FRAUD-ON-THE MARKET CLASS ACTIONS AGAINST FOREIGN ISSUERS

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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 §10(b) of the Securities and Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5 promulgated thereunder,1 give rise to the bulk of all the private litigation damages paid out in settlements and judgments under the U.S. securities laws.2 With securities trading becoming globalized,3 foreign issuers have been

1A 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 Securities Exchange Act of 1934 (the “Exchange Act”, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 77a-78lll)) §10(b) and Rule 10b-5, 15 U.S.C. § 78j(b), promulgated thereunder. The nature and development of the fraud-on-the-market cause of action is described more fully in Part IV infra. Fraud-on-the-market class actions are also available for sellers who claim to be injured for 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.

2This 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 percent of securities class actions alleged Rule 10b-5 claims and less than a third of these 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 percent of all securities class actions complaints included a claim under Section 11 of the Securities Act of 1933 (the “Securities Act”) and 19 percent 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.cornerstone.com/pdfs/YIR2008.pdf. As for securities class action settlements, Section 11 and/or Section 12(a)(2) were involved in only 22 percent 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.cornerstone.com/pdfs/Settlements_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. Source: NERA Economic Consulting http://www.nera.com proprietary data base on securities class actions.
increasingly frequent targets of such actions, with one in six being against a foreign issuer in 2009, compared to only one in sixteen a decade earlier. Two of the six 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). A judgement estimated in the press to be worth over $9 billion, an amount larger than any payout yet made in any U.S. securities case, was recently rendered against another foreign corporation, Vivendi.

The law behind these actions against foreign issuers has been thrown into flux with the
Supreme Court’s decision this June in *Morrison v. Nat’l Austl. Bank* and Congress’ response in provisions of the subsequently enacted Dodd Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”). This Article addresses the fundamental question raised by these cases and by the recent actions of the Court and Congress: As a matter of good policy, is it ever appropriate that foreign issuers 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 these questions has 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. More fundamentally, the United States’ decision concerning the reach this action has a significant impact around the world on both the overall efficiency of securities trading and the quality and cost of corporate governance. The decision also materially affects U.S. economic relations with other countries.

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8 H.R. 4173 (111th Cong. 2d Sess.)

9 John C. Coffee, *Securities Class Actions? The Cost of Global Class Actions*, N.Y.L.J., Sept.18, 2008 at 5 (citing data from interviews with leading practitioners conducted by Harvard Law School students under the direction of Professor Howell Jackson concerning what the greatest concern was of foreign issuers about entry into U.S. capital markets); Howell Jackson, *Summary of Research Findings on Extra-Territorial Application of Federal Securities Laws*, 1742 PLI/Corp 1243 at 1246 (same).

10 One indication of the difficulties that fraud-on-the-market class actions against foreign issuers can pose for U.S. economic relations abroad is the reaction of public officials abroad to the plaintiffs’ appeal to the Supreme Court of the Second Circuit decision in *Morrison v. Nat’l Austl. Bank*, 547 F.3d 167 (2d Cir. 2008). Brief of the United Kingdom as Amicus Curiae in Support of Respondents, *Morrison v. Nat’l Austl. Bank*, 130 S. Ct. 2869 (2010) (No. 08-1191) (arguing in part that foreign purchasers in foreign markets should have no such private right of action against foreign issuers); Brief of the Government of the Commonwealth of Australia as Amicus Curiae in
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. The resulting analysis suggests a simple, clear rule that can be shown likely to both maximize U.S. economic welfare and, by also promoting global economic welfare, foster good U.S. foreign relations as well. U.S. law based class action fraud-on-the-market claims, I conclude, should not as a general matter be allowed against 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. 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 purchase of a security in a secondary market at a price inflated

Support of the Defendant-Appellees, Morrison v. Nat’l Austl. Bank, 130 S. Ct. 2869 (2010) (No. 08-1191) (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 Republic of France as Amicus Curiae in Support of Respondents, Morrison v. Nat’l Austl. Bank, 130 S. Ct. 2869 (2010) (No. 08-1191) (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). Also instructive is foreign official reaction to provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173 (111th Cong. 2d Sess.) both as it made its way through Congress and after enactment. See, e.g., Helen Thomas and Tom Braithwaite, Europe Expresses Concern Over US Laws On Investor Protection, FIN. TIMES, Nov. 23, 2009, at 14 (quoting an unnamed EU official with respect to European reaction to Washington concerning provisions of the bill relating to the reach of U.S. antifraud laws, "We’ve been in contact and are keeping a close interest in the situation"). See also with regard to Sec. 929Y of the enacted legislation, discussed infra at note [ ] and accompanying text, which requires the SEC to submit a report to Congress concerning the reach of private actions against foreign issuers. Ives Mamou, Washington veut réaautoriser le retour des “class actions” étrangères, LE MONDE, July 21, 2010 (“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).
by the issuer’s misstatement can have a connection with a country 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 was effected, the place of each of the exchanges where the security is listed, and the place or places where conduct relating to misstatement occurred. When such a claim is against a foreign issuer, the reach of the U.S. fraud-on-the-market action can be defined in terms of the needed connections with the United States along these other dimensions.

Until very recently, development of the U.S. approach to the reach of the fraud-on-the-market class action was, by default, entirely the province of the lower federal courts. Congress did not speak to the reach of §10(b), the statute whose violation is the basis of the cause of action. The language of §10(b) makes no distinctions between the United States and elsewhere world with respect to any of the possibly relevant connections. Read literally, it authorizes the SEC to promulgate rules that govern the whole world. The SEC has not spoken either: the language of Rule 10b-5 itself is equally sweeping in terms of its possible reach and the SEC has not promulgated any other rules relevant to the reach of the Rule or to the fraud-on-the-market cause of action that is based on its violation. The Supreme Court had never spoken to the issue either. The approach developed by the lower courts over the last four decades was to find that in transnational situations, the prohibitions of §10(b) and Rule 10b-5 reached conduct, and its violation could be the basis of a fraud-on-market damages cause of action, under two circumstances: where conduct in connection with the violation occurred in the United States (the “conduct test”) and where effects from the violation were experienced in the United States (the
“effects test”).\textsuperscript{11} What the nature and importance of this conduct and these effects needed to be was 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, litigants, and sometimes even the courts themselves as lacking sufficient consistency and coherence to permit reliable predictions going forward as to what transnational situations would give rise to a violation and what fraud-on-the-market claims based on any such violation would be actionable.\textsuperscript{12}

The use of the conduct/effects test framework also seriously impeded a well articulated judicial consideration of many of the important issues of public policy at stake. This was in part so because it 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 §10(b) and Rule 10b-5, and, second, assuming a violation, whether these connections are sufficient to justify imposing on the issuer civil damages liability for the trading losses suffered by those who paid an inflated price as


\textsuperscript{12}Choi & Silberman, \textit{supra} note [just above], at 467; Buxbaum, \textit{supra} note [just above], at 17; Kun Y. Chang, \textit{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, 106–108, 115–116 (2004); Brief for the Securities Industry Financial Markets Association and the Chamber of Commerce of the United States of America as Amici Curiae In Support of Appellants and Reversal at 23, In Re Infineon Tech. AG Sec. Litig., No. 09-15857 (9th Cir. filed Sept. 9, 2009) (“these concerns are exacerbated by [the] unpredictability of the conduct test. For without a coherent applicable standard . . . foreign companies can only assume that any sort of activity in the United States will create the risk of massive f-cubed liability”).
a result of the violation.

The legal landscape changed dramatically this summer. In *Morrison v. Nat’l Austl. Bank*, the Supreme Court threw out the whole lower court jurisprudence built on the conduct/effects test, concluding instead that §10(b) reached only situations where the securities were listed on a U.S. exchange or where their purchase and sale was effected in the United States. The Court joined the commentators in criticizing the unpredictability of the lower courts’ jurisprudence and stated that in contrast its approach “preserv[ed] a stable background against which Congress can legislate.” Congress did not wait long. Within weeks, it enacted of the Dodd Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”), which included provisions relating to the reach of §10(b). For suits instituted by public entities – the Securities and Exchange Commission (the “SEC”) and the United States Department of Justice – the new legislation essentially reverses the Court’s *Morrison* decision and reimposes a particular articulation of the conduct/effects approach. For private anti-fraud 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

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14 *Id.* at 2888.

15 *Id.* at 2880-81.

16 *Id.* at 2881.

17 H.R. 4173 (111th Cong. 2d Sess.)

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 18 months.19

These dramatic moves of the Court and Congress clearly put us at a moment of decision. They signal the importance of a serious analysis of the full range of possible approaches for determining the reach of civil liability fraud-on-the-market class actions, which certainly extends beyond simply choosing between using the Supreme Court’s new *Morrison* test for the reach of §10(b) and the variant of the conduct/reliance test adopted by Congress for actions brought by public entities.

**I. OVERVIEW**

This Article has two objectives. The first objective is to determine the approach to the reach of fraud-on-the-market actions that would best further the twin goals of maximizing U.S. economic welfare and, by the promotion of global economic welfare as well, fostering good U.S. foreign relations. The second objective is to chart a practical path to reform that reflects an awareness of the complications posed by the real world context in which the choice of approach needs to be made.

Parts II and III of this Article are devoted to the first objective. These Parts 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. The answer is the simple rule set out above. The logic behind this answer is highly compelling but the proposed rule is sufficiently novel that is worthwhile outlining the main arguments in order to give the reader a good idea of where we are going in advance of the

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more detailed analysis.

The method of addressing the question is to start by identifying what policy concerns appear potentially most relevant to deciding the reach of fraud-on-the-market class actions. These are concerns that either arguably justify imposing this liability system against a foreign issuer on behalf of a specified group of purchasers of its shares or are concerns that are otherwise impacted by such imposition of liability. Seven such policy concerns are identified. Each is analyzed to see what direction it points.

The first policy concern relates to the compensatory justification for imposing fraud-on-the-market liability: the purported need to compensate the trading losses suffered by investors who innocently purchase shares at a price inflated by an issuer’s material misstatement. U.S. resident investors are equally injured whether they purchase the shares of a U.S. issuer that makes a price inflating misstatement or a foreign one. Thus this compensatory concern, assuming it is valid, points toward a rule allowing U.S. investors to bring the same kind of claims against a foreign issuer as they can against a U.S. issuer.

The key question, however, is whether the compensatory concern in fact is valid: why, out of all the losses that persons can suffer in life, should trading losses of this kind be among the select group for which the community arranges compensation? The usual rationales given for providing compensation in the case of fraud-on-the-market type losses are the unfairness of these losses and the inefficient allocation of risk that would result from leaving these losses where they
initially lie. These rationales are frequently invoked by courts\textsuperscript{20} and public officials\textsuperscript{21} and at first may appear eminently sensible. Under close examination, however, they simply do not hold up,\textsuperscript{22} a view widely shared by thoughtful commentators on the issue.\textsuperscript{23} There may be good reasons to make an issuer subject to the fraud-on-the-market liability regime, but the discussion will show that the compensatory concern is not one of them, whether the issuer is domestic or foreign. The logical conclusion is that the compensatory concern should not play a role in fashioning the rule on the reach such liability against foreign issuers. The fact that a claimant is a U.S. resident is thus not a connection that should be considered in whether the cause of action should extend against a foreign issuer, at least if the compensatory concern is given as the reason for doing so.

The second policy concern relates to the deterrence justification for imposing fraud-on-the-market liability: issuers subject to the threat of such liability can be expected to be less likely to make misstatements and therefore be more transparent. Transparency is particularly enhanced by this threat of liability where the issuer operates within a regulatory environment requiring significant periodic disclosure. An issuer subject to rigorous mandatory disclosure requirements has no choice but to answer a variety of questions relevant to predicting its future cash flows. The threat of liability increases the chances that its answers are truthful. Greater transparency in turn

\textsuperscript{20} [Cites to come re court opinions saying that compensation is needed to correct an unfairness that has befallen the pl’s.]

\textsuperscript{21} [Cites to come re statements of the SEC or congressmen or executive department spokespersons saying that compensation is needed to correct an unfairness that has befallen the pl’s.]

\textsuperscript{22} See notes [II.A and II.B] infra and accompanying text.

improves an issuer’s corporate governance by limiting the extent to which the managers of a public corporation place their own interests above those of their shareholders — the “agency costs of management.” 

Greater transparency also increases the liquidity of the issuer’s shares by reducing the information asymmetries between insiders and outsiders. This reduces the bid/ask spread demanded by market makers and other suppliers of liquidity.

Utilizing the threat of damages liability to increase transparency has social costs as well as social benefits, however. Doing so is only worthwhile if the benefits are expected to exceed the costs. For reasons explored more fully later, these benefits and costs will each tend to be concentrated in the country where an issuer has its economic center of gravity as a firm, even if many of its investors reside abroad or transact in its shares on foreign markets. Moreover, because countries differ considerably in their predominant systems of corporate governance, the balance of these benefits and costs is likely to differ considerably across countries. These conclusions suggest that the legal system of the country where an issuer has its economic center of gravity is the most appropriate one for deciding when, if ever, the issuer should be liable to secondary market purchasers of its shares if it makes a price inflating misstatement. For the genuinely foreign issuer, this means the issuer’s home country legal regime. Thus the deterrence justification for imposing fraud-on-the-market liability should provide no support for extending

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24See notes [ II.D.3] infra and accompanying text.


26See notes [ III.B] infra and accompanying text.

27See notes [ III.B.1] infra and accompanying text.
the reach of the U.S. regime beyond domestic issuers.\textsuperscript{28} Indeed, doing so is likely to lower global economic welfare and damage U.S. economic relations with other countries.

The third policy concern relates to foreign issuers that would not be subject to a fraud-on-the-market class action type liability system under their home legal system, but that want, despite the expected costs, to be subject to the U.S. liability regime due to the resulting increased transparency’s expected benefits in terms of corporate governance and liquidity. Global economic welfare is unambiguously enhanced if foreign firms that would want to be subject to the U.S. liability regime are able to be, because, as will be demonstrated, a firm’s private cost and benefit calculations will understate the net social benefits from the firm being subjected to such a regime.\textsuperscript{29} This third concern therefore points toward imposing the U.S. fraud-on-the-market system on foreign issuers that, as a form of bonding, voluntarily commit in advance to be subject to it on an ongoing basis.

The fourth policy concern relates to assuring that exchanges located in the United States are places where only the shares of high transparency issuers trade. Because imposing the fraud-on-the-market liability regime on an issuer enhances its transparency, this concern, if sound, would point toward imposing this regime on any foreign issuer that lists its shares on a U.S. exchange. Two arguments are made in support of this concern. First, it allows an issuer in an easily

\textsuperscript{28} An argument that transparency is needed for reasons to protect investors against unfairness and risk and that for this reason U.S. purchasers of foreign issuer shares have a stake in the extent to which such foreign issuers are deterred from making misstatements is unsound for reasons similar to why the compensatory concern is unsound. See notes [II.C] \textit{infra} and accompanying text. Thus an investor protection oriented deterrence concern also provides no support for extending the U.S. regime beyond domestic issuers.

\textsuperscript{29} See notes [ III.C] \textit{infra} and accompanying text.
identifiable way to bond to providing a high level of transparency on an ongoing basis.\(^{30}\) Second, it protects investors by assuring them that if they purchase shares in U.S. market listed issuers, they are purchasing high transparency issuers.\(^{31}\)

Neither argument is sound, however. With respect to the first, the law can instead simply allow foreign issuers subject themselves individually to the U.S. fraud-on-the-market liability regime. Even if most individual investors would not know whether or not a given issuer has elected this option, markets are sufficiently efficient that they can detect and price the actual situation. As to the second argument, this market efficiency protects uninformed investors from paying an unfairly high price for an issuer that lists on a U.S. exchange but is not to be subject to the liability regime. Admittedly, the greater transparency associated with a foreign issuer being subject to the liability regime would likely reduce the riskiness for an investor for which the issuer’s shares constitute a substantial portion of her total investment portfolio. If the investor is unsophisticated, a rule bundling a U.S. listing with the liability regime would be a convenient way of signaling to this investor this lower risk. Diversification, however, is a much more effective way of reducing an investment portfolio’s risk and involves less social cost than would

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\(^{30}\) Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 Card. L. Rev. 675, 686-87 (2002) (“By opting in to the U.S. disclosure system, a system that demands a high level of disclosure, with severe sanctions for incomplete or inaccurate disclosure, combined with the difficulty of opting out once the decision has been made to opt in, foreign issuers, like domestic closely held firms, are able to make a credible commitment to provide high quality disclosure into the indefinite future.”). John C. Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 286 (2007) (noting as evidence for the bonding hypothesis that “Empirical studies have found that firms cross-listing in the United States make better financial disclosures”) (citing Tarun Khanna et al., *Disclosure Practices of Foreign Companies Interacting with U.S. Markets*, 42 J. Acct. Res. 475, 499-50 (2004)). In footnote 19 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.”

\(^{31}\) [Cite to come of scholar saying this. Cox 99 Colum. L. Rev 1200?]
a bundling rule. The failures of these two arguments suggests that fact that a claimant purchased a foreign issuer’s share on a U.S. exchange or that the share is listed on a U.S. exchange is not a reason to extend to such issuer the reach of the fraud-on-the-market cause of action.

The fifth, sixth, and seventh policy concerns, while not potential justifications for imposing fraud-on-the-market liability, each relate to matters that would be impacted by imposition of such liability. The fifth policy concern relates to a core principle in corporate law around the world that common shareholders should receive pro rata any benefit from the issuer that arises from their status as shareholders. Dividends are one such benefit. Insurance in the form of the right of a shareholder to receive payment from an issuer’s treasury for trading losses if her purchase of the issuer’s shares turns out to be at a price inflated by its misstatements is another such benefit. Respect for this core principle of pro rata treatment calls either for all of an issuer’s shareholders to have the right to this insurance, wherever they reside or transact, or for none. The sixth policy concern relates, for reasons of market efficiency, to avoiding distortions in the market-based choices by the world’s issuers as to where to list their shares and by the world’s investors as to where to trade. This concern suggests that the location of the particular market in which an

32 There are two kinds of social costs associated with a bundling rule, both associated with foreign issuers that do not find it advantageous to be subject to the U.S. fraud-on-the-market liability regime. One is that some such issuers are deterred from listing on a U.S. exchange by the prospect of such liability when there would gains from its shares trading there. See notes [III.F] infra and accompanying text. The second is that other such issuers would find the advantages of a U.S. listing to outweigh the disadvantage of being subject to the liability regime and so would list, but in so doing would impose on themselves a corporate governance device with greater costs than benefits. See notes [ III.C] infra and accompanying text.

investor makes a purchase of an issuer’s shares should not affect the determination of whether the investor has the right to make a fraud-on-the-market claim. Again, when an issuer makes a price inflating misstatement, either all purchasers of its shares should have the right, regardless of where they transacted, or none should. The seventh policy concern relates to the economies of scale of resolving similar claims in one place at one time and to the desirability of similar claims being treated in similar fashion. This concern too tends to militate in favor of any given country’s court, including a U.S. court, hearing all of similar claims against an issuer if it is to hear any.

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 first and fourth concerns – the need to provide compensation to cover investor trading losses and assuring that U.S. exchanges are places for the trading of high transparency issuers – are shown to be ill founded reasons for imposing fraud-on-the-market liability and thus should not play a role in determining the reach of U.S. regime. The second concern – improving transparency in order to enhance corporate governance and liquidity – points toward a rule that in general that does not extend the reach of the U.S. law based fraud-on-the-market based claims to genuinely foreign issuers. The third concern – relating to concerns about foreign issuers whose corporate governance and share liquidity would benefit in a cost effective way from being subject to such claims – calls for an exception to this general rule where a foreign issuer voluntarily agrees to be subject to the U.S. liability regime. The fifth, sixth and seventh policy concerns – pro rata distribution of benefits,
undistorted issuer and investor choices of where to list and trade, and adjudicatory consolidation – are better, or at least as well, served by this same rule barring U.S. law based fraud-on-the-market claims against all genuinely foreign issuers (and by the proposed exception) as they are by any other rule concerning the reach of the action.

While the United States is at a moment of decision concerning the reach of fraud-on-the-market actions, it is not writing on a clean slate. The path that is charted toward adoption of the simple rule proposed must take account of the complications posed by the context in which the decision needs to be made in the real world. This requires an assessment of both the attractions of, and the problems with, each of the likely competing alternative approaches. And there needs to be an consideration of the three institutional ways by which the decision can be made: judicial decision making, SEC rule making, and legislation.

One competing alternative, explored in Part IV, is to return to the conduct/effects test approach that Congress has already chosen for actions brought by public officials. Doing so would have the comfortable allure of the familiar. Such an approach, however, would impose the U.S. fraud-on-the-market liability regime on many foreign issuers when doing so would not serve either U.S. or global economic welfare, as the discussion above suggests. Moreover, such an approach is shown to have inherent defects when used to determine the reach of the later developed fraud-on-the-market cause of action that do not arise when it is used to determine the reach of traditional reliance based fraud actions, whose reach the approach was originally developed to determine. Relative to the traditional reliance based actions, differences in the kind of transactions that give rise to fraud-on-the-market actions and in the way the action works
make it difficult to find meaningful significance in the fact that some kind of conduct occurs, or some kind of effect is experienced, in one country rather than in another.\footnote{See notes [ IV] infra and accompanying text.} These difficulties account for much of the inconsistency in outcome and incoherence in reasoning displayed by the lower court cases determining the reach of fraud-on-the-market suits prior to \textit{Morrison}. Because the defects are inherent in trying to use the conduct/effects approach for this purpose, they cannot be cured by more precise language in any new legislation, SEC rule or better crafted judicial decisions.\footnote{The conduct/effects test, after originally being developed to determine the reach of traditional reliance based private actions of fraud, was also later applied to determine the reach of actions brought by the SEC and the U.S. Justice Department. [cites to first SEC case, and if it exists the first Justice Dept. case, where the court applies the conduct/effects test.] Its application to actions brought by the government did not create the same problems as application to fraud-on-the-market cases, however, because of prosecutorial discretion discretion can be used to avoid actions that for good reasons are not appreciated by the issuer’s home country.}

Another competing alternative, explored in Part V, would be to use Supreme Court’s approach in \textit{Morrison}. The Court ruled that §10(b) only reaches situations where the securities involved were listed on a U.S. exchange or where their purchase and sale was effected in the United States.\footnote{\textit{Morrison}, 130 S. Ct. at 2888.} Because there can be no cause of action without a underlying violation of the statute, this ruling concerning the reach of the statute sets an outside limit on the reach on the fraud-on-the-market cause of action as well. Using the \textit{Morrison} approach to determine the reach of the fraud-on-the-market cause of action would make it coextensive with the reach of the statute, thereby taking reach of the cause of action to this outside limit.

Compared to restoring the conduct/effects test, using the \textit{Morrison} test to determine the reach
of the cause of action would reduce confusion and likely lead to more consistent court decision making. And because it piggy backs on a test that has that has already been developed and must in any case be applied before liability is imposed – the question of the reach of the statute – it has the attraction of requiring less judicial effort. Again, however, this approach would impose the U.S. fraud-on-the-market liability regime on many foreign issuers when, as the discussion above suggests, doing so would not serve either U.S. or global economic welfare. Nothing in *Morrison*, which goes to the reach of the statute, calls for using its test for determining the reach of the cause of action as well. The cause of action is implied, meaning that it is entirely a creation of the courts. The courts define its meets and bounds. Thus not every transaction whose connection with questionable conduct is sufficient to make that conduct a violation need be a transaction that gives rise to the cause of action. The proposals of other commentators in their criticisms of the pre-*Morrison* lower courts jurisprudence suggest yet other competing alternatives for determining the reach of private rights of action. These are also considered in Part V and are found to have, to one extend or another, similar defects to the use of the *Morrison* test.

Part VI concludes the Article by analyzing the three institutions by which the choice of the U.S. approach to the reach of fraud-on-the-market actions can be made: judicial decision making,

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37See notes [ IV] infra and accompanying text.

38See Buxbaum, *supra* note [near beginning], at 68 (allowing claims against foreign issuers only by investors, whether U.S. or foreign, who purchased their shares on a U.S. market); John C. Coffee, Jr., *Global Class Actions, The National Law Journal*, June 11, 2007 at 12, 13 (allowing claims against foreign issuers 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); Choi & Silberman, *supra* note [near beginning], at 506 (using presumptions instead of bright line rules to the same effect).
SEC rule making, and legislation. After *Morrison*, the courts do, in a sense, have a clean slate. They have no choice but to start afresh in the task of defining the reach of the fraud-on-the-market cause of action. Before *Morrison*, the lower courts had been using the conduct/effects test to define both the reach of the statute and the cause of action. In the process of throwing out this test for defining the reach of the statute, the Supreme Court almost certainly discredited as well the method that the lower courts had previously used to determine the reach of the cause of action. But the Supreme Court did not address what the substitute approach to the reach of the cause of action should be because it found there was no violation of the statute in the first place.  

To the extent that neither the SEC nor Congress acts, the courts will again have no choice, as case come before them, but to create a new approach to the reach of the cause of action. They could conclude, in accordance with the arguments here, that fraud-on-the-market actions against foreign issuers are not socially useful and therefore not include claims against them within the reach of the cause of action. Alternatively, the SEC could act. Section 36 of the Exchange Act 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 18 months a report and recommendations concerning the reach of private actions, has already indicated possible future interest in legislating in the area.

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


The ideas set out in this article have the potential to animate reform through each of these routes. The decision making of each of these institutions over the last few decades suggest trends reflecting an 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 its direction. Moreover, time is on its side. Further globalization will create pressures that will both increase, and make unavoidably self evident, the inadequacies of the competing alternatives.

II. UNDERSTANDING THE SOCIAL FUNCTIONS OF THE FRAUD-ON-THE-MARKET CLASS ACTIONS

The first step to determining the appropriate reach of U.S. fraud-on-the-market class action liability regime against foreign issuers is to analyze, as a general matter, what the consequences of imposing it on an issuer are in 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 III, of what circumstances, if any, the United States has an interest in imposing this liability regime not just on U.S. issuers but on foreign issuers as well.

Stripped down to its bare essentials, the fraud-on-the-market cause of action work as follows. An issuer that is not selling any shares makes a material misstatement that violates Rule 10b-5. For a period of time, the misstatement inflates the prices at which its shares trade in the secondary market. Because of the existence of the cause of action, the issuer is liable to all those who purchase its shares during the period of inflated prices for the losses they suffer as a result.42

42 A description of the legal origins and basis of the cause of action is contained in Part IV.A
This liability regime can potentially be justified on either fairness or efficiency grounds. This involves a consideration of both its compensation aspect – the wealth transfers involved in the payments to share purchasers by issuers that make misstatements – and deterrence effects arising from the threat of need to make such payments. The analysis below suggests that the compensation provided by this cause of action provides 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 cost effectively reallocating the risks generated by issuer misstatements in a way that lessens the disutility in society suffered because of these risks.

The threat of needing to provide such compensation will, 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 cost effective notwithstanding its substantial costs of operation. The balance between these 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 an implicit determination that, at least within the entirely domestic context, the benefits are greater than the costs.

A. Fairness Based Compensation Rationales for Liability

When an issuer makes a price inflating misstatement in violation of law and a purchaser of its shares pays more than she otherwise would, any resulting losses suffered by the purchaser would appear unfair. Paying damages equal to these losses would rectify this apparent unfairness as far as this purchase is concerned. What, though, is the exact nature of this unfairness and, to the
extent that it 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 outsider secondary market traders in the issuer’s shares.\textsuperscript{43} If a falsely positive misstatement increases an issuer’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 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 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 the same chance that she will be overpaid at the time of sale (the time when the rewards from her original purchase decision are determined).\textsuperscript{44} The neutrality of the expected impact on an investor’s wealth from

\textsuperscript{43}This analysis assumes that neither the issuer nor its insiders are selling and therefore making trading gains as a result of the misstatement, a situation that in the United States would give rise to a different kind of Rule 10b-5 claim for civil damages based on insider trading.

\textsuperscript{44}The purchaser may, of course, be planning to hold her shares for a significant period of time and thus be looking to receive part or all of her return through the receipt of dividends. The existence of such purchasers might appear to undermine the proposition in the text. See, e.g., Alicia Davis Evans, \textit{The Investor Compensation Fund}, 33 J. CORP. L. 223, 232 (2007). These investors, however, just like investors who look only to resale for their returns, also do not, on an expected basis, face any unfairness from the existence of issuers that make occasional
the share price effects of an issuer’s misstatement is highly relevant. This because the underlying rationale for fraud-on-the-market actions relates the misstatements’ effect on price, not, as with the traditional reliance based action, on the misstatement inducing the investor into a transactions she later regrets.45

Thus, even though issuer misstatements add another element to risk to the purchasing of equity,46 they do not change the overall odds of winning. Investing in misstatement making issuers is not like playing a game against someone using dice loaded in his 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, though, 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 misstatements 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

45See [IV.A] for a discussion of the traditional reliance based cause of action for fraud.

46See I.B for a discussion of whether this imposition of additional risk justifies requiring compensation.
A welfare economist would reject this argument and instead analyze the problem in terms of the disutility, if any, suffered by the purchaser when the issuer makes a misstatement. He would assume that the purchaser is risk averse but he would likely view any disutility from the gamble that the misstatement forces the investor to take as actually a product of joint causes. Any disutility that the purchaser experiences would not have occurred but for the misstatement, but it also would not have occurred but for the purchaser not being fully diversified. See I.B. infra. Being less than fully diversified is not illegal and making a misstatement in violation of Rule 10b-5 is, but the good reasons for making such misstatements illegal may or may not include the gambles they impose on investors. In any event, equity investing involves a considerable gamble to start with and the disutility for a less than fully diversified investor that comes from the additional variability due to the issuer’s misstatement will be less, probably much less, than the ex post dollar loss.

47A welfare economist would reject this argument and instead analyze the problem in terms of the disutility, if any, suffered by the purchaser when the issuer makes a misstatement. He would assume that the purchaser is risk averse but he would likely view any disutility from the gamble that the misstatement forces the investor to take as actually a product of joint causes. Any disutility that the purchaser experiences would not have occurred but for the misstatement, but it also would not have occurred but for the purchaser not being fully diversified. See I.B. infra. Being less than fully diversified is not illegal and making a misstatement in violation of Rule 10b-5 is, but the good reasons for making such misstatements illegal may or may not include the gambles they impose on investors. In any event, equity investing involves a considerable gamble to start with and the disutility for a less than fully diversified investor that comes from the additional variability due to the issuer’s misstatement will be less, probably much less, than the ex post dollar loss.

48See I.B for a discussion of whether this imposition of additional risk justifies requiring compensation.
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 each of these 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). The price of the shares will thus drop from $70 to $56. Ten dollars of this price drop reflects the dissipation of the inflation when the truth comes out and the additional $4 reflects the payout to the injured shareholders of $20 million ($4 per share for the 5 million shares outstanding). Thus a portion of the damages received by the injured shareholders

\[49\text{In reality, it takes time for an injured party to recover damages through a law suit. The simplifying assumption can be justified, however, because the market will anticipate the need for the issuer to make such payments once it becomes aware of the misstatement and discount price accordingly.}\]
is indeed “circular” as many critics suggest: the injured shareholders, because of the drop in share price attributable to the payout, themselves fund $4 of the $10 in damages. The remaining portion of the damages ultimately come 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. Risk Reallocation Arguments for Compensation

A second argument for providing compensation to traders who suffer losses from purchasing the issuer’s shares at prices inflated its misstatements is that doing so reduces the amount of disutility in society arising from the risk of suffering such a loss. Providing compensation through fraud-on-the-market suits will in fact have this effect to a limited extent because the shift of the losses from the purchasers to the issuer’s shareholders will spread them over a larger number of people. These suits consume substantial amounts of legal and other real resources in society, however. Compared to the alternative way of dealing with this risk – investor


51 [insert fn refuting Cunningham argument that it is fair for longer term shareholders to pay]
diversification – fraud-on-the-market suits are far less effective and far more expensive.52

C. Investor Protection Arguments for Deterrence

The threat of a fraud-on-the-market suit will tend to deter a corporate manager from making material misstatements. Everything else being equal, he will be worse off if his 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 discussions above. Many provisions in the securities laws, including major parts of broker-dealer regulation, have important investor protection purposes. It 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.53 According to the efficient market hypothesis, the price of such a share is unbiased – as likely to be below the share’s actual value as above – whether there is a great deal of accurate information publicly available about the issuer or very little. In other words, greater transparency is not necessary to protect investors from buying its shares at prices that are, on average, unfair, i.e., greater than their actual values. Greater transparency may reduce risk – on average bringing price closer, on one side or the other, to actual value – but the only kind of risk that it reduces is unsystematic risk. Again, simply by being diversified, investors can protect

52 One additional factor to consider is that given the high rate of turnover of most issuer’s shares, shifting the risk from the purchasers to the shareholders at the time of suit does not spread the risk very much because it only modestly increases the number of people bearing it. This factor, and the more general inadequacy of the efficient risk reallocation argument for compensation, is considered in detail in Merritt B. Fox, Why Civil Liability for Disclosure Violations When Issuers do not Trade, 2009 WISC. L. REV. 297.

53 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).
themselves from this unsystematic risk much more effectively and at less social cost than by improvements in the quality of issuer disclosure.

D. Corporate Governance and Liquidity Arguments for Deterrence

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 threat of liability increasing an issuer’s transparency and that its power to do so 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. Thus the corporate governance and liquidity arguments for imposing liability on issuers that do not voluntarily commit to be subject to such a liability regime are inextricably tied up with the underlying rationale for mandatorily imposing periodic disclosure requirements on issuers.

1. The Rationale for Mandatory Disclosure

The rationale for mandatory periodic disclosure arises from the fact that issuers, if left unregulated, are likely to choose a level of disclosure that is less than socially optimal. This is because, as developed below, each issuer’s private costs of disclosure are greater than the social costs of this disclosure, while its private benefits are less than the social benefits. 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

54 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 (2009).
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 it confers 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 have beneficial effects on their governance and liquidity. It could, for example, reveal something about possible industry wide trends. 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. These benefits will not be captured in the price of the issuer making the disclosure and therefore the private benefit to the issuer and its shareholders from disclosure 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 private 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 so that costs of disclosure to the shareholders are equivalent to costs to them – would, if free to choose a disclosure level to which to bind the firm, choose a level below the social optimum.\textsuperscript{56} Mandatory disclosure can be viewed, in important part, as an effort to correct this shortfall. 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. Deterring Misstatements Makes Mandatory Disclosure More Effective at Promoting Transparency

A comprehensive system of mandatory periodic disclosure will require issuers to truthfully reveal a wide range of information relevant to predicting their future cash flows and to make most of their material corporate public statements, either initially or quickly thereafter, in forms filed pursuant to the system’s requirements. Fraud-on-the-market class actions are 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 promotes transparency.

3. Greater Transparency’s Contribution 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 share value maximizing ways. Transparency prompts managers of established corporations to make share value maximizing decisions through its 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.

a. Transparency’s effects on the legal mechanisms for promoting good corporate governance.

Transparency strengthens the effective exercise of the shareholder franchise because a better informed shareholder is more likely to vote for the directors who in fact are most likely to maximize share value, as well as for the share value maximizing choice with regards to all other matters subject to shareholder vote. Transparency also enhances effective derivative suit enforcement of management’s fiduciary duties because managers are unlikely to provide information voluntarily concerning their breaches of these duties. And it makes more meaningful corporate law provisions requiring special procedures in connection with the authorization of transactions in which management has an interest by making the existence of such conflicts more easily detected.

b. Transparency’s effects on the market mechanisms for promoting good corporate
governance. Transparency has beneficial effects on the operation of three of the economy's key market based mechanisms for controlling managerial behavior: the market for corporate control, share price based managerial compensation, and the terms at which new funding is available to the corporation.

i. Market for corporate control. Transparency strengthens the effectiveness of the market for corporate control by increasing the threat of hostile takeover when managers act in a non-share-value-maximizing way. A potential acquirer must make an inherently risky assessment of what a target would be worth in its hands. Greater transparency reduces the riskiness of this assessment. Because the potential acquirer’s management is risk averse, this reduction in the riskiness of its assessment means that a smaller apparent deviation between incumbent management decision making and what would maximize share value is then needed to 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 those who fail nevertheless to do so, it increases the likelihood of the managers’ replacement.

ii. Share price based compensation. 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. The problem for managers with share price based compensation, compared to straight salary with the same expected value, is the undiversifiable unsystematic risk that it imposes on the manager. More transparency makes share prices more accurate, which reduces this unsystematic risk. More
accurate share prices also make such compensation a more focused reward mechanism.

**iii. Terms of funding new projects.** 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., to invest in 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., to pass up 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. Share price also appears to affect management’s willingness to use internal funds to implement a new project.

4. Greater Transparency’s Contribution 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 reduces illiquidity in the secondary market for an issuer’s shares. Insiders and their tippees can make supranormal profits by engaging in trades based on non-public information. Since market makers, specialists and other providers of liquidity have difficulty knowing whether

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they are dealing with such inside-information-informed traders 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 price at which they accept buyer orders and the price at which they accept seller orders. The bigger the spread, the less liquid are the issuer’s shares, and the less valuable they are to hold. Greater transparency, by reducing the amount of non-public information and hence the opportunities for insiders and tippees to engage in trades based on such information, reduces bid/ask spreads, increases liquidity, and, as a consequence, reduces the cost of capital.

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

Assume that the United States can start from scratch in determining the reach of fraud-on-the-market class actions with significant transnational elements and that it wishes to design a rule that would maximize U.S. economic welfare, and by also promoting global economic welfare, foster good U.S. foreign relations as well. As discussed in Part I, four important policy concerns arguably justify imposing U.S. fraud-on-the-market class action liability against an issuer of secondary market purchasers of its shares who suffer losses because the price was inflated by the issuer’s misstatements: providing compensation in order to correct for the unfairness of these losses or to spread their risk; deterring issuers from making misstatements in order to increase

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corporate transparency where issuers are on average of a type that the imposition of such liability improves their corporate governance and increases the liquidity of their shares in a socially cost effective way; permitting a voluntary opt in by issuers that are not of this type but whose individual private calculations suggest the corporate governance and liquidity gains from being subject to the U.S. liability regime are greater than the costs; and 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 impacted by imposition of such liability on an issuer: assuring that the issuer’s shareholders receive corporate benefits on a pro rata basis; avoiding unnecessary distortions in the market choices of the world’s issuers as to where to list their shares and of the world’s issuers as where to trade; and promoting the economies of scale and consistency of treatment that result from similar claims being heard in one place.

As noted earlier, putting the properly analyzed implications of these policy concerns together will be seen to suggest that as a general rule, U.S. law based 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. The Illusory Compensation Concern

The policy rationale most commonly articulated in court opinions for imposing fraud-on-the-market liability is the desirability of providing investor protection through compensation.  

Providing compensation is supposed to reverse the purportedly unfair trading losses suffered by investors who purchased at a price inflated by an issuer’s material misstatement and sold after the inflation has dissipated and to reduce investor risk.

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. market. The analysis in Part II, however, shows that providing such compensation is not justified on fairness grounds and does not cost effectively reduce risk. Compensation concerns, therefore, should not play a role in terms of determining optimal rule concerning the range of allowable claims. In other words, while the United States is particularly interested in the welfare of its own residents, this interest is not a good a reason put weight on the national residency of a purchaser in determining whether a class action fraud-on-the-market claim may be brought on her behalf. This conclusion is important because much of the discussion relating to the properly allowable range of fraud-on-the-market cause of action against foreign issuers, in both court opinions and commentary, relies on this

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63 In re SCOR Holdings (Switzerland) AG Lit., 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.’” (quoting Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir. 1968)); See Hannah L. Buxbaum, Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict, 46 Col. J. Transnat’l L. 14, 53 (2007) (“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…even if the conduct in question caused significantly more harm to foreign investors than to U.S. investors.”).

concern to favor the claims of U.S. resident investors.

\[ B. \textit{Misstatement Deterrence to Promote Corporate Governance and Liquidity and the Scope of U.S. Interest} \]

The threat of fraud-on-the-market liability, as we have seen, 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.”\textsuperscript{65} Thus 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 reduces information asymmetries in the market and hence improves the liquidity of an issuer’s shares.\textsuperscript{66}

\[ 1. \textit{Corporate Governance} \]

The corporate governance gains from the transparency enhancing effects of the threat of fraud-on-the-market suits is real, but the extent of the gain varies across countries depending on their issuers’ typical share ownership structures and their larger overall systems of corporate governance. The ownership pattern of the typical publicly traded corporation in the United States

\textsuperscript{65} See I.D supra.

\textsuperscript{66} See I.D.4 supra.
is dispersed, with no single controlling shareholder.⁶⁷ In a substantial majority of other countries, most corporations are controlled by families or the state.⁶⁸ These differences affect disclosure’s usefulness for improving corporate governance and hence disclosure’s level of social benefits.⁶⁹ With dispersed ownership, as is typical in the United States, the primary corporate governance problem is the divergence of interests between management and shareholders, i.e., the agency costs of management. As discussed in Part II, disclosure can be very helpful in ameliorating this problem.⁷⁰ The agency problems associated with management are lower in countries where most corporations are controlled by families or banks. This is because persons with control 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 at least many of the countries where dispersed ownership is unusual, the corporate governance gains from the increased transparency prompted by imposing on its issuers a fraud-on-the-market liability scheme are probably smaller than in the United States. It is less likely that doing so, therefore, will enhance economic welfare.⁷¹ Whether involuntarily imposing a fraud-on-the-market liability


⁶⁸La Porta et al., at 496.

⁶⁹John 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, 16—17 (2001); COFFEE, GATEKEEPERS, supra note [ ] at 78—83 (explaining that dispersed ownership creates managerial incentives to exaggerate reported income while concentrated ownership tends to lead to the extraction of private benefits of control).

⁷⁰See notes [II.B] and accompany text.

⁷¹Disclosure can be helpful in discouraging such behavior, 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 disclosure has some other kind of deterring effect depends both on the overall social and business mores of the country and the extent to which such behavior can be meaningfully
regime on the issuers of any given country enhances economic welfare depends on weighing the
gains from the resulting increased transparency against the very substantial amount of real
resources that such a regime consumes. These include both the resources consumed by issuers to
try to comply in order to avoid liability and the efforts of both sides and the judiciary in
connection with litigation when claims nevertheless are brought.

The foreign issuer’s home country government is better positioned than the U.S. government
in weighing these considerations. It is better informed because it has access to local knowledge.
It is better motivated to get it right because ultimately most of the benefits from doing so will
accrue to its own residents. 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. This includes, if the issuer is subject to a fraud-on-the-market
liability regime, the benefits and costs of being 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, and the costs of the devices used to promote it, may vary widely from one
country to the next. The higher returns that result from a country’s issuers being subject to an
optimal mix of good corporate governance prompting devices therefore go largely to the
suppliers of the issuers’ less mobile factors of production. These are their entrepreneurs, who will
get higher prices when they sell shares in the firms they founded, and labor, who are likely to

challenged in court.
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 good corporate governance prompting devices are the country's entrepreneurial talent and labor, who are residents of the country, not the investors in these issuers.\textsuperscript{72}

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 of producing the additional transparency and the litigation the system entails will be concentrated in the United States, regardless of how global their shareholders are. Similarly, if issuers with an economic center of gravity in another country are subject to fraud-on-the-market suits, the ultimate impact of both the benefits of improved corporate governance and the costs of producing the additional transparency and of litigation

\textsuperscript{72} If a country's issuers represent only a small portion of all equities available to investors in the world, investors would share in 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 firm produces products. A disclosure 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 entrepreneurs, who are selling the cash flow, and labor, who gain from the overall increase in the country’s economic efficiency. See Fox Disclosure in a Globalizing Market, supra note [ ] at 2561-69. Because the country is like a small firm, however, the increase in the amount supplied 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 in the world, its investors 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 the country has to offer 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. This is equally true of investors from every country in the world, though, not just investors from the country improving its corporate governance because investors the world round all receive the same global expected rate of return (adjusted for risk). For more detailed discussions of these points, see, id at 2552-2580 and Fox, Political Economy, note [ ] supra at 732-739.
based on the cause of action will be concentrated on residents of that country. The United States does not have a large stake in the matter even if U.S. investors own substantial shareholdings in these issuers. This same reasoning shows as well that the location of where an issuer’s shares are traded is simply irrelevant to where is felt the ultimate impact of the benefits and costs of the mix of good corporate governance prompting devices to which the issuer is subject.

2. Liquidity

The transparency enhancing impact of fraud-on-the-market suits on liquidity leads to a similar conclusion. If an issuer’s shares are more liquid, they are more valuable to hold. This gain in value must be added to the social gains in the quality of corporate governance and balanced 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 offering and thereafter. The beneficiaries will be the entrepreneurs who take the firm public,

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73 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 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 concentrated at home. A country whose issuers are subject to an optimal mix will have capital utilizing enterprises that produce higher returns on their real investments net of the costs of these corporate governance devices. If the single rate assumption is correct, the gains from getting the mix right will primarily be enjoyed by the less mobile claimants on these returns, domestic entrepreneurs and labor, not by the suppliers of capital, who, wherever in the world they live, will at best enjoy a slight increase in the overall global expected return on capital. See supra note [one above] If the assumption is incorrect, the reason would be that each country’s investors still have a degree of bias against issuers from other countries. In that event, U.S. investors, for example, might share disproportionately in the gains from moving the mix imposed on U.S. firms toward the optimum. The bias of foreign investors against U.S. issuers would mean that the increase in the number of expected dollars of future cash flow resulting from moving the mix would be offered to a somewhat restricted market and push the price for them down more for U.S. investors than for other investors. Id. To the extent that a U.S. issuer has U.S. shareholders, the fact that U.S. investors will share disproportionately in the gains simply creates an additional U.S. interest in the mix of good corporate governance prompting devices imposed on U.S. issuers. As for U.S. issuers whose shares are sold to and traded among only foreign investors, entrepreneurs and labor in the United States would, just as if there were a single global expected rate of return on capital, enjoy most of the gains. See Fox, Securities Disclosure in a Globalizing Market, supra note [ ] at 2561-2569. Thus, the United States interest in the corporate governance of this second set of issuers would be as strong as it is shown to be under the assumption in the text.
who again are likely to be located in the country where the issuer has its economic center of
gavity, not the initial or subsequent public holders of the shares, who will pay a premium at the
time of purchase for shares with superior liquidity.

3. 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 implies that the U.S. fraud-on-the-market class action
liability regime should not be imposed on foreign issuers, even in the case of claims by U.S.
resident purchasers or purchasers or who purchased the shares in a U.S. market. Concern with
the transparency enhancing impact of fraud-on-the-market suits on liquidity leads to the same
conclusion. What may be a coporate governance and liquidity enhancing device worth its costs
in the United States may not be worth its costs when imposed on issuers of another country. The
other country is a better judge of the costs and benefits of utilizing this device and its residents
will be the ones to feel the consequences if the wrong choice is made. Its government will thus
likely resent a device imposed on its issuers that it has not determined is worth the costs.

C. Enhancing Global Welfare by Facilitating Foreign Issuer Bonding

Consider a foreign issuer whose home securities laws do not subject it to U.S. style fraud-on-
the-market class action type civil liability for material misstatements. The home country laws
may well reflect a determination that for most of its issuers, imposing such a system of liability
would not be cost effective from a social point of view. Suppose, however, the management of
this particular issuer, after taking account of just the private costs and benefits, concludes that the
issuer would be a net gainer from being subject to such a system of liability, particularly if it
were, at the same time, subject to a U.S. style periodic affirmative disclosure requirements. 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 the risk of associated litigation. The firm’s private calculations will, from a social point of view, overstate the costs and underestimate the benefits of the firm being subject to such a regime, as we saw in the discussion of the market failure justification for mandatory disclosure. 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. disclosure and litigation regime will therefore enhance global economic welfare.

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74 Litigation expenses would not include payments actually received by the share purchasers at the time of judgment or settlement. These 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 taken out and paid to the plaintiffs’ lawyers.

75 Being subject to the liability regime enhances an issuer’s transparency by making it more likely that the issuer will be truthful in its response to applicable mandatory disclosure requirements. The private costs of enhanced transparency exceed the social costs and the private benefits are less than the social benefits. See II.D.1 supra.

76 There are under current law several routes by which a foreign issuer can become subject to the U.S. periodic disclosure regime. The issuer can list its shares on a national securities exchange, which today both the New York Stock Exchange and NASDAQ are, in which case, under Exchange Act §12(a), its shares cannot be traded unless it registers them pursuant to Exchange Act §12(b), thereby triggering periodic disclosure obligations under Exchange Act §13(a). The issuer can file a registration statement under the Securities Act of 1933 (the “Securities Act”), which is required to do a public offering in the United States, and thereby, pursuant to Exchange Act §15(d), likewise trigger these §13(a) periodic disclosure obligations. Finally, assuming that the foreign issuer has more than 500 shareholders worldwide, more than $10 million in assets and a business that has some kind of affect on U.S. interstate commerce – a reasonably safe assumption for a foreign issuer of any significance – Exchange Act §12(g)(1) requires registration of its shares, again triggering Exchange Act §13(a) periodic disclosure obligations, unless the issuer is exempt from these registration requirements pursuant to a rule promulgated by the SEC pursuant to Exchange Act §12(g)(3). If the issuer has more than 300 U.S. shareholders, it will not be exempt even if it not listed on a U.S. exchange unless it seeks an exemption under Exchange Act Rule 12g3-2(b). If the issuer has fewer than 300 U.S. shareholders, under current law, it would be automatically exempt under Exchange Act Rule 12g3-2(a), but the SEC could obviously amend this Rule so that any issuer that affirmatively sought not to be covered by it
In many cases, of course, these gains in global economic welfare will be enjoyed primarily abroad. If the foreign issuer chooses the option to be subject to the U.S. 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 benefits.\(^{77}\) Still, even under these circumstances, the United States has motivations for offering the option of being subject to the U.S. disclosure and liability regime. A practice of helping in the construction of a global system of finance that promotes overall wealth generation will promote good economic relations abroad and create the potential for reciprocity in other matters.\(^{78}\) It also serves the “cosmopolitan” values of the many Americans who have concern for the welfare of persons living outside the United States, not just for the welfare of their fellow citizens.

Moreover, there are situations where offering the option to foreign firms can yield direct benefits to U.S. residents. In contrast to the initial public offering stage, if an issuer that is an already established, publicly traded firm chooses to subject itself to the U.S. disclosure and liability regime, the issuer’s U.S. shareholders at the time the choice is made would, on a pro rata

\(^{77}\)See notes [in II.B] supra and accompanying text.

\(^{78}\)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, but these same benefits would be enjoyed by all investors in the world and would accrue whether or not any U.S. residents purchased any shares of the firms that chose to exercise the option. The analysis is identical the analysis above of the gains to U.S. investors when another country’s issuers represent a substantial portion of all equities available to investors in the world and the country moves its mix of corporate governance devices closer to what is optimal. See supra note [a few above]. A large number of foreign firms choosing to exercise the option of being subject to the U.S. disclosure and liability regime will lead to a sufficient increase the number of dollars of future expected cash flow these firms have to offer that the price at which a dollar of future expected cash flow is sold would be lowered, at least slightly. In other words, the expected future rate of return on a dollar of investment will increase and transnational capital flows assure that, on a risk adjusted basis, this return is the same everywhere. Thus investors worldwide, including those in the United States, would gain from the improvement.
basis, share the increase in share value that would come from the increase in the issuer’s expected cash flow and the liquidity of the shares.

The idea that U.S. securities law can provide some kind of bonding mechanism for foreign issuers is not new. Professor Ed Rock\(^7\) and Professor John Coffee\(^8\) 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 subjects them to the U.S. periodic disclosure regime.\(^9\) 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.\(^10\)

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 they cross list on the NYSE or NASDAQ.\(^11\) 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 due to


\(^9\) Exchange Act §12(a) prohibits any trading of shares on a national securities exchange, which today both the New York Stock Exchange and NASDAQ, unless the issuer has registered the shares pursuant to Exchange Act §12(b). Such registration triggers periodic disclosure obligations under Exchange Act §13(a).

\(^10\) Id.

expectation of improved corporate governance, and to a reduction in the rate at which the market discounts these cash flows (the firm’s cost of capital), 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. At least part of this increase in the expected level of transparency was probably due to an increased chance that the issuer would face fraud-on-the-market liability if it made misstatements, although the extent to which cross listing increased the this increased risk of liability, and hence its contribution to increased transparency, is unclear. Hail and Leuz find no

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84 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 managerial or, where applicable, controlling shareholder behavior, that will increase *actual* future cash flows to non-control shareholders. Hail & Leuz *U.S. Listings* at 7-8 (explaining effects of bonding oncompanies under increased U.S. disclosure requirements and threats of SEC enforcement and shareholder suits). The other 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.

85 *Id.* at 2.

86 *Id.* at 1.

87 A listing on a U.S. exchange would have increased transparency presumably for two reasons. One is that it would have triggered imposition of the Exchange Act’s periodic disclosure regime, which calls for the issuer to provide a variety of kinds of information that the issuer’s home country disclosure regime did not call for. The other is that it would have increased the prospect that the issuer would be subject to having to make fraud-on-the-market damage pay outs if it made misstatements in its responses to what the disclosure regime called for. How much this second reason contributed to the Hail and Luez results is unclear. Under the conducts/effects test jurisprudence used by the courts until this last summer’s decision in *Morrison*, it was unpredictable the extent to which a misstatement that appears in a foreign issuer’s periodic disclosure filing with the SEC generated the potential for class action fraud-on-the-market liability. The case law on the question was highly inconsistent, with some courts treating the making of such a filing as conduct in the United States (which justifies including in the class foreign purchasers of the issuer’s stock on foreign markets), while other courts focused instead on the effect of the misstatement on the price of shares in the U.S. and yet others on the effect of the misstatement on the price paid by U.S. purchasers whether they purchase at home or abroad. See Part [IV ] *infra*. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. REV. 229, 304 (2007) (“it must be recognized that private enforcement of the securities laws in the United States is working imperfectly, achieving little, if any, compensation and only limited deterrence because its costs fall largely on innocent shareholders rather than the culpable corporate officers actually responsible for “cooking the books” and other misdeeds.”).
comparable results for a foreign firm’s over the counter (OTC) cross listing in the U.S. (the so-called “pink sheets” market), or for a Rule 144A\textsuperscript{88} offering (under which unregistered shares of foreign issuers can be traded in the United States among large institutional investors), neither of which trigger the need to comply with the U.S. periodic disclosure requirements.\textsuperscript{89}

The proposal here would make clear that those 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 same extent that a U.S. issuer would be in an entirely domestic context. For a foreign issuer, cross listing on a U.S. exchange and being subject to this U.S. liability regime would be independent options, with neither being a condition for choosing the other.\textsuperscript{90} Both United States and global welfare is enhanced by an approach that separates these two decisions. The United States is not negatively affected if a foreign issuer declines to be subject to the U.S. fraud on the market regime, even if it has U.S. investors\textsuperscript{91} and even if its shares trade on a U.S. exchange.\textsuperscript{92} The U.S. benefits from more business for its exchanges since issuers that would want their shares traded a U.S. exchange but do not want to be subject to the U.S. liability regime would no longer be deterred from listing. The world benefits from the

\textsuperscript{88}17 C.F.R. §230.144A (1990).

\textsuperscript{89}Hail & Luez, supra note [a few above], at 40.

\textsuperscript{90}Under the lower court conduct/effects test jurisprudence prior to Morrison, these decisions were linked because the decision to cross list increased the risk of fraud-on-the-market liability. See note [a couple above] supra. If the courts end up applying the Morrison test not just to the reach of the statute, but to the reach of the fraud-on-the-market liability regime as well, a cross listing would unambiguously impose this liability regime on the foreign issuer, at a minimum with respect to shares traded on the U.S. exchange. See Part I supra and Part V infra.

\textsuperscript{91}See III.A and III.B supra.

\textsuperscript{92}See III.D infra.
issuer being able to choose to have its shares in places it calculates are most advantageous.

In sum, the foregoing analysis suggests that it is good policy for the United States to offer foreign issuers the option of being subject to a package that includes both its disclosure regime and its class action fraud-on-the-market liability regime, at least assuming that the sum of an issuer’s expected registration fees and court fees if there is litigation exceeds the sum of the expected administrative costs of applying the U.S. disclosure regime to the issuer and the expected consumption of U.S. judicial resources.

D. 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, serious analysis shows that it is not sound.

One argument in favor of requiring all issuers trading on a U.S. exchange, whether U.S. or foreign, to be subject to the U.S. liability regime relates to price accuracy. With such a requirement, the argument goes, the listing of an issuer would send a clear “short hand” signal to the market that it is subject to the liability regime with the resulting boost in transparency.\(^{93}\) As a result, the market prices of the world’s issuers would easily and accurately reflect which issuers

\(^{93}\)See note [around 28, Rock, Coffee] *supra*.
are subject to the liability regime and which not. More accurate prices would improve the efficiency of capital allocation and managerial incentives in the economy and protect uninformed individual investors from paying an unfairly high price for an issuer is not subject to the U.S. liability regime.

The problem with this argument is that market prices do not need this short hand signal in order to reflect each issuer’s actual situation. Markets are sufficiently efficient to reflect in price all kinds of publicly available information, including information much less salient than the important fact of whether or not an issuer is subject to the U.S. fraud-on-the-market regime, and do so even if most individual investors are unaware this information.\(^4\) So if the law allows a foreign issuer listing on a U.S. exchange to choose whether or not to subject itself to the U.S. fraud-on-the-market liability regime, its share price will reflect this choice as long as the choice is publicly disclosed. A rule bundling together the decision of a foreign issuer to list on a U.S. exchange and to be subject to the U.S. liability regime is not necessary for market prices to perform properly their resource allocation and managerial incentive functions or to protect investors from paying an unfairly high price for an issuer that is not subject to the U.S. regime.

A second argument in favor of requiring all foreign issuers trading on the U.S. exchange to be

\(^{44}\)Richard A. Brealey, Stewart C. Myers & Franklin A. Allen, *Principles of Corporate Finance* 358-59 (9th ed. 2008) (the prices of established issuers trading in liquid markets reflect all publicly available information). It should be noted that 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). More recently, some federal courts of appeal have required that plaintiffs show that the issuers trade in a market with a high level of efficiency before they are entitled to utilize the cause of action. Oscar Private Equity Inv’s v. Allegiance Telecom, Inc., 487 F.3d 261, 264 (5th Cir. 2007) (“We now require more than proof of a material misstatement; we require proof that the misstatement actually moved the market.”). In re PolyMedica Corp. Sec. Litig., 432 F.3d 1, 19 (1st Cir. 2005) (“For purposes of establishing the fraud-on-the-market presumption of reliance, we adopt the prevailing definition of market efficiency, which provides that an efficient market is one in which the market price of the stock fully reflects all publicly available information.”).
subject to the U.S. fraud-on-the-market liability regime relates to protecting investors from risk. While this risk related argument is somewhat stronger than the accurate pricing argument, it is ultimately also unpersuasive. The greater transparency associated with a foreign issuer being subject to the liability regime would likely reduce the riskiness for an investor for whom the issuer’s shares constitute a substantial portion of her total investment portfolio. If the investor is an unsophisticated individual, a rule subjecting a foreign firm listed in a U.S. exchange to the U.S. liability regime would signal to the investor of this lower risk.95 Here the “shorthand” concept makes more sense: without a rule bundling the two together, it is much more likely that an unsophisticated individual investor will know whether a foreign issuer is U.S. listed than whether it is subject to the U.S. liability regime. With a bundling rule, the investor can know that by confining herself to U.S. listed foreign issuers, she can protect herself against the extra risk of the lower-transparency foreign issuers that are not subject to the U.S. liability regime.

The problem with this second argument is that the protection against risk provided by a bundling rule comes at a considerable cost. As discussed below,96 a bundling rule distorts in the market-based choices by the world’s issuers of where to list their securities and creates serious inefficiencies. These inefficiencies means that a bundling rule must be compared in terms of effectiveness and cost with alternative ways for such an investor to avoid risk. The alternative is for the investor to diversify the investments in her portfolio, a strategy that costs very little to

95 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 apply the U.S. mandatory disclosure regime to foreign issuers that list on a U.S. exchange.

96 See III.F infra.
implement. The extra risk when an issuer is not subject to the U.S. liability regime is firm specific. By being well diversified, an investor eliminates completely not just the extra risks when an issuer is not subject to the fraud-on-the-market liability regime, but also the thousands of other firm specific risks associated with investing in the issuer that a bundling rule can do nothing about.\textsuperscript{97} Given this lower cost and more broadly effective alternative, justifying a rule that bundles the listing and liability decisions together on the grounds that it protects uninformed individual investors against risk is unpersuasive. An educational campaign urging unsophisticated individual investors to diversify is a more promising public policy for providing such protection.

In sum, the fact that a foreign issuer’s shares are listed on a U.S. exchange or does not appear to be a connection with the United States that should be considered in whether the issuer should be within the reach of the U.S. fraud-on-the-market regime. This is an important conclusion because such a connection does increase the likelihood that a foreign issuer will be brought within the reach of the fraud-on-the-market cause of action under the lower court conduct/effects test jurisprudence prevailing before \textit{Morrison} to which there might be a return. The listing would also extend the reach of the regime to the issuer under the \textit{Morrison} test itself if ultimately the test were to used to determine the reach of the cause of action, not just the statute.

\textit{E. 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 shareholders on a pro rata basis in accordance with

\textsuperscript{97}Diversifying a portfolio over as few as 20 randomly selected stocks can eliminate almost all the firm specific risk associated with each. \textit{Brealey, Myers \& Allen, supra} note [], at 187.
the number of shares that they hold.\textsuperscript{98} Thus, for example, if dividends are paid, they are paid on a per share basis to all holders. One of the advantages of such a rule is that it permits a single, more liquid market for the shares bought and sold in portfolio investment amounts because the shares offer the same expected cash flow to all shareholders, whoever holds the shares and however they were acquired. It also prevents resources from being wasted on 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 that should conform to this rule. To see why, consider a regime where \textit{all} shareholders are entitled to be paid compensation from the corporate treasury for any losses they suffer if they unknowingly purchase shares 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 acquires each of her shares, and so, ex ante, the benefit is received pro rata. The expected value of this insurance benefit is equal for all shareholders because they are equally likely to have made a purchase that would result in their collecting on it. Whenever payment has to be made out of the treasury, all shareholders pay derivatively pro rata as well. Now imagine a regime where \textit{only some} shareholders — ones 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, since shareholders who do not have this residence or do not buy in this country’s market do not receive it. Yet whenever payment of compensation has to be made out

\textsuperscript{98}Frank H. Easterbrook & Daniel R. Fischel, \textit{The Economic Structure of Corporate Law} 143-44 (1991),
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 that all claims should be allowed against the foreign issuer regardless of the nationality or residence of the plaintiff and the place she executed the transaction.

\[ F. \textit{Promoting the Efficient Functioning of Secondary Trading Markets Through Undistorted Choice of Venues and the Benefits to U.S. Competitiveness} \]

Suppose, as is the case today, that the United States rules concerning the reach class action fraud-on-the-market liability against foreign issuers are such that they affect the choices by the world’s issuers as to where to promote trading of their shares. In such a case, the rules would introduce an inefficient distortion into these choices. Market efficiency requires that these choices be made based on the quality of services that different potential trading venues offer buyers and sellers of an issuer’s shares and the costs of acquiring these services. Tying whether liability is imposed to the geographic location of the trading venues chosen by an issuer and the traders in the issuer’s shares introduces a consideration unrelated to service quality and cost.

The efficiency with which trading services are provided in the world would be significantly enhanced by issuers and traders being able to make choices concerning trading venues for issuer shares free of concerns unrelated to the quality and cost of these services. A securities trading venue is 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 her. The venue produces value by providing these potential traders with liquidity. Liquidity is a multi-dimensional 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, the fees of the trading venue and clearance and settlement fees. Oversimplifying somewhat, there are tradeoffs and so, generally, the faster the trader wants her trade to execute and the larger the size of the trade, the more the trade will cost.\textsuperscript{99}

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 effect their trades are complicated ones. On the one hand, there are advantages to all trades occurring at one venue because it 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 virtues to having multiple venues for trading an issuer’s shares. A trading venue can be superior to another along any one or more of the three dimensions of liquidity. Multiple venues can compete to be meeting places for traders in a given issuer’s stock. Such competition can eliminate what would otherwise be monopoly prices and reduce costs by being a spur to efficient operation, and create incentives for innovation. So with competition the costs of a trade of a given size and speed can cost less. Because trader needs vary in terms of the different dimensions of liquidity, multiple venues can also 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 because substantial real resources are devoted to operating the trading venues that

\textsuperscript{99} [cite to come]
facilitate these trades and many kinds of trades are socially valuable. Equity is a more effective device for raising capital, for example, when shares are expected subsequently to trade in a liquid secondary market, thereby making the shares a convenient place for savers to store wealth and to withdraw this wealth when it is needed. Liquid markets also facilitate hedging transactions and diversifying 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 their predictions. These activities make share prices more informed and thus act as better guides for real economic activity.

Avoiding distortions in these choices by issuers as to where to promote trading of their shares and by traders as to where to trade implies either that no fraud-on-the-market claims should be allowed against a foreign issuer or that all claims should be allowed against the foreign issuer.

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100 Average discounts for restricted stock issued under SEC Rules 144 and/or 144A range from 13 to 15 percent. Prior to 1997, when the SEC reduced the Rule 144 holding period from 2 years to 1 year, average discounts ranged from the high teens to the low twenties. For a summary of relevant studies see Stuart A. Ober, Discounts for Lack of Marketability, Financial Counsel.com Professional (2010), available at http://professional.financialcounsel.com/Articles/Broker/ARTBROK0000380-DiscountsForLackOfMarketability.asp. One study focusing on 144A debt issuance has found that “all else equal, for a typical foreign issuer, borrowing costs are approximately 49 basis points higher on average for rated 144A relative to public debt issues” but they do not specify what portion of this discount is attributable to illiquidity. Susan Chaplinsky and Latha Ramachand, The Impact of SEC Rule 144A on Corporate Debt Issuance by International Firms, 77 J. OF BUS. 1073, 1089 (2004). Another study, however, glosses the Chaplinsky and Ramachand result as follows: “Another test case for the value of liquidity has been provided by the SEC’s Rule 144A, which allows for limited trading of bonds that cannot be traded in the public markets. Trading of these so-called Rule 144A bonds is restricted to “qualified” investors (generally institutional investors), which makes the bonds less liquid than otherwise comparable publicly traded corporate bonds. Supporting our prediction that less liquid securities would have higher required returns, a 2004 study reported that the yields on Rule 144A bonds were 0.49% higher, on average, than the yields on unrestricted, publicly traded bonds with similar characteristics.” Yakov Amihud and Haim Mendelson, Liquidity, the Value of the Firm, and Corporate Finance, 20 J. APPLIED OF CORP. FINANCE 32, 36 (2008).
regardless of the nationality or residence of the purchaser and the place she executed the transaction.\(^{102}\)

The United States has a particularly strong interest in avoiding such distortions because it has within its boundaries 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 diversify 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 having their shares trade in U.S. markets.\(^{103}\) This will hurt U.S. capital market competitiveness because of the reduced number of listings.\(^{104}\) And it will discourage

\(^{102}\) A bundling rule also involves another social cost beyond the inefficiencies created by distortions, discussed in the text, in issuer and investor choices as to where shares should be listed and traded. This second set of social costs involves foreign issuers that do not find it advantageous to be subject to the U.S. fraud-on-the-market liability regime, but that find that the advantages of a U.S. listing to outweigh the disadvantage of being subject to the U.S. liability regime. These issuers will decide to list but in so doing will have imposed on themselves a corporate governance device not well suited to their situations, with greater costs than benefits. See notes [ III.B.3] supra and accompanying text.

\(^{103}\) See note [around 7] supra concerning survey data showing that fear of fraud-on-the-market suits being the single most important deterrent to foreign issuers offering or listing their shares in the United States.

\(^{104}\) 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 domestic alike. For example, it calls upon the SEC to impose a stricter standard than most courts have adopted concerning what must be shown to demonstrate that the market for a security is sufficiently efficient to justify application of the fraud on the market theory. \textit{Interim Report of the Committee on Capital Markets Regulation} 81-82 (Nov. 30, 2006), http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. (calling for adoption of the rule in \textit{In re Polymedica Securities Litigation} that plaintiffs must show that the market price fully reflects \textit{all} publicly available information. 432 F.3d 1, 26 (1 Cir. 2005) (emphasis added)). More
internationally, the Committee calls for the SEC to permit managers, with the approval of shareholders, to adopt charter amendments barring shareholders from bringing fraud-on-the-market damage actions in court at all. Such claims would instead be heard in arbitration. If the charter amendment so provided, the claims could only be brought individually by each shareholder, not by a class action. \textit{Id.} at 109–10. This would largely eliminate issuer liability altogether since, for most investors, individual actions do not have the prospect of sufficiently large recovery to merit the costs of bringing the action. There is no need, however, to mix the issues of the desirability of having fraud-on-the-market actions imposed on domestic U.S. issuers and the competitiveness consequences of imposing them of foreign issuers that utilize U.S. capital markets. See \textit{Fox},

\textit{G. Advantages of Resolving Similar Claims in One Place}

There are economies of scale in resolving similar claims in one place. It is also desirable that similar claims be treated in similar fashion rather than depending on inconsistent findings of fact arising from multiple triers of fact. As a general matter, this concern would argue in favor of permitting class action status for all claims against foreign issuers that are decided to be within U.S. jurisdictional reach. A genuinely realistic prospect that a claim would be re-litigated abroad after a U.S. judgment or court approved settlement would erode this rationale for inclusion of the claimant within the class. Given, however, the general absence abroad of “opt out only” class actions or of contingent fee arrangements, combined with the prevalence of “loser pay” rules, the likelihood of a fraud-on-the-market type 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. This likelihood is further reduced by the fact that payment to investors under the claims process associated with the U.S. judgment or settlement can be conditioned upon agreement not to re-litigate the claim abroad. Thus this final policy concern suggests that class action status should be permitted for all claims against foreign issuers that are
decided to be within U.S. jurisdictional reach, regardless of the nationality or residency of the plaintiff or the place of execution.

_H. 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. 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 its economic center of gravity as an operating firm outside the United States. This rule shielding foreign issuers should apply 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. 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.

This simple rule is derived from the analysis of the seven policy concerns as follows. The first and fourth concerns – the need to provide compensation to cover investor trading losses and assuring that U.S. exchanges are places for the trading of high transparency issuers – are poor justifications for imposing fraud-on-the-market liability on any issuer and thus 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 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 costs. But the government of a foreign issuer’s home country is in a better position than the United States to make this judgement and so this second concern points toward not imposing the U.S. liability regime on any genuinely foreign issuer. The third concern – relating to concerns about 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 an exception to this general rule where a foreign issuer voluntarily agrees to be subject to the U.S. liability regime. The fifth, sixth and seventh policy concerns – pro rata distribution of benefits, undistorted issuer and investor choices of where to list and trade, and adjudicatory consolidation – are better, or at least as well, served by this same rule barring U.S. law based fraud-on-the-market claims against all genuinely foreign issuers (and by the proposed exception) as they are by any other rule concerning the reach of the action.

IV. 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 the promoting of global economic welfare as well, best foster good U.S. foreign relations. With this ideal in mind, the next task next is to chart a practical path to reform that reflects an awareness of the complications posed by the real world context in the decision as to reach of the liability regime will be made. This task involves an assessment of the attractions of, and the problems with, each of the likely competing alternative approaches to determining this reach and a consideration of the three institutional ways by which
the decision as to approach can be made: judicial decision making, SEC rule making, and legislation. This Part is devoted to an assessment of the first of the competing alternatives: returning to the conducts/effects test. Part V will be devoted to assessing other alternatives—adopting the Morrison test and to approaches suggested by other commentators. Part VI considers the three institutional ways the decision can be made.

Congress, in the Dodd Frank Act, has already chosen to return to the conduct/effects test approach to define the reach of the Exchange Act’s anti-fraud provisions in cases brought by the SEC or the U.S. Department of Justice and it has public officials.\textsuperscript{105} In the same Act, it has required the SEC to solicit public comment and conduct a study concerning the extent to which the reach of private actions should follow the same approach.\textsuperscript{106} Returning to the conduct/effects test also has 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. These are all factors that would tend to nudge decision makers in the direction of returning to use of the conduct/effects test to determine the reach of the U.S. fraud-the-market liability regime.

This assessment of the conduits/effects test will begin with a brief history of the courts’ creation of the Rule 10b-5 implied right of action for damages and a comparison between the traditional reliance based fraud action under Rule 10b-5 and the later developed fraud-on-the-market action. The claim in the traditional reliance based action is that a material misstatement with scienter, typically made by the defendant seller, damaged the purchaser plaintiff by having

\textsuperscript{105} [proper cite for Sec. 929p]

\textsuperscript{106}[proper cite for Sec. 929y]
induced her to enter into what turns out to be a losing transaction. The claim in the later
developed fraud-on-the-market action is typically that the issuer, although not a seller, publicly
made with scienter a material misstatement that led to the plaintiff’s being damaged by the price
at which she purchases being inflated. This brief history and comparison is followed by a review
of the origin of the conduct test/effects test, which arose from a handful of seminal Second
Circuit cases in the 1960s and 1970s. These seminal cases each involved the reach of the
traditional reliance based Rule 10b-5 fraud cause of action for damages. The courts then later
transplanted this same approach to determine the reach of the subsequently developed fraud-on-
the-market cause of action. What worked reasonably well for the cause for which it was
originally developed made a poor transplant. In a fraud-on-the-market action, the fact that some
kind of conduct occurs, or some kind of effect is experienced, in one country rather than another,
while allowing formal distinctions to be made, will be shown either to lack meaningful
significance or to lead to serious problems interacting with other legal systems. This problem left
the courts without bearings when trying to decide the reach of fraud-on-the-market actions and
explains much of their inconsistency in outcome and incoherence in reasoning. This inherent
defect in the transplanted approach means that a return now to the conduct/effects test is unlikely
to lead to any better results than before, even if the test was refined by more precise language in
legislation or by SEC rule. The return would be to a line of cases that grew out of a fundamental
mistake, not a way of tapping back into legal wisdom grown organically from experience. Thus
there are no real advantages to counterbalance the fact that such a approach would impose the
U.S. fraud-on-the-market liability regime on foreign issuers in many situations when doing so
would reduce both U.S. and global economic welfare.

A. Origins of the Fraud-on-the-Market Action and its Differences from the Traditional Reliance Based Fraud Actions

The fraud-on-the-market cause of action that is the basis of class action claims for secondary market trading losses caused by issuer misstatements arose in an entirely domestic context through legal evolution from the standard fraud action based on traditional reliance concepts. A review of these domestic origins of is a crucial first step in understanding the confusion in the later case law concerning its reach to foreign issuers.

1. 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. Such a statement would be a clear violation of Rule 10b-5 if the issuer were selling its shares at the same time. 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 the resulting damages. Three principles needed to be established before this situation could change: (i) an issuer making such a statement violates Rule 10b-5 even though it is not selling any securities, (ii) such a violation can give rise to a private right of action for damages on behalf of
those injured by the violation, and (iii) the investor can 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 all investors who are similarly situated.

a. The illegality of corporate misstatements. Rule 10b-5 provides in part “it shall be unlawful for any person, directly or indirectly, ... to make any untrue statement of 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.” On the face of the rule, an issuer that makes a material misstatement but does not sell any securities does not obviously commit a violation because there is a serious question whether the misstatement is made “in connection with the purchase or sale of a security.” In 1968, however, in S.E.C. v Texas Gulf Sulphur, the Second Circuit held that any issuer statement that is “reasonably calculated to influence the investing public,” for example by making the statement to the media, satisfies Rule 10b-5’s requirement that it be “in connection with the purchase or sale of a security,” even if neither the issuer nor its officials buy or sell shares themselves. The theory as to why such a statement satisfies the “in connection with” requirement is that the issuer would know that persons trading in the secondary market would be affected in their trading decisions by the misstatement.

107 S.E.C. v Texas Gulf Sulphur, 401 F.2d 833, 859--61 (2d Cir. 1968)
b. 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*, 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. The theory behind this finding was that under the common law, a violation of a legislative enactment is a tort against such a person suffering such an injury.

c. Presumption of reliance on the integrity of the market and the possibility of class actions. By the end of the 1960s, a positive material public corporate misstatement made with scienter by a non-trading issuer would have been considered to violate Rule 10b-5 and give rise to a private right of action. This potential liability had not yet become a serious threat to the issuer in most situations, however. The stumbling block for plaintiffs was the requirement that they show “reliance,” as this term was traditionally understood. A large portion of the secondary market purchasers of the issuers shares would not have “relied” on the issuer’s misstatement in the sense of it did not induce them into action. Even for those whose purchases were induced by the misstatement, demonstrating this fact is individualistic and so the reliance requirement made a class action against an issuer impractical.

i. The traditional reliance requirement. The seminal case defining traditional reliance is

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110 *Id.* at [ ]

112 *Id.* at [ ]. The Supreme Court ultimately affirmed the existence of this right 25 years later in *Supt. of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, [ ] (1971).

113 [put in a std. case cite that if each pl needs to show reliance individually, common issues do not predominate and so FRCP Rule 23 stds for class cert are not satisfied.]
the Second Circuit’s 1965 opinion in List v. Fashion Park.\textsuperscript{114} The district court in List found that the plaintiff, with regard to one of his allegations, would have purchased even if he had known the true situation.\textsuperscript{115} On the basis of this finding, the district court dismissed the claim relating to the allegation. The Second Circuit affirmed.\textsuperscript{116} The Second Circuit, in affirming the district court opinion started with a ruling that the requirement in common law misrepresentation cases that the plaintiff show “reliance” “carried over into civil suits under Rule 10b-5.”\textsuperscript{117} 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;’”\textsuperscript{118} the court stated “the reason for this requirement is to certify that the conduct of the defendant actually caused the plaintiff’s injury.”\textsuperscript{119} Given the district court’s finding that the plaintiff would have purchased anyway, which the Second Circuit did not find clearly erroneous, the plaintiff clearly failed the test.

\textit{ii. The fraud-on-the-market theory of reliance.} The fraud-on-the-market theory of reliance was first enunciated in some lower courts in the 1970s and was affirmed by the Supreme Court in

\textsuperscript{114}List v. Fashion Park, 340 F.2d 457 (2d Cir. 1965). \textit{List} was a non-disclosure 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. The court’s analysis, however, drew upon affirmative misleading statement cases in the common law and its definition of reliance has been regularly cited as controlling in subsequent Rule 10b-5 affirmative misleading statement cases.

\textsuperscript{115}340 F.2d at 464

\textsuperscript{116}Id.

\textsuperscript{117}340 F.2d at 462-63.

\textsuperscript{118}340 F.2d. at 462 (citations omitted) (emphasis added).

\textsuperscript{119}Id. (Emphasis added).
the Basic v. Levinson in 1988.\textsuperscript{120} Under the theory, a material public misstatement by an official of an issuer whose shares trade in an efficient market will, consistent with the efficient market hypothesis (EMH), affect the issuer’s share price. This effect on price provides a plaintiff with a way of showing “the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”\textsuperscript{121} Traditional reliance — showing that the misstatement induced the plaintiff into purchasing or selling the security — was previously the only way of establishing this causal link. With the ruling in Basic, the court established an alternative way of doing so.

The Court insisted in Basic that its ruling maintained the need for plaintiff to show reliance, just in the form of “reliance on the integrity of [the market] price”\textsuperscript{122} instead of reliance on the misstatement itself. The case establishes a presumption of this new kind of reliance on the integrity of the market price.\textsuperscript{123} There is a big difference between these two forms of reliance, however. Unlike traditional reliance, the plaintiff no longer needs to show she would have acted differently — i.e., not purchased the security — if the defendant had not made the misstatement.

\textit{iii. 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 — eliminates the need to make particularized claims of reliance for

\textsuperscript{120}Basic Inc. v Levinson, 485 U.S. 224 (1988)

\textsuperscript{121}Id. at 243.

\textsuperscript{122}Id. at 247.

\textsuperscript{123} [Explain how can be rebutted]
each purchaser. 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 just her own damages sufficient to justify the cost of bringing suit. Through bundling together many claims against the same issuer for the same misstatement, class actions permit realization of very substantial economies of scale. With this reduction in the cost per dollar of prospective recovery, bringing suit often becomes 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 the claims of ordinary portfolio investors who suffer losses from share transactions at prices unfavorably influenced by issuer misstatements.

2. Lessons from the History of the Two Causes of Action

This history contains two important lessons for assessing a return to the conduct/effects test as a way of determining the reach of the fraud-on-the-market cause of action. First, this newer action arises from a distinctly different claim of injury in terms of the nature of the defendant’s violation, the effect on the plaintiff and the overall situation than the claim of injury associated with a traditional reliance based fraud action. Second the development of the private right of action under Rule 10b-5 is process of court decision making characterized by great plasticity, a plasticity that can extend as well to determinations of the reach of these actions in transnational situations.

a. Differences in the nature of the injury giving rise to the cause of action. The plaintiff in a traditional reliance based action needs to show that she would have acted differently but for the wrongful misstatement and that she would have been better off if she had. At a minimum, this
requires that the plaintiff have been aware of the misstatement. The plaintiff in the fraud-on-the-market action needs to show that the price at which she transacted would have been more favorable but for the misstatement and thus does not require awareness of the misstatement.

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 IPO, because these are the only situations where investors are likely to be able to show that they would have acted differently. The focus on the effect of the misstatement on the decision of the plaintiff 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 one 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 price which the plaintiff paid is unclear.124

In a fraud-on-the-market action, the typical plaintiff is an individual portfolio investor, or an institution doing index investing, fund which has engaged in an impersonal secondary market transaction on the NYSE or NASDAQ. The plaintiff may well not even have been aware of the misstatement. Even if she were, the misstatement is unlikely to have been decisive in 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 statement or not, she likely would have made the purchase even if the misstatement had not been made, just at a lower price. Consequently, the misstatement is not likely to be a

124 As one district court, quoted in Basic, put it, “In face-to-face transactions, the inquiry into an investor’s reliance upon information is in the subjective pricing of that information by that investor.” In re LTV Securities Litigation, 88 F.R.D. 134, 143 (ND Tex. 1980) (quoted in Basic, 485 U.S. at 244).
“but for” cause for the purchase. But a genuinely material misstatement will likely affect the price paid.

b. Plasticity of the process. 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. To quote Justice Renquist,

“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.”

It can be seen from this statement that there was nothing inevitable about the lower courts’ pre-
Morrison use of the conducts/effects test to determine the reach of the fraud-on-the-market cause of action. Nor, given that the decision concerning reach needs to be made afresh in any event, is there any special reason for courts to return to it when a clearly reasoned policy analysis now reveals a wiser alternative.

B. The Origins of the Conduct/Effects Test

Four seminal Second Circuit cases form the origins of the conceptual framework that has been used at least until now to determine the reach of all Rule 10b-5 actions for damages, both traditional reliance based and fraud-on-the-market: Shoenbaum v. Firstbrook, Leasco v.

125 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, [   ]

126 Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), rev’d on other grounds on rehearing en banc, 405 F.2d 215 (2d Cir. 1968).
These seminal cases, however, each involved traditional reliance based claims and were decided prior to the fraud-on-the-market action. Commentators and later court decisions subsequently distilled the results of these seminal cases down to two tests: the “effects test” and the “conduct” test. The four seminal cases do not themselves use the terms “effects test” and “conduct test,” however, and both their reasoning and their holdings are more nuanced than this subsequently developed conceptual framework suggests. Each provides a plausible rationale for its decision regarding the reach of the action in the particular transnational situation before the court, but these rationales make little sense in the very different situation that characterizes a fraud-on-the-market case.


Shoenbaum involved a shareholder derivative suit filed on behalf Banf 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. Banf’s U.S. connections were that it was an Exchange Act registered company and that its shares also traded on the American Stock Exchange. Banf’s officials and its controlling shareholder Acquitaine were aware of successful oil drilling operations by Banf, but the public was not aware. Banf issued to Acquitaine Banf shares at the then market price of Banf shares, a price that allegedly did not reflect these successful drilling operations. The suit claimed that this stock transaction was

127 Leasco Data Processing Equipment Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972).


129 ITT v. Vencap, Ltd., 519 F.2d 1001 (2d Cir. 1975).
fraudulent in violation of Rule 10b-5. The defendants moved for summary judgment on the ground, among others, that the Exchange Act did not apply extraterritorially to a stock transaction occurring in Canada between two Canadian corporations. The district court granted the motion, but the Second Circuit reversed, holding that the district court did have subject matter jurisdiction (the term that the courts prior to Morrison generally used to mean that, notwithstanding transnational elements, a matter was within the reach of Rule 10b-5's prohibitions or the cause of action based thereon) 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.”

The Second Circuit begins its argument by noting that although Banff was a foreign corporation located outside the United States, it was registered under the Exchange Act and that as a result was required, in order to protect U.S. shareholders, to comply with various requirements of the Act, including making periodic mandatory disclosure filings with the SEC.

The court goes on to say:

Similarly, the anti-fraud provisions of §10(b) ... reach beyond the territorial limits of the United States and apply 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

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130Prior to Morrison, the lower courts consistently used the term “subject matter jurisdiction” to mean that the cause of action reached the matter of the case before them notwithstanding its transnational elements. Justice Scalia, in his opinion in Morrison, states that this is an incorrect use of the term, which he says “refers to a tribunal’s ‘power to hear a case’”. [insert citation]. The Court’s conclusion that the statute did not reach the conduct alleged to violate Rule 10b-5 was, in contrast, what Scalia refers to as a “merits question.” [insert cite].

131405 F.2d [FN 4]

132405 F.2d [FN 1].
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]”.

The Second Circuit dismissed the district court’s finding that the issuance of the shares to Acquitaine had no effect within the United States because the only resulting harm occurred to a foreign corporation. The Second Circuit found that such harm would reduce the value of the corporation’s shares and the price at which they were trading in the U.S. market, concluding, “this impairment of value of American investments ... has ... a sufficiently serious effect upon United States commerce to warrant assertion of jurisdiction for the protection of American investors.”

This decision has three notable features relevant to our subsequent discussion concerning the reach of fraud-on-the-market claims. The first, which has been the focus so far, is that the decision interprets Rule 10b-5 and Exchange Act §10(b) as having a jurisdictional reach broad enough to include the regulation, at least in some situations, of a share transaction that occurs outside the United States between a foreign issuer and a foreign buyer.

The second notable feature is that this decision on the reach of Rule 10b-5 occurs within the context of a derivative suit. Thus, while the court’s concern is with its conception of what it believes Congress would have wanted in terms of regulatory protection for U.S. investors, non-U.S. investors will receive the same protection. From a recovery point of view, if the action succeeds on the merits, non-U.S. investors will derivatively share equally, on a pro-rata basis with the U.S. investors, the damages received by Banf. More generally, the decision implies that


134 405 F.2d [FN 3]
non-U.S. shareholders in foreign corporations registered under the Exchange Act will have their investments subject to the kind of regulation that the U.S. believes is best for the issuer’s investors, whether or not the issuer’s home country, or the home country or countries of the non-U.S. shareholders, would agree. This is a striking result given that the non-U.S. shareholders of the typical foreign issuer, even if Exchange Act registered, will way outnumber the U.S. shareholders and often a substantial portion of these non-U.S. shareholders will be from the same country as the issuer.

The third notable feature of the decision is that the regulatory aspect of Rule 10b-5 alleged to be violated in *Shoenbaum* primarily concerns corporate governance, not the trading of shares. In reality, agents of both parties to the transaction – the directors and officers of Banf and the officials of Acquitaine – knew of the successful drilling operations. Thus, if the court had followed the usual rule of attributing to the principal – Banf – the knowledge of its agents, there could be no securities fraud because parties on both sides of the transaction were equally informed and so there was no deception. The real underlying issue is one of corporate governance: whether it was appropriate for the Banf to sell something of value to its controlling shareholder at the price that it did using the approval processes that were followed. Acquitaine, in addition to its claim of no subject matter jurisdiction, moved for summary judgment as well on the theory that Rule 10b-5 did not govern corporate governance issues of this kind. The Second Circuit, in an *en banc* decision, denied the motion. In its view, there were genuine issues of fact with respect to the plaintiff’s claim that the process by which Banf’s board approved the transaction was insufficient to legitimate the price at which the transaction occurred given
Acquitaine’s control position in Banf. Based on this alleged defect in the process of approval, the court decided that it should not attribute to Banf knowledge of the successful drilling, at least at the summary judgment stage of the litigation. With Banf being considered uninformed of material information possessed by Acquitaine, a claim of securities fraud could then be made out.

The final notable feature relates to the nature of the effect in the United States of alleged conduct abroad that would have constituted a Rule 10b-5 violation if it had occurred in the United States. In *Schoenbaum*, the alleged conduct’s sole effect in the United States was the diminution in wealth of U.S. investors. Focus on the nature of the effect is important because the finding of subject matter jurisdiction is premised entirely on the basis of the conduct’s effect in the United States. Not only did none of the alleged conduct occur in the United States, none of the defendants were U.S. persons.

2. *Leasco v. Maxwell*

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 corporation controlled by Maxwell. Some of these misstatements were made during discussions between Leasco and Maxwell or his representatives in meetings in New York and others during meetings in London. These misstatements made Pergamon look more valuable than it was. Leasco, at Maxwell’s suggestion, purchased publicly traded shares of Pergamon on the London Stock Exchange at a price in excess of their value. Pergamon was not listed on any U.S. exchange and was not registered under the Exchange Act. Maxwell argued that there was no subject matter jurisdiction
because the transaction was conducted abroad and involved shares of a foreign issuer whose shares did not trade on an American exchange (and hence did not need to be registered under the Exchange Act). The Second Circuit, in a well-known opinion by Judge Friendly, denied Maxwell’s motion to dismiss, but added in dicta that the result would have been different if all the misrepresentations had been made abroad:

We must ask ourselves whether, if Congress had thought about the point, it would not have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him purchase foreign securities abroad ... We doubt that impact on an American company and its shareholders would suffice to make the statute applicable if the misconduct had occurred solely in England, we think it tips the scales in favor of applicability when substantial misrepresentations were made in the United States.135

Again the case has several notable features relevant to our subsequent discussion of the reach of fraud-on-the-market claims against foreign issuers. To start, the ultimate effect of the misconduct — the diminution in the wealth position of a United States person as the result of a securities transaction — is as much located in the United States as it is in Schoenbaum. In Schoenbaum, none of the misconduct occurred in the United States but the court nevertheless finds subject matter jurisdiction. In contrast, Friendly says that the court would not have found subject matter jurisdiction if none of the conduct in Leasco occurred in the United States. The fact that the issuer of the shares is not registered under the Exchange Act is thus important.136 Therefore, Schoenbaum does not exactly establish an “effects” test for finding subject matter jurisdiction and Leasco an alternative “conduct” test. Rather, both cases involve effects that

135 468 F.2d [FN 1].

136 Judge Friendly explicitly uses Banf’s Exchange Act registration “to differentiate the problem here presented [in Leasco] from the point decided in Schoenbaum.” 468 F.2d [FN2].
occur in the United States and both have something more in addition. In *Shoenbaum*, the something more is registration under the Exchange Act. In *Leasco*, the something more is the fact that some of the conduct occurred in the United States.

Judge Friendly’s opinion is also interesting for its reasoning in refusing to find the location of the transaction or the nationality of the issuer to be critical in the subject matter jurisdiction determination, even for an issuer not registered under the Exchange Act. In dismissing the portion of the defense argument that there is no subject matter jurisdiction based on the fact that the place of the transaction is abroad, he observes “in [the] closely related context of choice of law, the mechanical test that, in determining the *locus delecti*, ‘The place of the wrong is in the state where the last event necessary to make an actor liable for an alleged tort takes place’ ... has given way in the case of fraud and misrepresentation to a more extensive and sophisticated analysis.” 137 In dismissing the portion of the parallel defense argument based on the fact that the nationality of the issuer is foreign, he says that given that §10(b) is not limited to securities listed on organized public markets in the United States, there is no reason why Congress “should have wished to limit the protection to securities of American issuers.” His rationale goes back, for issuers not registered under the Exchange Act, to the combined importance of effect and conduct in the United States, saying “The New Yorker who is the object of fraudulent misrepresentations

137 468 F.2d [FN3]. The opinion carries the suggestion that the place of the transaction still matters at least to some extent, however. Friendly says “When no fraud has been practiced in this country and the purchase or sale has not been made here, we would be hard pressed to find justification for going beyond *Shoenbaum*, *id.* at [FN 4], i.e., beyond finding subject matter jurisdiction based on effects in the United States alone unless the issuer is registered under the Exchange Act. This statement implies that if a transaction in the shares of an unregistered foreign issuer occurred in the United States, Friendly might find subject matter jurisdiction even if there were no fraudulent conduct in the United States or at least where the amount of conduct in the United States was less than what would be required to find subject matter jurisdiction if the transaction instead occurred abroad.
in New York is as much injured if the securities are of a mine in Saskatchewan as in Nevada.”

3. Bersch v. Drexel Firestone

Bersch involved a class action by purchasers of shares of IOS, Ltd., a company that managed mutual funds, in what were three simultaneous, coordinated public offerings of IOS shares – the “Primary offering,” the “IOB offering” and the “Crang offering” – each of which was aimed at a different set of offerees in terms of residency or employment status. There had previously been no organized public trading of IOS shares and so the overall three-offering deal was equivalent to an IPO. IOS 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. The funds it managed, while marketed to persons abroad, invested primarily in the shares of U.S. companies. Indeed their purpose was to be vehicles by which persons from abroad could, indirectly, invest in the U.S. stock market. The offering of IOS stock purported to be structured so as not to extend to residents of the United States. The vast majority of the class members were non-U.S. citizens residing outside the United States, but 22 U.S. resident Americans acquired IOS shares through the deal and were included in the class. The record does not reveal how these U.S. resident Americans acquired their shares. The complaint alleged that the prospectus in each of the three offerings contained material misstatements in violation of Rule 10b-5.

138 468 F.2d [FN 5]

139 Prior to the offering, there was no organized market for IOS shares. 519 F.2d [FN 1]

140 519 F.2d [FN 4].

141 519 F.2d [FN 5]
a. Non-U.S. resident foreigners. Judge Friendly found that the court does not have subject matter jurisdiction with respect to the claims of the non-U.S. resident foreign members of the class.\footnote{519 F.2d [FN 6]} Clearly, with respect to these plaintiffs, the materially misleading statements had no effects in the United States. Friendly’s inquiry therefore was focused on whether there was alleged conduct within the United States by any of the defendants that was sufficient by itself to create subject matter jurisdiction and he concluded there was not.

The activities that were alleged to have been undertaken in the United States in connection with the deal were primarily undertaken by the defendant Drexel. Drexel, a U.S. headquartered investment bank, was a managing underwriter for the Primary offering. The Primary offering was aimed at investors in Europe, Asia and Australia. Drexel, and the lawyers and accountants that it retained, undertook a number of activities in the United States that were associated with the Primary offering. These activities included meeting with representatives of IOS and their attorneys and accountants to organize and structure the offering, discussing preliminarily underwriting discounts and commissions, and drafting parts of the prospectus.\footnote{519 F.2d [FN 7]} The place from which the 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.

Friendly’s conclusion that there was not subject matter jurisdiction with respect to the foreign non-U.S. resident class members flows from his statement “The fraud, if there was one, was committed by placing the allegedly false and misleading prospectus in the purchaser’s hands.
Here the final prospectus emanated from a foreign source."\textsuperscript{144} In his summary of his opinion, he states "the federal securities laws ... do not apply to losses from sales of securities to foreigners outside the United States unless acts ... within the United states \textit{directly} caused such losses\textsuperscript{145}

In other words, conduct in the United States, without any effects there, can by itself give rise to subject matter jurisdiction if the U.S. conduct is sufficiently extensive relative to the total set of acts constituting the fraud. Friendly breaks new ground by suggesting the existence of such a threshold, the crossing of which would result in subject matter jurisdiction despite no effects being felt in the United States by the plaintiffs. But the suggestion is only \textit{dicta} because he finds that Drexel’s alleged U.S. conduct did not reach this less than fully defined threshold.

\textit{b. U.S. resident Americans.} Judge Friendly found that the court \textit{does} have subject matter jurisdiction with respect to the claims of the U.S. resident American members of the class.\textsuperscript{146} All of the U.S. resident American members of the class acquired their shares in the IOB offering, not the Primary offering, but the two offerings had essentially identical prospectuses. Judge Friendly "see[s] no reason there would not be subject matter jurisdiction ... on the part of defendants IOS and Cornfeld who were responsible for the IOB Offering,"\textsuperscript{147} even though their conduct appears

\begin{footnotes}
\item[144] 519 F.2d [FN2] (emphasis added). The court said it had no doubt that Drexel’s activities in the United States were sufficient for the United States to have jurisdiction to prescribe under international law and if it wished impose its rules as to whatever consequences might flow from such activities. \textit{Id.} at [FN 8]. The question of jurisdictional reach, however, is one of statutory interpretation and the court suggests it would be a mistake that the legislature necessarily intended the reach of its regulation to extend as far as would be permitted under international law. \textit{Id.}
\item[145] 519 F.2d [FN3]
\item[146] 519 F.2d [FN 9].
\item[147] \textit{Id.}
\end{footnotes}
to have largely taken place outside the United States. As for Drexel, which underwrote only the Primary Offering, not the IOB offering, subject matter jurisdiction depends “on whether their activities, whether in the United States or abroad, can be considered essential to the carrying out of the IOB offering”\(^{148}\) because of the coordinated, simultaneous nature of the two offerings. Friendly adds, “on the material before the district judge we think they can properly be, although this would be open to disproof at trial.”\(^{149}\)

Recall that in *Leasco*, the Second Circuit said that where the conduct is primarily abroad and the issuer is foreign and not Exchange Act registered, if the only effect in the United States were the diminution in the wealth of U.S. investors in the issuer’s stock, there would be *no* subject matter jurisdiction. In *Bersch*, however, it concludes that if, as it assumes at this stage of the litigation, the effects of the conduct abroad include receipt of prospectuses by investors located in the United States that induce these investors to undertake the act of investing in the issuer’s shares, then there *is* subject matter jurisdiction:

\[
\text{[A]}t\text{ the present stage we must assume that there was some mailing of the prospectuses into the United States and some reliance upon them ... [A]ction [by defendants] in the United States is not necessary when subject matter jurisdiction is predicated on a direct effect here}^{150}\]

Thus in *Leasco* Judge Friendly said in *dicta* that conduct abroad by a foreign issuer not registered

\(^{148}\)519 F.2d [FN 10]

\(^{149}\)519 F.2d [FN 11]

\(^{150}\)519 F.2d [FN 12] The court concluded that it had subject matter jurisdiction with respect to the claim by U.S. resident Americans against Arthur Andersen also, based on this reasoning. Andersen permitted its report on the IOS financials to be used in the prospectuses of the IOB offering. While the preparation of the report and the granting of permission may have occurred abroad, the IOB offering prospectus is assumed by the court to have been mailed into the United States.
under the Exchange Act could give rise to subject matter jurisdiction, but only if it had a “direct effect” in the United States. A mere diminution in U.S. investor wealth would not be such a “direct effect.” In Bersch he shows us what in his view would constitute a “direct effect.” . . . .

c. Notable features. Bersch adds to the jurisprudence of the reach of Rule 10b-5 in two ways that will be relevant to our later discussion. First, it establishes, though in dicta, that conduct alone in the United States, without any effects occurring in the United States or the defendant being a U.S. person or the issuer registered under the Exchange Act, is sufficient to establish subject matter jurisdiction. Second, the court holds that there is subject matter jurisdiction, despite the conduct being primarily abroad and the issuer being foreign and not Exchange Act registered, where the effect in the United States goes beyond a mere diminution of wealth of U.S. persons and includes the misstatement being sent into the United States and reaching investors who are induced into acting by purchasing the issuer’s securities.

4. IIT v. Vencap

This final seminal case 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 of certain corporations in which IIT had invested. 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 the trust in violation of Rule 10b-5.

IIT was organized under the laws of Luxembourg and the liquidators were Luxembourg citizens appointed by the District Court of Luxembourg. IIT was not registered under the Exchange Act or other U.S. securities laws. IIT shares “apparently were not intended to be
offered to American residents or citizens\textsuperscript{151} and only a tiny fraction of IIT’s investors were Americans.\textsuperscript{152}

The “leading player” among the defendants was Richard Pistell,\textsuperscript{153} a U.S. citizen who resided in the Bahamas. He was the organizer of the defendant Vencamp Limited, which was purported to be a venture capital company organized under the laws of the Bahamas. IIT invested in Vencap, the funds of which were subsequently allegedly misused by Pistell and entities that he controlled. While the facts concerning how IIT’s investment in Vencamp transpired were very complex and to some extent disputed, it appears that the transaction was largely negotiated outside the United States and that the closing, where IIT exchanged funds for an interest in Vencamp, occurred in the Bahamas. After Vencap obtained its financing, however, it appears to have used its law firm’s office in New York as its base. This period after the IIT financing was obtained is when the alleged funneling of funds occurred.

Among several theories presented by plaintiffs as to how the events related in the complaint constituted a violation of Rule 10b-5, Judge Friendly finds two potentially plausible. One theory is that IIT, as a shareholder of Vencamp, is essentially bringing a derivative suit on Vencamp’s behalf.\textsuperscript{154} This theory is similar to that in \textit{Shoenbaum} except that, unlike in \textit{Shoenbaum}, the issuer is not registered under the Exchange Act. Under this theory, the securities transactions in

\[\text{\textsuperscript{151}519 F.2d 1017.}\]

\[\text{\textsuperscript{152}At most, Americans constituted .2\% of IIT’s fundholders and their holdings constituted at most .5\% of the total amount invested in IIT. 519 F.2d 1016.}\]

\[\text{\textsuperscript{153}519 F.2d 1004.}\]

\[\text{\textsuperscript{154}519 F.2d 1013.}\]
connection with which the fraud occurred were the transactions between Vencamp and Pistell and his other controlled entities that, because of their unfair non-arms-length terms, funneled off funds from Vencamp to Pistell’s advantage. The other theory is that Vencamp implicitly represented to IIT in connection with obtaining IIT’s funds that Vencamp “would be run solely as a bona fide venture capital enterprise whereas in truth and fact it was intended, at least in part, to be used for Pistell’s private benefit.”¹⁵⁵ Under this theory, the securities transaction in connection with which the misstatement occurred was IIT’s investment in Vencamp.

Judge Friendly rejects two possible bases for subject matter jurisdiction. The first rejected idea is that subject matter jurisdiction in this case could be based solely on the defendant Pistell’s U.S. citizenship. He notes that while under international law jurisdiction to prescribe, the United States clearly has the authority to prohibit a U.S. citizen anywhere in the world from behaving in a way that would, if it occurred in an entirely domestic situation, violate Rule 10b-5, it is “unimaginable that Congress would have wished [§10(b)] ... to apply ... if Pistell while in London had done all the acts here charged and had defrauded only European investors.”¹⁵⁶ As for basing subject matter jurisdiction on effects in the United States, Friendly finds that given the tiny percentage of American ownership in IIT, the United States, under international jurisdiction to prescribe, would not even have the authority to prohibit the behavior with which Pistell was charged based solely on its effects in the United States.¹⁵⁷

¹⁵⁵519 F.2d 1013.

¹⁵⁶519 F.2d 1016.

¹⁵⁷519 F.2d 1017. Though not stated explicitly, the final step in the analysis — the conclusion that is no subject matter jurisdiction solely on the basis of the effects in the United States of the defendants’ alleged activities — flows directly from the determination that under international law there would be no jurisdiction to prescribe these
activities on this basis. This is because courts employ the presumption that absent explicit language to the contrary, Congress does not intend the reach of a statute to exceed what is permitted under international law. United States v. Aluminum Co. of America, 148 F.2d 416, 443 (2d Cir. 1945). Cf. Leasco Data Processing Equipment Corp. v. Maxwell, 468 F. 2d 1326, 1134 (2d Cir. 1972). There is clearly no explicit language to the contrary in the case of Exchange Act §10(b).

158 519 F.2d 1018.

159 519 F.2d 1018.

Friendly concludes, however, that, depending on further findings by the district court, conduct in the United States could be the basis for subject matter jurisdiction in the case. Under the derivative suit theory, given that Vencap appears to have used its lawyers’ offices in New York as its base after the financing from IIT was obtained, the defendants’ alleged acts of inducing of Vencap into the securities transactions by which Pistell funneled off money may have occurred in New York. Under the theory that Vencap was misrepresented as being a legitimate venture capital firm in order to induce IIT to invest, the subsequent acts that resulted in the use of part of Vencap’s funds instead being used for Pistell’s personal benefit may, given Vencap’s apparent base, also have occurred in New York. These acts “would not only be evidence of the misrepresentation but the cause of the damage.” Under either theory, if the requisite acts were in fact found to have occurred in New York, this conduct in the United States would be sufficient, apparently by itself, for there to be subject matter jurisdiction.

Friendly’s rationale for finding subject matter jurisdiction 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.\textsuperscript{160}

In sum, the most notable feature of the \textit{Vencap} decision thus was a holding to the effect that even where the issuer was foreign and not registered under the Exchange Act, the transaction occurred abroad, and the ultimate effects were essentially entirely abroad, conduct alone in the United States could give rise to subject matter jurisdiction.

\textit{5. Distillation into the Effects Test/Conduct Test Framework}

The jurisprudence developed in these four seminal cases concerning the transnational reach of Rule 10b-5 has been distilled into two tests through numerous subsequent traditional reliance cases. In accordance with the “effects test,” U.S. courts have “asserted jurisdiction over extraterritorial conduct that produces substantial effects within the United States.”\textsuperscript{161} 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.”\textsuperscript{162}

Use of these tests for determining the reach of even the traditional Rule 10b-5 reliance based fraud actions has not been straightforward. The tests are articulated vaguely. Also, the underlying the willingness of courts to find that the cause of action reaches any particular transnational situation where there is some kind of conduct in the United States or some kind of

\textsuperscript{160}519 F.2d 1017 (citations omitted).

\textsuperscript{161}See, e.g., \textit{Zoelsch v. Arthur Andersen & Co.}, 824 F.2d 27, 30 (D.C. Cir. 1987) [citing \textit{Shoenbaum}].

\textsuperscript{162}\textit{Id} [citing \textit{Bersch}].
effect appears to depend on a number of other factors. As exemplified by the four seminal cases, these factors include whether the issuer registered its securities under the Exchange Act, whether, in an effects case, there was some U.S. conduct or whether, in a conduct test case, there were some U.S. effects, whether documents containing the alleged misstatements were sent from abroad to the plaintiffs in the U.S. in a case focusing on effects or vice versa on a case focusing on conduct, and where the transaction was effected. Nevertheless, as discussed just below, the conduct/effects test approach has been reasonably workable for these traditional fraud cases.

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

The nature of the kinds of transactions that give rise to traditional reliance based actions and the way the cause of action works makes it possible to find meaningful significance in the fact that some kind of conduct occurs, or some kind of effect is experienced, in one country rather than in another and to do so in a way that is workable in terms interaction with other countries’ legal systems. The same cannot be said for fraud-on-the-market actions, which suggests that a return to the conduct/effects test would not be an appropriate way of determining their reach.

1. Traditional Reliance Based Fraud Actions

Traditional reliance based fraud cases, it will be recalled, typically involve a one-on-one transaction in the shares of a non-publicly traded issuer or an IPO with the seller 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 conduct placing the message in the investor’s
hands – typically, in an IPO, the sending out of a prospectus, and in a one-on-one deal, a communication sent directly to the potential investor – occurs abroad but the investor, who is induced into purchasing, is in the United States. Determining that this foreign conduct 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 a bullet across state lines” hypothetical, cited by Judge Friendly in Bersch, that is a key illustration in the discussion that gives rise to the effects tests in the international law jurisdiction to prescribe jurisprudence. The sending of the misstatement, like firing a bullet across state lines, is conduct that can only impose a deprivation, not a benefit, upon its target. There are no complications in the analysis arising from the investor 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 – to prevent such deprivations from occurring in the first place by deterring such conduct and to correct for the deprivation when such conduct nevertheless does occur – are sound and are as well served by applying the cause of action to conduct abroad that has its effects in the United States as by applying it to entirely domestic transactions.

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 all countries in the world use an effects test in terms of applying whatever cause of action they might have based on such conduct, the sender of a statement to an investor

163 See ALI Restatement (3rd) of Foreign Relations Law, §§402, 403; Bersch, 519 F.2d at [ ].
need be concerned with actions based on the laws of only two countries – the United States and
the country where the conduct occurred – because the action is premised on the false or
misleading nature of a statement specifically placed in the investors hands and the sender is
likely to know the location of a person to whom it is sending a message. With the universe
confined to two legal systems, both the sender and the investor will be on clear notice as to the
standards that will be used for determining whether statements made were materially false or
misleading and the consequences if they are. Moreover, imposing the U.S. traditional fraud
liability system on a 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 would give rise to a
traditional reliance based fraud action.\footnote{[Insert cite for the “most countries” proposition]}

\textit{b. Conduct test.} Consider a situation where the conduct placing the message in the investor’s
hands – typically the sending out of 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 really
matters – the reduction in the investor’s wealth position – is thus abroad. There is a 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 despite its negative effects being entirely
outside the United States. This rationale parallels Judge Friendly’s reasoning in \textit{Vencap}: extending the action to cover this situation is an act of good neighborliness toward the country
where the effects are brought. Doing so deters conduct in the United States that causes

\footnote{164 [Insert cite for the “most countries” proposition]}
deprivations to the other country’s residents and it corrects for such deprivations when such conduct nevertheless occurs. It also would encourage reciprocity so that the other country extends to U.S. residents the reach of a similar cause of action under its laws when the conduct is in its country and the effects in the United States. The availability of the foreign cause of action would be valuable to such U.S. residents even if the U.S. cause of action were, under the effects test, also available, because use of the U.S. action might involve problems in obtaining personal jurisdiction over the foreign defendant or in obtaining evidence or securing witnesses.

Finding such U.S. conduct to be within the reach of a Rule 10b-5 action is also again reasonably workable in terms of the interaction with other legal systems in the world. This situation is just the reciprocal of the traditional fraud action effects test situation discussed just above and so again the universe will be confined to two legal systems, putting both the sender and the investor will be on clear notice as to the range of conduct that would not trigger liability under either. And providing residents of the other country with a cause of action is very unlikely to create conflict with that country given that in most instances the defendants will not be its 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. She 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 thought the issuer did not trade and thus could not make any trading profits from selling at the inflated price. 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. Thus there are fundamental differences between the fraud-on-the-market action and the traditional reliance based fraud action in terms of the kinds of transactions involved and the way the action works. These differences either make highly arbitrary the use of distinctions related to where conduct occurred, or effects were felt, to determine what is and is not within the reach of the fraud-on-the-market cause of action, or they create real problems in terms of interactions with other legal systems.

a. Effects in the United States. Consider a situation where a foreign issuer with scienter makes a material misstatement outside the United States to the public media that inflates the price at which its 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 it affects the price at which the shares trade in the U.S. market. The other is that U.S. residents purchase the issuer’s shares and their wealth position is diminished because the misstatement inflated the price that they paid.

i. Effect on price in U.S. markets. An effect on a price is an effect on an abstraction. To be a meaningful basis of a legal distinction, the effect must be described with reference to an impact on real persons. To say that the issuer’s conduct affects an issuer’s share price in the
U.S. market is to say that investors who purchase their shares on the U.S. market pay more than they otherwise would have but for the conduct. But the fact that the purchase at this inflated price was in a U.S. market rather than abroad turns out to be a dubious basis for distinction. Why should investors who purchase in this U.S. market have a claim for damages and ones who purchase elsewhere not, given that the misstatement did not induce these investors to purchase in a U.S. market rather than elsewhere. Because of arbitrage, the issuer’s shares will trade at essentially the same inflated price everywhere else as well. The fact that the investor’s buy order was executed on a U.S. market rather than elsewhere is purely arbitrary. Typically the decision as to where to execute a buy order for a foreign issuer’s shares would be made by the investor’s broker, who simply tries to find the market where best execution is available at the moment. The investor may well not even know the location of the market where execution turns out to occur. Moreover, 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 else in the world and perform identically, with no one caring about its location or necessarily even knowing. There is no obvious reason why its location should be an important factor in whose claims should be within the reach of a U.S. law based cause of action.

ii. 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. If they hold until market realizes the truth and the inflation in price dissipates, they suffer a diminution in wealth from having paid the inflated price. There is of
course nothing arbitrary about U.S. law being especially concerned with the effects of conduct on U.S. residents as opposed to residents of other countries. However, relative to the traditional reliance based fraud action, making a distinction between the two types of 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. The issuer is the defendant making the payout.

To the extent that other countries of the world do not provide their resident investors with damages for the same kind of losses, extending the U.S. cause of action to U.S. resident purchasers of the issuer’s shares and not to others results in a non-pro-rata dividend to the U.S. investors paid for by investors resident in these other countries. This is particularly problematic because, unlike a traditional fraud action, a U.S. investor is as likely to be a sellers to be the beneficiary of the conduct as they are as buyers to suffer a deprivation.

To the extent that other countries move toward having fraud-on-the-market type causes of action of their own, the issuer’s conduct still does not resemble Judge Friendly’s analogy to shooting a gun across state lines. The better analogy would be the release of a cloud of gas that covers 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 is materially false or misleading and the level of mens rea or lack of care necessary for liability.

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165 See III.E supra.
b. Conduct in the United States. Now consider instead a situation where a foreign issuer with scienter makes a material misstatement to the public media that inflates the price at which its shares trade and 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.

The location of the act of public dissemination should matter little in terms of any consequences that might prompt the need for regulation. Regardless of where the act of public dissemination occurs, the misstatement of a substantial established foreign issuer whose shares trade in an efficient market is inevitably going to circulate globally in the same way in the financial media and have the same effects on the price that investors around the world pay for the issuer’s shares. Also, 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 decision making organization that the law finds responsible for the statement. Wherever the misstatement happens to be introduced into global media circulation, the top decision makers of this organization by and large operate at its headquarters, which, for a genuinely foreign issuer, is located abroad. The exact same observations can be made about the location of conduct that leads up to the dissemination of the misstatement. Finally, the location of the situation that the misstatement concerns – for example the location of the operations the performance of which the issuer falsely exaggerates – should be irrelevant. In this example, Rule 10b-5 does not prohibit performing below a certain level, it prohibits making a misstatement concerning the level of
performance, whatever that level might be.

The problem goes beyond the difficulty in finding meaning in the location of conduct. The whole rationale for taking account of conduct in the United States in traditional reliance based actions fails in the case of fraud-on-the-market cases. In contrast to the traditional reliance based fraud action, a failure to use the conduct test to extend the reach of the U.S. fraud-on-the-market regime to claims against foreign issuers by foreign purchasers effecting their transactions abroad is unlikely to cause other countries to, in Judge Friendly’s words, “look askance.” The amici briefs of several foreign governments submitted to the Supreme Court in *Morrison* suggest quite the opposite.166 Their resistance is understandable given the analysis above that fraud-on-the-market liability is really a corporate governance and liquidity enhancing device and that other countries may not judge that the resulting gains are worth the considerable cost.

**D. Resulting Pre-Morrison Case Law**

[Note: this is an abbreviated summary. Full text to come] Examples of the findings of the courts applying the conduct/effects test to fraud-on-the-market actions against foreign issuers shows the inconsistencies and incoherence in reasoning that the problems outlined above have caused. As for the conduct test, some courts maintain that filing with the SEC an Exchange Act periodic disclosure form containing a material misstatement is sufficient “conduct” in the United States to include the foreign issuer within the reach of the cause of action. Other courts maintain that such a filing is merely ministerial and would not give rise to jurisdiction unless the foreign issuer has more actively come to the United States and disseminated the misstatement. Others

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166 See note [ ] *supra.*
focus on where the filing was prepared. Still others focus on where the decision as to the content of the filing was made. Some courts find that there is conduct in the United States if actions or matters that are the subject of the misstatement occur in the United States even if the statements themselves were issued abroad, whereas others reject this idea. As for the effects test, some courts define the location of an “effect” in terms of the residency of persons who are damaged, whereas others define it in terms of where the transaction that gave rise to the damage occurred.

**IV. COMPETING ALTERNATIVES: THE _MORRISON_ TEST AND COMMENTATOR PROPOSALS**

*Note: this is an abbreviated summary. Full text to come* Another alternative for defining the reach of the fraud-on-the-market cause of action would be to use Supreme Court’s approach in _Morrison_. The Court ruled that §10(b) only reaches situations where the securities involved were listed on a U.S. exchange or where their purchase and sale was effected in the United States. 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 outside limit, absent new legislation, on the reach on the fraud-on-the-market cause of action as well. Using the _Morrison_ approach to determine the reach of the fraud-on-the-market cause of action would make it coextensive with the reach of the statute, thereby taking it 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 decision making. Where a foreign issuer lists all of its underlying common shares on the U.S. exchange, the test would actually broaden
the reach of the action to include all purchases in the world, even purchases by foreign investors in markets abroad.\textsuperscript{167} Where instead the foreign issuer lists ADRs on the U.S. exchange, or lists its underlying common shares but only a subset that can be traded exclusively on the U.S. exchange, the test would narrow the reach of the action because it would cut out U.S. purchasers who effect their purchases abroad.\textsuperscript{168} But in either case, the decision to list on a U.S. exchange would subject the foreign issuer to the risk of fraud-on-the-market actions on behalf of U.S. and foreign investors who purchase their shares on the U.S. exchange.

Use of the \textit{Morrison} test, therefore, would mean that fear of liability would continue to distort Issuer choices as to where to list their shares would persist, with the extent of the distortion and the resulting inefficiency either being aggravated or diminished depending on how the issuer would want to list its equity. This would also result in the continued needless reduction in the competitiveness of U.S. capital markets. For those foreign issuers that view this threat of liability as a detraction but find that it is outweighed by the advantages to them of a U.S. listing, the \textit{Morrison} approach would also continue the U.S. liability system’s inefficient insertion of an ill fitting U.S. corporate governance device into the overall mix already governing them pursuant to home country law and institutional structures. Also, for such issuers, unless they list all their underlying common on the U.S. exchange, their exposure to fraud-on-the-market actions on behalf of purchasers on the U.S. exchange but not of those buying abroad means the continued violation of the pro rata rule for the distribution of benefits to shareholders.

\textsuperscript{167} See [ ] \textit{infra} for a more extended discussion of the effect of using the \textit{Morrison} test to determine the breadth of the reach of fraud-on-the-market actions against foreign issuers listing on U.S. exchanges.

\textsuperscript{168} \textit{Id.}
In sum, relative to the simple rule proposed here which has none of these defects, using the *Morrison* test to determine the reach of the cause of action would unnecessarily continue to depress U.S. and global economic welfare and to create friction with other countries.

The proposals of other commentators in their criticisms of the pre-*Morrison* lower courts jurisprudence suggest yet other alternatives for determining the reach of fraud-on-the-market cause of action. To one extent or another, they have similar defects to the use of the *Morrison* test. In a frequently cited recent article, Professor Hannah Buxbaum, for example, would restrict claims against foreign issuers only to those brought by buyers, whether U.S. or foreign, who effected their purchases on U.S. markets.\(^{169}\) My colleague Professor John Coffee would likewise restrict claims by foreign buyers to those who effected their purchases on U.S. markets, but does not call for excluding the claims of U.S. buyers who effect their purchases abroad.\(^{170}\) Professor 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.\(^{171}\)

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 decision making. And each of these proposals would, 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. None, however, seriously addresses the question of what is the U.S. interest in subjecting foreign

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issuers to fraud-on-the-market actions in the first place. As a result, these other reforms have a number of disadvantageous consequences that the proposal here avoids. One of the disadvantages of the other proposals is that each would aggravate the existing law’s violation of the pro rata rule for the distribution of benefits to shareholders. Another is that the existing law’s distortions in issuer choices of where to list and investor choices in where to trade would persist, though somewhat changed in their mix. In particular, the threat of U.S. fraud-on-the-market class actions would continue to reduce the attractiveness of a listing on a U.S. exchange, thereby needlessly handicapping the competitiveness of U.S. capital markets. Finally, each of the other proposals would continue the U.S. liability system’s inefficient insertion of an ill fitting U.S. corporate governance device into the mix of devices governing foreign issuers. Because of these disadvantages, each of the other proposals would, relative to the approach advocated here, unnecessarily depress U.S. and global economic welfare and allow fraud-on-the-market class actions to continue as a source of friction with other countries.

The approach advocated here, in contrast, squarely addresses what are the U.S. stakes in imposing its liability system on unwilling foreign issuers. The finding that the benefits to the United States of doing so are small or nonexistent allows the development of a simple rule that avoids all the disadvantages that have been identified here with the other reform proposals.

VI. IMPLEMENTATION

[Note: this is an abbreviated summary. Full text to come] There are three possible routes to adoption of the simple rule proposed here: the courts, SEC rule making and legislation. Consider first the courts. After Morrison and enactment of the Dodd-Frank bill, the current law
is clear as to the only kinds of conduct that a private plaintiff potentially can claim violates §10(b) and Rule 10b-5: conduct in situations where the securities involved were listed on a U.S. exchange or where their purchase and sale was effected in the United States. As noted above, however, the range of transactions whose connection with conduct can make the conduct a violation only constitutes the outer limit of the range of transactions that would be subject to the reach of the fraud-on-the-market cause of action based on that violation. This cause of action is implied, meaning that it is entirely a creation of the courts. Thus the courts define its meets and bounds and not every transaction whose connection with conduct makes that conduct a violation need give rise to the cause of action.

After Morrison, the courts do in a sense do have a clean slate. They have no choice but to start afresh in the task of defining the reach of the fraud-on-the-market cause of action. Before Morrison, the lower courts had been using the conduct/effects test to define both the reach of the statute and the cause of action. By throwing out this test for defining the reach of the statute, the Supreme Court almost certainly discredited the method the lower courts had used to determine the reach of the cause of action. But the Supreme Court did not need to address the the issue of the reach of the cause of action because it found there was no violation of the statute in the first place. Thus, in creating the new approach to the reach of the cause of action, the courts could conclude, in accordance with the arguments here, that fraud-on-the-market actions against foreign issuers are not socially useful and therefore not include claims against them within the reach of the cause of action.

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 issues 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 only render only decisions that can be justified in opinions using a form of reasoning that is evolutionary in nature. Thus there will likely be a pull toward making any purchase of foreign issuer shares whose connection with the issuer’s conduct constitutes a violation of Rule 10b-5 is a purchase within the reach of a fraud-on-the-market cause of action. But the analysis used here may create some resistance to that pull and help the courts, as they deal with future cases, gradually nudge the law in the desired direction. For example, they can make the cause of action against foreign issuers listed on U.S. exchanges that violate the statute more difficult in various ways than ones against U.S. issuers that violate the statute.

The second possible route would be through SEC rulemaking. Section 36 of the Exchange Act grants the SEC broad exemptive authority and the full adoption of the simple rule recommended here is clearly within its power. At first blush, it might seem unlikely that the SEC would be willing to use its power in this fashion. Investor protection is practically an 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 have always been given certain concessions not afforded to U.S. issuers under the U.S. securities laws. Moreover, the SEC’s recent acceptance of financials prepared in accordance with international accounting rules
instead of U.S. GAAP for use in registered public offerings and periodic disclosure filings\textsuperscript{172} and its proposal to allow “foreign trading screens” \textsuperscript{173} (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) each 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 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 thus may well 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. The enactment of the Dodd Frank bill should add to this receptivity. Under the bill, the SEC can bring an action itself when it perceives that another country would in fact appreciate that proceedings be instituted under U.S. law in the case of conduct in the United States by a foreign issuer constitutes significant steps toward a Rule 10b-5 violation. In contrast, fraud-on-the-market class actions against foreign issuer are brought by persons who have no reason to be sensitive as to whether the action is appreciated by foreign authorities or not. The SEC will be aware of this difference and, knowing that the government has its own ability to bring suit, may

\textsuperscript{172} Acceptance From Foreign Private Issuers, Securities Act Release No. 8879, Exchange Act Release No. 57,026, 73 FR 986 (Jan. 4, 2008); see especially 17 C.F.R. 230.701(e)(4) and Form 20-F(G)(h)(2) referenced in 17 C.F.R. 249.220f. 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

\textsuperscript{173} Exemption of Certain Foreign Brokers Or Dealers, Exchange Act Release No. 58,047, 73 FR 39182 (July 8, 2008) (proposing that 17 C.F.R. 240.15a-6 be revised to allow foreign broker dealers to conduct regular business with qualified investors).
be comfortable exempting foreign issuers from private suits.

The third possible route is through legislation. Congress, by the provision in the Dodd-Frank bill mandating the SEC to prepare within 18 months a report and recommendations concerning the reach of private actions, has already indicated possible future interest in legislating in the area.

VII. CONCLUSION

[to come]