a sound one in terms of the analysis in Part IV.

Relative to the traditional reliance-based fraud action, however, making a distinction between U.S. versus foreign investors for determining the reach of the fraud-on-the-market action is much less workable in terms of interaction with other legal systems in the world. In a fraud-on-the-market action brought

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196. *See supra* Parts IV.A.2.c, IV.B.2.

by a foreign investor, the nontrading issuer is the defendant making the payout. Few other countries in the world provide their resident investors with an action for the same kind of losses. Extending the U.S. cause of action to U.S.-resident purchasers of the issuer's shares but not to foreign purchasers results in a non-pro rata dividend to the U.S. investors, paid for, typically, in large part by investors who are residents of the rest of the world.<sup>197</sup> Unlike a traditional fraud action, any given U.S. investor is as likely to be a seller and the beneficiary of the conduct as she is to be a buyer and suffer a deprivation. If the U.S. buyers get compensation for their deprivations and foreign buyers do not, while sellers from everywhere keep their gains, there is an arbitrary transfer of wealth from foreign investors to U.S. investors.

Even if more countries move toward permitting fraud-on-the-market causes of action of their own, the issuer's conduct still does not resemble Judge Friendly's analogy to shooting a gun across a state line. The better analogy would be the release of a cloud of noxious gas that spreads around the earth. If the United States uses the effects test and inspires others to do the same, every corporate statement would have the potential of triggering liability under many different legal systems. Issuers striving to avoid liability would have to inform themselves about (and tailor their public-statement-making processes to account for) a myriad of different standards concerning what is considered materially false or misleading and the level of mens rea or lack of care necessary for liability.

#### b. *Conduct in the United States*

Now consider a situation where again a foreign issuer with scienter makes a material misstatement to the public media that inflates the price at which its shares trade, but where at least some of the issuer's conduct relating to the misstatement occurs within the United States. This conduct could either be the actual act of publicly disseminating the misstatement—the utterance of the words or the release of a document containing the misstatement—or some conduct leading up to this act of dissemination. Or the conduct in the United States could be the business activity of the issuer that the misstatement is describing.

The location of the act publicly disseminating the misstatement (and the location of any conduct leading up to this act) should matter little in terms of any consequences that might prompt the need for regulation.<sup>198</sup> The misstate-

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197. *See supra* Part IV.B.1.

198. The filing with the SEC of a periodic disclosure form containing the misstatement might be treated as constituting more serious and geographically distinct misconduct in the United States, as compared to the United States simply being the point of media dissemination for a message with inevitable worldwide reach. The effect of the SEC filing on prices

ment of a substantial, established foreign issuer whose shares trade in an efficient market is inevitably going to circulate globally in the financial media. Regardless of where the act of public dissemination occurs, or of conduct leading up to it, the misstatement will very rapidly have the same effect on the price that investors around the world pay for the issuer's shares. And it is the increase in price that purchasers pay that is the injury that gives rise to the cause of action.

It should also be noted that the reason the utterance or writing of a real person—an official of the issuer—is attributed by law to a fictional person—the issuer—is because the official is part of a decisionmaking organization that the law finds responsible for the statement. Wherever the misstatement happens to be introduced into global media circulation and wherever conduct leading up to this dissemination occurs, the top decisionmakers of this organization by and large operate at its headquarters, which, for a genuinely foreign issuer, is located abroad.

The location of the business activity that the misstatement describes—for example, the location of the operations the performance of which the issuer falsely exaggerates—should also be irrelevant. Rule 10b-5 does not prohibit an issuer's operations from performing below a certain level; it prohibits making a misstatement concerning the level of performance, whatever that level might be.

The problem with using the conduct test for determining the reach of the fraud-on-the-market liability system against foreign issuers goes beyond the difficulty in finding meaning in the location of conduct. The conduct test finds conduct within the reach of a U.S. action when that conduct, although occurring in the United States, has all its effects abroad. In the case of the traditional reliance-based Rule 10b-5 cause of action, the whole rationale for allowing plaintiffs to use the test to bring such conduct within the reach of the action has been good neighborliness. Judge Friendly suggested in *Vencap*, a traditional fraud case, that if the United States allowed such conduct to be without consequence, other countries would “look askance.”<sup>199</sup> This rationale totally fails in

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around the world is the same as that of the media release, however. If the issuer was going to make a misstatement, in all likelihood the reason the issuer made the misstatement in the SEC filing was because it was required to make such a filing due to having a U.S. listing. Any issuer that lists its securities on a U.S. exchange must be subject to the Exchange Act periodic disclosure regime. 15 U.S.C. §§ 78l(a)-(b), 78m (2006 & Supp. IV 2010). Companies subject to this regime must make, or promptly repeat, most important corporate announcements in an SEC filing. See 17 C.F.R. § 249.308 (2011); SEC, FORM 8-K, *available at* <http://www.sec.gov/about/forms/form8-k.pdf>. Thus, the underlying issue is again whether the trading of the issuer's shares on a U.S. exchange is a factor that should weigh in favor of bringing the claim against the issuer within the reach of the action.

199. *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975).

the case of a fraud-on-the-market action. A U.S. refusal to allow the fraud-on-the-market claims of non-U.S. residents who execute purchases of foreign-issuer shares abroad is unlikely to cause other countries to look askance. Indeed, the amici briefs of several foreign governments submitted to the Supreme Court in *Morrison* suggest quite the opposite of Judge Friendly's concern in *Vencap*.<sup>200</sup> Their opposition to the United States allowing such claims is understandable given the analysis here that a fraud-on-the-market type of liability is really a device for enhancing corporate governance and liquidity, and that other countries may judge that for their issuers, the resulting gains are not worth the liability system's considerable cost.

### C. Resulting Pre-Morrison Case Law<sup>201</sup>

The pre-*Morrison* attempts of the lower courts to apply the conduct/effects test to determine the reach of fraud-on-the-market actions against foreign issuers were unusually inconsistent.<sup>202</sup> This inconsistency is not surprising given the inherent problems identified above with using the test for this purpose.

#### 1. Conduct test

Consider first how the courts applied the conduct test to fraud-on-the-market class actions. Some courts maintained that a foreign issuer that filed with the SEC an Exchange Act periodic disclosure form containing a price-inflating material misstatement, or that made a media or investor presentation in the United States containing such a misstatement, had engaged in "conduct" that could be a basis for meeting the test.<sup>203</sup> Under this theory—since this U.S. conduct has just as direct an effect inflating the price of the issuer's shares on markets abroad as it does inflating the price in the United States—foreign purchasers on foreign markets had just as good a cause of action for their losses as U.S. purchasers had on the U.S. market.

Other courts maintained that such a filing or presentation in the United States—even though it inflated the price paid by foreign purchasers of the issu-

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200. See *supra* note 10.

201. For more extensive reviews of the pre-*Morrison* case law, see Buxbaum, *supra* note 14; Choi & Silberman, *supra* note 14; and Grant & Zilka, *supra* note 14.

202. This is a broadly held view. See *supra* text accompanying note 15.

203. See, e.g., *In re Royal Dutch/Shell Transport Sec. Litig.*, 380 F. Supp. 2d 509, 544-45 (D.N.J. 2005) (determining SEC filings and media and investor presentations in the United States constituted "conduct"); *In re Cable & Wireless, PLC, Sec. Litig.* 321 F. Supp. 2d 749, 763-64 (E.D. Va. 2004) (finding SEC filings constituted "conduct"); *Kaufman v. Campeau Corp.*, 744 F. Supp. 808, 810 (S.D. Ohio 1990) (deciding SEC filings and press releases in the United States constituted "conduct").

er's shares on a foreign exchange—would not by itself be sufficient conduct in the United States to give these foreign purchasers a valid claim.<sup>204</sup> The only reason given by any of these courts was that to hold that such conduct was sufficient to meet the conduct test would in essence be to create a global fraud-on-the-market action, thereby “extend[ing] the reach of the [securities laws] too far.”<sup>205</sup> This conclusory reasoning is not very helpful since presumably the whole task of the courts with regard to this issue is to provide principles for determining what is, and is not, “too far.”

Some courts, when applying the conduct test, focused on where the misstatement was prepared and on where the decision authorizing the statement's dissemination occurred, rather than on the point of dissemination.<sup>206</sup> But another court specifically criticized this alternative focus.<sup>207</sup>

Finally, some courts found that there was sufficient conduct in the United States to meet the test if the actions or matters that were the subject of the misstatement occurred in the United States, wherever the misstatement was prepared, authorized, or disseminated.<sup>208</sup> Others entirely rejected the importance of this factor.<sup>209</sup>

## 2. *Effects test*

Application of the effects test to the fraud-on-the-market class action was similarly confusing. One approach was to consider the test solely in terms of

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204. *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 10 (D.D.C. 2000); *see also, e.g.*, *AstraZeneca Sec. Litig.*, 559 F. Supp. 2d 453, 465-66 (S.D.N.Y. 2008), *aff'd sub nom.* *State Univ. Ret. Sys. of Ill. v. AstraZeneca PLC*, 334 F. App'x 404 (2d Cir. 2009); *Tri-Star Farms Ltd. v. Marconi, PLC*, 225 F. Supp. 2d 567, 579 (W.D. Pa. 2002); *McNamara v. Bre-X Minerals Ltd.*, 32 F. Supp. 2d 920, 925 (E.D. Tex. 1999).

205. *In re Baan*, 103 F. Supp. 2d at 10.

206. *See, e.g.*, *In re CP Ships Ltd. Sec. Litig.*, 578 F.3d 1306, 1315-16 (11th Cir. 2009) (finding the conduct test met because fraudulent accounting practices that led to the misstatement occurred in the U.S. office of a foreign company); *In re SCOR Holding (Switzerland) AG Litig.*, 537 F. Supp. 2d 556, 566-68 (S.D.N.Y. 2008) (same); *Nathan Gordon Trust v. Northgate Exploration, Ltd.*, 148 F.R.D. 105, 108 (S.D.N.Y. 1993) (“The mere filing of reports with the SEC [containing the allegedly false information] . . . [was] merely incidental to [its] authorship, preparation and dissemination, . . . all of which occurred in Canada.”).

207. *In re Gaming Lottery Sec. Litig.*, 58 F. Supp. 2d 62, 75 (S.D.N.Y. 1999).

208. *See, e.g.*, *Wagner v. Barrick Gold Corp.*, 251 F.R.D. 112, 120-21 (S.D.N.Y. 2008); *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 245 F.R.D. 147, 174 (S.D.N.Y. 2007), *aff'd in part, vacated in part*, 574 F.3d 29 (2d Cir. 2009); *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334, 361-62 (D. Md. 2004).

209. *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 346, 394 (S.D.N.Y. 2005); *Tri-Star Farms*, 225 F. Supp. 2d at 578-79.

the location where the purchaser effected her transaction.<sup>210</sup> In any case where the issuer's behavior did not satisfy the conduct test, this approach put purchasers by U.S. residents of shares of a foreign issuer on a market abroad outside of the reach of the cause of action. An alternative approach was to consider the residency of the purchaser as an additional basis for finding the effects test satisfied.<sup>211</sup> Under this alternative approach, even in cases where the issuer's behavior did not satisfy the conduct test, U.S. residents who purchased shares of a foreign issuer on a market abroad *were* within the reach of the cause of action. The second approach raised questions as to its coherence because the two kinds of effects—on the price at which shares trade in the United States and on the wealth position of U.S. residents—seemed to have little in common in terms of the purported U.S. interests promoted by their respective inclusion within the test. Research does not reveal any case (other than where the issuer's behavior satisfies the conduct test) where the only U.S. purchasers in the proposed class against a foreign issuer had purchased abroad. This is interesting because the purchasers in any such situation would have engaged in transactions that were identical to transactions that are within the cause of action under the second approach in cases where there were also U.S. plaintiffs who purchased in the United States.<sup>212</sup>

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210. *Nathan Gordon Trust*, 148 F.R.D. at 108 (finding insufficient U.S. conduct by the foreign issuer to satisfy the conduct test and excluding from the class all claims based on purchases on any foreign exchange, thereby limiting the class only to those investors, whether U.S. or foreign, who purchased on the NYSE).

211. *In re China Life Sec. Litig.*, No. 04 Civ. 2112(TPG), 2008 WL 4066919, at \*1 (S.D.N.Y. Sept. 3, 2008) (finding jurisdiction as to claims of U.S. purchasers both at home and abroad and as to claims of foreign purchasers in the United States, but no jurisdiction as to claims of foreign purchasers abroad); *In re SCOR*, 537 F. Supp. 2d at 560-61, 564-65 (same); *In re Royal Ahold N.V.*, 219 F.R.D. at 351-52 (finding the same for U.S. purchasers at home and abroad and foreign purchasers in United States, with the decision as to foreign purchasers abroad to be determined later); *In re Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1, 9 n.11 (D.D.C. 2000) (finding jurisdiction as to claims of U.S. purchasers both at home and abroad and as to claims of foreign purchasers in the United States, but no jurisdiction as to claims of foreign purchasers abroad).

212. The absence of such claims may be because plaintiffs' counsel does not expect such claims to succeed. The difference between such a case and one where the proposed class includes claims by U.S. residents purchasing at home as well is that the cases with the purchasers at home are likely to involve issuers that are registered under the Exchange Act and file periodic reports with the SEC. Even though the courts in these cases do not consider this conduct in the U.S. sufficient to meet the conduct test, this U.S. conduct appears to boost the effects test claims of the U.S. purchasers abroad. Finding jurisdiction based a combination of factors, some of which relate to the conduct test and others to the effects test, but neither set of which is sufficient by itself, is consistent with Second Circuit authority. *See, e.g., Itopa Ltd. v. Lep Grp. PLC*, 54 F.3d 118, 124 (2d Cir. 1995) (“[A] sufficient combination of ingredients of the conduct and effects tests is present . . . to justify the exercise of jurisdiction . . .”).

#### D. *Evaluation*

Returning to the conduct/effects test for fraud-on-the-market class actions may have the comfortable allure of the familiar: the feeling that the test is the product of organic growth that has been guided by wisdom gleaned from experience.<sup>213</sup> Doing so, however, would be undesirable relative to adopting the simple rule advocated here. To start, as we have just seen, the pre-*Morrison* attempts by courts to apply the conduct/effects test in such actions lacked sufficient consistency and coherence to permit reliable predictions going forward as to which situations would give rise to actionable claims and which would not. This is not a problem that could be easily corrected by clear statutory language. The fact that some kind of conduct occurs, or some kind of effect is experienced, in one country rather than another allows formal distinctions to be made. In contrast to their use for determining the reach of the traditional reliance-based fraud action, however, these distinctions, when used in the fraud-on-the-market context, either lack meaningful significance or lead to serious problems interacting with other legal systems. These problems leave courts without reliable bearings as to how to decide close cases.

More fundamentally, the conduct/effects test did not result in a set of decisions that discriminated well between the situations in which there are significant U.S. interests in imposing liability on an issuer and the ones in which there are not. Subjecting an issuer to the fraud-on-the-market liability regime improves its transparency with resulting improvements in corporate governance and liquidity. But doing so entails costs as well, and both the benefits and costs of using a liability regime for this purpose are, as we have seen, concentrated in the issuer's home country.<sup>214</sup> Thus the United States benefits little from the governance and liquidity gains that would result from imposing its liability system on issuers from other countries. Indeed, doing so is likely to engender resentment abroad and reduce global economic welfare because the government of the issuer's home country is more motivated and better informed than the U.S. government to judge correctly the benefits and costs of using this particular device to enhance corporate governance and liquidity.

There were many factors that, in the view of one court or another, increased the likelihood that a foreign issuer would be liable to any particular purchaser. They included the purchaser being a U.S. resident, the issuer filing Exchange Act disclosure reports and being listed on a U.S. exchange, a U.S.

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213. This was essentially Justice Stevens' argument in his concurrence in *Morrison*. Justice Stevens called for retention of the conduct/effects test but concluded that, using this test, the facts alleged in the complaint did not warrant extending the reach of the statute to the purchases of the plaintiffs. *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2890-91 (2010) (Stevens, J., concurring).

214. *See supra* Part IV.A.2.

location being the point of dissemination of the misstatement to the media or of conduct leading up to this act of dissemination, and the issuer conducting the misdescribed part of its business in the United States. Notably, these are all unrelated to any U.S. interest in imposing fraud-on-the-market liability. As we have seen, the place of dissemination and the location of the business that the misstatement concerns are simply meaningless in terms of how the fraud-on-the-market cause of action works and what it intends to achieve. Use of the residency of the purchaser and the location of the market on which the issuer's shares are listed as bases for discriminating among claims actually reduces global economic welfare by distorting foreign-issuer choices as to where to promote the trading of their shares. It also hurts the competitiveness of U.S. markets. Moreover, when the presence of these factors does result in liability being imposed on an issuer, the pro rata rule for shareholder distributions is violated because some purchasers who suffered losses from purchasing at an inflated price receive payments from the corporation and usually others do not.<sup>215</sup>

Finally, as we have seen, global efficiency is enhanced if foreign issuers that wish to be able to bond on an ongoing basis to a higher level of transparency by imposing the U.S. disclosure and liability regime on themselves. Use of the conduct/effects test factors to determine whether to impose liability provides at best a clumsy, usually only partially effective, way for an issuer to undertake this desirable bonding, because, under most circumstances, only a portion of investors who purchase the foreign issuer's shares at a misstatement-inflated price would have a claim for damages. Thus a foreign issuer would not be subjected to the full level of potential liability faced by a domestic U.S. issuer.

## VI. COMPETING ALTERNATIVES: THE *MORRISON* TEST AND COMMENTATOR PROPOSALS

Another competing alternative to the approach recommended here would be to use the approach that the Supreme Court employed in *Morrison* for defining the reach of the underlying statute to determine the reach of the private fraud-on-the-market cause of action for damages as well. The Court, it will be recalled, ruled that section 10(b)'s prohibitions only reach situations where the securities involved were listed on a U.S. exchange or where their purchase or sale was effected in the United States.<sup>216</sup> Because there can be no private cause of action for damages without an underlying violation of the statute, *Morri-*

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215. The unusual situations under which all purchasers of a foreign issuer's shares would have a claim would be where the conduct test is met or where a foreign issuer lists its shares exclusively in the United States.

216. *Morrison*, 130 S. Ct. at 2888.



*son*'s ruling concerning the reach of the statute sets an outside limit, absent new legislation, on the reach of the fraud-on-the-market cause of action. Using the *Morrison* approach to determine the reach of this private action would take the action's reach to this outside limit.

#### A. *Need for a Serious Assessment*

If neither Congress nor the SEC speaks to the question, using the *Morrison* test to determine the reach of the fraud-on-the-market cause of action will have a natural appeal to the courts. Doing so would minimize judicial effort by piggybacking on a test that has already been developed and that must in any case be applied before liability can be imposed. Also, the lower courts, in their pre-*Morrison* use of the conduct/effects test, already tended to treat as one the two questions of the reach of the statute's prohibitions and the reach of the cause of action.

It is important to recognize, however, that even in the absence of action by Congress or the SEC, use of the *Morrison* test to answer the distinctly different question of the reach of the fraud-on-the-market action for damages is in no way required or inevitable. The Rule 10b-5 cause of action for damages is implied, meaning that it is entirely a creation of the courts.<sup>217</sup> The courts define its metes and bounds. Thus not every transaction whose connection with questionable conduct is sufficient to make this conduct a Rule 10b-5 violation need be a transaction that gives rise to a private cause of action.<sup>218</sup>

#### B. *The Reach of the Test*

The allegations in *Morrison* were that an Australian banking corporation, National Australia Bank Ltd. (NAB), made material misstatements that inflated the price of its securities. The misstatements related to the value of the assets of a U.S. subsidiary of NAB. These misstatements were claimed to inflate the purchase price of NAB's securities. The numbers exaggerating the value of these assets were sent to NAB's officials in Australia by the subsidiary's managers in the United States. NAB's common stock (called "ordinary stock") traded on an exchange in Australia. In the United States, American Depositary Receipts (ADRs) for NAB common shares were listed to trade on the NYSE, but the underlying NAB common shares themselves were not listed for trading on any U.S. exchange.<sup>219</sup> ADRs are negotiable instruments issued by a deposi-

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217. *See supra* Part II.A.2.

218. *See infra* Part VII.A.

219. Justice Scalia stated that NAB's common stock was not listed on a U.S. exchange: "This case involves no securities listed on a domestic exchange . . ." *Morrison*, 130 S. Ct. at

tory bank that give the holder a beneficial interest in a given number of underlying common shares of the issuer.<sup>220</sup> A class action claiming losses due to NAB's alleged misstatements was brought against NAB on behalf of non-U.S. purchasers of the common shares, all of whom executed their purchases outside of the United States.<sup>221</sup> Thus the defendant issuer, the plaintiff purchasers, and the place of the purchases were all outside the United States. Plaintiffs' claim that their situation was within the reach of the fraud-on-the-market cause of action was based on the conduct within the United States of the subsidiary managers who sent the exaggerated numbers to headquarters in Australia.<sup>222</sup>

The district court dismissed the complaint for lack of subject matter jurisdiction on the theory that the conduct in the United States was not sufficient to satisfy the conduct test.<sup>223</sup> The Second Circuit affirmed, on the grounds that the conduct in the United States did not "compris[e] the heart of the alleged fraud."<sup>224</sup> The Supreme Court disagreed with the lower courts about the lack of subject matter jurisdiction. It clarified that the question of subject matter jurisdiction turned on the scope of the district court's adjudicatory authority, not the reach of the statute. The Court nevertheless dismissed the complaint for failing to state a claim, because, in the Court's view, the statute whose violation was the basis of the private damages claim—Exchange Act section 10(b)—did not reach the situation alleged in this case.

The Court said that its conclusion as to the reach of the statute was based on the words of the statute combined with the interpretative presumption against giving statutes extraterritorial effect.<sup>225</sup> Specifically, the Court held that section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an

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2888. This statement, however, was not correct, at least as a formal matter. NAB's underlying common stock was listed on the NYSE, but not listed for trading. This nontrading listing of the underlying stock was required for the ADRs to be listed for trading there. See Supplemental Joint Appendix at SA-58, *Morrison*, 130 S. Ct. 2869 (No. 08-1191), 2010 WL 286689; EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS 2-34 n.85 (9th ed. 2006); NYSE AMEX, SAMPLE LISTING APPLICATION FOR AMERICAN DEPOSITARY RECEIPTS (2008), available at [http://www.nyse.com/pdfs/altus\\_app\\_adr.pdf](http://www.nyse.com/pdfs/altus_app_adr.pdf) (last visited May 11, 2012).

220. See notes 243-47 and accompanying text for a further discussion of ADRs.

221. The class originally included purchasers of the NAB ADRs on the NYSE, but the claims of these purchasers were dismissed because their representative plaintiff failed to allege damages. *Morrison*, 130 S. Ct. at 2876 n.1.

222. *Id.* at 2875-76.

223. *In re Nat'l Austl. Bank Sec. Litig.*, No. 03 Civ. 6537(BSJ), 2006 WL 3844465, at \*4-8 (S.D.N.Y. Oct. 25, 2006).

224. *Morrison v. Nat'l Austl. Bank Ltd.*, 547 F.3d 167, 175 (2d Cir. 2008).

225. *Morrison*, 130 S. Ct. at 2877, 2881-83.

American stock exchange, or the purchase or sale of any other security in the United States.<sup>226</sup>

The Court, applying this holding to the facts as it characterized them, found that the statute did not reach the plaintiffs' claims because the case "involve[d] no securities listed on a domestic exchange, and all aspects of the purchases . . . occurred outside the United States."<sup>227</sup>

The Court's statement and application of its holding both clearly contemplate that a manipulative or deceptive device or contrivance can violate section 10(b) if it is made in connection with either of two kinds of transactions: a transaction in a security listed on a U.S. exchange or a transaction occurring in the United States. As will become apparent in the discussion below, however, there is some question as to whether the courts in subsequent cases will apply this holding in accordance with its terms, particularly if the holding is being used to determine the reach of the private fraud-on-the-market damages action rather than simply whether a deceptive act violated the Rule and the statute.

### 1. *Foreign issuers with no securities listed on a U.S. exchange*

For a foreign issuer that does not have any securities listed on a U.S. exchange—either ADRs or its underlying common shares—use of the *Morrison* test would likely provide complete protection from fraud-on-the-market suits. The matter is not entirely free from doubt, however. Obviously there is no possibility of claims based on the exchange-listed prong of the test. The alternative "purchase in the United States" prong of the test could be the basis for two kinds of claims that, depending on the facts, might be made against such an issuer. The legal arguments in support of each of these claims, however, would appear to involve an uphill battle.

#### a. *Claims based on purchases in the U.S. OTC market*

The first possible claim arises if the issuer is one of the many substantial, established non-U.S.-exchange-listed foreign issuers whose equity securities, in addition to trading on a deep, liquid exchange at home, trade in the United States on the over-the-counter market, either as ADRs or as the underlying common stock itself.<sup>228</sup> Typically, the equity securities of such an issuer trade in the United States on OTCQX International or OTCQX International Premier.

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226. *Id.* at 2888.

227. *Id.*

228. There are about 1800 foreign-issuer ADRs listed on OTC and OTCQX. See *DR Directory*, BNY MELLON, [http://www.adrbnymellon.com/dr\\_directory.jsp](http://www.adrbnymellon.com/dr_directory.jsp) (last visited May 11, 2012).

These markets operate very much like NASDAQ, with broker-dealers posting firm bid and asked quotes for stated quantities against which there can be automatic execution. These bids and asks are either the quotes of a market-making dealer or are based on limit orders that such a dealer holds on its books.<sup>229</sup> A purchase on one of these markets by a U.S. resident would clearly be “in the United States” and thus would satisfy the alternative “purchase in the United States” prong of the *Morrison* test.<sup>230</sup>

The problem for such a claimant is that OTC markets have often been found insufficiently efficient to allow purchasers to invoke the fraud-on-the-market theory presumption of reliance, without which a class action is impractical.<sup>231</sup> A more nuanced analysis suggests a more complicated picture,

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229. All broker-dealers are required to trade at their publicly quoted bid-ask prices. *Investors Information—Marketplace Rules*, OTC MARKETS, <http://www.otcmarkets.com/otc-101/marketplace-rules> (last visited May 11, 2012). This is similar to listed securities trading except that there is “no central system that matches/executes orders [automatically] in the OTC.” *Learn—Part 2—Trading*, OTC MARKETS, <http://www.otcmarkets.com/otc-101/trading> (last visited May 11, 2012). Further, these broker-dealers are not required to display their customers’ limit orders in their quotes because OTC stocks are not subject to Limit Order Display requirements. *Investors Information—Investor FAQs*, OTC MARKETS, <http://www.otcmarkets.com/otc-101/investor-faq> (last visited May 11, 2012). They are, however, required to protect their customers’ limit orders. *Id.*

230. A purchase in one of these markets by a non-U.S. resident would also clearly be “in the United States” unless, as is unlikely, the courts accept the argument—which is the basis of the second possible claim discussed in the text immediately below—that a purchase occurs where the investor placing the order resides, not at the location of the institution operating the forum where the trade is executed.

231. The issue of efficiency arises because the fraud-on-the-market theory depends on market prices reflecting both the issuer misstatement—hence the inflation—and subsequent market realization of the truth—hence the dissipation of the inflation and the loss to the holder who purchased at the inflated price. See Part II.A.3 above for a discussion of the market efficiency conditions that courts require a plaintiff to satisfy in order to be able to invoke the fraud-on-the-market presumption of reliance and the impracticality of bringing a class action if the presumption is not available. Many courts decline to adopt a bright-line test for determining if an OTC security is traded on an efficient market, instead applying five factors known as the *Cammer* factors on a case-by-case basis. See *Cammer v. Bloom*, 711 F. Supp. 1264, 1285-87 (D.N.J. 1989) (finding that specific OTC securities have the potential to trade on an efficient market depending on the following five factors: average weekly trading volume, analyst following, number of market makers, qualification to use Form S-3 for public offerings, and empirical record of price responsiveness to unexpected news). However, some courts have found the OTC market to be inefficient as a matter of law. See *Epstein v. Am. Reserve Corp.*, No. 79 C 4767, 1988 WL 40500, at \*5 (N.D. Ill. Apr. 21, 1988); *In re Data Access Sys. Sec. Litig.*, 103 F.R.D. 130, 138 (D.N.J. 1984), *rev’d on other grounds*, 843 F.2d 1537 (3d Cir. 1988); see also Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in Cammer v. Bloom and Its Progeny*, 10 U. MIAMI BUS. L. REV. 303 (2002) (discussing the differing approaches taken by courts in assessing whether a market is sufficiently efficient to support the fraud-on-the-market presumption).

however. The typical U.S. issuer trading on the parallel domestic OTCQX market is relatively small, not thickly traded, not widely followed, and not traded on some major exchange outside the United States. Consequently, the share prices of these smaller U.S. issuers are clearly not as efficient, in the sense of quickly incorporating all publicly available information, as are the prices of large, established, thickly traded, and widely followed U.S. issuers trading on the NYSE or NASDAQ.<sup>232</sup> In contrast, a foreign issuer trading in a U.S. OTC market may be just as large, established, and well-followed as the largest, most established U.S. issuers trading on the NYSE and NASDAQ. The home markets on which these large, established foreign issuers trade work well enough that their shares are often as efficiently priced as those of their U.S. counterparts on the NYSE or NASDAQ.<sup>233</sup> Many such foreign-issuer shares (or ADRs) will, because of cross-market arbitrage, trade on the OTC market at approximately the same price as they do in the home market.<sup>234</sup> Hence purchases and sales of shares of these foreign-issuer securities on the U.S. OTC market would be at prices roughly as efficient as those found for purchases and sales of large, established U.S. issuers on the NYSE or NASDAQ.

A purchaser of such a foreign issuer's shares in the U.S. OTC market could thus argue both that section 10(b) reaches her claim pursuant to *Morrison's* purchased-in-the-United States second prong, and that, because of the efficiency of the OTC prices of the foreign issuer's shares, she is as entitled to the fraud-on-the-market presumption of reliance as are the purchasers of large, established U.S. issuers trading on the NYSE or NASDAQ. Despite the logic of this argument, a court might not be persuaded. There would be an inherent reluctance to impose liability on a foreign issuer when the only trading of its

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232. See Jonathan Macey et al., *Down and Out in the Stock Market: The Law and Economics of the Delisting Process*, 51 J.L. & ECON. 683, 708 fig.6, 709 (2008); Jeffrey H. Harris et al., *Off but Not Gone: A Study of NASDAQ Delistings 2* (Dice Ctr., Working Paper No. 2008-06, 2008), available at <http://ssrn.com/abstract=628203>.

233. See Michael Aitken & Audris Siow, *Ranking World Equity Markets on the Basis of Market Efficiency and Integrity 14-15 & tbl.1* (2003) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=490462](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=490462); see also Bruno Biais et al., *Price Discovery and Learning During the Preopening Period in the Paris Bourse*, 107 J. POL. ECON. 1218, 1245 (1999) (finding a large degree of efficiency in prices on the Paris Bourse as the opening of trading gets close); Marc Bremer & Takato Hiraki, *Volume and Individual Security Returns on the Tokyo Stock Exchange*, 7 PAC. BASIN FIN. J., 351, 368-69 (1999) (finding the pricing patterns of stocks on the Tokyo Stock Exchange is similar to NASDAQ and U.S. exchanges); Wael Louhichi, *Adjustment of Stock Prices to Earnings Announcements: Evidence from Euronext Paris*, 7 REV. ACCT. & FIN. 102, 113 (2008) (finding price reaction to earnings announcements begins quickly).

234. See note 246 and accompanying text below for a discussion of how closely the price of a foreign issuer's ADRs or shares trading in the United States track the price of the shares in the home market.

shares or ADRs in the United States is on the OTC market.<sup>235</sup> The lesser importance of OTC trading of a foreign issuer's shares, as opposed to exchange trading of such shares, is suggested by the SEC's exemption for OTC-traded foreign issuers from the periodic disclosure requirements under the Exchange Act.<sup>236</sup> One way that a court could act on this reluctance would be to deny the purchaser's claim based on the proposition that the OTC market as a general matter is insufficiently efficient to support the fraud-on-the-market presumption, even though the court would be ignoring strong evidence of the efficiency of the pricing of this particular security.<sup>237</sup>

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235. Indeed, the likely desire of courts to strain in this direction is illustrated by the only post-*Morrison* case so far involving the purchase of a foreign-issuer ADR on a U.S. OTC market. See *In re Société Générale Sec. Litig.*, No. 08 Civ. 2495 (RMB), 2010 WL 3910286 (S.D.N.Y. Sept. 29, 2010). The court granted the defendants' motion to dismiss simply by finding the "purchase in the United States" prong of *Morrison* inapplicable because "[t]rade in ADRs is considered to be a 'predominantly foreign securities transaction.'" *Id.* at \*4 (quoting *Copeland v. Fortis*, 685 F. Supp. 2d 498, 506 (S.D.N.Y. 2010)). The court reached this conclusion notwithstanding the fact that the *Morrison* holding clearly would find within the reach of section 10(b) a purchase in the United States of a foreign-issuer ADR listed on a U.S. exchange, which suggests that a trade in ADRs is not necessarily considered a foreign transaction.

236. Exchange Act section 12(g)(1), as modified by Rule 12g-4, requires every issuer with more than \$10 million in assets and with shares held of record by more than 500 persons to register its shares, and thereby also be subject to the Exchange Act's periodic disclosure regime, even though the shares are not listed on a U.S. exchange. 15 U.S.C. § 78l(g)(1) (2006); 17 C.F.R. § 240.12g-4 (2011). This provision makes no distinction between foreign and domestic issuers; all that is required is that the issuer has some connection with interstate commerce, a test that almost any public issuer in the world would meet. However, section 12(g)(3) authorizes the SEC, by rule or regulation, to exempt any foreign issuer. 15 U.S.C. § 78l(g)(3). Rule 12g3-2b exempts from the requirements of section 12(g)(1) any foreign issuer not listed on a U.S. exchange that has its primary trading market abroad and that makes the information that its home government and primary trading market require available in English on its website or other publicly accessible electronic medium. 17 C.F.R. § 240.12g3-2(b) (2011).

237. In *Parmalat*, a pre-*Morrison* conduct/effects test case involving a large, well-established foreign issuer whose securities traded in an active market at home and on the OTC market in the United States, the court did not take this path. See *In re Parmalat Sec. Litig.*, No. 04 MD 1653 (LAK), 2008 WL 3895539, at \*9-10 (S.D.N.Y. Aug. 21, 2008). It rejected the defendants' argument that the class of the purchasers in the U.S. OTC market should not be certified because the volume of trading of Parmalat shares in this market was very low. *Id.* at \*10. The court instead cited the trading volume and other features of the worldwide market for Parmalat shares and the interconnectedness of the U.S. market and those abroad. *Id.* at \*9. The overall tenor of the *Morrison* opinion, however, is likely to change the atmosphere. An early indication that such a change in atmosphere has occurred is the one post-*Morrison* case so far involving the purchase, on a U.S. OTC market by a U.S. investor, of the ADRs of an established foreign issuer whose shares traded on an efficient market at home. See *In re Société Générale*, 2010 WL 3910286, at \*6. The court granted the defendants' motion to dismiss. *Id.* at \*9. While the court did not justify its decision specifically in terms of a claimed lack of efficiency of the OTC market, it stated that the ADRs

b. *Claims based on the purchase order being placed in the United States*

The second possible claim against a foreign issuer not listed on a U.S. exchange involves the situation where a U.S.-resident purchaser contacts her U.S. broker and places a purchase order that the broker then arranges to have executed on an exchange abroad. These facts differ in important ways from those of *Morrison*, where the purchase orders were not only executed abroad, but were placed from abroad by non-U.S. investors. Such a purchase, it can be argued, is “in the United States” because the United States is where the order was made and where the securities end up.<sup>238</sup> Exchange Act section 3(13) defines “purchase” to include “any contract . . . to purchase.”<sup>239</sup> The executory contract constituting the plaintiff’s purchase would be between the purchaser in the United States and a dealer or some other seller offering the security from some location abroad, and would presumably have been created by some electronic or telephonic communication. Such a transaction has no self-evident geographic location. If the geographic location of the transaction is not self-evident, its location is not clearly abroad.

Such an argument is not frivolous, but claimants who invoke it face long odds. While the purchase may have a U.S. location in some sense, it does not have a U.S. location in the sense that the Supreme Court in *Morrison* appears to mean. The Court’s discussion seems to focus primarily on the geographic location of the institution that operates the matching of buy and sell orders and on the place where funds are exchanged for the security.<sup>240</sup> Certainly the handful of district courts that have considered the issue so far do not view purchases made “in the United States” to include the kind of purchase being discussed

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“were not traded on an official American securities exchange; instead, ADRs were traded in a less formal market with lower exposure to U.S.-resident buyers.” *Id.* at \*6.

238. See *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 471 (S.D.N.Y. 2010); Plaintiff’s Memorandum of Law in Opposition to Defendants’ Supplemental Memorandum of Law in Further Support of Their Motion to Dismiss the Second Amended Complaint at 5-8, *Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166 (S.D.N.Y. 2010) (No. 1:08-cv-01958-JGK), 2010 WL 3017695; Lead Plaintiffs’ Memorandum of Law in Opposition to the Joint Supplemental Memorandum of Law in Further Support of Defendants’ Motions to Dismiss at 8-10, *In re Satyam Comp. Servs., Ltd. Sec. Litig.*, No. 09 MD 2027 (BSJ) (S.D.N.Y. Sept. 27, 2010).

239. 15 U.S.C. § 78c(a)(13).

240. See *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2884-85 (2010) (“We know of no one who thought that the Act was intended to ‘regulat[e]’ foreign securities exchanges—or indeed who even believed that under established principles of international law Congress had the power to do so. . . . Like the United States, foreign countries regulate their domestic securities exchanges and securities transactions occurring within their territorial jurisdiction.” (quoting 15 U.S.C. § 78l(a)).

here.<sup>241</sup> As a practical matter, the argument is really a disguised reintroduction of something close to the broadest possible version of the effects test—extending the reach of the fraud-on-the-market cause of action to cover foreign-issuer misstatements simply because they reduced the wealth position of a U.S.-resident investor—a test that was heavily critiqued in the majority opinion in *Morrison*.<sup>242</sup>

## 2. Foreign issuers with securities listed on a U.S. exchange

For an issuer that does have equity securities listed on a U.S. exchange, if the *Morrison* test is used to determine the reach of the fraud-on-the-market cause of action, purchases executed on the U.S. exchange would clearly be within its reach. Arguments can be made that the reach would extend beyond this to purchases of the issuer's securities that are executed abroad, but the strength of the arguments depends considerably on whether the issuer listed just ADRs to trade on the U.S. exchange or whether it listed to trade the underlying common shares themselves.

### a. Purchases executed on the U.S. exchange—ADRs

Most foreign issuers that list foreign securities on a U.S. exchange do so in the form of ADRs rather than listing the underlying common shares themselves.<sup>243</sup> Unlike the common shares trading in the home market, an ADR trades on the U.S. exchange in U.S. dollars; clearance and settlement of trades

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241. See *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 532 (S.D.N.Y. 2011); *Plumbers' Union*, 753 F. Supp. 2d at 178; *In re Alstom SA*, 741 F. Supp. 2d at 472-73; *Cornwell v. Credit Suisse Grp.*, 729 F. Supp. 2d 620, 623-24 (S.D.N.Y. 2010) (“[I]nsofar as this proposition superimposes an exclusion based strictly on the American connection of the purchaser or seller, it simply amounts to a restoration of the core element of the effect test.”); *Stackhouse v. Toyota Motor Co.*, No. CV 10-0922 DSF (AJWx), 2010 WL 3377409, at \*1 (C.D. Cal. July 16, 2010).

242. *Morrison*, 130 S. Ct. at 2878-81.

243. See NASDAQ, GOING PUBLIC: A GUIDE FOR EUROPEAN COMPANIES TO LISTING ON THE U.S. SECURITIES MARKETS 6 (2006), available at <http://www.scribd.com/doc/87905783/NASDAQ-GP2005Europe-Chapter-1>; NYSE, IPO GUIDE 11 (2010), available at [https://usequities.nyx.com/sites/usequities.nyx.com/files/nyse\\_ipo\\_guide\\_-\\_updated\\_september\\_2011-print.pdf](https://usequities.nyx.com/sites/usequities.nyx.com/files/nyse_ipo_guide_-_updated_september_2011-print.pdf). A recent survey of annual reports for companies that the NYSE lists as foreign issuers, for example, found only 26 non-Canadian/non-Israeli firms listed their underlying shares as compared with over 273 non-Canadian/non-Israeli firms that listed ADRs. This calculation excludes issuers incorporated in jurisdictions of convenience (i.e., the Bahamas, Bermuda, Guernsey, Liberia, and Panama), because these issuers may well be U.S.-based corporations, and issuers incorporated in Puerto Rico. See generally 421 NYSE and Arca-listed Non-U.S. Issuers from 45 Countries, NYSE EURONEXT (Aug. 31, 2008), <http://www.nyse.com/pdfs/09nonUSIssuers.pdf> (last visited May 11, 2012).



in ADRs occurs in the United States; and dividends are paid to their holders in U.S. dollars.<sup>244</sup> Still, the home market for the common shares and the U.S. market for the ADRs are closely linked: holders of common shares acquired in the home market can deposit them with the depository banks to create new ADRs that can be sold on the U.S. exchange, and holders of the ADRs can withdraw the underlying shares and sell them in the issuer's home country market.<sup>245</sup> For many foreign issuers listing ADRs on a U.S. exchange, arbitrageurs, using this conversion mechanism, keep share prices in the two markets very close.<sup>246</sup> The depository bank earns income by charging investors fees for depositing and withdrawing shares and, in the case of sponsored ADRs, dividend payment fees paid by the issuer.<sup>247</sup>

The first prong of the *Morrison* test would clearly extend the reach of the fraud-on-the-market cause of action to any purchase executed on a U.S. exchange of the ADR of a foreign issuer listed on that exchange, whether the purchase was made by a U.S. or foreign investor. The ADR is a security<sup>248</sup> and is unambiguously listed on a U.S. exchange.

b. *Purchases executed on the U.S. exchange—issuers listing their underlying common shares on a U.S. exchange*

Over 400 foreign issuers list the underlying common shares themselves for trading on a U.S. exchange, rather than listing ADRs, even though the same shares are listed in one or more well-established markets abroad as well.<sup>249</sup>

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244. HAL S. SCOTT, INTERNATIONAL FINANCE: LAW AND REGULATION 34 (2d ed. 2008).

245. See JPMORGAN, DEPOSITORY RECEIPTS: REFERENCE GUIDE 31-36 (2005), available at <https://www.adr.com/Home/LoadPDF?CMSID=88b09551120043cface03554006845cb>.

246. Any difference in price parity is usually temporary, with the magnitude and duration depending on institutional barriers to arbitrage. See Louis Gagnon & G. Andrew Karolyi, *Multi-Market Trading and Arbitrage*, 97 J. FIN. ECON. 53, 77-78 (2010); Junming Hsu & Hsin-Yi Wang, *Why Do Price Spreads Between Domestic Shares and Their ADRs Vary over Time?*, 13 PAC. ECON. REV. 473, 490 (2005) (finding that Korean and Taiwanese ADRs exhibit persistent premiums as a result of regulatory capital controls); see also Samuel Koum kwa & Raul Susmel, *Arbitrage and Convergence: Evidence from Mexican ADRs*, 11 J. APPLIED ECON. 399, 422 (2008).

247. SCOTT, *supra* note 244, at 34.

248. Exchange Act section 3(10), which defines the term "security" as used in the statute, includes within the definition any "certificate of deposit for a security." 15 U.S.C. § 78c(a)(10) (2006). See also Exchange Act Rule 12b-2, which defines a depository share. 17 C.F.R. § 240.12b-2 (2011).

249. Richard W. Painter et al., *When Courts and Congress Don't Say What They Mean: Initial Reactions to Morrison v. National Australia Bank and to the Extraterritorial Jurisdiction Provisions of the Dodd-Frank Act 6* (Univ. of Minn. Law Sch., Research Paper No. 10-40, 2010), available at <http://ssrn.com/abstract=1662590>.

These include most U.S.-listed foreign issuers from Canada and Israel,<sup>250</sup> a few very large European corporations and banks including Celanese AG, UBS, Schlumberger, and Deutsche Bank, and a number of other somewhat smaller companies concentrated mostly in the petroleum and shipping industries.<sup>251</sup> This practice permits a share purchased on the U.S. exchange to be sold on the home market abroad and vice versa without the expense or inconvenience of withdrawing or depositing the shares in an ADR facility, and thereby presumably adds to the share's liquidity. However, if a foreign issuer lists its underlying common shares for trading on a U.S. exchange, the first prong of the *Morrison* test would clearly extend the reach of the fraud-on-the-market cause of action to any purchase of these shares on the U.S. exchange, whether the purchase be made by a U.S. or foreign investor.<sup>252</sup>

c. *Purchases executed abroad—issuers listing their underlying common shares on a U.S. exchange*

What, though, would be the status of purchases abroad of shares of a foreign issuer that lists its underlying common shares, rather than ADRs, on a U.S. exchange? If the *Morrison* test is used to determine the reach of the fraud-on-the-market cause of action, there are substantial arguments going both ways as to whether it would reach these purchases abroad.

For foreign issuers that list their underlying shares for trading on a U.S. exchange, the more natural reading of the actual holding in *Morrison* would extend the reach of fraud-on-the-market claims to every purchase in the world, even purchases by foreign investors executed on markets abroad. The holding, by its terms, brings within the reach of section 10(b) manipulative or deceptive devices in connection with “the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.”<sup>253</sup> If the first prong were to be limited to purchases of securities listed on an American exchange that are executed on that exchange, there would be no reason for the first prong to exist at all. Everything within the

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250. A survey of the companies NASDAQ describes as “international” shows that all forty-six Canadian companies list their underlying shares, as do fifty-six of the sixty Israeli firms, while NYSE’s list of international companies as of mid-2008 shows all Canadian NYSE companies and all but one Israeli company listing their underlying shares for trading rather than ADRs. See *Non US Companies*, NASDAQ, <http://www.nasdaq.com/asp/nonUSoutput.asp> (last visited May 11, 2012); *421 NYSE and Arca-Listed Non-U.S. Issuers from 45 Countries*, *supra* note 243.

251. SCOTT, *supra* note 244, at 35-36. See generally *421 NYSE and Arca-Listed Non-U.S. Issuers from 45 Countries*, *supra* note 243.

252. See *Lapiner v. Camtek, Ltd.*, No. C 08-01327 MMC, 2011 WL 445849, at \*2 (N.D. Cal. Feb. 2, 2011).

253. *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2888 (2010).

reach of the first prong, if interpreted in this more limited way, would already be covered by the second prong. The Court reinforces the more natural broader reading of the holding—that the first prong not be read so as to render it completely redundant—when it applies its holding to the facts of the case. The Court states that the purchases involved in *Morrison* neither involved securities listed on a U.S. exchange *nor* did they in any aspect occur within the United States.<sup>254</sup>

The question posed here is how to deal with a case where, unlike *Morrison*, the security that is purchased *is* listed on a U.S. market, but like *Morrison*, the issuer is foreign and the purchase is executed on a market abroad. The argument for including such a purchase within the reach of the U.S. fraud-on-the-market cause of action is that the holding in *Morrison*, if it were used to determine the reach of the fraud-on-the-market private damage action, plainly says that it should be. The counterargument is that the Court did not mean what it said and that future cases should be controlled by what it meant, not what it said.<sup>255</sup>

The argument that the Court means something different from what it says in its holding in *Morrison* plays out as follows. The Court's analysis starts with the proposition, based on its *Aramco* decision from 1991, that in interpreting a statute, “‘unless there is an affirmative intention of the Congress clearly expressed’ to give a statute extraterritorial effect, ‘we must presume it is primarily concerned with domestic conditions.’”<sup>256</sup> The Court finds no clearly expressed intention to give section 10(b) of the Exchange Act extraterritorial effect.<sup>257</sup> The question then becomes what constitutes “giving the statute extraterritorial effect” in terms of its reach in cases involving both domestic and foreign elements.<sup>258</sup> With regard to this question, one sentence in *Morrison* is critical to the case that the Court does not mean what its holding says: “[W]e think that the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States.”<sup>259</sup> Read

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254. *Id.*

255. Painter et al., *supra* note 249.

256. *Morrison*, 130 S. Ct. at 2877 (quoting *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991)).

257. *Id.* at 2883.

258. The Court recognizes that the presumption “is not self-evidently dispositive” and that “its application requires further analysis.” *Id.* at 2884. It rejects the idea that the presumption does not apply if there is any domestic element to the case. *Id.* On the other hand, even the narrowest reading of the Court's opinion demonstrates that there can be considerable foreign elements to the case without the presumption applying. The holding and the supporting discussion both are clear that a foreign investor's purchase of the shares of a foreign issuer would be within the reach of section 10(b) if the purchase were executed on a U.S. exchange.

259. *Id.*

by itself, this sentence obviously suggests that a manipulative or deceptive act that is in connection with a purchase executed abroad of a share listed on a U.S. exchange does not violate section 10(b).

The case that the Court means something different from what it says in its holding is not clear cut, however. The Court, in the same paragraph, follows the sentence quoted above with a more in-depth analysis. It says that section 10(b) does not seek to prevent deception generally, and that it is transactions that are the objects of the statute's solicitude.<sup>260</sup> It then describes the kinds of transactions that are such objects of this solicitude in terms of the same two prongs that it uses in its holding.<sup>261</sup> This muddies the case that the sentence quoted above represents what the Court really means and leaves open the possibility that the Court believes that the statute's solicitude extends to preventing deception in connection with all transactions in a security listed on a U.S. exchange, wherever the transactions may be executed.

Indeed, a belief that the statute's solicitude extends to transactions executed abroad in securities listed on a U.S. exchange is not necessarily inconsistent with the idea that the statute is primarily concerned with domestic conditions and is focused on purchases and sales in the United States. The foreign issuer, the Court's reasoning might go, has undertaken the steps necessary for listing all its shares on the U.S. exchange and has subjected itself to the U.S. mandatory disclosure regime. Because of the U.S. listing, there will be purchases of the issuer's shares executed on a U.S. exchange on an ongoing basis. If the issuer makes a material public misstatement with scienter, the misstatement will be made in connection with a kind of purchase or sale of a security—ones executed on a U.S. exchange—that triggers a violation of Rule 10b-5 and section 10(b). This will be so whether or not purchases of the issuer's shares executed abroad are also considered within the solicitude of the statute. However, unless the U.S. fraud-on-the-market cause of action reaches all purchases of the issuer's shares wherever executed, the foreign issuer will face smaller potential liability for its failure to comply with Rule 10b-5 than would a comparably positioned U.S. issuer listed on the U.S. exchange. Smaller potential liability means lower incentives to comply with the U.S. disclosure regime. As a result, the foreign issuer would be less transparent than the U.S. issuer. Less transparency reduces the foreign issuer's share price accuracy, including the accuracy of the prices of its shares traded on the U.S. market. Less transparency can also reduce the quality of the issuer's corporate governance and hence the level of

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260. *Id.*

261. *Id.*

cash flows to its shareholders, including to those whose share purchases were executed in the U.S. market.<sup>262</sup>

One objection to the argument that the foregoing reasoning represents the Court's thinking is that the same reasoning would apply as well to the foreign issuer that just lists ADRs on the U.S. market; however, it is highly unlikely the *Morrison* holding will be read to reach purchases abroad of the ADR-listing issuer's underlying common shares.<sup>263</sup> There is one possibly significant difference between the ADR-listing foreign issuer and the foreign issuer that lists all its underlying common shares on a U.S. exchange. For the foreign issuer listing all its underlying common shares on a U.S. exchange, its shares are trading in something more closely resembling a single, seamless global market, of which the trading executed on the U.S. exchange is just part of an integrated whole. This is because a purchase of a share abroad and its subsequent sale on the U.S. exchange, and vice versa, does not involve the costs and inconvenience of making deposits in, or making withdrawals from, an ADR facility. Avoiding this cost and inconvenience is an important reason why U.S. institutional investors, when they trade in the equities of issuers that only have ADRs listed for trading in the United States, typically avoid executing their trades on the U.S. exchange and instead buy and sell the issuer's underlying shares in its home market.<sup>264</sup>

It should also be noted that including within the reach of the cause of action purchases executed abroad in shares that are listed on a U.S. exchange does not necessarily do violence to the policy reasons discussed in *Morrison* for abandoning the conduct and effects test in favor of a new approach. The Court's first policy objection was that the old approach was hard to administer because it required a fact-intensive application of vague standards, with a resulting unpredictability of how a court would react to the facts of any new case coming before it.<sup>265</sup> The Supreme Court's new approach, though, is an equally great advance in terms of this kind of administrability whether the resolution of the issue is that the reach of the cause of action does, or does not, include purchases executed abroad of shares of a foreign issuer listed on a U.S. exchange. Thus ease of administration and predictability is no reason to resolve the question one way rather than the other.

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262. The normative conclusions that I am suggesting the Court might have reached from this hypothetical line of thinking are different from the ones that I draw from a similar line of reasoning in Parts III and IV above. There, I suggest that the United States has no special interest in the level of transparency of foreign issuers, wherever the shares are listed and wherever purchases in them are executed. The conclusions I am suggesting the Court might have reached are fully plausible, however, in terms of the ways that these kinds of issues are often discussed in judicial opinions and commentary.

263. See *infra* Part VI.B.2.d.

264. See *infra* note 272 and accompanying text.

265. *Morrison*, 130 S. Ct. at 2879-81.

The Court's second policy objection to the old approach was that it led to conflicts with the foreign issuer's home country, which imposes on the issuer its own regulations. As noted above, whether or not purchases executed abroad of shares of a foreign issuer listed on a U.S. exchange that makes with scienter a material misstatement are resolved to be within the reach of the cause of action, the issuer will violate Rule 10b-5 because there will be purchases being executed on the U.S. exchange at the time of the misstatement. Thus any offense that the foreign issuer's home country takes at its issuer being branded a violator of U.S. securities law will occur whichever way the issue is resolved. The extent of fraud-on-the-market liability will of course be greater if purchases executed abroad are within the reach of the cause of action, indeed much greater in the case of most foreign issuers. But, unlike with the old conduct/effects test approach, the offense to the issuer's home government of this greater liability would be buffered by the fact that this exposure to liability was voluntarily incurred by the issuer as a result of its decision to list its shares for trading on the U.S. exchange, a decision that the issuer can reverse at any time by delisting. As long as a foreign issuer never lists, or it delists prior to making with scienter a material misstatement, it faces no such exposure.

The case that the Court in *Morrison* means something different from what it says is not clear cut for one more reason as well: the Justices may in fact have never given consideration to the issue of purchases executed abroad of shares listed for trading on a U.S. exchange. The question that the Court purports to decide in its holding—what does and does not constitute giving section 10(b) the prohibited extraterritorial effect in cases involving both foreign and domestic elements—never requires, as a practical matter, resolution of the issue of whether purchases executed abroad of foreign-issuer shares listed on a U.S. exchange are objects of the statute's solicitude. As noted, in all such cases, because of the U.S. listing, there will always be purchases of the issuer's shares executed on a U.S. exchange on an ongoing basis. If the issuer makes a material public misstatement with scienter, the misstatement will in every case be in connection with a purchase or sale of a security executed on a U.S. exchange, which, according to the holders, unquestionably triggers a violation of Rule 10b-5 and section 10(b). The issue of the status of purchases executed abroad only comes up if courts use the *Morrison* test for a different purpose—to determine the reach of the fraud-on-the-market cause of action.

The bottom line is that if courts use the *Morrison* test to determine the reach of the private cause of action, the outcome with respect to purchases executed abroad of foreign-issuer shares listed for trading on a U.S. exchange depends on how much importance these courts put on the words of the holding in

a situation where there is a good, but certainly not proven, case that the Court meant something different from what it said.<sup>266</sup>

d. *Purchases abroad—issuers listing only ADRs on a U.S. exchange*

Consider the many foreign issuers that list only their ADRs for trading on a U.S. exchange, not their underlying common shares. *Morrison*, if its rule determines the reach of the U.S. fraud-on-the-market cause of action, would not extend this reach to purchases of the issuer's underlying common stock executed abroad. The ADRs and the underlying common shares, though closely con-

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266. Research reveals only one court to date since *Morrison* that has rendered a definitive holding on the question of whether the purchase on a foreign exchange of common shares that are listed for trading on a U.S. exchange can give rise to an actionable claim. See *In re UBS Sec. Litig.*, No. 07 Civ. 11225 (RJS), 2011 WL 4059356 (S.D.N.Y. Sept. 13, 2011). The court answers the question in the negative and grants the defendants' motion to dismiss with respect to claims based on these purchases. *Id.* at \*5. In justifying its decision, the court refers to the language in *Morrison* that the focus of the Exchange Act is on purchases and sales in the United States. *Id.* at \*4. It calls the plaintiffs' interpretation of the holding "strained" and "hypertechnical" and contrary to the "broader holding" of *Morrison*, *id.* at \*5, but does not directly address the point that there is no reason for the first prong of the actual holding to exist if it is limited to just purchases in the U.S. market. The court, while expressing concern that a ruling in favor of the plaintiffs would, contrary to the policy enunciated in *Morrison*, involve interference with the regulation of markets abroad by their home authorities, largely does not confront the arguments suggested here for the proposition that the more natural reading of the actual holding should be respected. *Id.* at \*4. The court also states that it is following other courts that have addressed the issue. *Id.* at \*5. None of the cases that it cites in fact have holdings regarding the issue. Two of them involved purchasers of common shares abroad of issuers that listed for trading only ADRs on U.S. exchanges. In *In re Alstom SA Securities Litigation*, the court—noting both that in *Morrison* the underlying common shares of NAB were in fact listed on the NYSE and that the Court found that section 10(b) did not reach purchases of shares of this underlying common stock on an exchange abroad—concluded that "the Court was concerned with the territorial location" of the purchase and therefore that a foreign purchase of a security listed on a U.S. exchange would be outside the reach of section 10(b) even where the security was listed on a U.S. exchange. *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469, 472 (S.D.N.Y. 2010). The *Alstom* court, however, failed to consider that in the case before it, just like in *Morrison*, the underlying common shares were not listed for trading on a U.S. exchange. Rather, they were listed only for the purpose of allowing trading of the company's ADRs. See *supra* note 219. Thus the *Alstom* holding did not directly address the question faced by the *UBS* court, and it appears in any case to be based on a misunderstanding of *Morrison*. The second case involving an issuer that only listed for trading ADRs on a U.S. exchange, *In re Royal Bank of Scotland Group PLC Securities Litigation*, in turn relies on *Alstom*. 765 F. Supp. 2d 327, 336 (S.D.N.Y. 2011). The third case cited by the *UBS* court, *In re Vivendi Universal, S.A. Securities Litigation*, similarly involved a claim that an issuer's listing of the underlying shares on a U.S. exchange as part of an ADR program—not for trading purposes—could give rise to a claim based on transactions conducted abroad in these shares. 765 F. Supp. 2d 512 (S.D.N.Y. 2011).

nected, are separate securities. While NYSE and NASDAQ rules both require that an issuer listing its ADRs for trading also list the underlying common shares, the required listing of the underlying shares is of a kind that does not permit the trading of these shares on the exchange.<sup>267</sup> Thus, assuming that *Morrison*'s first prong is referring only to listings that are for trading, purchases abroad of these underlying common shares do not fit within either prong of *Morrison*'s holding.

Under the *Morrison* test, the only argument that the cause of action would extend to purchases abroad of the underlying common shares where an issuer lists its ADRs to trade on a U.S. exchange depends on the first prong of the holding in *Morrison*, which refers only to a security "listed" on an American exchange, not to a security "listed to trade" on such an exchange.<sup>268</sup> The problem with this argument is that Justice Scalia, when he used the term "listed," almost certainly meant "listed to trade." NAB's ADRs were listed to trade on the NYSE. Its underlying common shares were thus listed as well on the NYSE in the nontrading fashion contemplated by the NYSE requirements.<sup>269</sup> Yet Justice Scalia stated that the underlying common stock was not "listed" and dismissed the claim of purchasers abroad of this underlying common stock.<sup>270</sup> His statement that NAB's underlying common stock was not listed on an American exchange only makes sense if, when he used the term "listed," he meant "listed for trading."<sup>271</sup>

This conclusion has particular relevance for U.S. institutional investors. Such institutional investors, including pension funds and mutual funds, are the conduits through which flow considerable portions of all the savings of individual U.S. residents invested in foreign issuers. When such institutional investors wish to invest in the equity of a foreign issuer that lists only its ADRs on a U.S. exchange, they typically purchase the issuer's underlying common stock on the issuer's home-country exchange, placing the order from a facility abroad and holding these shares until resale in a custodial account abroad.<sup>272</sup> The

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267. See *supra* note 219.

268. See Michael C. Spencer, *Defense Contorts the Meaning of Morrison*, N.Y. L.J., Nov. 29, 2010 (arguing as counsel for the plaintiff in *In re Vivendi*, 765 F. Supp. 2d 512, that construing "listed" as "listed for trading" would contort the words of Justice Scalia).

269. See *supra* note 219.

270. See *supra* note 219.

271. See Irwin H. Warren & Margarita Platkov, *Further Look at Morrison: A Plain Meaning Analysis*, N.Y. L.J., Nov. 2, 2010 (arguing—as counsel for the defense in two cases where the common shares were U.S.-exchange listed in order to effect an ADR listing, but not listed for trading—that "listed" and "listed for trading" are distinct and Justice Scalia purposefully used "listed" to mean "listed for trading"); see also 17 C.F.R. § 240.3b-1 (2011) ("The term *listed* means admitted to full trading privileges . . .").

272. See Richard Dobbs & Marc H. Goedhart, *Why Cross-Listing Shares Doesn't Create Value*, MCKINSEY & COMPANY (Nov. 2008), [http://mkqpreview1.qdweb.net/Why\\_cross](http://mkqpreview1.qdweb.net/Why_cross)



greater liquidity in the home market is particularly valuable to them because of the much larger purchase and sale orders that they execute relative to a retail investor. Buying and selling the underlying common in the home market also allows them to avoid the fees and other inconveniences associated with depositing or withdrawing shares from the ADR facility maintained by the depository bank. The services offered by the depository bank are ones that the institutional investor, given the size of its holdings and its volume of trading, can likely more cheaply perform itself.

Unlike these institutional investors, U.S.-resident purchasers of the underlying common shares of an issuer that just lists its ADRs on a U.S. exchange would have an additional possible claim as well. If they place their orders for the underlying common with domestic brokers that arrange for their execution on a foreign exchange, the U.S.-resident purchasers could rely on the second prong of *Morrison* and use the same argument discussed above. That is, they could argue that the location of their transaction is the place where they placed their orders (i.e., the United States), and thus that the reach of the private action extends to their purchases.<sup>273</sup> But, as discussed above, this argument is unlikely to succeed.

### C. Evaluation

Adoption of the *Morrison* rule to determine the reach of the fraud-on-the-market action, although on balance preferable to returning to the conduct/effects test, would also be a mistake. In operational terms, compared to the conduct/effects test, use of the *Morrison* test would likely lead to more consistent, predictable decisionmaking. However, as we have just seen, there is still considerable ambiguity in how it would be applied in a number of situations of significance, most importantly whether it would reach purchases executed abroad of shares that are listed for trading on a U.S. exchange. The case going each way on this question is sufficiently strong that, absent legislative or SEC action, doubt will remain until the issue is ultimately resolved by another Supreme Court case.

Use of the *Morrison* test would pose more subtle operational problems as well: it does not provide courts with a very useful framework for thinking about the reach of the cause of action. The opinion lacks an inner logic that would help resolve many of the ambiguities identified in the discussion above or that would guide analysis as the experience of new cases over time informs the ju-

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-listing\_shares\_doesnt\_create\_value\_2253 (“[B]ecause of better trading liquidity in the home market, institutional investors often prefer to buy a stock there rather than the cross-listed security.”).

273. See *supra* Part VI.B.1.b.

diary concerning how the world works and is changing. The majority provides little in the way of reasons why it applied the presumption against extraterritoriality in the particular way that it did. As noted in the introduction, securities transactions have connections with countries along each of a number of dimensions. A transaction is transnational if, along at least one of these dimensions, the country with which the transaction is connected is different from the country or countries with which it is connected along the other dimensions. The Court largely dodges the issue of why listing location and transaction location should be the dimensions of nationality that determine whether application of section 10(b) is “extraterritorial” or not. Why not, for example, the place the misstatement was made, the nationality of the issuer (the location to which actual or apparent authority for the making of the misstatement can be traced), or the residency of the purchasers (the group the statute seeks to protect)? Justice Scalia’s opinion provides no serious support for the choice of listing and transaction location in terms of statutory language, legislative history, or policy.<sup>274</sup>

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274. The Court concedes that the typical case that raises the question of whether or not a U.S. law is being applied extraterritorially would involve both domestic as well as foreign elements. *See Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2884 (2010). Thus it appears to acknowledge that a necessary part of the analysis is to determine which combinations of foreign and domestic elements would lead to the conclusion that U.S. law is being applied extraterritorially and which combinations to the conclusion that it is not. The analysis that it provides, however, is largely an unconvincing search for clues in the structure and language of the statute that will be of little help to courts resolving issues that arise in future cases.

In formulating its rule for what does and does not constitute extraterritorial application of section 10(b), the Court starts by saying: “[W]e think that the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States.” *Id.* Nothing that follows, however, provides much of a reason why it thinks this. The next thing the Court says is that “[s]ection 10(b) does not punish deceptive conduct, but only deceptive conduct ‘in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.’” *Id.* (quoting 15 U.S.C. § 78j(b) (2006)). It is hard to see how this assertion is a reason for the Court’s thinking that the Exchange Act’s focus is on domestic transactions, since transactions in unregistered securities can occur both at home and abroad. No further clarification comes from the citation that follows to *SEC v. Zandford*, which simply reads section 10(b)’s and Rule 10b-5’s “in connection with” clauses broadly to reach the misappropriation by a broker of the proceeds from the sale of securities in a customer’s account. 535 U.S. 813, 819-20 (2002). The Court then cites other earlier cases for the propositions that “[i]t is [purchase and sale] transactions that the statute seeks to ‘regulate’” and “it is parties or prospective parties to those transactions that the statute seeks to ‘protect[.]’” *Morrison*, 130 S. Ct. at 2884 (third alteration in original) (citing *Superintendent of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976)). In this context, the first proposition seems irrelevant because fraud-on-the-market suits do not involve the regulation of the transactions. The second would imply that it is U.S. investors, not transactions in the United States, that are the focus of the Exchange Act. The Court also argues that the whole focus of the Exchange Act is on national securities exchanges, which arguably can only be in the United States, and thus any other transactions that are its concerns must be

Even more important are substantive problems with using the *Morrison* test. As demonstrated in Part IV, the United States has little interest in imposing its fraud-on-the-market regime on any foreign issuer that does not wish to be subject to the regime as a form of bonding. Indeed, doing so could worsen U.S. economic relations with other countries and reduce global welfare. Yet adopting the *Morrison* rule would result in this regime being applied to many such foreign issuers.

For foreign issuers not wishing to bond but that for other reasons nevertheless wish to list their underlying common shares on a U.S. exchange (the mode of equity listing currently employed by most Canadian and Israeli issuers), use of the *Morrison* test, if based on the more natural reading of the opinion's holding, is particularly unfortunate. It would extend the cause of action to cover every purchase in the world and thus would fully substitute the U.S. judgment for that of the home country concerning what devices promote corporate governance and liquidity cost-effectively.

For issuers that list ADRs on a U.S. exchange, use of the *Morrison* test would substitute a diluted version of the U.S. judgment for that of the home country, since a material misstatement made with scienter would give rise to liability for the losses associated with purchases of the ADRs, but not losses associated with purchases abroad of the underlying common shares. For the typical foreign issuer, trading in its U.S.-listed ADRs typically represents no more than five to ten percent of the trading volume around the world in its equity securities.<sup>275</sup> Compared to a return to the conduct/effects approach, these issuers also avoid the possibility of liability for the losses associated with all

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domestic too. *Id.* at 2884-85. In making this argument, the Court ignores section 12(g)(1), which requires all issuers not trading on a national exchange that have any contact with interstate commerce and a sufficient number of shareholders and amount of assets to register these shares under the Exchange Act. 15 U.S.C. § 78l(g)(1). This provision clearly applies to foreign issuers as well as domestic ones, because the Act also includes section 12(g)(3), which authorizes the SEC by rule or regulation to exempt any security of a foreign issuer from the operation of section 12(g)(1). *Id.* § 78l(g)(3). This interpretation is confirmed by the legislative history of the amendment. *See* H.R. REP. NO. 88-1418, at 11 (1964).

The Court also argues that the focus of the Exchange Act on domestic transactions must be correct because Congress would not want section 10(b) applied in ways that would create conflict with other countries. *Morrison*, 130 S. Ct. at 2885. This disguised policy argument could be helpful to courts in future cases. It should be noted, however, that the foregoing analysis suggests that relative to the simple rule proposed here, the holding in *Morrison* is not the optimal one for implementing this concern in the sense of minimizing both the number of cases within the statute's reach that would cause conflict and the number outside its reach that affect U.S. interests but would not cause conflict.

275. *See* Sugato Chakravarty et al., *The Choice of Trading Venue and Relative Price Impact of Institutional Trading: ADRs Versus the Underlying Securities in Their Local Markets*, 34 J. FIN. RES. 537, 546-47 (2011).

equity purchases worldwide where there is sufficient issuer conduct in the United States associated with the misstatement to meet the conduct test.<sup>276</sup>

The use of the factors under the *Morrison* test that determine whether a foreign issuer would be subject to the U.S. fraud-on-the-market regime and the extent of potential liability—whether the issuer listed equity on a U.S. exchange and, if so, whether the listed equity was ADRs or the underlying common shares—are, like the factors used under the conduct/effects test, unrelated to any U.S. interest in imposing such liability. Again, use of these factors actually reduces global economic welfare by distorting the foreign issuers' choices about where to promote the trading of their equity and, if they decide to list their equity on a U.S. exchange, whether to list their underlying common shares or ADRs. These distortions again also hurt the competitiveness of U.S. markets. And if there is a U.S. listing, but it is of ADRs (or if the underlying common stock is listed but the courts settle on the less natural reading of the *Morrison* holding), the pro rata rule for shareholder distributions is violated.

Unlike a return to the conduct/effects test, use of the *Morrison* test—at least if the more natural reading of its holding prevails—does provide a foreign issuer with a reliable and fully effective way of bonding to be highly transparent by imposing on itself the U.S. liability regime: it can list its underlying common stock on a U.S. exchange. Bundling the listing decision with the liability regime decision, however, imposes an unnecessary cost on those issuers that wish to bond in this fashion, but that for listing-fee reasons or due to concerns about deconcentrating the market for their shares do not wish their equity to trade on a U.S. exchange.

#### D. *Proposals of Other Commentators*

The proposals of other commentators in their criticisms of the pre-*Morrison* lower courts' jurisprudence suggest still other alternatives for determining the reach of the fraud-on-the-market cause of action. To one extent or another, however, they have defects very similar to the problems that would arise with the use of the *Morrison* test. In a frequently cited recent article, for example, Hannah Buxbaum would restrict claims against foreign issuers only to those brought by buyers, whether U.S. or foreign, who effect their purchases on U.S. markets.<sup>277</sup> John Coffee would likewise restrict claims by foreign buyers to those who effect their purchases on U.S. markets, but does not call for

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276. These observations about issuers that list ADRs would apply as well to foreign issuers that list their underlying common shares on a U.S. exchange if the narrower, less natural interpretation of the *Morrison* holding prevails.

277. See Buxbaum, *supra* note 14, at 68.

excluding the claims of U.S. buyers who effect their purchases abroad.<sup>278</sup> Stephen Choi and Linda Silberman take an approach similar to Coffee's, but propose to implement it through the use of presumptions rather than bright-line rules.<sup>279</sup>

Compared to the use of the conduct/effects test prior to *Morrison*, each of these proposals would reduce confusion and likely lead to more consistent court decisionmaking. Each of these proposals would also, by reducing the range of circumstances under which foreign issuers are subject to such actions, move the law partially in the direction of what is proposed here. Each, however, to at least some extent, would still share with the use of the *Morrison* test the problems of distorting foreign-issuer choices concerning where to list their shares, and would injure U.S. market competitiveness. And for those issuers that do not wish to bond but that nevertheless choose to list on a U.S. exchange because the liquidity and other advantages are sufficiently attractive, each of these proposals, like the use of the *Morrison* test, would insert an ill-fitting U.S. corporate governance device into the mix of devices governing those foreign issuers. This is because under each of the commentators' respective proposals, such issuers would, to one extent or another, be subject to the U.S. fraud-on-the-market liability regime.

## VII. IMPLEMENTATION

There are three possible routes to reforming the rules concerning the reach of the U.S. fraud-on-the-market action with respect to foreign issuers: judicial decisionmaking, SEC rulemaking, and legislation. Each route has potential to move these rules in the direction of what is proposed here. Each route, however, faces obstacles as well, and so, despite forces that will over time make the logic of the proposal increasingly compelling, full adoption may take many years.

### A. *The Courts*

Absent further legislation or SEC rulemaking, after *Morrison*, the only bad conduct that potentially can be claimed to violate section 10(b) and Rule 10b-5 in a way that gives rise to a private action is conduct in connection with a transaction when the security involved was listed on a U.S. exchange or when its purchase or sale occurred in the United States. As noted above, however, this range of transactions whose connection with bad conduct can make that conduct a Rule 10b-5 violation constitutes only the outer limit of the range of

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278. See Coffee, *supra* note 24, at 12-13.

279. See Choi & Silberman, *supra* note 14, at 506.

transactions that might be found to give rise to a fraud-on-the-market cause of action. This cause of action is implied, meaning that it is entirely a creation of the courts.<sup>280</sup> Thus the courts define its metes and bounds. Not every transaction whose connection with conduct makes that conduct a violation need give rise to the cause of action.

The courts have no choice but to start afresh in defining these metes and bounds. Before *Morrison*, the lower courts had been using the conduct/effects test to define *both* the reach of the statute's prohibitions on conduct and the reach of the fraud-on-the-market cause of action. But the Supreme Court in *Morrison* only addressed the first of these issues. The Court did not need to address the issue of the reach of the cause of action because it found there was no violation of the statute in the first place.

Defining who has standing to bring implied right of action claims under Rule 10b-5 is one place where the Supreme Court has openly acknowledged that its decisions are driven in part by considerations of policy. In the seminal *Blue Chip* case,<sup>281</sup> the Court determined that, among all persons claiming to be injured as a result of a violation of section 10(b), only those whose injury arose out of being a purchaser or seller of the security involved have standing to maintain a private right of action. There would be no standing, for example, for the plaintiffs in *Blue Chip*, who claimed to have been damaged because the defendant's misleadingly negative statement deterred them from purchasing shares that were being offered to them by the defendant pursuant to an antitrust consent decree.<sup>282</sup>

The Court justified its adoption of the purchaser/seller rule on policy grounds. It argued that a disproportionate number of claims of injury by persons falling outside this limitation would be meritless but would nevertheless be able to survive summary judgment and hence have settlement value. In an oft-quoted passage, Justice Rehnquist stated:

[W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express "intent of Congress" as to the contours of a private cause of action under Rule 10b-5. When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn . . . . It is therefore proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.<sup>283</sup>

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280. *See supra* Part II.A.2.

281. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

282. *See id.* at 726-27.

283. *Id.* at 737.

Thus, as courts develop a substitute to the conduct/effects test for determining the reach of the fraud-on-the-market cause of action, they are free to consider policy. They are free to put claims by purchasers of the shares of foreign issuers outside this reach, based on the conclusion, in accordance with the arguments here, that fraud-on-the-market actions against foreign issuers are not socially useful.<sup>284</sup>

Whether the courts will do so is an open question. Neither the opinion in *Morrison* nor the prior lower court jurisprudence provides a very useful framework for discussing the most fundamental social policy issues at stake—the ones raised in the analysis here. While many judges are motivated in part by policy concerns, they typically feel a need, reinforced by the fear of reversal, to render only decisions that can be justified by opinions that use a form of reasoning that is evolutionary in nature. Thus there will likely be a pull toward treating any purchase of foreign-issuer shares as within the reach of a fraud-on-the-market cause of action so long as the transaction's connection with the issuer's conduct makes the conduct a Rule 10b-5 violation under *Morrison*. The analysis used here, however, may create resistance to this pull and help the courts, as they deal with future cases, gradually nudge the law in the desired direction. At a minimum, for example, the courts can make the cause of action against foreign issuers listed on U.S. exchanges more difficult in various ways, including, if *Morrison* is used to define the reach of the private right of action, construing its ambiguities to favor a narrow reach.

Alternatively, the courts could deny the fraud-on-the-market presumption of reliance to purchasers of shares of foreign issuers that do not affirmatively choose to be subject to the U.S. fraud-on-the-market liability regime. The Supreme Court in *Basic* justified creation of the presumption on the basis that it was good public policy to facilitate securities litigation.<sup>285</sup> It was self-evident

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284. Overall, the Supreme Court over the last thirty years has shown more wariness than openness with regard to most issues that touch upon a purchaser's ability to sue on a fraud-on-the-market theory. Since *Blue Chip*, the Supreme Court has, for example, been increasingly cautious about implying causes of action. See *Touche Ross v. Redington*, 442 U.S. 560 (1979); *Cannon v. Univ. of Chi.*, 441 U.S. 677 (1979). In *Cannon*, it described its earlier affirmation of the implied right of action under section 10(b) as having "explicitly acquiesced in the 25-year-old acceptance by the lower federal courts of a Rule 10b-5 cause of action." *Cannon*, 441 U.S. at 690. While the Court continues to endorse the usefulness of the private Rule 10b-5 cause of action, see *Tellabs, Inc. v. Makor Issues Rights, Ltd.*, 551 U.S. 308, 313 (2007) (finding private actions are an essential supplement to governmental enforcement), a number of its recent decisions suggest a certain hostility as well. See *supra* note 28; see also John C. Coffee, Jr., *U.S. Supreme Court and Securities Litigation*, N.Y. L.J., July 21, 2011.

285. The Court stated that that presumptions arise in part out of "considerations of . . . public policy" and that the presumption of reliance adopted by the Court was intended to "facilitat[e] Rule 10b-5 litigation." *Basic Inc. v. Levinson*, 485 U.S. 224, 245 (1988).

that the way the presumption would facilitate such litigation would be to facilitate class actions. Courts could conclude, in accordance with the arguments here, that this kind of class action litigation against nonconsenting foreign issuers is not socially useful, and that therefore the presumption should not be available for actions against such issuers. There is precedent for such a move in the decisions of some pre-*Morrison* lower courts to deny a “worldwide” fraud-on-the-market presumption, though they were generally excluding from class actions claims by foreign purchasers on foreign markets, rather than excluding all claims against foreign issuers.<sup>286</sup>

### B. *The SEC*

The second possible route would be through SEC rulemaking. The SEC has broad powers of exemption from the impact of both statutory provisions and its own rules. Joseph Grundfest argued that the SEC had the authority to “disimply,” either for a defined range of circumstances or entirely, the private right of action under Rule 10b-5,<sup>287</sup> even before the 1996 amendments to the Exchange Act. These amendments resolved any doubt on the question. They added section 36 of the Exchange Act, which provides that the SEC

may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.<sup>288</sup>

At the same time, in an instruction to the SEC to take into account the kinds of policy arguments put forward here, these amendments added section 3(f) of the Exchange Act, which provides that when “determin[ing] whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”<sup>289</sup>

The full adoption of the simple rule recommended here is clearly within the SEC’s power under section 36. At first blush it might seem unlikely that the SEC would be willing to use this power, however. “Investor protection” is an

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286. See *In re AstraZeneca Sec. Litig.*, 559 F. Supp. 2d 453, 456 (S.D.N.Y. 2008), *aff’d sub nom.* State Univs. Ret. Sys. of Ill. v. AstraZeneca PLC, 334 F. App’x 404 (2d Cir. 2009); *In re Bayer AG Sec. Litig.*, No. 03 Civ. 1546 (WHP), 2004 U.S. Dist. LEXIS 19593 (S.D.N.Y. Sept. 30, 2004); *Tri-Star Farms v. Marconi, PLC*, 225 F. Supp. 2d 567, 579 (W.D. Pa. 2002).

287. See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority*, 107 HARV. L. REV. 961, 965 (1994).

288. 15 U.S.C. § 78mm(a)(1) (2006).

289. *Id.* § 78c(f).



SEC mantra, and in the past the SEC has argued that at least some fraud-on-the-market actions serve a useful investor protection function. On the other hand, foreign issuers listed on U.S. exchanges and registered under the Exchange Act have always been given certain concessions not afforded to U.S. issuers under the U.S. securities laws.<sup>290</sup> Moreover, the SEC's recent acceptance of financials prepared in accordance with international accounting rules instead of U.S. Generally Accepted Accounting Principles (GAAP) for use in registered public offerings and periodic disclosure filings,<sup>291</sup> as well as its proposal to allow "foreign trading screens,"<sup>292</sup> both show an increasing willingness to treat foreign issuers differently in order to allow further integration of the world's capital markets. Adoption of the simple rule proposed here would be consistent with these recent moves and would have similar political supporters: persons concerned with U.S. capital market competitiveness and persons concerned with good U.S. economic relations with other countries. The SEC may therefore be receptive to the sound policy arguments advanced here in favor of treating foreign issuers differently from domestic issuers in terms of fraud-on-the-market liability.

Even if the SEC is not prepared at this time to embrace the arguments here to the extent of fully exempting nonconsenting foreign issuers from fraud-on-the-market liability, it may be sufficiently persuaded that it would not recommend, in its report to Congress pursuant to section 929Y of the Dodd-Frank Act, a return to the conduct/effects test for determining the reach of such actions. The SEC could, for example, take the more nuanced position that there

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290. In terms of periodic disclosure, such foreign issuers may file their annual report on Form 20-F, which does not require as much disclosure as the domestic issuer's Form 10-K. For example, it does not require disclosing individual compensation figures for top officers. *See* Rules, Registration and Annual Report Form for Foreign Private Issuers, Exchange Act Release No. 16,371, 18 SEC Docket 1118 (Nov. 29, 1979). Unlike domestic issuers, these foreign issuers are also not required to file quarterly reports. *See* 17 C.F.R. § 240.15d-13(b)(2) (2011). These foreign issuers are also exempt from the operation of certain provisions of the proxy rules under section 14 of the Exchange Act, and from the operation of section 16 of the Exchange Act, relating to reporting on insider purchases and sales and the return of short swing profits from trading in the issuer's shares. *See* 17 C.F.R. § 240.3a12-3(b) (2011).

291. 17 C.F.R. pts. 210, 230, 249. *See* especially 17 C.F.R. § 230.701(e)(4) (2011) and Form 20-F(G)(h)(2), referenced in 17 C.F.R. § 249.220f (2011). These Rules exempt foreign private issuers from reconciling SEC filings with U.S. GAAP if the filings are prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

292. "Foreign trading screens" are screens that allow U.S. institutional investors to trade from their U.S. offices shares listed only on a foreign, not a U.S., exchange. *See* Exemption of Certain Foreign Brokers or Dealers, Exchange Act Release No. 58,047, 73 Fed. Reg. 39,182, 39,185 (proposed July 8, 2008) (to be codified at 17 C.F.R. pt. 240) (proposing that 17 C.F.R. § 240.15a-6 be revised to allow foreign broker-dealers to conduct regular business with qualified investors).

should be a return to the conduct/effects test only for determining the reach of traditional reliance-based actions, the actions for which the test was originally developed and which it better fits. At worst, this would leave the reach of fraud-on-the-market actions to be determined by using the *Morrison* rule.

The enactment of the Dodd-Frank Act should add to the SEC's receptiveness to the policy arguments advanced here. As discussed earlier, section 929P(b) of the Dodd-Frank Act returns determination of the reach of section 10(b) and Rule 10b-5 to the conduct/effects test for actions brought by the SEC or the Department of Justice. The SEC can therefore bring an action itself in a case where a foreign issuer's conduct in the United States constitutes significant steps toward what, in a fully domestic situation, would clearly be a Rule 10b-5 violation. Thus, when the SEC perceives that another country would in fact appreciate it if proceedings were instituted under U.S. law, the SEC can institute them. In contrast, fraud-on-the-market class actions against foreign issuers are typically brought by entrepreneurial plaintiffs' lawyers who are interested in the contingent fee generated by a successful judgment or settlement and who have no reason to be sensitive as to whether the action is appreciated by foreign authorities or not. Given that the SEC has the ability to bring suit in situations where foreign authorities would appreciate it, it may be comfortable exempting foreign issuers from being subject to private suits, thereby preventing actions where the SEC thinks foreign disapproval should be respected. At a minimum, for these reasons, the SEC might not recommend a return to the conduct/effects test for fraud-on-the-market suits.

### C. Congress

The third possible route to reforming the reach of the fraud-on-the-market class action is through legislation. Congress has already indicated interest in considering the matter by its inclusion of the provision in section 929Y of the Dodd-Frank Act mandating the SEC to provide a report and recommendations concerning the matter within eighteen months of passage.

The policy arguments in favor of the simple rule proposed here have been clearly laid out. The politics are more complicated. The group that would have the greatest interest in this rule's adoption would be the financial industry. There has been much concern within this industry that U.S. capital markets are losing competitiveness in terms of offerings and listings by foreign issuers, and fraud-on-the-market suits have taken much of the blame.<sup>293</sup> Officials from the

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293. See *supra* note 123. Senator Charles Schumer and New York Mayor Michael Bloomberg commissioned a study on the competitiveness of U.S. capital markets. See MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES

executive branch in the State Department and Treasury are also potential supporters because of their responsibilities for good economic relations with other countries.

The managers of U.S. issuers, who tend to complain about domestic fraud-on-the-market suits,<sup>294</sup> might seek to convert the cause to one of eliminating fraud-on-the-market suits against all issuers, domestic and foreign. They may argue that the simple rule proposed here would give foreign issuers an unfair advantage. Ultimately, however, the analysis here suggests that U.S. issuers do not have a lot at stake with regard to the treatment of foreign issuers. The question that really relates to their interests is whether the social benefits from applying this liability system to U.S. issuers exceed the social costs (and hence the system adds to the value of U.S. issuers' shares), or, alternatively, whether the costs exceed the benefits (and hence the system subtracts from the value of U.S. issuers' shares). This issue needs to be decided on its own merits. As we have seen, the answer is largely independent of how this calculation would work out for foreign issuers, and it is residents of the home countries of these foreign issuers that will feel most of the consequences, good or bad, of the decision whether or not they are subject to a fraud-on-the-market type of liability regime.

The most prominent opponents of legislating the simple rule proposed here are likely to be members of the plaintiffs' bar, who would lose a set of issuers that might otherwise be subject to actions from which they could earn contingent fees. These lawyers will be the primary advocates of moving in the opposite direction, and legislating a return to the conduct/effects test for fraud-on-the-market actions. By bringing valid actions in class form that the economics of litigation would make impossible to bring on an individual basis, these lawyers may be acting in a socially beneficial way in many areas, but fraud-on-the-market actions against foreign issuers is not one of those cases. All that can be said about the politics of the matter is that there are political forces whose self-interest would favor the proposed rule as well, and the policy analysis here may suggest sound arguments for their cause that they had not previously fully appreciated.

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LEADERSHIP (2007), *available at* [http://apps.americanbar.org/buslaw/committees/CL116000pub/materials/library/NY\\_Schumer-Bloomberg\\_REPORT\\_FINAL.pdf](http://apps.americanbar.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf).

294. The U.S. Chamber of Commerce, for example, has strongly supported elimination of fraud-on-the-market class actions. *See* Anjan V. Thakor, U.S. Chamber Inst. for Legal Reform, *The Unintended Consequences of Securities Litigation* (Oct. 2005) (unpublished manuscript), *available at* <http://www.instituteforlegalreform.com/doc/the-unintended-consequences-of-securities-litigation>.

## CONCLUSION

The story in this Article fits into a larger picture. The few thousand largest, established publicly traded issuers in the world are responsible for an important portion of global production of goods and services. The shares of these issuers are typically thickly traded and efficiently priced. The market for them has become increasingly global, yet securities regulation remains primarily national, creating the potential for serious regulatory conflict. A growing uniformity among countries in the rules that each adopts has ameliorated this problem with respect to many aspects of securities regulation. Disclosure rules, for example, have shown increasing convergence, including, most importantly, in accounting standards. Also, while in the past many countries at best only paid lip service to fighting insider trading, today securities regulators of most of the world's major economies recognize that lax enforcement of insider trading laws undermines liquidity and market confidence.

One area of securities regulation, however—private enforcement—displays striking divergences among different countries. The United States in particular stands out when compared to the other major developed capitalist countries in terms of the magnitude of private damages paid out under its securities laws.<sup>295</sup> These payouts are primarily related to fraud-on-the-market class actions.<sup>296</sup> In the first decade of the 2000s, foreign issuers became frequent targets of such suits, with some of the suits against them yielding among the very largest payouts in securities regulation history.<sup>297</sup> Fear of these suits by foreign issuers became a major impediment to the further integration of the global capital market for equities, and placed U.S. capital markets at a competitive disadvantage.<sup>298</sup> Thus the increasing globalization of the market for equities and the U.S. fraud-on-the-market liability regime appeared to be on a collision course.

*Morrison* can be viewed as an attempt to head off this collision. By ruling that section 10(b) only reaches conduct in connection with transactions in securities listed on a U.S. exchange or other securities transactions in the United States, the Court appears to have sought to reduce tensions with other countries.<sup>299</sup> Under the ruling, any foreign issuer that does not wish to be subject to the U.S. fraud-on-the-market liability regime can largely protect itself simply by not publicly offering its shares in the United States, and not listing its shares

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295. See, e.g., Coffee, *supra* note 97, at 266-68.

296. See *supra* note 2 and accompanying text.

297. See *supra* notes 5-6 and accompanying text.

298. See *supra* note 9 and accompanying text.

299. See *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2886 (2010) (noting that the rule adopted by the Court meets complaints of other countries that the reach of section 10(b) can interfere with their own securities regulation regimes).

on a U.S. exchange or otherwise promoting their U.S. trading. If the issuer is already listed, it can delist.

The Court's effort to cure the problem was unfortunately highly imprecise, cutting both too broadly and too narrowly. The *Morrison* rule cuts too broadly because the Court casts it as an interpretation of the reach of section 10(b), rather than of the reach of the court-created fraud-on-the-market implied private right of action. As a result, the rule also blocks government enforcement actions and traditional reliance-based fraud actions in any situation where the actual transaction occurs outside the United States, even when much of the fraudulent conduct occurred within the United States or U.S. investors were directly hurt by the fraud. The government actions and traditional reliance-based fraud actions that were previously possible under the conduct/effects test often served valuable U.S. interests, and there is little reason to think that they created frictions with other countries or inhibited the development of globally integrated capital markets. Indeed, by deterring fraudulent conduct associated with transnational transactions, they may have promoted such development.<sup>300</sup>

On the other hand, by leaving in place fraud-on-the-market suits against foreign issuers with respect to purchases of securities listed on U.S. exchanges and purchases in the United States of unlisted securities, the *Morrison* rule, if used to determine the reach of such actions, also cuts too narrowly. The Court failed to focus with sufficient precision on the real source of the impending collision—the private fraud-on-the-market actions that are the judiciary's own creation—and failed to ask under what circumstances, if any, the United States would benefit from imposing this liability regime on foreign issuers. The answer, as we have seen, is that there are no such circumstances except where the issuer seeks to bond. The failure to ask, and properly answer, this question needlessly left in place much of the impediment to the further integration of the global market for equities that had existed under the conduct/effects test and with it the resulting competitive disadvantage for U.S. capital markets.

This Article has proposed the simple, clear rule that an American-law-based class action fraud-on-the-market liability regime should not as a general matter be imposed upon any genuinely foreign issuer, even when the claimant is a U.S. investor purchasing shares in a U.S. market or when the issuer engages in significant conduct in the United States that contributes to the misstate-

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300. As discussed, Congress reacted almost immediately with respect to government actions, reinstating the old conduct/effects test approach for those cases. With respect to private actions, there is a risk that Congress, after it receives the SEC report, will overcorrect the problem and reinstate the conduct/effects test for all private actions, thereby displaying an inability, similar to that of the Court, to distinguish between traditional reliance-based fraud actions and fraud-on-the-market actions.

ment. The only exception would be a foreign issuer that has agreed, as a form of bonding, to be subject to the U.S. liability regime.

The Article has explored a number of inefficiencies that will arise if the United States deviates from this simple rule either by using the *Morrison* rule to determine the reach of the fraud-on-the-market action, or by returning to the conduct/effects test. To start, any such deviation from the rule proposed here will lead some foreign issuers, in an effort to avoid the U.S. fraud-on-the-market regime, to distort their choices as to where to offer, or promote the trading of, their shares. As a result there will be situations in which a public offering to U.S. residents would provide an issuer with the lowest cost of capital but the offer is not made, or in which a U.S. trading venue would offer the best liquidity services relative to cost for the trading of the issuer's shares but the issuer does not list or otherwise promote trading there. Second, U.S. investors will face needless barriers to enjoying the risk reduction benefits from full international diversification. Third, foreign issuers that by their own actions, such as offering, or promoting trading of, their shares in the United States, do come within the reach of this liability regime will have imposed upon them a device for enhancing corporate governance and liquidity, even though the costs of that device in many cases exceed the benefits. Finally, for most of the foreign issuers that do come within the regime's reach, some of their shareholders will receive insurance against losses from having purchased shares at prices inflated by issuer misstatements and the rest of their shareholders will not, thereby violating the fundamental corporate law rule against non-pro rata distributions.

The problems caused by not adopting the simple rule proposed here will grow in importance over time. Further progress in information technology is inevitable. With it will come a relentless increase in the forces for global equity market integration. For investors around the world, the gap between their knowledge concerning issuers of their own country and issuers from other countries will narrow. This will lead to a desire to have an increasing portion of their portfolios in the shares of issuers from other countries,<sup>301</sup> continuing a trend that has been going on for decades.<sup>302</sup> At the same time, the technological capacity of trading platforms to integrate buy and sell orders from around the world will be perfected. Anticipation of this development is reflected in the spate of transnational stock exchange mergers over the last few years.

If the United States fails to adopt the simple rule proposed here, the global integration of equity markets will continue to progress, just without the United States. This integrating market outside the United States will improve the non-U.S. options available to foreign issuers. Fewer and fewer foreign issuers will find that the benefits of offering their shares in the United States or promoting

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301. See Fox, *supra* note 61, at 2526-29.

302. See *supra* note 3.

U.S. trading of their shares is worth the cost. U.S. capital markets will be left with just U.S. issuers (and those foreign issuers that wish to bond), while competing markets abroad will have the opportunity to be trading venues for all the world's issuers. As the integration of the global market outside the United States progresses, it will therefore increasingly diminish the level of activity in the U.S. capital markets, as well as the skill-based rents earned by the U.S. residents employed by enterprises associated with these markets.

In addition, if the rule proposed here is not adopted, U.S. investors and U.S. broker-dealers will suffer increasing disadvantages. How the problem is distributed between these two groups depends on whether U.S. broker-dealer regulations change over time. Under current law, foreign broker-dealers face legal difficulties dealing with U.S. investors, both retail and institutional. If the law remains unchanged, U.S. investors who, absent these barriers, would be increasingly willing to hold foreign-issuer shares will be hindered in doing so. As a result, a smaller proportion of their portfolios will be in foreign-issuer shares and they will be deprived of the further reduction in risk that greater international diversification would bring. If U.S. broker-dealer rules are liberalized so that it becomes easier for foreign broker-dealers to deal with U.S.-resident investors, these investors will no longer face as big an obstacle in acting on their increasing willingness to have foreign stocks in their portfolio. But in that case U.S. investors will not receive the consumer protection that the regulation of U.S. broker-dealers provides. Also, U.S. broker-dealers will be left with just servicing the U.S. equity trading needs of U.S. investors at a time when U.S. equities are becoming a smaller portion of U.S. investors' portfolios.

Radical as the simple rule proposed here may sound to some, time is on its side. Globalization forces hard thinking about what a regulation can and cannot be expected to accomplish, and this reevaluation does not always happen instantaneously. Fraud-on-the-market liability is an example. Within an entirely domestic system, both protecting investors and enhancing corporate governance and liquidity appear to be plausible rationales for such liability. As long as enough people think at least one of the rationales is correct, such liability will be part of the domestic regulatory system. Determining whether the regime should be applied in a situation having transnational elements requires a more refined understanding of the way such liability works. This is because each rationale has different implications as to which such situations with transnational elements should be within the regime's reach. Thus it is possible that the newness of the idea, or the existing alignment of entrenched political forces, may frustrate full adoption of the simple rule proposed here in the immediate future. Even if it is not immediately adopted in full, though, its longer-term prospects are bright. As the negative consequences to U.S. and global interests from the United States not adopting the proposed rule grow, the proposal's logic will become increasingly compelling, and those members of our political community

who would benefit from its adoption will become increasingly aware of this fact and thus inclined to act.



