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Client Alert

BEIJING FRANKFURT HONG KONG LONDON LOS ANGELES MUNICH NEW YORK SÃO PAULO SINGAPORE TOKYO WASHINGTON, DC

SUPREME COURT LIMITS EXTRATERRITORIAL APPLICATION OF EXCHANGE ACT SECTION 10(b), BUT FINANCIAL REFORM BILL WOULD LARGELY PRESERVE SEC JURISDICTION

The Supreme Court ruled last week that §10(b) of the Securities Exchange Act of 1934 does not apply in a “foreign-cubed” case – that is, a private action involving a foreign plaintiff, a foreign defendant, and securities purchased on a foreign exchange. In *Morrison v. National Australia Bank, Ltd.* (Dkt. 08-1191), the Court ruled that there was no cause of action, focusing on the fact that the securities that plaintiffs purchased were listed only on foreign exchanges and the purchases took place outside the United States. In so ruling, the Supreme Court adopted an objective “transactional” test, rather than the Second Circuit’s more subjective “conduct” test, to determine extraterritorial application. The new test focuses on whether the purchase or sale takes place within the United States, or involves a security listed on a domestic exchange.

This standard for determining the extraterritorial reach of §10(b) is welcome news to foreign companies that access the U.S. capital markets. Concern about U.S. class actions has run high since the recent multi-billion-dollar jury verdict in the Vivendi Securities Litigation, a class action brought by French investors who purchased shares of the French media conglomerate on the Paris Exchange, as well as Americans who bought Vivendi ADRs. However, the Financial Regulatory bill discussed below, if enacted, would supersede *Morrison*, at least as far as the Court’s decision affects the power of the SEC and federal prosecutors to bring enforcement actions in cases involving foreign investors.

Background

The shares of National Australia Bank, one of the largest banks in Australia, trade on the Australia Stock Exchange, while its ADRs are listed and traded on the New York Stock Exchange. The foreign plaintiffs represented a class of Australian investors who purchased the bank’s shares in Australia on the Australia Stock Exchange.

For further information about this Client Alert, please contact:

Taisa Markus
Global Securities
+1-212-530-5165
tmarkus@milbank.com

Dorothy Heyl
Litigation & Arbitration
+1-212-530-5088
dhey@milbank.com

You may also contact any member of Milbank’s Global Securities and Litigation & Arbitration Groups. Contact information can be found at the end of this Client Alert or in the Practice Areas section at www.milbank.com.

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The alleged fraud related to deficient disclosure in National Australia's public filings of activities at its U.S. subsidiary HomeSide Lending, Inc., a mortgage servicing company, and subsequent write-downs of assets. The Australian investors claimed that the U.S. federal securities laws applied because the alleged fraud took place in the United States and the United States has an interest in ensuring that it does not export fraudulent conduct abroad.

The Second Circuit “conduct” test and the Supreme Court “transactional” test

The Exchange Act is silent as to its extraterritorial reach. Finding for National Australia, and ruling that it did not have jurisdiction to hear the case, the Second Circuit applied a multi factor “conduct” test, which turned on whether conduct in the United States was “more than merely preparatory to the fraud,” and whether particular acts or culpable failures to act within the United States directly caused losses to foreign investors abroad. Concluding that the actions taken by National Australia in Australia were “significantly more central to the fraud and more directly responsible for the harm to investors,” the Second Circuit ruled that the U.S. courts had no jurisdiction to decide the case.

The Supreme Court disagreed with the Second Circuit's approach, referring to the “conduct” test as “judicial-speculation-made-law,” but affirmed the result. In an opinion authored by Justice Scalia, the Court announced a bright-line rule for determining the application of §10(b) to predominantly foreign actions. The new test focuses on the transaction as opposed to the conduct. Specifically, the Court held that §10(b) applies only when “the purchase or sale is made in the U.S., or involves a security listed on a domestic exchange.” In the case of Australians who purchased securities on the Australia Stock Exchange, clearly the purchase was not made in the United States, or on a U.S. exchange.

The ramifications of the “transaction” test to foreign issuers and financial intermediaries who raise capital in the United States are not entirely clear, given the extreme facts at issue in *Morrison*. As Justice Ginsburg observed at the oral argument, “It has Australia written all over it.” While one of the original plaintiffs (*Morrison*) was an American who purchased an ADR, he was not part of the case that was appealed to the Supreme Court, and the issues raised with respect to ADRs were “not before us,” as Justice Scalia observed. It is also unclear from the *Morrison* opinion what circumstances constitute a transaction taking place in the United States. For example, if the security at issue is not one that trades on any exchange, there may be some question as to where the purchase or sale actually takes place for purposes of § 10(b). However, the main effect of *Morrison* will be with respect to class actions, which typically involve securities listed on exchanges.

Pending legislation

The federal securities laws may soon no longer be silent on the question of their extraterritorial application. The financial regulatory bill now pending before both houses of Congress—the “Dodd-Frank Wall Street Reform and Consumer Protection Act”—would overrule *Morrison* with respect to the enforcement power of the SEC and federal prosecutors under §10(b) (and parallel provisions in the Securities Act and the Investment Advisers Act). The legislation would function, in other words, like the Private Litigation Securities Reform Act of 1995, which was enacted after the Supreme Court ruled in *Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), that private plaintiffs could not bring cases based on the alleged “aiding and abetting” of primary

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violations by secondary actors, such as accountants. Fifteen years ago, Congress acted to preserve the SEC's power to bring such cases, even while it let stand a Supreme Court ruling that barred private suits against secondary actors based on an aiding-and-abetting theory.

The statutory standard now being considered by Congress would apply in SEC and criminal actions when a securities transaction occurs outside the United States and involves only foreign investors if there is "conduct within the United States that constitutes significant steps in furtherance of the violation." This standard is slightly different from the one the SEC advocated in the Solicitor General's amicus curiae brief in *Morrison*: fraud involving "significant conduct in the United States that is material to the fraud's success." The meaning of "significant steps in furtherance of a violation" remains to be seen, if the bill becomes law. No matter what happens with the legislation and its use by the SEC, foreign companies can take some comfort in the cessation, at least for the foreseeable future, of U.S. class actions brought by foreign plaintiffs involving securities of foreign issuers purchased on a foreign exchange.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any member of our Global Securities and Litigation & Arbitration Groups listed below.

Global Securities

James Ball	New York	212-530-5515	jball@milbank.com
Paul Denaro	New York	212-530-5431	pdenaro@milbank.com
Michael Fitzgerald, <i>Chair</i>	New York	212-530-5224	mfitzgerald@milbank.com
Joy Gallup	New York	212-530-5211	ygallup@milbank.com
Naomi Ishikawa	Singapore	65-6428-2525	nishikawa@milbank.com
Taisa Markus	New York	212-530-5165	tmarkus@milbank.com
Marcelo Mottes, <i>Practice Group Leader</i>	New York	212-530-5602	mmottes@milbank.com
Robert Mullen	New York	212-530-5150	rmullen@milbank.com
Arnold Peinado	New York	212-530-5546	apeinado@milbank.com
Anthony Root	Hong Kong	852-2971-4842	aroot@milbank.com
Tom Siebens	London	44-20-7615-3034	tsiebens@milbank.com
Edward Sun	Beijing	86-10-5969-2772	esun@milbank.com
Douglas Tanner	New York	212-530-5505	dtanner@milbank.com
Robert Williams	New York	212-530-5516	rwilliams@milbank.com
Joshua Zimmerman	Hong Kong	852-2971-4811	jzimmerman@milbank.com

Litigation & Arbitration

Wayne M. Aaron	New York	212-530-5284	waaron@milbank.com
Thomas A. Arena	New York	212-530-5328	tarena@milbank.com
Sander Bak	New York	212-530-5125	sbak@milbank.com
James N. Benedict, <i>Chair</i>	New York	212-530-5696	jbenedict@milbank.com
James G. Cavoli	New York	212-530-5172	jcavoli@milbank.com
Christopher E. Chalsen	New York	212-530-5380	cchalsen@milbank.com
David S. Cohen	Washington, DC	202-835-7517	dcohen2@milbank.com
Linda Dakin-Grimm	Los Angeles	213-892-4404	ldakin-grimm@milbank.com
Scott A. Edelman	New York	212-530-5149	sedelman@milbank.com
Gregory Evans	Los Angeles	213-892-4488	gevans@milbank.com
David R. Gelfand	New York	212-530-5520	dgelfand@milbank.com
John M. Griem, Jr.	New York	212-530-5429	kgriem@milbank.com
Douglas W. Henkin	New York	212-530-5393	dhenkin@milbank.com
Michael L. Hirschfeld	New York	212-530-5832	mhirschfeld@milbank.com
Lawrence T. Kass	New York	212-530-5178	lkass@milbank.com
Robert J. Koch	Washington, DC	202-835-7520	rkoch@milbank.com
Andrew M. Leblanc	Washington, DC	202-835-7574	aleblanc@milbank.com
Robert J. Liubicic	New York	212-530-5333	rliubicic@milbank.com
Jerry L. Marks	Los Angeles	213-892-4550	jmarks@milbank.com
Sean M. Murphy	New York	212-530-5688	smurphy@milbank.com
Michael M. Murray	New York	212-530-5424	mmurray@milbank.com
Michael D. Nolan	Washington, DC	202-835-7524	mnolan@milbank.com
Daniel Perry	Los Angeles	213-892-4546	dperry@milbank.com
Stacey J. Rappaport	New York	212-530-5347	srappaport@milbank.com
Mark Scarsi	Los Angeles	213-892-4580	mscarsi@milbank.com
Richard Sharp	New York	212-530-5209	rsharp@milbank.com
Julian Stait	London	44-20-7615-3005	jstait@milbank.com
Alan J. Stone, <i>Practice Group Leader</i>	New York	212-530-5285	astone@milbank.com
Errol B. Taylor	New York	212-530-5545	etaylor@milbank.com
Andrew E. Tomback	New York	212-530-5971	atomback@milbank.com
Fredrick M. Zullow	New York	212-530-5533	fzullow@milbank.com

Offices Worldwide

Beijing Frankfurt Hong Kong London Los Angeles Munich New York São Paulo Singapore Tokyo Washington, DC