Extraterritoriality and American Depository Receipts: The Evolution of Section 1 O(b) from Morrison to Dodd-Frank

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Extraterritoriality and American Depository Receipts: The Evolution of Section 10(b) from 
Morrison to Dodd-Frank

Kelly Anderson

Part I. Introduction

Extraterritoriality refers to the application of domestic laws outside of the jurisdiction. Conflicts can arise either between state laws and those of a foreign nation or between federal statutes and foreign laws; both of these are issues of choice or law or legislative jurisdiction.

According to the presumption against extraterritoriality—one of the essential canons of construction—when Congress fails to specify whether its laws apply extraterritorially, courts are instructed to assume that they do not. The presumption reflects the general view that Congress is primarily concerned with domestic conditions and with not offending international comity, an international principle that involves respect for other countries' laws.

Arguably one of the most important decisions in the last few decades concerning application of the presumption is *Morrison v. National Australia Bank*. In this case, the Supreme Court determined that the presumption applied to the securities antifraud statute, Section 10(b) (hereinafter “Section 10(b)” or “10(b)”). Section 10(b) of the Exchange Act declares that it is “unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in

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2 Id.


6 Id. at 2881.
contravention of such rules and regulations as the Commission may prescribe[].” According to the *Morrison* court, since the statute did not give a clear indication of extraterritorial application, then Congress must not have intended it to apply extraterritorially. Further, since the statute specifically refers to purchases and sales of securities, its focus must be on the location of the transaction, rather than on the location of the fraud.

The *Morrison* decision was important in two key respects. First, it transformed the presumption against extraterritoriality into a two-step inquiry. Now, a plaintiff who wants to argue that a law should be applied extraterritorially might “try to show that Congress wanted its law to apply, or else argue that the case is sufficiently domestic, so that no congressional mandate need be shown to justify the statute's application.” Second, it abrogated the *conduct and effects test* that had governed Second Circuit jurisprudence for roughly four decades.

According to the *Morrison* Court, whether significant conduct in perpetration of a fraud occurs on U.S. soil or whether the effects of the fraud are felt in the U.S. no longer determines whether Section 10(b) will apply to the purchases and sales of securities. Rather, Section 10(b) will apply if the dispute involves: (1) “securities listed on domestic exchanges;” or (2) “domestic transactions in other securities.” The Supreme Court criticized the Second Circuit for ignoring the traditional presumption against extraterritorial application of statutes and for crafting a test

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8 *Morrison*, 130 S. Ct. at 2873.
9 Id. at 2874.
11 Id.
13 *Morrison*, 130 S. Ct. at 2869.
14 Id. at 2884.
that had no textual support and produced inconsistent results.\textsuperscript{15} But, even this seemingly straightforward approach left many open questions, such as the definition of a domestic transaction and to whom it applies.\textsuperscript{16}

Shortly after the Supreme Court announced the \textit{Morrison} decision, Congress passed the Dodd-Frank Act.\textsuperscript{17} In this Act, Congress essentially codified the conduct and effects test of the Second Circuit for actions brought by the SEC or the DOJ only.\textsuperscript{18} In Section 929Y of the Act, Congress called for a survey of potential solutions to the extraterritoriality question in relation to private actions.\textsuperscript{19} This survey serves as a springboard for the following discussion and for advocating a more “bright-line” approach to the treatment of American Depository Receipts (ADRs). This Comment argues that the best approach is to maintain the \textit{Morrison} transactional test, but to redefine the second prong by clarifying that domestic transactions include instances in which \textit{irrevocable liability} is incurred in the United States.

Part II of the Comment examines the history of Section 10(b) jurisprudence from the Second Circuit’s conduct and effects tests to the transactional approach in \textit{Morrison} and introduces the concept of irrevocable liability. Then, it will explain how the Dodd-Frank Act left open the question of whether \textit{Morrison} is still good law and how the courts will treat private causes of action. Part III will offer some background on American Depository Receipts (ADRs), explain how they work, and distinguish between the different types of ADRs. Part IV will

\textsuperscript{15} \textit{Id.} at 2873–74.
\textsuperscript{16} See, e.g., Absolute Activist Value Master Fund Ltd. v. Ficeto, 672 F.3d 143, 152–53 (2d Cir. 2012) (“[R]ather than looking to the identity of the parties, the type of security at issue, or whether each individual defendant engaged in conduct within the United States, we hold that a securities transaction is domestic when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States.”); SEC v. Ficeto, 839 F. Supp. 2d 1101, 1108 (S.D.N.Y. 2010) (“We do not agree that \textit{Morrison} held that fraud on the domestic over-the-counter market does not fall within the prohibitions of § 10(b) except where the trades qualify independently as ‘domestic transactions.’”).
\textsuperscript{17} Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010).
\textsuperscript{18} \textit{Id.} at § 929P(b)(2).
\textsuperscript{19} \textit{Id.} at § 929Y.
discuss different courts’ analysis of complex financial instruments and these courts’ interpretations of extraterritoriality in ADR cases. Part V discusses the findings of 929Y, and recommends an approach that leaves the *Morrison* approach largely intact, while safeguarding against the unfortunate circumstance mentioned in Justice Stevens’ concurrence—the possibility of a fraud perpetrated on U.S. soil involving a foreign issuer and a foreign security.20 This Comment advocates for an approach that maintains the transactional test, while adopting the irrevocable liability definition for domestic transactions and thereby partially resurrecting the conduct test. This Comment also discusses how a bright-line rule will impact other types of complex financial instruments, such as contracts for difference (CFDs) and security-based swaps. Part VI concludes by summarizing the major points of the argument, calling on Congress to clarify the uncertain future of private causes of action for 10(b) violations, and suggesting that Congress institute the irrevocable liability standard for domestic transactions.

**Part II. History and Development of Section 10(b)**

**A. Early Interpretations of Extraterritoriality: The Second Circuit’s Conduct and Effects Test**

Since 1968, the Second Circuit, widely regarded as the go-to venue for securities litigation given that the premier stock exchanges in the United States are all within its jurisdiction, helped guide the interpretation of extraterritoriality claims under Section 10(b).21 The Second Circuit first articulated the effects test in *Schoenbaum v. Firstbrook*.22 In *Schoenbaum*, an American shareholder of a Canadian oil company brought suit alleging that the company defrauded investors by selling significantly undervalued treasury shares to finance a

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22 *Schoenbaum*, 405 F.2d 200, *invalidated by Morrison*, 130 S. Ct. 2869.
According to the court, Congress intended Section 10(b) to “protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities.” In this case, since the alleged deceit could have reasonably impacted the value of Amex-listed equities, the plaintiffs successfully argued that Section 10(b) applied.

In 1972, the Second Circuit offered an alternative approach to Section 10(b): the conduct test. In *Leasco Data Processing Equipment Corp. v. Maxwell*, the U.S. plaintiffs alleged that defendant Maxwell deceived them into purchasing over-inflated shares of Pergamon Press Limited, a British publishing company listed on the London Stock Exchange. Since Maxwell had made several trips to Leasco in New York to solicit the investment, the court concluded that significant conduct in perpetrating the fraud occurred on U.S. soil. Interpreting Congress’s intent, the court concluded that “when, as here, there has been significant conduct within the territory, a statute cannot properly be held inapplicable simply on the ground that, absent the clearest language, Congress will not be assumed to have meant to go beyond the limits recognized by foreign relations law.” Since Maxwell’s conduct while in New York induced the plaintiffs to buy the shares (and subsequently lose money when the price fell), the court determined that Section 10(b) applied.

Although the two cases seemed to establish a clear dictate on when Section 10(b) should apply, subsequent court interpretations surrounding the meaning of conduct seemed to blur the

23 *Id.* at 205.
24 *Id.* at 206 (emphasis added).
25 *Id.* at 208–09.
26 *Leasco*, 468 F.2d at 1326 (2d Cir. 1972), *invalidated by Morrison*, 130 S. Ct. 2869.
27 *Id.* at 1330.
28 *Id.* at 1330–33.
29 *Id.* at 1334.
30 *Id.*
approach.\textsuperscript{31} For example, in \textit{Zoelsch v. Arthur Andersen & Co.}, the Court of Appeals for the D.C. Circuit concluded that 10(b) would only apply when the referenced conduct in itself constituted a securities violation.\textsuperscript{32} By contrast, other courts, such as the Third, Eighth, and Ninth Circuits, found that “some conduct” in perpetration of the fraud was sufficient.\textsuperscript{33}

Eventually, some courts even chose to adopt a hybrid approach, applying both tests to the same set of facts in order to determine “whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than [to] leave the problem to foreign countries.”\textsuperscript{34} For example, in \textit{SEC v. Berger}, the court balanced the two approaches, ultimately determining that while it was likely that the alleged fraud would have satisfied the effects test, there was sufficient evidence to justify 10(b) jurisdiction based on the conduct test alone.\textsuperscript{35} Given these varying interpretations of the Second Circuit’s two approaches, the Supreme Court, on June 24, 2010, elected to use the \textit{Morrison} case as a forum for resolving the varying interpretations of 10(b) extraterritoriality.\textsuperscript{36}

\textbf{B. Morrison v. National Australia Bank}

During the relevant period, National Australia Bank (the “Bank”) was the largest bank in Australia.\textsuperscript{37} In 1998, the Bank bought Homeside Lending, Inc., a mortgage servicing company

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{32} \textit{Zoelsch}, 824 F.2d at 31 (“The Second Circuit's rule seems to be that jurisdiction will lie in American courts where the domestic conduct comprises all the elements of a defendant's conduct necessary to establish a violation of section 10(b) and Rule 10b-5.”).
\item \textsuperscript{34} Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 985 (2d Cir. 1975).
\item \textsuperscript{35} Berger, 322 F.3d at 192–93; \textit{see also} Psiminos v. E.F. Hutton & Co., Inc., 722 F.2d 1041, 1045 (2d Cir. 1983) (“Since we find that there is jurisdiction under the [conduct test], we do not need to reach the question whether the effects test provides an independent basis for jurisdiction.”).
\item \textsuperscript{36} \textit{Morrison}, 130 S. Ct. 2869 (2010).
\item \textsuperscript{37} \textit{Id.} at 2875.
\end{itemize}
\end{footnotesize}
based in Florida. Although National Australia Bank touted Homeside’s early success, the Bank eventually wrote down more than $2 billion in assets after it was discovered that the company used unrealistically low rates for risk of prepayment in its model, causing the assets to appear significantly more valuable than they actually were. These actions prompted a precipitous decline in stock price and a loss of goodwill.

The District Court dismissed the action based on a lack of subject matter jurisdiction pursuant to Federal Rule of Civil Procedure 12(b)(6). The Court of Appeals affirmed, arguing that the fraud arose from the actions of the corporate officers in Australia, rather than the accounting manipulation in Florida. Therefore, since the conduct at the center of the fraud occurred abroad, the court declined the exercise subject matter jurisdiction.

As a threshold matter, the Supreme Court first had to address the issue of jurisdiction. Subject matter jurisdiction refers to the determination of whether or not a court is permitted to rule on a particular issue, depending on various factors, such as the nature of the case and the relief sought. Prior to Morrison, the extraterritorial reach of Section 10(b) itself determined whether a court could hear a case. Instead, the majority argued that the extraterritorial application of Section 10(b) was a merits question, and therefore dismissal on the basis of subject matter jurisdiction was not appropriate. In the end, the Morrison case was dismissed anyway—

38 Id.
39 Id. at 2875–76. A company will write down (reduce the value of) an asset when the value shown on the company’s balance sheet (book value) exceeds its market value.
40 Id. at 2876.
41 Id.
43 Id.
45 BLACK’S LAW DICTIONARY 931 (9th ed. 2009).
46 If Section 10(b) applied, the court could hear the case. If not, the case was automatically dismissed on the grounds of subject matter jurisdiction.
47 Morrison, 130 S. Ct. at 2877.
a decision that still falls within the purview of Federal Rule of Civil Procedure 12(b)(6)—so there was no need for remand.\textsuperscript{48}

The Court then rejected the conduct and effects tests that had prevailed in the Second Circuit for decades, and opted instead for a transactional approach.\textsuperscript{49} In the court’s view, the purpose of the Exchange Act was not merely to punish \textit{any} deceptive conduct but to punish “deceptive conduct ‘in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.’”\textsuperscript{50} The Supreme Court explained that, according to the essential canons of statutory construction, there is a presumption against extraterritorial application when Congress does not expressly indicate otherwise.\textsuperscript{51} The Court did not find a sufficient “textual or even extratextual basis” for assuming that 10(b) should apply extraterritorially.\textsuperscript{52} Based on the express language found in the Exchange Act, the Supreme Court concluded that Congress intended 10(b) to apply to: (1) “securities listed on domestic exchanges;” or (2) “domestic transactions in other securities.”\textsuperscript{53} This test is known as the bright-line or “transactional approach” to 10(b) application, and it supplanted the Second Circuit approach, which the Court found had suffered from unpredictable and inconsistent application.\textsuperscript{54}

The Court’s finding that extraterritoriality concerns precluded foreign plaintiffs holding the foreign securities of a foreign issues (so-called F-cubed litigation) from bringing a Section 10(b) fraud action in U.S. court was unanimous.\textsuperscript{55} All eight justices agreed that the United States

\textsuperscript{48} \textit{Id.} (“Since nothing in the analysis of the courts below turned on the mistake, a remand would only require a new Rule 12(b)(6) label for the same Rule 12(b)(1) conclusion.”).
\textsuperscript{49} Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972), \textit{invalidated by Morrison}, 130 S. Ct. 2869; Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), \textit{invalidated by Morrison}, 130 S. Ct. 2869.
\textsuperscript{50} \textit{Morrison}, 130 S. Ct. at 2884 (citing 15 U.S.C. § 78j(b)).
\textsuperscript{51} \textit{Id.} at 2879.
\textsuperscript{52} \textit{Id.} at 2881; \textit{see also} Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., 753 F. Supp. 2d 166, 176 (S.D.N.Y. 2010).
\textsuperscript{53} \textit{Morrison}, 130 S. Ct. at 2884.
\textsuperscript{54} \textit{Id.} at 2878.
\textsuperscript{55} \textit{Id.}
was not the proper forum for this predominantly foreign dispute. Even so, Justice Stevens (joined by Justice Ginsberg) concurred, arguing that since this case was so easily decided (given that essentially none of the parties had any ties to the United States), it was unnecessary to abrogate the decades-old Second Circuit approach. As well, Justice Breyer wrote separately in order to reinforce that although Section 10(b) did not apply, fraudulent conduct may still fall within the purview of other state or federal antifraud statutes.

C. How Dodd-Frank Complicated the Extraterritoriality Question

Shortly after the Supreme Court issued its ruling in *Morrison*, Congress responded by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act ("The Dodd-Frank Act" or "The Act"). The Act appears to rebuke *Morrison* and reinstate the Second Circuit’s conduct and effects tests but only as applied to public actions brought by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ). Under both the Securities Act of 1933 and Securities Exchange Act of 1934, actions by the SEC or the DOJ are permissible as long as the claims involve: (1) "conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors"; or (2) "conduct occurring outside the United States that has a foreseeable substantial effect within the United States." Although the language of the Act appears to be a strong indication of congressional intent, the language contains two key

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56 Id. "Justice Sotomayor took no part in consideration or decision." Id. at 2870.
57 Id. at 2888 (Stevens, J., concurring) ("I would adhere to the general approach that has been the law in the Second Circuit, and most of the rest of the country, for nearly four decades.").
58 Id. at 2884 (Breyer, J., concurring) ("Thus, while state law or other federal fraud statutes . . . may apply to the fraudulent activity alleged here to have occurred in the United States, I believe that § 10(b) does not. This case does not require us to consider other circumstances.").
59 Dodd-Frank Act, Pub. L. No. 111-203.
60 Id.
61 Id.
faults. First, it does not expressly overrule *Morrison*, and second, it does not address extraterritoriality questions for private causes of action. Therefore, the future of Section 10(b) in private actions remains uncertain.

D. The Irrevocable Liability Approach

The approach recommended in this comment seeks to preserve, but refine the *Morrison* approach, as it pertains to private causes of action. By adopting the Second Circuit’s irrevocable liability approach to refine the definition of “domestic transactions,” it casts a slightly wider net in order to capture some transactions in which a foreign issuer perpetrates a fraud on U.S. soil, while simultaneously seeking to minimize the risk to international comity. The concept of irrevocable liability dates back to the Second Circuit’s 1954 decision of *Blau v. Ogsbury*. In that case, the court had to determine whether the shareholder bound himself to a stock purchase, or in legal parlance “incurred an irrevocable liability” when he mailed his notice of election to purchase the shares or when he actually paid for the shares three years later. The court held that the plaintiff incurred irrevocable liability when the letter was mailed—thus forming an “executory transaction,”—and therefore actual payment could not also constitute a “purchase.”

The courts later resurrected the concept of irrevocable liability in *Plumbers’ Union Local No. 12 Pension Fund v. Swiss Reinsurance Company*. Drawing from the language of *Blau v. Ogsbury*, the court explained that an investor became a “purchaser” when “he or she ‘incurred an

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62 *Id.*
63 *Id.*
64 *Id.*
65 210 F.2d 426 (2d Cir. 1954).
66 *Id.* at 427.
67 *Id.*
irrevocable liability to take or pay for the stock."\textsuperscript{69} Although the plaintiffs argued that irrevocable liability arises when an investor places a purchase order for a security, the judges highlighted that other courts have already summarily rejected this definition.\textsuperscript{70} The court explained that the "Exchange Act requires that 'context' be considered in constructing terms such as 'purchase.'"\textsuperscript{71} As such, an investor's residency, where they made the decision to invest, where they suffered the harm, where the order was placed, and where the trade was executed were all insufficient bases upon which to assert 10(b) application.\textsuperscript{72} Although the court did not specifically lay out at which point irrevocable liability would be incurred in this case, it stated conclusively that the facts of the case did not meet this test.

Approximately nine months later, the Southern District of New York again addressed the issue of irrevocable liability.\textsuperscript{73} There, the court explained that a purchaser incurs irrevocable liability to "take or pay" for a stock at the same time that the seller incurs irrevocable liability to deliver the security.\textsuperscript{74} Simply distributing marketing materials and exchanging emails that encouraged an investor to purchase a stock by itself does not create irrevocable liability,

\textsuperscript{69} \textit{Id.} at 177; \textit{see also} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) ("[T]he holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for purposes of Rule 10b-5, not because of a judicial conclusion that they were similarly situated to 'purchasers' or 'sellers,' but because the definitional provisions of the 1934 Act themselves grant them such a status.") (emphasis added).


\textsuperscript{71} \textit{Plumbers' Union Local No. 12}, 753 F. Supp. 2d at 177.

\textsuperscript{72} \textit{Id.} at 178.


\textsuperscript{74} \textit{Id.} at 157–158.
according to the court. Therefore, the SEC failed to establish that the transaction occurred in the United States.

Similarly, in Liberty Media Corp. v. Vivendi Universal, S.A., the court likened irrevocable liability to "entering into a binding contract." In 2001, Liberty Media agreed with Vivendi executives to exchange its shares of multiThematiques for Vivendi American Depository Shares (ADSs). Thereafter, defendants were accused of defrauding plaintiffs when, instead of delivering ADSs, they were given ordinary shares when the merger closed. The plaintiffs complained that this transaction constituted a breach of the original merger agreement, which expressly called for delivery of ADSs. The court concluded that the merger agreement was a binding contract and therefore the defendant incurred irrevocable liability at the point the merger agreement was executed. Moreover, even if conditions remained or the agreement was amended thereafter, the parties were still bound by the initial agreement.

These cases demonstrate that partial or revocable liability will not suffice. The plaintiff must definitively establish that the seller incurred irrevocable liability. Simply marketing a security or executing a trade is insufficient. But, for example, execution of a merger agreement or a transfer of title will yield irrevocable liability. Therefore, if Congress did opt to define "domestic transaction" in terms of irrevocable liability, it may be worthwhile to create a representative list of instances that satisfy the definition of incurring irrevocable liability in order

75 Id. at 157; see also Basis Yield Alpha Fund (Master) v. Goldman Sachs Grp. Inc., 798 F. Supp. 2d 533, 537 (S.D.N.Y. 2011) (holding that a fraudulent statement made to New York-based managing director that induced him to purchase the stock was insufficient to claim irrevocable liability).
77 Id. at 268.
78 Id.
79 Id.
80 Id.
81 Id. at 269.
to maintain Morrison's bright line and avoid inadvertently reinstating a full version of the conduct test.

**Part III. What Are ADRs and How Do They Work?**

The issue of whether or not Section 10(b) applies is even more complicated when the security itself has both foreign and domestic facets. American Depository Receipts ("ADRs"), for example, present a unique challenge to the Morrison approach. An ADR is essentially a certificate that represents a U.S. investor's ownership of a foreign stock.\(^{83}\) Although the ADR is the actual physical certificate signifying an investor's ownership interest in a foreign security, and an American Depository Share ("ADS") is the security itself, these terms are often used interchangeably, and this Comment will treat them as such.\(^{84}\) Each ADR may represent one share, many shares, or fractional shares of a foreign stock, and the price of each ADR depends on the listed price of the underlying security in the issuer's home market.\(^{85}\) The allure of the ADR—versus actually listing ordinary common shares on an exchange—is that ADRs offer a cost-effective way to raise new capital or reach new investors without necessarily having to incur the expense of the expensive reporting requirements of the SEC.\(^{86}\)

Among other things, the creation of ADRs allowed investors access to foreign markets—thereby permitting international diversification of their portfolios—and generate new ways to raise capital.\(^{87}\) To create an ADR, foreign securities are deposited with a custodian, usually a domestic bank or trust company, which holds the securities for its counterpart bank or trust

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\(^{83}\) SEC Study, *supra* note Error! Bookmark not defined., at A1 (An ADR is "a negotiable security that represents an ownership interest in a specified number of foreign securities that have been placed with a depository financial institution by holders of such securities").

\(^{84}\) SEC Study, *supra* note Error! Bookmark not defined., at A1, n.1.


company in the United States.\textsuperscript{88} The trust company will, in turn, issue negotiable receipts to distribute to U.S. investors.\textsuperscript{89} These receipts are listed in U.S. dollars, and the custodian, where applicable, is responsible for issuing dividends and reporting on major corporate events in English.\textsuperscript{90}

There are two primary classes of ADRs: sponsored and unsponsored.\textsuperscript{91} For a sponsored facility, the ADR is “created jointly by the issuer and the depository through the execution of a deposit agreement and a registration statement on Form F-6.”\textsuperscript{92} By contrast, an unsponsored ADR is created independently of the issuer, although sometimes the depository will solicit letters of non-objection.\textsuperscript{93} The shares are usually not listed on any national exchange and, since the relationship between custodian and the company is informal, the company may not be required to make any filings with the SEC.\textsuperscript{94} Domestic exchanges, such as the NYSE and the American Stock Exchange (Amex), generally refuse to list ADRs, so investors will typically trade such instruments over-the-counter and on the Pink Sheets.\textsuperscript{95}

ADRs are divided into three official levels: Level I, II, and III. Level I ADRs are traded over-the-counter, do not raise new capital, and are subject to only minimal registration and reporting requirements—a company usually only has to sign a registration statement.\textsuperscript{96} Similarly, Level II ADRs do not raise new capital, but since they are listed on a domestic

\textsuperscript{88} SCOTT & GELPERN, supra note 86, at 122.
\textsuperscript{89} Id.
\textsuperscript{90} Id.
\textsuperscript{91} Saunders, supra note 87, at 54–57.
\textsuperscript{92} SCOTT & GELPERN, supra note 86, at 123.
\textsuperscript{93} Id.
\textsuperscript{94} Id. (“While issuer participation is not necessary in establishing an unsponsored facility, its cooperation may be necessary. If the issuer is not exempt from reporting under the 1934 Act, the issuer must apply for the 12g3-2(b) exemption.”).
\textsuperscript{95} Id. Over-the-counter stocks refer to those “[n]ot listed or traded on an organized securities exchange.” BLACK'S LAW DICTIONARY 1214 (9th ed. 2009). A pink sheet is a “daily publication listing over-the-counter stocks, their market-makers, and their prices.” Id. at 1265.
\textsuperscript{96} SCOTT & GELPERN, supra note 86, at 124.
exchange, they are subject to heightened reporting requirements.\footnote{Id.} Level III ADRs are most closely analogous to stocks in that they raise new capital, are listed on the major exchanges—such as the NYSE, NASDAQ and Amex—and must be reported to the SEC.\footnote{Id.}

Alternatively, some issuers may opt to distribute their securities through a 144A offering, in which the securities are distributed only to qualified institutional investors.\footnote{Private Resales of Securities to Institutions, 17 C.F.R. § 230.144A(a)(1) (2011); Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 391–92 (4th ed. 2001).} In a 144A offering, an issuer offers a limited number of restricted shares to qualified institutional buyers\footnote{Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6862, 55 Fed. Reg. 17,933, 17,934 (Apr. 23, 1990) (defining a Tier One qualified institutional buyer as one with more than $100 million in assets).} only in order to avoid the registration requirements of the SEC.\footnote{William K. Sjostrom, Jr., The Birth of Rule 144a Equity Offerings, 56 UCLA L. Rev. 409, 422 (2008).} Since the shares are not registered, it allows an issuer to raise new capital, while avoiding the expensive reporting requirements of the SEC.\footnote{Loss & Seligman, supra note 99, at 434–37.} These shares raise new capital for the issuer, but are not listed and are generally exempt from nearly all registration and reporting requirements.\footnote{Scott & Gelpen, supra note 86, at 124.} The drawback of these offerings is that even the buyers are prohibited from re-selling the securities without first registering them or finding an applicable exemption.\footnote{Id. at 122–24.}

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<thead>
<tr>
<th>Classes of ADRs</th>
<th>Listing</th>
<th>Capital</th>
<th>Filing Requirements</th>
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</thead>
<tbody>
<tr>
<td>Level I</td>
<td>Over the Counter</td>
<td>Do not raise new capital for the issuer</td>
<td>Minimal (usually only need to file a registration statement)</td>
</tr>
<tr>
<td>Level II</td>
<td>Listed on a domestic exchange, such as NYSE or NASDAQ</td>
<td>Do not raise new capital for the issuer</td>
<td>Heightened reporting requirements</td>
</tr>
</tbody>
</table>
Depending on the type, ADRs may fall under either prong of the *Morrison* test. Courts tend to disagree on whether ADRs qualify as listed on a domestic exchange, a domestic transaction, or neither. Some courts have characterized ADRs as a “predominantly foreign securities transaction,” suggesting that Section 10(b) should not apply. But, according to the SEC, “[w]hen you buy and sell ADRs you are trading in the U.S. market. Your trade will clear and settle in U.S. dollars.” The SEC definition suggests that ADRs function like U.S. securities and therefore one would assume Section 10(b) should apply. As of the publication of this Comment, it seems as though the majority of courts are willing to extend application of Section 10(b) to ADRs.

**Part IV. How ADRs Have Fared Since *Morrison***

Prior to the *Morrison* decision, courts generally found that holders of ADRs could assert antifraud claims under Section 10(b). In *In re SCOR Holding*, the plaintiffs asserted antifraud claims against a multinational reinsurer headquartered in Switzerland, claiming that the company misrepresented the sufficiency of their loss reserves in North America. Applying the Second Circuit’s conduct and effects test, the court found that, while the holders of foreign securities

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<table>
<thead>
<tr>
<th>Level III</th>
<th>Listed on a domestic exchange, such as NYSE or NASDAQ</th>
<th>Raise new capital for the issuer</th>
<th>Mandatory reporting requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>144A Offering</td>
<td>Not listed on any domestic exchange</td>
<td>Raise new capital for the issuer</td>
<td>Typically, exempt from reporting requirements</td>
</tr>
</tbody>
</table>

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108 *International Investing, supra* note 85.
110 *In re SCOR Holding (Switzerland) AG Litig.*, 537 F. Supp. 2d at 556.
were not permitted to assert a claim, the claim by ADS holders was permissible. 111 In particular, the court considered that seven to eleven percent of the company’s shares traded in the form of ADSs on the NYSE; therefore, the court held that the fraud had a substantial effect on the United States and its citizens. 112

Even under the new Morrison approach, courts have generally favored application of 10(b) to claims by ADR holders. In 2010, the district court for the Central District of California ruled that ADR holders could maintain an antifraud suit against Toyota. 113 The court held that “domestic transactions” under Section 10(b) included “purchases and sales of securities explicitly solicited by the issuer within the United States rather than transactions in foreign-traded securities where the ultimate purchaser or seller has physically remained in the United States.” 114

Similarly, the District Court for the Southern District of New York ruled that the mere involvement of “some domestic activity” would not be sufficient to overcome the presumption against extraterritoriality. 115 Here, the plaintiffs tried to argue that Morrison was a narrow holding that only applied to so-called F-cubed cases. 116 The court disagreed, however, and asserted that the plaintiffs’ attempts to bring holders of CSG—listed on SWX, the Swiss stock exchange—within the ambit of Section 10(b) on the grounds that some activity in the trade’s execution occurred in the U.S. was akin to attempting to resurrect the conduct approach, which had been clearly repudiated in Morrison. 117 Therefore, although the holders of ADSs were

111 Id. at 560.
112 Id. at 561.
113 Stackhouse, 2010 WL 3377409, at *1.
114 Id.
116 Id. at 625.
117 Id. at 627.
permitted to state a claim under 10(b), the claims brought by the foreign security holders were dismissed.  

Later, the Southern District of New York clarified that mere possession of ADRs was insufficient to establish jurisdiction for foreign plaintiffs. In In re Vivendi Universal, the plaintiffs alleged that Vivendi executives misled investors about the financial health and outlook of the business; once the company unveiled the true condition of the business, the shares plummeted. The plaintiffs argued that since the shares were cross-listed (ordinary shares listed in France and Level III ADRs listed on the NYSE in the United States), any existing shareholder could assert a cause of action under 10(b). The court found this argument unpersuasive, holding that the plaintiff’s contention was contrary to the “spirit” of Morrison.  

Recently, the Second Circuit addressed the issue of whether plaintiffs could bring an action against a foreign fund that traded U.S.-listed stocks through a U.S. broker dealer. The court determined that the appropriate test for whether the defendant’s actions constituted a “domestic” transaction turned on whether the issuer incurred irrevocable liability or “title passe[d] within the United States.” Here, the defendants traded penny stocks through PIPE (public investment private equity) transactions. Although the plaintiffs attempted to argue that the location of the broker dealer or the origin of the securities (U.S.-listed penny stocks) should determine whether 10(b) should apply, the court concluded that these arguments conflicted with

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118 Id. at 629.  
120 Id. at 524.  
121 Id. at 531.  
122 Id. at 530.  
123 Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 67 (2d Cir. 2012).  
124 Id. at 66–67.  
125 Practicing Law Institute defines PIPEs as “private placements of publicly traded equity securities that are contractually structured to provide future liquidity through an effective resale registration statement.” PIPEs: A Review of Key Legal Issues, Practicing Law Inst., 1761 Prac. L. Inst. 371, 373 (2009).
the logic of *Morrison*. Ultimately, the court held that the plaintiffs did not present sufficient evidence to show that the transactions occurred in the United States.  

Even private placements of ADRs to qualified institutional buyers may constitute "domestic transactions" for the purposes of Section 10(b). In *Wu v. Stomber*, the plaintiffs alleged that they were defrauded into buying shares of a company, whose sole business was buying residential mortgage-based securities on margin, without adequate explanation of the risks associated with this type of investment. The court found that holders of Restricted Depository Shares (RDSs) could maintain a cause of action under 10(b) because, even though not listed on any exchange, the RDSs were "bought or sold in the United States."  

These cases provide several important lessons about how the courts may be willing to treat ADRs in the aftermath of *Morrison*. First, the courts may analyze whether extraterritoriality precludes a finding of liability for ADR holders under either the first or second prong of the *Morrison* test. Level II and Level III ADRs will most likely satisfy the first prong ("securities listed on domestic exchanges"), since they are typically listed on the NYSE, Amex, or NASDAQ. In most instances, courts are also willing to apply Section 10(b) to Level I ADRs or those issued through 144A offerings under the second prong ("domestic transactions in other securities.").  

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126 Id. at 68–69.  
127 *Absolute Activist*, 677 F.3d at 70.  
129 RDSs are similar to ADRs, but they are sold only to qualified institutional buyers and accredited investors.  
130 *Stomber*, 2012 WL 3276975, at *15.  
Second, trades of foreign securities that are merely executed, cleared, or settled in the United States do not constitute "domestic transactions" for the purposes of 10(b).133 As applied to ADRs, this means that the trade itself will not create liability under 10(b); rather, the court will look for something more, such as listing ADRs on an exchange, filing with the SEC, or generating capital from U.S. markets.134 Similarly, merely cross-listing some shares in the United States does not create a cause of action for individuals who purchased their securities abroad.135 If 10(b) applied to cross-listed shares, then holders of foreign securities could theoretically piggy-back on the claims of exchange-listed ADR holders, leading to excessively unpredictable results and potentially creating serious conflicts with international laws.136 Third, residency in the United States or citizenship does not automatically trigger 10(b) application.137 Finally, as explained in Morrison, the key concern is where the transaction occurred, and not the deception itself.138

And yet, even with the wealth of cases in support of treating ADRs under Section 10(b), several courts might still disagree. For example, to date, no court has expressly overruled the holding in In re Societe Generale Securities Litigation.139 In this case, plaintiffs brought suit against Societe Generale, a French company whose ordinary shares were listed on the Euronext Paris stock exchange, for failing to establish sufficient internal risk controls, for misleading investors about the extent of their subprime mortgage exposure, and generally for making

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135 In re Alstrom SA Sec. Litig., 741 F. Supp. 2d 469, 473 (S.D.N.Y. 2010); see Cornwell, 729 F. Supp. 2d at 620.

136 See, e.g., In re UBS Sec. Litig., 07 Civ. 11225 (RJS), 2011 WL 4059356 (S.D.N.Y. Sept. 13, 2011); In re Vivendi Universal, S.A. Sec. Litig., 765 F. Supp. 2d 512, 531 (S.D.N.Y. 2011); In re Alstrom, 741 F. Supp. 2d at 472 (“Though isolated clauses of the opinion may be read as requiring only that a security be ‘listed’ on a domestic exchange for its purchase anywhere in the world to be cognizable under the federal securities laws, those excerpts read in total context compel the opposite result.”).

137 See Cornwell, 729 F. Supp. 2d at 620.


139 In re Societe Generale Sec. Litig., No. 08 Civ. 2495 (RMS), 2010 WL 3910286 (S.D.N.Y. Sept. 29, 2010).
materially false financial statements to shareholders. The court highlighted that the ADRs were not traded on an official exchange—such as New York Stock Exchange or NASDAQ—but were rather traded over the counter, and therefore, 10(b) would not apply to what the court considered a “predominantly foreign securities transaction.” As such, the court granted the defendants’ motion to dismiss.

In the absence of an express Supreme Court ruling on ADRs or a clearer Congressional mandate, the controversy over when to apply Section 10(b) is likely to continue. Given ADRs’ ties to the underlying foreign security, there are arguments to be made against the application of 10(b). But, in order to further the interests of the Exchange Act in protecting U.S. investors, this Comment advocates for a test that brings ADRs definitively under the ambit of 10(b).

Part V. Alternative Solutions and the Irrevocable Liability Standard

A. The Results of the Cross-Border Study

In order to try to answer the extraterritoriality question, the Commission authorized a study through Section 929Y in order to solicit comments and suggestions on this issue. In response, the Commission received seventy-two comment letters, more than forty of which supported the conduct and effects test (or some modified version thereof), more than twenty of which supported the Morrison approach, and only a handful of which advocated a different approach or simply provided additional information to the Commission. Letters submitted by investors homogeneously supported the conduct and effects tests, whereas those submitted by

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140 Id. at *1.
141 Id. (quoting In re SCOR Holding (Switzerland) AG Litig., 537 F. Supp. 2d 556, 556 (S.D.N.Y. 2008)).
142 Id. at *2.
144 SEC Study, supra note Error! Bookmark not defined., at v, 39.
foreign governments generally advocated limiting private causes of action.\textsuperscript{145} Moreover, issuers and their associated organizations consistently supported \textit{Morrison}'s transactional approach.\textsuperscript{146}

The primary arguments for retention of the transactional approach included concerns about excessive litigation, international comity, and policy choices.\textsuperscript{147} Additionally, supporters argued that a bright-line approach would lead to enhanced market growth by increasing predictability and preventing “wasteful and abusive litigation” in order to “ease the burden of the already overtaxed courts.”\textsuperscript{148} According to the study:

\begin{quote}
[i]nternational comity is a customary international-law principle involving respect for the validity and effect of nations' executive, legislative and judicial determinations . . . . U.S. courts and government agencies often attempt, where possible, to balance the public and private interests of the United States with the competing policies of foreign jurisdictions when a conflict arises between U.S. and foreign law.\textsuperscript{149}
\end{quote}

Critics, on the other hand, argued that even the bright-line approach is still not so bright given the difficulty in determining where the transaction itself took place or whether investors would even be aware of the location of the transaction.\textsuperscript{150} Moreover, they argued that the transactional approach restricts portfolio diversification by scaring away foreign issuers, forces institutional investors into the more illiquid ADR markets, requires investors to resort to foreign litigation, and fails to protect investors who were duped by foreign companies.\textsuperscript{151}

Those in favor of retaining the conduct and effects test argued that it promoted investor protection and reflected the “economic reality” that even foreign issuers may have extensive

\textsuperscript{145} \textit{Id.} at 39.
\textsuperscript{146} \textit{Id.} at 39–40.
\textsuperscript{147} \textit{Id.} at v.
\textsuperscript{148} \textit{Id.} at v, 21.
\textsuperscript{149} \textit{Id.} at 9 (citing Hilton v. Guyot, 159 U.S. 113, 143 (1895)); Joel R. Paul, \textit{The Transformation of International Comity}, 71 LAW & CONTEMP. PROBS. 19, 19 (2008)).
\textsuperscript{150} SEC Study, \textit{supra} note \textit{Error! Bookmark not defined.}, at 42–43 (citing a letter submitted from sixty-nine pension funds, which warned that the Morrison approach may deprive private investors of a 10(b) right of action when they may have had no knowledge of or no choice in where their transaction took place).
\textsuperscript{151} \textit{Id.} at 9.
operations in the United States.\textsuperscript{152} In addition, proponents argued that the conduct and effects test ensured that cunning, fraudulent issuers could not skirt 10(b) liability merely by listing abroad and defrauding investors within the United States and that the test actually facilitated comity by protecting U.S. and foreign ideals.\textsuperscript{153} On the other hand, the conduct and effects opponents argued that the DOJ and SEC were more than capable of protecting investors without the need for such a complicated approach and foreign markets could offer protection to U.S. investors in antifraud matters that occurred on foreign soil.\textsuperscript{154} The critics also pointed out that the conduct and effects test "bears little relation to investors' expectations about whether they are protected by U.S. securities laws."\textsuperscript{155} Further, they warned that the conduct and effects test can lead to unpredictable results, potentially spurring a "chilling effect on foreign direct investment in the United States as well as capital formation in U.S. markets."\textsuperscript{156}

Institutional investors, in particular, cited a number of concerns with respect to ADRs. First, they noted that it is unclear whether ADRs are considered a "domestic transaction" under the transactional test.\textsuperscript{157} Yet, even if \textit{Morrison} does protect purchasers of ADRs, the relatively small size of the ADR markets relative to equities may severely constrain a portfolio manager's ability to diversify its holdings internationally, since the transactional test does not protect investors of foreign securities.\textsuperscript{158} Moreover, limiting investors' holdings only to ADRs inhibits their ability to trade quickly on market information, since investors would have to wait until U.S.

\begin{flushright}
152 \textit{Id.} at v–vi.
153 \textit{Id.}
154 \textit{Id.} at 54–55. Several letters in support of this view were submitted from the governments of Australia, France, Germany and Switzerland, among others. \textit{Id.} at 55 n.202.
155 \textit{Id.} at vi.
158 \textit{Id.} at 45.
\end{flushright}
markets open. Trading in ADRs is also much more expensive than equities trading, if one factors in the depository fees. On the whole, institutional investors agreed that the conduct and effects test better protects U.S. investors from fraud.

B. Potential Solutions From The 929Y Study

One potential solution proffered from the comment letters was that Congress should reinstate the conduct and effects test but limit its availability to U.S. citizens or U.S.-based institutions. Arguably, this solution most directly addresses one of the key aims of the Securities Exchange Act: namely, protecting U.S. investors. Additionally, this approach would likely not offend international comity, since foreign nations would be hard-pressed to argue against the U.S. protecting its own citizens. But, this approach would effectively overrule, at least in part, one post-Morrison decision in which the court stated that residency/citizenship is an insufficient basis for application of 10(b). Further, potential criticisms of this approach may be that it does not resolve the “predictability” problem of the conduct and effects test that Morrison tried to remedy, that it is unfair to distinguish between U.S. and foreign investors, and that it could create a chilling effect on foreign investment in the U.S.—although this fear has yet to be substantiated.

Alternatively, some of those surveyed, including the American Bar Association and prominent law professors, advocated a “fraud-in-the-inducement test,” which dictates that 10(b) should apply in situations where the issuer reached into the United States. This test would "focus on the location of the investor at the time the investor is induced to purchase or sell

159 Id.
160 Id. at 45–46.
161 SEC Study, supra note Error! Bookmark not defined., at 55.
162 Id.
164 SEC Study, supra note Error! Bookmark not defined., at 57.
securities in reliance on a materially false or misleading statement or pursuant to a manipulative act." Arguably, by focusing on how the fraudsters targeted U.S. investors, this approach would alleviate international comity concerns while still protecting against the very scenario that Justice Stevens warned of in *Morrison*. Like conduct and effects, however, it too could suffer from unpredictable and inconsistent results.

Instead, other commenters suggested a variation of the *Leasco* conduct test, under which 10(b) would only apply if the plaintiff's injury was a direct result of conduct in the United States. According to the study, when securities fraud actually occurs in the United States, "there seems little doubt that the resulting injuries that occur to investors outside the United States would be a direct result of the U.S. conduct." This approach would likely produce the benefits described by the Solicitor General in *Morrison*, including easing international comity concerns and filtering frivolous claims—especially those that have only a loose connection to the United States. Yet, it could still lead to expensive and time-consuming litigation, which would tax the U.S. court system and potentially deter foreign investors. Unfortunately, if the injury resulted from solicitation of a foreign purchase, 10(b) would apply, even if the foreign nation is perhaps a better venue to resolve the controversy.

A fourth approach authorized application of 10(b) in cases where securities listed on a foreign exchange were of the same type of shares as those listed in the United States. The ingenuity of this approach is that it creates predictability—foreign issuers should reasonably

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165 Id.
166 *Morrison v. Nat’l Australia Bank Ltd.*, 130 S. Ct. 2869, 2895 (2010) (Stevens, J., concurring) (discussing the injustice of an F-cubed plaintiff who was defrauded at his home by representatives of a foreign issuer).
170 See SEC Study, *supra note Error! Bookmark not defined.*, at vi.
171 Id. at 64.
expect to be subject to litigation in a nation where it has listed shares—and it solves the dilemma of “best execution” policy. Here, institutional investors would also be more apt to trade in foreign markets because they would have a cause of action available in the United States. That said, the “same class” method does open the door for F-cubed cases, presenting a threat to comity, undermining the result in *Morrison*, and potentially deterring foreign issuers from cross-listing their shares on a U.S. exchange.

Finally, one additional solution contained in 929Y is that Congress could mandate that whenever a transaction takes place in the United States, regardless of whether the underlying security is listed in the United States, 10(b) should apply. This solution would essentially codify the irrevocable liability test advocated in *Absolute Activist Value Master Fund Limited v. Ficeto*. The focus is not on trade execution per se, which would undermine the holding in *Cornwell*, but more so on whether the investor makes or accepts an offer to purchase a security on U.S. soil. This approach would afford the greatest protection to U.S. citizens, it would not present international comity concerns, and would generally be consistent with principles of contract law. But concerns over predictability and its potential chilling effect on foreign investment would still remain.

C. How Irrevocable Liability Can Save *Morrison* and Appease Congress

Although, in theory, the *Morrison* approach presents a compelling, straightforward approach for when courts should apply Section 10(b), in practice the test is not perfectly predictable, especially in cases involving complex financial instruments, like ADRs. Although

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172 Several commentators complained that because some brokers have a rule of “best execution,” investors are not always informed from which exchange (international or domestic) their purchases derive. SEC Study, supra note Error! Bookmark not defined., at 43. Therefore, if a fraud occurs and “best execution” forced a broker to purchase their shares on a foreign exchange, they have no recourse under Morrison. *Id.*

173 SEC Study, supra note Error! Bookmark not defined., at 68.

174 *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 672 F.3d 143, 152–53 (2d Cir. 2012).

175 SEC Study, supra note Error! Bookmark not defined., at 68–69.
the majority of courts have found that sponsored ADRs should fall under 10(b), at least one other court has held that ADRs represent a "predominantly foreign securities transaction." It is possible that *In re Societe Generale* will be expressly overruled. But, in the interim, Congress will need to craft its own solution for private causes of action under 10(b).

Adoption of the irrevocable liability definition under the second prong of *Morrison* would alleviate tension in the courts by creating a bright-line rule for application of 10(b) to fraud in connection with the purchase and sale of ADRs. To illustrate, it is useful to consider a few hypothetical examples demonstrating the precise application of irrevocable liability.

Scholars and courts agree that plaintiffs in an F-cubed action (foreign issuer, foreign plaintiff, and foreign transaction) should not be entitled access to U.S. courts. For a variety of reasons—most notable of which is that the U.S. class action litigation is perceived as the most efficient vehicle for litigating securities fraud cases—many foreign plaintiffs try to litigation in the United States. But with little to nothing to tie them to the United States or its securities markets, courts have flatly refused to hear such cases likely due to concerns over international comity, judicial resources, and jurisdiction.

The answer to the extraterritorial question is even more complicated in F-squared cases, where the issuer, plaintiff, or security is based in the United States, but the other two (issuer, plaintiff, or security) are not.

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177 *See* *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2894 n.11 (2010) (Stevens, J., concurring) (although Justice Stevens supported maintaining the Second Circuit's approach, the Justice noted that virtually all F-cubed actions "should" and "would" be rejected given their tenuous connection to the United States); *Cornell v. Credit Suisse Grp.*, 729 F. Supp. 2d 620, 625 (S.D.N.Y. 2010) (Section 10(b) "clearly" does not apply to F-cubed actions).
179 *See, e.g., Morrison*, 130 S. Ct. at 2874; *Quail Cruises Ship Mgmt. Ltd. v. Agencia de VIagens CVC Tur Limi tada*, 732 F. Supp. 2d 1345, 1349 (S.D. Fla. 2010) vacated and remanded, 645 F.3d 1307 (11th Cir. 2011) (merely sending documents to and intending to close a transaction in Miami did not render the transaction domestic); *In re Banco Santander Sec.-Optimal Litig.*, 732 F. Supp. 2d 1305, 1317-18 (S.D. Fla. 2010) *aff'd sub nom. Inversiones Mar Octava Limi tada v. Banco Santander S.A.*, 439 F. App 'x 840 (11th Cir. 2011) (even though the funds invested in U.S. securities, because they were registered in the Bahamas, the plaintiffs had asserted an F-cubed claim that falls outside the protection of 10(b)).
plaintiff, or security) are foreign. Both deal with fraud perpetrated by a foreign issuer with a foreign security on a U.S. investor. In both instances, the Morrison test precluded application of extraterritoriality to the hypothetical 10(b) claim.

Imagine, for example, an American investor who buys shares in a company listed only on an overseas exchange. That company has a major American subsidiary with executives based in New York City; and it was in New York City that the executives masterminded and implemented a massive deception which artificially inflated the stock price—and which will, upon its disclosure, cause the price to plummet.

Under the classic conduct and effects test, the court would absolutely be entitled to hear the 10(b) claim. Since the foreign executives were based in New York and devised and executed the fraudulent scheme in New York, sufficient conduct in perpetration of the fraud occurred on U.S. soil. Conversely, under the new Morrison test, the investor would have to resort to foreign courts to hear the claim. Extraterritoriality applies under Morrison when the transaction involves either a U.S. security or a U.S. transaction in some “other” security. Here, clearly the first prong of Morrison will not apply, because it is indisputably a foreign security. In addition,

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180 See, e.g., In re BP p.l.c. Sec. Litig., 843 F. Supp. 2d 712, 799 (S.D. Tex. 2012) (granting motion to dismiss 10(b) action brought by U.S.-based holders of BP common stock traded on the LSE on the grounds that citizenship was an insufficient ground to extend 10(b) liability over a foreign issuer); In re Infineon Techs. AG Sec. Litig., C 04-04156 JW, 2011 WL 7121006, at *3 (N.D. Cal. Mar. 17, 2011) (although Infineon shares were cross-listed on the New York Stock Exchange, the court concluded that holders of common stock listed on the Frankfort Stock Exchange could not assert a case of action under 10(b)); Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 623–24 (S.D.N.Y. 2010) (the mere fact that the foreign issuer also had ADRs listed in the U.S. was insufficient ground to bring an action based on trading in common stock).
181 Morrison, 130 S. Ct. at 2895 (2010).
182 Id.
183 Id.
184 Id.
185 Leasco Data Processing Equip. Corp. v. Maxwell, 468 F. 2d 1326, 1334 (2d Cir. 1972), invalidated by Morrison, 130 S. Ct. 2869 ("[W]hen, as here, there has been significant conduct within the territory, a statute cannot properly be held inapplicable simply on the ground that, absent the clearest language, Congress will not be assumed to have meant to go beyond the limits recognized by foreign relations law.") (emphasis added).
186 Morrison, 130 S. Ct. at 2884.
the second prong will also not apply because no transaction has occurred in the U.S., foreign
security or otherwise.

Now, consider how this investor would fare if the second prong of Morrison was
redefined to include instances in which the issuer incurred irrevocable liability in the United
States. At this point in the hypothetical, the investor will still have no recourse, because the
scheme has been developed but not yet implemented. The investor has not yet suffered an
injury, and there are no facts to suggest that the investor incurred irrevocable liability.
Therefore, this approach would yield the same result as Morrison, and the courts would not run
afoul of international comity concerns.

On the other hand, consider Justice Stevens’ second hypothetical.

Imagine that those same executives go knocking on doors in Manhattan
and convince an unsophisticated retiree, on the basis of material
misrepresentations, to invest her life savings in the company’s doomed
securities.

Here, the result from the conduct and effects test is unchanged. Clearly, the fraudulent
conduct from the first hypothetical continues to the second. In addition, since the primary effect
of the scheme was to defraud U.S. investors, the case for application of extraterritoriality is even
stronger. As the Second Circuit has articulated, the Exchange Act was designed 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

187 This is true under any of the above-referenced approaches. A 10(b) cause of action requires proof of six
elements: (1) material misrepresentation or omission; (2) in connection with the purchase or sale of a security; (3)
scienter; (4) reliance; (5) economic loss, and (6) causation. Private Securities Litigation, 15 U.S.C.A. § 78u-4(b)
(West 2010); see also Basic Inc. v. Levinson, 485 U.S. 224, 231–232, 248–249 (1988); Ernst & Ernst v. Hochfelder,
425 U.S. 185, 197 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730–731 (1975). In the first
hypothetical, a purchase or sale has not yet occurred. If one assumes for the purpose of the hypothetical that the
investor did purchase the security after the scheme was hatched and was the unfortunate victim of the subsequent
decrease in share price, the investor would still have no recourse under 10(b) because the issuer did nothing to incur
irrevocable liability on U.S. soil.

188 Id.
securities.”189 Similarly, the result under *Morrison* does not change. Even though the investor likely made the decision to purchase the stock in United States and called her broker in the United States to place the trade, and even though the trade most likely cleared in the United States, the post-*Morrison* courts have already determined that these are insufficient bases to render the transaction “domestic.”190 Ultimately, since the trade was executed on the floor of the foreign exchange, it is definitively a foreign transaction and thus, the investor will have no recourse in the American courts.

One might argue that this result produces a grave injustice. As Justice Stevens articulated, the new test narrowed “[10(b)’s] reach to a degree that would surprise and alarm generations of American investors . . . [and] the Congress that passed the Exchange Act.”191 Yet if the *Morrison* approach was modified slightly to include the irrevocable liability standard, the investor would most likely be protected. Here, the plaintiff’s case would focus on the fact that representatives of the issuer came to her home and convinced her to invest her entire life savings in the security. The parties thus entered into an “executory transaction,” and her later payment for the shares that she already promised to buy is irrelevant.192 This hypothetical goes far beyond simply distributing marketing materials or exchanging emails,193 but rather represents a willingness of the parties to enter into a binding, implied-in-fact contract.194 Therefore, the representatives of the issuer could be said to incur irrevocable liability in the United States. This

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189 Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir. 1968), invalidated by *Morrison*, 130 S. Ct. 2869 (emphasis added).
191 *Morrison*, 130 S. Ct. at 2895 (2010). In *Liberty Media Corp. v. Vivendi Universal*, 861 F.Supp.2d 262, 269 (S.D.N.Y. 2012), the court distinguished a merger agreement that would solidify irrevocable liability from a “preliminary agreement.” According to the court, the merger agreement constituted a binding obligation to purchase the company; therefore, it did not matter if conditions remained. *Id.*
192 Blau v. Osgury, 210 F.2d 426, 426 (2d Cir. 1954).
conclusion avoids the unjust result Justice Stevens predicted and since the United States clearly has an interest in protecting its citizens—particularly when the fraud occurs within its borders—it should not offend international comity.

Under this new articulation of the *Morrison* approach “some conduct”—as in the first hypothetical—will not suffice, but 10(b) *will* reach the most egregious cases where the fraud was actually perpetrated inside the United States. This result can hardly be said to offend international comity when the crimes were committed within a U.S. jurisdiction and the victims were U.S. citizens. Moreover, it does not disturb precedent holding that mere residency or trade execution is insufficient to establish applicability of 10(b).

By preserving the *Morrison* approach and expressly adopting the irrevocable liability standard, all types of sponsored ADRs should fall within the purview of 10(b). Level II and Level III ADRs easily satisfy the first prong of the *Morrison* test since they are listed on a U.S. exchange. The analysis is slightly more complicated, however, for Level I ADRs and those ADRs distributed through a 144A offering. In a 144A offering, the issuer tenders the ADRs in exchange for new capital. As in *Liberty Media*, since this transaction constitutes a binding contract (capital exchanged for shares), the investor incurred irrevocable liability. For Level I ADRs, one could argue that the act of registering the securities is a clear indication that the issuer intends to execute a sale in the United States. As a result, Congress should treat Level I ADRs in a similar manner to merger agreements. Although some variables may remain undetermined, such as who the ultimate purchaser of the security will be, by registering the securities the issuer

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196 *Morrison*, 130 S. Ct. at 2895 (2010) (Under the first prong of the transactional test, Section 10(b) only applies to "securities listed on domestic exchanges").
197 Saunders, supra note 87, at 70–74.
has affirmatively indicated that it intends to be bound by the transaction. In addition, by transferring title to a U.S. custodian, the issuer should meet the standard of "irrevocable liability." \footnote{See Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 67 (2d Cir. 2012); Blau v. Ogsbury, 210 F.2d 426, 426 (2d Cir. 1954).}

The only gray area remaining within this modified \textit{Morrison} framework pertains to unsponsored ADRs. For an unsponsored ADR facility, ADRs may be issued without the express cooperation of the issuer. \footnote{Saunders, \textit{supra} note 87, at 54-55.} Here, the dividing line may need to be whether the issuer reaches out to establish an exemption under Section 12g3-2(b) of the Exchange Act. If the issuer is an active participant (by soliciting an exemption), one could argue that the company has incurred irrevocable liability in the United States. If the issuer's cooperation is unnecessary, then there is nothing to tie the company to the transaction. Therefore, although the approach advocated herein should create a bright line for sponsored ADRs, unsponsored ADRs will most likely remain beyond 10(b)'s reach.

ADRIs will not be the only market plagued with uncertainty until Congress finally rules on how 10(b) should be applied for private causes of action. Unanswered questions remain concerning other types of complex financial instruments, such as CFDs and swaps. \footnote{Freudenberg v. E*Trade Fin. Corp., No. CIV A 07 CIV. 8538, 2008 WL 2876373 (S.D.N.Y. July 16, 2008) ("CFD purchasers acquire the future price movement of the underlying company's common stock (positive or negative) without taking formal ownership of the underlying shares. Unlike calls and puts, which trade in tandem with, but not at the same price as, the underlying publicly traded common stock, the purchase and sale prices of CFDs are alleged to be identical to the prices quoted for shares of the underlying company's common stock on the public securities exchange."). A swap is a contractual agreement evidenced by a single document in which two parties, called counterparties, agree to make periodic payments to each other. \textsc{Jack Marshall \\& Ken Kapner}, \textit{Understanding Swaps} 3 (1993). In the agreement, the counterparties specify which currencies they intend to exchange, the applicable interest rates, the timetable for payments, and any other terms that impact the relationship of the parties. \textit{Id.}} For example, \textit{SEC v. Compania Internacional Financiera S.A.} concerned the potential application of
Section 10(b) to holders of United Kingdom CFDs. These CFDs were traded based on the price of Arch Chemicals listed on the NYSE in the United States. The court ultimately concluded that there was nothing in Morrison that precluded the application of 10(b). This result is incredibly surprising given that the CFDs were certainly not listed on any U.S. exchange, and, even though the value of the instrument was tied to a U.S. security, the actual instrument was bought and sold in the United Kingdom. Arguably, the verdict would have been the same had the court applied the conduct and effects test, but this decision raises the question of whether Morrison truly does create a more predictable approach.

By contrast, in Elliott Assoc. v. Porsche Automobile Holding SE, the court held that security-based swap agreements did not fall under the protection of 10(b). The court placed heavy emphasis on the fact that the swap agreements were linked to the share price of a foreign stock, similar to the argument made above. By referencing the foreign stock price, the court determined that the swap agreements were the “functional equivalent of trading the underlying VW shares on a German exchange.” Again, the decision produces a puzzling result: although the swap agreement is itself American (and therefore the transaction likely took place on U.S. soil), 10(b) offers no protection for the investor, since the reference security is foreign. The foreign issuer is likely the big winner in these cases because, in the first instance, at least it could predict potential litigation in the United States by listing stock there. Yet the U.S. investors who conduct trades entirely in the United States by virtue of an instrument that was created entirely in the United States are left unprotected. These examples illustrate that while Morrison creates a

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203 id. at *1.
204 id. at *6.
205 id. at *8.
207 id. at 469.
208 id. at 476.
bright-line approach in theory, in practice results vary dramatically. Irrevocable liability, by contrast, may better serve the twin goals of predictability and comity.

Part VI. Conclusion

While the *Morrison* decision abandoned the conduct and effects test for private antifraud actions,\(^{209}\) the Dodd-Frank Act—without expressly stating as much—effectively put an end to *Morrison*’s transactional approach for actions brought by the SEC and the DOJ.\(^{210}\) According to the *Morrison* court, one of the major flaws of the Second Circuit’s approach was that it led to unpredictable and inconsistent application;\(^{211}\) therefore, a bright-line transactional approach would simplify the extraterritoriality analysis.\(^{212}\) Unfortunately, the *Morrison* decision and the Dodd-Frank Act left open many questions, including what the appropriate standard should be for private causes of action and how the courts should interpret the second prong of the *Morrison* test, particularly when examining complex financial products, like ADRs.

Since *Morrison* was decided, the courts’ treatment of ADRs has been somewhat inconsistent.\(^{213}\) Most courts have found that Level II and III ADRs fall under the first prong, while Level I and 144A ADRs fall under the second prong.\(^{214}\) The courts have been forced to perform fact-intensive inquiries to examine the type of ADR, the nature and location of the transaction and what prompted the purchase or sale of the security. This expensive and time-consuming analysis is contrary to both the goals and the spirit of *Morrison*.

\(^{211}\) *Morrison*, 130 S. Ct. at 2873 (2010).
\(^{212}\) *Id.* at 2881 ("we apply the presumption in all cases, preserving a stable background against which Congress can legislate with predictable effects").
\(^{214}\) *Morrison*, 130 S. Ct. at 2874 (2010) (the second prong of the test covers “domestic transactions in other securities”).

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Under the irrevocable liability approach, Level II and III ADRs would still satisfy the first prong of *Morrison*, leaving precedent undisturbed. For Level I ADRs, by abiding by the reporting requirements of the SEC, thereby affecting an executory transaction, the issuer would be said to incur irrevocable liability at the time it authorized the shares for issue, rather than the point at which the shares are actually purchased by investors. The same analysis could easily apply to ADRs issued through a 144A offering, where irrevocable liability arises when the issuer reaches in to the United States to generate capital from qualified investors. Absent an exemption—which arguably reflects an issuer’s reaching in to the United States—unsponsored ADRs are likely to be the only category of ADR’s that fall outside 10(b)’s protection, a result that is consistent with legal and scholarly precedent.

Although it remains to be seen which approach Congress will adopt, 929Y offered several compelling solutions, which could reconcile the goals of Congress, the Supreme Court, issuers, and institutional investors. But just as the Second Circuit guided early 10(b) jurisprudence by inventing the conduct and effects test that governed securities regulation for four decades, the Second Circuit with the assistance of the Southern District of New York has taken the helm in developing and re-defining the irrevocable liability standard.215 Perhaps, history will repeat itself, and the Second Circuit will once again re-emerge as the “north star” for 10(b) analysis.216 In any event, Congress should consider adopting the irrevocable liability approach for private causes of action, since it best advances the objectives of predictability and international comity, while protecting the stability and integrity of the U.S. financial markets.

216 *Morrison*, 130 S. Ct. at 2889.