

**AMPUTATING THE LONG ARM OF THE LAW:  
AN ANALYSIS OF THE U.S. SUPREME COURT'S  
DECISION IN *MORRISON* AND WHY § 10(B)  
STILL REACHES ISSUERS OF ADRS**

**PAUL B. MASLO\***

INTRODUCTION

The U.S. Supreme Court's recent decision in *Morrison v. National Australia Bank* has substantially shortened the reach of the anti-fraud provisions of the securities laws.<sup>1</sup> Before *Morrison*, the courts utilized the conduct and effects tests to determine whether § 10(b) of the Securities Exchange Act of 1934 applied. Under those tests, the statute reached fraudulent conduct that occurred in the U.S. and fraudulent conduct abroad that had a substantial effect in the U.S. In *Morrison*, however, the Supreme Court, in an opinion authored by Justice Antonin Scalia, held that regardless of where the fraudulent conduct occurs or whether the conduct has an effect in the U.S., the anti-fraud provisions of the Exchange Act apply only to transactions in securities that trade on a U.S. exchange or that are purchased in the U.S.

This Commentary reviews the conduct and effects tests and the Supreme Court's decision in *Morrison*. It then addresses the new transactional rule's impact on the application of the Exchange Act's anti-fraud provisions in several situations where courts before *Morrison* routinely allowed § 10(b) claims to proceed: (1) foreign-cubed actions (*i.e.*, claims involving a foreign citizen's purchase of a foreign issuer's ordinary shares on a foreign exchange) where the fraud impacts U.S. investors or is executed in the U.S.; (2) cases involving a U.S. citizen's purchase of a foreign issuer's ordinary shares outside the U.S.; and (3) actions concerning the purchase of a foreign issuer's American Depository Receipts ("ADRs"). While courts are in agreement that the test articulated in *Morrison* prevents § 10(b) from reaching defendants in the first and second types of actions, they are in conflict as to whether ADR purchasers should be able to bring a claim. This Commentary argues that a recent

---

\* Paul Maslo is an Associate at Boies, Schiller & Flexner LLP. Mr. Maslo earned his A.B. at Cornell University, M.S. at Johns Hopkins University, and J.D. at the University of Pennsylvania, where he also studied finance at the Wharton School of Business.

1. *Morrison v. Nat'l Australia Bank*, 130 S. Ct. 2869 (2010).

district court decision wrongly decided the application of *Morrison* in the ADR context and that the new rule should not prevent most ADR purchasers from bringing a cause of action under § 10(b).

### I. CONDUCT AND EFFECTS TESTS

Before *Morrison*, courts looked at two factors to determine whether they possessed subject matter jurisdiction<sup>2</sup> over a § 10(b) claim: (1) whether the wrongful conduct occurred in the U.S. (the conduct test), or (2) whether the wrongful conduct, even if it occurred in a foreign country, had a substantial adverse effect on U.S. investors (the effects test).<sup>3</sup> Even though a plaintiff needed only to satisfy either the conduct or the effects test to support a finding of subject matter jurisdiction, there was no requirement that the two tests be applied separately and distinctly from each other, and courts often found that “an admixture or combination of the two . . . gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court.”<sup>4</sup>

The courts focused “on the nature of conduct within the United States as it relates to carrying out the alleged fraudulent scheme” to determine whether subject matter jurisdiction existed under the conduct test.<sup>5</sup> The circuits were divided as to precisely what conduct was necessary to satisfy the test:

The more restrictive position, generally that the domestic conduct must have been of “material importance” or “significant” to the fraud and have “directly caused” the alleged loss [wa]s followed in the Second, Fifth, and District of Columbia Circuits. In contrast, the Third, Eighth, and Ninth Circuits generally require[d] some lesser quantum of conduct.<sup>6</sup>

---

2. As discussed below, the Court’s decision in *Morrison* made clear that whether a § 10(b) cause of action exists is a merits question. *Morrison*, 130 S. Ct. at 2876–77.

3. See, e.g., *In re Lemout & Hauspie Sec. Litig.*, No. Civ.A.00-11589-PBS, 2004 WL 1490435 (D. Mass. June 28, 2004); *Tabor v. Bodisen Biotech, Inc.*, 581 F. Supp. 2d 552 (S.D.N.Y. 2008); *Blechner v. Daimler-Benz AG*, 410 F. Supp. 2d 366 (D. Del. 2006); *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d 334 (D. Md. 2004); *Zurich Capital Mkts. Inc. v. Coglianese*, 332 F. Supp. 2d 1087 (N.D. Ill. 2004); *Crosbie v. Endeavors Techs., Inc.*, No. SA Civ. 08-1345 AHS (SSx), 2009 WL 3464135 (C.D. Cal. Oct. 22, 2009); *SEC v. Wolfson*, No. 2:03CV914 DAK, 2003 WL 23356418 (D. Utah Dec. 10, 2003); *Baan Co. Sec. Litig.*, 103 F. Supp. 2d 1 (D.D.C. 2000).

4. *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 122 (2d Cir. 1995).

5. *Id.* at 123.

6. *Wolfson*, 2003 WL 23356418, at \*15.

Under the effects test, subject matter jurisdiction existed when fraudulent acts committed abroad resulted “in injury to purchasers or sellers of those securities in whom the United States has an interest, not where acts simply have an adverse affect on the American economy or American investors generally.”<sup>7</sup> It conferred jurisdiction “where the harm inflicted on the foreign plaintiff actually causes harm to U.S. investors or markets because of the relationship between the foreign plaintiff and U.S. investors.”<sup>8</sup>

The fact-intensive nature of the analysis under each of these tests compelled the courts to exercise a great deal of discretion in determining whether § 10(b) applied, which resulted in judicial inconsistencies and created an atmosphere of uncertainty.<sup>9</sup>

## II. *MORRISON*

*Morrison*'s journey to the U.S. Supreme Court began in the Southern District of New York.<sup>10</sup> Plaintiffs alleged that National Australia Bank (“NAB”), Australia's largest bank, made false and misleading statements regarding HomeSide, its Florida-based mortgage servicing unit. NAB booked the present value of HomeSide's mortgage servicing rights on its balance sheet, and plaintiffs claimed that a faulty valuation model was used. When the true value of the rights was revealed, NAB was forced to take a series of writedowns. As a result, its ordinary shares, which traded on foreign exchanges, tanked. In addressing whether subject matter jurisdiction existed under the effects test, the court found that “the alleged fraud had very little—if any—demonstrable effect on the U.S. market.”<sup>11</sup> As such, jurisdiction did not exist under the effects test. Applying the conduct test, the court determined that “the allegedly fraudulent statements were ‘fired’ from Australia at predominantly foreign plaintiffs who purchased NAB stock on that country's stock exchange.”<sup>12</sup> Because, “[o]n

---

7. *Parks v. Fairfax Fin. Holding Ltd.*, No. 06 CV 2820(GBD), 2010 WL 1372537, at \*5 (S.D.N.Y. Mar. 29, 2010) (emphasis removed).

8. *Copeland v. Fortis*, 685 F. Supp. 2d 498, 502 (S.D.N.Y. 2010) (emphasis removed).

9. *See, e.g., Tabor*, 581 F. Supp. 2d at 559 (“[N]o precise test has emerged from the various decisions in this Circuit . . .”) (listing six factors commonly considered by the courts when applying the conduct test); *IIT, an Int'l Inv. Trust v. Cornfeld*, 619 F.2d 909, 918 (2d Cir. 1980) (“It should be evident by now that the presence or absence of any single factor which was considered significant in other cases dealing with the question of federal jurisdiction in transnational securities cases is not necessarily dispositive in future cases.”).

10. *In re Nat'l Australia Bank Sec. Litig.*, No. 03 Civ. 6537(BSJ), 2006 WL 3844465 (S.D.N.Y. Oct. 25, 2006).

11. *Id.* at \*4.

12. *Id.* at \*6.

balance, it is the foreign acts—not any domestic ones—that directly caused the alleged harm,” the court held that it lacked subject matter jurisdiction and dismissed plaintiffs’ claims.<sup>13</sup>

On appeal, NAB and several *amici curiae* argued that the conduct and effects tests should be eschewed.<sup>14</sup> Moreover, they contended “that the general ‘presumption’ against the extraterritorial application of American laws bars American courts from exercising subject matter jurisdiction over these types of claims”<sup>15</sup> and that opening American courts to such actions would infringe upon the laws of other countries.<sup>16</sup> The court disagreed: “[T]he potential conflict between our anti-fraud laws and those of foreign nations does not require the jettisoning of our conduct and effects tests for ‘foreign-cubed’ securities fraud actions and their replacement with the bright-line ban advocated by Appellees.”<sup>17</sup> The court also noted that “declining jurisdiction over all ‘foreign cubed’ securities fraud actions would conflict with the goal of preventing the export of fraud from America.”<sup>18</sup> In addressing the jurisdictional issues in the case, the Second Circuit affirmed the Southern District’s decision:

This particular mix of factors—the fact that the fraudulent statements at issue emanated from NAB’s corporate headquarters in Australia, the complete lack of any effect on America or Americans, and the lengthy chain of causation between HomeSide’s actions and the statements that reached investors—add up to a determination that we lack subject matter jurisdiction.<sup>19</sup>

The U.S. Supreme Court granted *certiorari* to decide “whether § 10(b) of the Securities Exchange Act of 1934 provides a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign exchanges.”<sup>20</sup> Before diving into its analysis, the Court addressed a threshold error in the lower courts’ analyses and clarified that whether a § 10(b) cause of action exists is a merits—not jurisdictional—question.<sup>21</sup> Moving on to consider the application of § 10(b) on the merits, the court opined that “[i]t is a

---

13. *Id.* at \*8.

14. *Morrison v. Nat’l Australia Bank Ltd.*, 547 F.3d 167, 174 (2d Cir. 2008).

15. *Id.*

16. *Id.* at 174–75.

17. *Id.* at 175.

18. *Id.*

19. *Id.* at 177.

20. *Morrison*, 130 S. Ct. at 2875.

21. *Id.* at 2877.

longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.”<sup>22</sup> In contravention of this well-established canon of statutory construction, “the Second Circuit believed that, because the Exchange Act is silent as to the extraterritorial application of § 10(b), it was left to the court to ‘discern’ whether Congress would have wanted the statute to apply.”<sup>23</sup> This erroneous inference led to the development of the “complex” and “unpredictable” conduct and effects tests.<sup>24</sup> Unlike the Second Circuit, the Supreme Court concluded, on the basis of the canonical presumption against extraterritoriality, that the statute did not apply outside the U.S. because it lacked any affirmative indication from Congress that it should.<sup>25</sup> Moreover, the Court determined the statute’s application is not impacted by the presence of domestic fraudulent conduct: “For it is a rare case of prohibited extraterritorial application that lacks *all* contact with the territory of the United States. But the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever *some* domestic activity is involved in the case.”<sup>26</sup> Finding that “the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States,” and that “it is parties or prospective parties to those transactions that the statute seeks to protect,” the Court held that § 10(b) applies only to “transactions in securities listed on domestic exchanges[] and domestic transactions in other securities.”<sup>27</sup> Because this case did not involve securities listed on a domestic exchange and the purchases occurred outside the U.S., the Court affirmed the dismissal of the action.<sup>28</sup>

### III. APPLICATION OF *MORRISON*: DOES § 10(B) REACH ISSUERS OF ADRS?

Before *Morrison*, courts routinely held that § 10(b) applied in: (1) foreign-cubed actions if part of the fraud was carried out in the U.S. or had an impact on U.S. investors, (2) cases involving a U.S. citizen’s purchase of a foreign issuer’s ordinary shares outside the U.S., and (3) actions concerning the purchase of a foreign issuer’s ADRs. For example, in

---

22. *Id.*

23. *Id.* at 2878.

24. *Id.*

25. *Id.* at 2883.

26. *Id.* at 2884.

27. *Id.*

28. *Id.* at 2888.

*Wagner v. Barrick Gold*, the Southern District of New York held that a Canadian corporation's activities in the U.S. were sufficient to warrant exercise of subject matter jurisdiction over Canadians who purchased ordinary shares on the Toronto Stock Exchange.<sup>29</sup> In *Bersch v. Drexel Firestone*, a Canadian company made a series of public offerings of its common stock outside of the U.S., with some of the shares ending up in the hands of U.S. investors.<sup>30</sup> The Second Circuit granted subject matter jurisdiction to American purchasers resident in the U.S. and even allowed claims to proceed on behalf of American purchasers resident abroad. In *Billhofer v. Flamel Technologies*, the Southern District of New York denied a foreign corporation's motion to dismiss a securities fraud claim brought by a class of ADR purchasers.<sup>31</sup> By rejecting the conduct and effects tests, however, the bright-line rule articulated by the Supreme Court in *Morrison* drastically shortened the reach of § 10(b)'s application.

It is now unequivocal that, pursuant to *Morrison*, § 10(b) no longer applies in foreign-cubed actions.<sup>32</sup> While cases involving U.S. purchasers of foreign securities outside the U.S. are more challenging, the recent case law also indicates that "*Morrison* foreclose[s] the application of § 10(b) to any claims related to foreign securities trades executed on foreign exchanges even if purchased by American investors."<sup>33</sup> In *Plumbers' Union*, for example, plaintiffs purchased Swiss Re ordinary shares on a foreign exchange.<sup>34</sup> The Southern District of New York found plaintiffs' argument that "Plumbers' purchase is a domestic one because (a) Plumbers is a U.S. resident; (b) Plumbers made the decision to invest in the U.S.; (c) Plumbers suffered harm in the U.S.; (d) Plumbers' orders for Swiss Re stock were placed from Chicago; and (e) the traders who executed the purchase orders for Swiss Re stock were located in Chicago" to be without merit.<sup>35</sup> The court held that the transactions at issue were not covered by § 10(b) and dismissed the action because the "purchaser's

---

29. *Wagner v. Barrick Gold Corp.*, 251 F.R.D. 112, 120–121 (S.D.N.Y. 2008).

30. *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir. 1975).

31. *Billhofer v. Flamel Techs., SA*, 663 F. Supp. 2d 288 (S.D.N.Y. 2009).

32. *See, e.g., In re Celestica Inc. Sec. Litig.*, No. 07 CV 312(GBD), 2010 WL 4159587, at \*1 n.1 (S.D.N.Y. Oct. 14, 2010) (dismissing "claims of purported class members who acquired Celestica common stock on foreign markets"); *Terra Sec. ASA Konkursbo v. Citigroup, Inc.*, 740 F. Supp. 2d 441, 447 (S.D.N.Y. 2010) ("The parties do not dispute that the FLNs [fund-linked notes] that Plaintiffs purchased were listed on European stock exchanges and the TRS [total return swap] was sold in Europe. Accordingly, the Court grants Defendants' motion to dismiss Plaintiffs' federal securities fraud claims under § 10(b) . . .").

33. *Cornwell v. Credit Suisse Group*, 729 F. Supp. 2d 620, 628 (S.D.N.Y. 2010).

34. *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 753 F. Supp. 2d 166, 172 (S.D.N.Y. 2010).

35. *Id.* at 178–79.

citizenship or residency does not affect where a transaction occurs,” “the location of the harm to a plaintiff is independent of the location of the securities transaction that produced the harm,” and “[t]he place from which Plumbers’ traders placed Plumbers’ orders or executed the trades . . . does not affect the location of Plumbers’ purchase.”<sup>36</sup>

*Morrison*’s impact is unsettled in the ADR context, however. An ADR represents an interest in a specified number of shares in the equity of a foreign company that are held by a depository bank. A foreign company may establish a Level I, II, or III ADR program. In a Level I program, the ADRs, which trade in the over-the-counter market, have not been sold in the U.S. as part of a registered offering. Level II ADRs have not been sold pursuant to a registered offering, but are listed on a national securities exchange. The ADRs issued as part of a Level III facility are listed on a national exchange and issued pursuant to a registered offering.<sup>37</sup>

While some courts have allowed the claims of ADR purchasers to proceed under § 10(b) (e.g., in *Alstom* the Southern District of New York dismissed the claims of plaintiffs who purchased ordinary shares on a foreign exchange but allowed the claims of ADR purchasers<sup>38</sup>), others have not. In *Societe Generale*, for example, the Southern District of New York found that trade in ADRs is a predominantly foreign securities transaction to which § 10(b) is inapplicable.<sup>39</sup> Applying this reasoning, the court dismissed the claims of ADR purchasers *sua sponte*.<sup>40</sup> The rule articulated by the court in *Societe Generale* is arguably grounded in tenets of fairness and economic reality. For example, because purchasing an ADR is functionally equivalent to trading an ordinary share on a foreign exchange, it could be argued that it simply would not be equitable to allow ADR purchasers to bring claims under the U.S. securities laws while simultaneously denying the claims of similarly situated investors that purchased the company’s common stock.

But the Supreme Court in *Morrison* laid down a hard and fast rule precisely to avoid the type of subjective analysis that was employed by the courts before *Morrison* and resulted in the “unpredictable and inconsistent application of § 10(b).”<sup>41</sup> The value of the *Morrison* rule lies in its simplicity and clarity: “[I]t is . . . only transactions in securities listed on

---

36. *Id.*

37. See SEC Release No. 274, 1991 WL 294145, at \*3 n.21.

38. *In re Alstom SA Sec. Litig.*, 741 F. Supp. 2d 469 (S.D.N.Y. 2010).

39. *In re Societe Generale Sec. Litig.*, No. 08 Civ. 2495(RMB), 2010 WL 3910286, at \*6 (S.D.N.Y. Sept. 29, 2010).

40. *Id.*

41. *Morrison*, 130 S. Ct. at 2880.

domestic exchanges, and domestic transactions in other securities, to which §10(b) applies.”<sup>42</sup> In other words, “[s]ection 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.”<sup>43</sup> Although the trading in ADRs in *Societe Generale* was not on an exchange (it was over-the-counter),<sup>44</sup> it did take place in the United States, and therefore, the court’s holding is in direct conflict with the bright-line rule of *Morrison*.

The application of the transactional test of *Morrison* in the ADR context is also supported by public policy concerns. Contrary to the arguments presented above, it would be even more unjust to allow foreign corporations to sell ADRs in the U.S. while simultaneously granting them immunity from investor civil suits under the anti-fraud provisions of the U.S. securities laws. Foreign corporations gain several benefits from setting up ADR programs, not the least of which is the ability to tap the expansive U.S. capital markets. Foreign corporations can benefit from U.S. investor demand for convenient diversification by raising capital here which they can then deploy to support their operations abroad. Alternatively, since capital raised from ADRs is denominated in U.S. dollars, selling ADRs provides an easy mechanism for foreign corporations to amass a war chest which they can use to expand operations or make investments in the U.S. It also increases a foreign company’s visibility with U.S. institutional investors, which makes it easier to raise additional capital in the future, and increases liquidity for the company’s shares. Demanding that ADR issuers be subject to the reach of § 10(b) if they decide to defraud their investors is a small price to pay for receiving these benefits. And, now that *Morrison* has drawn a clear line in the sand, a foreign corporation can easily conduct this cost-benefit analysis before deciding whether to issue ADRs.

#### CONCLUSION

The Supreme Court’s recent decision in *Morrison* has already had a profound impact on securities litigation. The new transactional rule lends clarity to an area of the law that was uncertain. Under *Morrison*, a foreign

---

42. *Id.* at 2884.

43. *Id.* at 2888.

44. The issue of whether trading in Level II and Level III ADRs is covered under *Morrison* is just as clear-cut since these securities are traded on a national exchange.

corporation should be insulated from the U.S. securities laws unless it chooses to sell its securities in the U.S. (e.g., by setting up an ADR program). Allowing corporations the choice *ex ante* of whether they want to subject themselves to the U.S. securities laws is not only good for them, it is also advantageous for investors because they now know with certainty whether their investments will be protected by the anti-fraud provisions of the U.S. securities laws. By preventing the U.S. from becoming “the Shangri-La of class-action litigation,”<sup>45</sup> while staying true to the Exchange Act’s intended purpose of protecting parties who transact in securities in the U.S., the bright-line rule of *Morrison* strikes a perfect balance; its application will continue to dramatically alter the securities litigation landscape.

---

45. *Morrison*, 130 S. Ct. at 2886.