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FRAUD-ON-THE MARKET CLASS ACTIONS AGAINST FOREIGN ISSUERS

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Table of Contents

I. THE FRAMEWORK FOR CHOOSING THE REACH OF THE ACTION	12
II. THE FRAUD-ON-THE-MARKET CAUSE OF ACTION	12
A. The Development of a Claim for Damages from Corporate Misstatements	12
1. The Illegality of Corporate Misstatements	13
2. Private Right of Action	14
3. Presumption of Reliance on the Integrity of the Market and the Possibility of Class Actions	14
a. The traditional reliance requirement	15
b. The fraud-on-the-market theory of reliance	16
c. Availability of class actions	16
B. Traditional Reliance Based Claims Compared to Fraud on the Market Claims	17
III. THE EFFECTS TEST/CONDUCT TEST CONCEPTUAL FRAMEWORK	18
A. The Four Seminal Cases	19
1. Schoenbaum v. Firstbrook	20
2. Leasco v. Maxwell	23
3. Bersch v. Drexel Firestone	26
b. U.S. resident Americans	29
c. Notable features	30
4. IIT v. Vencap	31
B. Distillation into the Effects Test/Conduct Test Framework	35
C. Application of the Framework to Fraud-on-the-Market Cases.	36
D. The Need for a Clear Policy-Based Alternative	37
1. Failure to provide clear guidance	38
2. Lack of attention to policy	39
3. A new approach	39
IV. POLICY CONCERNS AND THEIR IMPLICATIONS FOR TRANSNATIONAL REACH	40
A. An Economic Analysis of Fraud-on-the-Market Actions	40
1. Fairness Arguments for Compensation	41
2. Risk Reallocation Arguments for Compensation	42
3. Investor Protection Arguments for Deterrence	42
4. Corporate Governance and Liquidity Arguments for Deterrence	43
1. Legal mechanisms	44
2. Market mechanisms	44
a. Market for corporate control	45
b. Share price based compensation	45
c. Terms of funding new projects	45

3. Liquidity	46
B. Investor Protection	47
C. Deterring Misstatements to Improve Corporate Governance and Liquidity	48
D. Pro-Rata Distribution of Benefits to Shareholders	52
E. U.S. Capital Market Competitiveness	53
F. Advantages of Resolving Similar Claims in One Place	54
G. Convergence on a Simple Rule	55
V. COMPARISON WITH OTHER COMMENTARY	56
VI. IMPLEMENTATION	56
VII. CONCLUSION	56

FRAUD-ON-THE-MARKET CLASS ACTIONS AGAINST FOREIGN ISSUERS

Merritt B. Fox

Fraud-on-the-market class actions result in the bulk of private litigation damages paid out in settlements and judgments under the U.S. securities laws. With globalization, foreign issuers have become common targets of such suits. Almost one in five such suits now are against foreign issuers and two of the six largest pay outs in the history of private U.S. securities litigation were made in settlements of suits against foreign issuer defendants: Nortel Networks (over \$2 billion) and Royal Ahold, NV (over \$1 billion). The increasing number of such suits raises a basic question: Should foreign issuers ever be subject to these U.S. law based class action claims in the first place, and, if so, by what kinds of claimants and under what circumstances? The way the United States ultimately answers this question will have important effects on the competitiveness of U.S. financial markets, the structure of the global market for equity and the governance of both U.S. and foreign corporations. These effects will in turn impact both U.S. and global economic welfare.

Fraud-on-the-market class action suits are a means by which persons trading in the secondary securities markets can recover losses they incur as a result of transacting at prices adversely affected by issuer misstatements. The legal theory behind such actions has four critical components. First, the prohibition on material misstatements made “in connection with the purchase or sale of a security” under Rule 10b-5 of the Securities and Exchange Act of 1934 (the “Exchange Act”) must apply to an issuer’s public statements even when the issuer itself does not trade. Second, Rule 10b-5 must give rise to a common law implied right of action against those

who violate it. Third, damages incurred by a person who transacts in the secondary market at a price adversely affected by such a misstatement must be recoverable under this implied right of action. And finally, such fraud-on-the-market claims must be able to be brought collectively in the U.S. federal courts on behalf of many claimants on the basis of a Federal Rules of Civil Procedure (FRCP) Rule 23 class action. As a doctrinal matter, the transnational reach of fraud-on-the-market claims depends on an analysis of each of these elements.

A. The Development of the Existing Doctrine

Rule 10b-5, and Exchange Act Section 10(b) under which it was promulgated, share essentially identical language that on its face provides a potentially very broad transnational reach in terms of what constitutes their violation. Neither the Rule nor Section 10(b) makes any distinction between securities of foreign issuers and those of domestic ones, between misstatements made abroad and ones made domestically, or between purchases and sales abroad and ones made domestically. Nor does either provide that U.S. nationals or U.S. residents are the only purchasers¹ intended to be protected by their prohibitions.² Moreover, there is no directly relevant legislative history concerning the reach of the statute. Given this potentially broad reach

¹Throughout this Article, for convenience it will be assumed that the plaintiff is a purchaser who claims to be injured from losses resulting from a falsely positive misstatement that inflated prices on the secondary market. As a general matter, however, the observations are equally applicable to a plaintiff who is a seller who claims to be injured for losses resulting from a falsely negative misstatement that depressed prices on the secondary market.

²The only limitation on the Rule's application is the requirement of the direct or indirect "use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange." [cite] Interstate commerce is broadly defined under Exchange Act §3(17) to include "trade or commerce in securities or any transportation or communications relating thereto . . . among the several States. . . or between any foreign country and any State." [cite] Given the global interconnectedness of finance today, a public statement by a substantial, established publicly traded issuer anywhere in the world would almost certainly involve such direct or indirect use.

of the Rule 10b-5's prohibitions on issuer misstatements, class action fraud-on-the market claims based on the common law implied right of action for damages from secondary market trading losses caused by the prohibited misstatements could have a similarly broad reach.

The language of FRCP Rule 23 is similarly broad. In terms of the claims that can be collectively adjudicated pursuant to a class action in U.S. courts, on its face, Rule 23 makes no distinctions in terms of the location of the defendant's behavior giving rise to the claim, the location of the behavior's effects, the location of the actions of the plaintiff giving rise to the losses, or the residence or nationality of either the defendant or the plaintiff.

The principal organs of the U.S. government that have the power to decide the transnational reach of Rule 10b-5's prohibitions on issuer misstatements and the corresponding cause of action for damages are the courts and, through rulemaking and exemptive powers, the Securities Exchange Commission ("SEC"). Decisions by the courts as to jurisdictional reach of the statute are acts of statutory interpretation, as are decisions by the SEC concerning the outer bounds of its rule making and exemptive powers. The rules for interpreting statutes with facially global application and no directly relevant legislative history are, taken as a whole, very capacious in their implications and allow the courts and the SEC considerable room for policymaking. The SEC so far has declined to use its rulemaking power to address the question of the reach of Rule 10b-5's prohibition on issuer misstatements and the corresponding implied right of action. Because of the many such actions that have been brought against foreign issuers, however, the courts have had no choice but to struggle with this issue of the jurisdictional reach. The law to date has therefore been the product of common law accretion.

These actions against foreign issuers have also forced the courts to struggle with the doctrinally distinct, but economically related, question of whether, in the bundling of claims under U.S. class action procedures, any of the claims that are interpreted to be within the Rule's transnational reach should nevertheless not be allowed as part of a U.S. class action. Because of the economics of securities litigation, a fraud-on-the-market claim that cannot be included in a class action is, with rare exceptions, effectively barred from being pursued at all. Thus the two types of decisions — whether a claim against a foreign issuer is within the jurisdictional reach of the fraud-on-the-market cause of action and whether it can be included within a class action — are, as an effective matter, jointly determinative of the same ultimate issue, what kinds of fraud-on-the-market claims against a foreign issuer, if any, can be brought in U.S. courts.

The body of law developed by the courts to date concerning this ultimate issue is highly unsatisfactory.³ The cases lack both consistency and coherent reasoning. As a result, for many types of fraud-on-the-market class action claims against foreign issuers, the cases do not allow reliable predictions concerning whether the claims will or will not be allowed. The law also has developed without any articulated consideration of a number of important issues of public policy implicated by the decisions.

A primary cause of these problems is that the courts have attempted to apply to fraud-on-the-market claims the traditional conceptual framework for determining the extraterritorial reach of the Exchange Act §10(b) and Rule 10b-5, which, speaking loosely, allows claims where a substantial portion of the fraudulent conduct was undertaken in the United States (the “conduct

³ Part III briefly reviews and critiques these cases.

test”) or where the fraudulent conduct, though undertaken abroad, results in significant effects in the United States (the “effects test”). This conceptual framework was developed in a handful of seminal Second Circuit cases in the 1960s and 1970s to determine the jurisdictional reach of the traditional reliance based Rule 10b-5 fraud cause of action, where the claim is that the misstatement damaged the plaintiff by having induced her to enter into what turns out to be a losing transaction. The framework is reasonably workable for this traditional fraud cause of action, which typically involves a face-to-face transaction of a non-publicly traded issuer or an IPO.

The conduct test/effects test framework does not provide a coherent way to determine the jurisdictional reach of the distinctly different, and later developed, fraud-on-the-market cause of action, however, which involves a claim by an investor transacting in the secondary market in shares of an established, publicly traded issuer. Here, the quite different claim is that the plaintiff is injured by a material misstatement circulated in the public media that unfavorably influences the price at which the plaintiff transacted. In terms of the ultimate consequences of the misstatement, it should matter little where the making of the misstatement – the conduct – occurred. Regardless of the location of the announcement, the misstatement of a substantial established foreign issuer whose shares trade in an efficient market is inevitably going to circulate globally in the financial media in the same way. Similarly, it should matter little where the market on which the share was purchased is located. The misstatement did not induce the purchase on that market and issuer’s shares will have the same distorted price whatever place or places it is traded. The ultimate damaging effect of the misstatement is simply that the plaintiff

is less wealthy than if she had transacted at a price undistorted by the misstatement, whatever the location of the market where the purchase occurred. This diminution in wealth is an effect which, to the extent that identifying its physical location is even meaningful, presumably occurs in the plaintiff's country of residency, not where the transaction occurs. These difficulties in finding meaningful significance in the place of conduct or the place where the transaction occurred leave the courts without bearings in fraud-on-the-market cases with transnational claims. The result has been a jumble of confusion.

The development of law concerning what fraud-on-the-market claims with transnational elements can be collectively adjudicated pursuant to a class action in a U.S. court are similarly unsatisfactory. There is the obvious requirement that the claim be one over which the court has subject matter jurisdiction. But beyond this, in many cases the court will analyze as well whether the transnational elements would provide the basis a court of another country to exercise jurisdiction over the same claim and, if so, whether the foreign court would give preclusive effect to a U.S. judgment or court approved settlement. In at least some of these cases, where the U.S. court has concluded that the foreign court would not give preclusive effect, the U.S. court has refused to certify a class whose membership includes persons making such a claim. There is no coherent logic, however, to which claims with transnational elements are subjected to this analysis and which are not. For example the claim of a foreign resident against a foreign issuer based on a security purchase in a U.S. market is rarely subjected to this preclusion analysis but the same claim based on a security purchase in a market abroad is subjected to the analysis, even though the issuer's home country court might well take

jurisdiction over both such claims. For claims that are subject to the analysis, the courts are not consistent how likely it must be that the foreign court would not grant preclusive effect before a person making the claim is rejected from the class. And in cases where it appears highly likely that the foreign court would not grant preclusive effect, some courts inquire no further and exclude the claimant from the class, whereas others investigate as well the likelihood that the claim would ever be brought before the foreign court. Given the absence of opt-out-only class actions and permissible contingent fee arrangements in most countries of the world and the prevalence of loser pay rules, the likelihood is in fact very small in almost all cases, which makes the use of the preclusive effect analysis seem irrelevant.

B. The Need for a Simple, More Policy-Relevant Rule

The goal of this Article is to derive a simple, clear rule that is likely to both maximize U.S. economic welfare and, by also promoting global economic welfare, foster good U.S. foreign relations as well. The approach to achieving this goal is to go back to first principles by looking at the basic policy concerns that are impacted by decisions on jurisdictional reach and class certification. Each of these policy concerns provides a perspective for thinking about the range of class action fraud-on-the-market claims against foreign issuers that should be allowed given the goal of a simple rule that tends to maximize both U.S. and global economic welfare.

The policy rationale most commonly articulated in court opinions for imposing fraud-on-the-market liability is the desirability of providing investor protection through compensation. Providing compensation is supposed to reverse the purportedly unfair trading losses suffered by investors who purchased at a price inflated by an issuer's material misstatement and sold after the

inflation has dissipated. Providing such compensation, however, is shown in this Article not to be strongly justified on fairness grounds and not to furnish any benefits in terms of enhancing economic welfare.

A second policy concern relates to the fact that imposing liability deters issuers from making misstatements in the first place. Greater transparency limits the extent to which the managers of a public corporation place their own interests above those of their shareholders — the “agency costs of management.” Thus class action fraud-on-the-market suits are a corporate governance device. This Article shows that the benefits and costs of imposing fraud-on-the-market suits are concentrated in the country of the issuer’s economic center of gravity — its “home country” — , which suggests that U.S. courts should impose them only on U.S. issuers.

Another policy concern relates to the core principle in corporate law around the world that common shareholders should receive benefits arising from their status as shareholders on a pro rata basis. The right to receive fraud-on-the-market damages is shown to be such a benefit. This concern suggests that either no class action fraud-on-the-market claims should be allowed against a foreign issuer or that all claims should be allowed against the foreign issuer regardless of the nationality or residence of the plaintiff or the place she executed the transaction.

Yet another policy concern relates to capital market competitiveness and the cost for U.S. investors to diversify internationally. If the United States permits fraud-on-the-market claims against foreign issuers, but only by investors who execute their purchases on a U.S. market or only by investors who are U.S. residents, fear of U.S. class action fraud-on-the-market liability deters foreign issuers from having their shares trade in U.S. markets. This policy concern thus

also implies that either that no class action fraud-on-the-market claims should be allowed against a foreign issuer (unless the issuer voluntarily agrees to be subject to them as a form of bonding), or that all claims should be allowed against the foreign issuer regardless of the nationality or residence of the plaintiff and the place she executed the transaction.

Another policy concern relates to good neighborliness and the benefits to the United States that capital utilizing enterprises everywhere maximize returns. This concern suggests that foreign issuers that other considerations would suggest should not be the subject of fraud-on-the-market suits should be allowed, as a form of bonding, to commit themselves to be subject to such suits. A firm foreign firm that chooses this option would be signaling that it believes that although its home country's corporate governance regime does not include subjecting issuers to such suits, the issuer believes that it can assure investors a higher expected cash flow if it does subject itself to such suits.

A final policy concern relates to the economies of scale of resolving similar claims in one place and to the desirability of similar claims being treated in similar fashion. As a general matter, this concern would argue in favor of permitting class action status for all claims against foreign issuers that are decided to be within U.S. jurisdictional reach, because the likelihood of a fraud-on-the-market type claim being subsequently re-litigated against a foreign issuer in a foreign court is in fact very low, except perhaps by an investor that has engaged in some significant portion of all the affected trading.

Putting the properly analyzed implications of all these policy concerns together turns out to be surprisingly straightforward and involves no difficult tradeoffs. The ultimate conclusion is

that no class action fraud-on-the-market claims should be allowed against any genuinely foreign issuer unless the issuer has agreed, as a form of bonding, to be subject to the U.S. regime, in which case all claims should be allowed regardless of the nationality or residence of the plaintiff and the place where she executed the transaction. This simple rule will be shown to both maximize U.S. economic welfare and, by promoting global economic welfare too, assist good U.S. foreign relations as well.

The thinking generating this conclusion should be helpful to the courts as they deal with future cases. It would be difficult, however, for the courts on their own to adopt the overall rule recommended here, given the backtracking necessary from the existing body of precedent and the fact it is the SEC that is explicitly granted broad exemptive power under the Exchange Act. Adopting this rule wholesale is within the power of the SEC, however. It may at first blush seem politically unrealistic to expect that the SEC would, notwithstanding the policy logic, adopt a rule that would exempt all foreign issuers from fraud-on-the-market class actions unless they opt into the system. Recent SEC actions suggest promise, however. The SEC's acceptance of financials prepared in accordance with international accounting rules instead of U.S. GAAP for use in registered public offerings and periodic disclosure filings and its proposal to allow "foreign trading screens" (screens that allow U.S. institutional investors to trade from their U.S. offices shares listed only on a foreign, not a U.S. exchange) each show an increasing willingness to treat foreign issuers differently in order to allow further integration of the world's capital markets. Adoption of the rule proposed here would be consistent with these recent moves.

C. Overview

Part I of this Article describes the institutions that make the choice of the range of allowable class action fraud-on-the-market claims against foreign issuers — the Congress, the courts, and the SEC — and the legal constraints under which they operate in making this choice. Parts II and III review the existing doctrinal terrain. Part II describes the origins and nature of the fraud-on-the-market cause of action and how it differs from traditional securities fraud claims. Part III reviews and critiques the existing case law concerning the reach of fraud on the market class action claims against foreign issuers. Part IV is the analytical heart of the article. It starts by providing an economic analysis of the fraud-on-the-market class action. It then examines the five basic policy concerns discussed above in terms of their implications concerning what should be the range of allowable class action fraud-on-the-market claims against foreign issuers. From this examination, it derives the recommended rule that foreign issuers should be exempt from such claims unless they opt into the system. Part V compares the rule proposed here with reforms recommended by other commentators in reaction to problems with the current body of case law relating to the range of allowable claims. Part VI discusses implementation of the proposed rule. Part VII concludes.

I. THE FRAMEWORK FOR CHOOSING THE REACH OF THE ACTION

[Discussion to come concerning the institutions that make the choice of the range of allowable class action fraud-on-the-market claims against foreign issuers – the Congress, the courts and the SEC – and the legal constraints under which they operate in making this choice. For courts, jurisdictional reach is a question of legislative interpretation. Where the statute is silent, the presumption is against extraterritorial application, but there are important exceptions, as well

as the existence of ambiguity as to where conduct occurs, that taken together give courts much discretion. Also there is a presumption against an interpretation that would exceed the reach permitted under international law in terms of jurisdiction to prescribe, which will be briefly described. These are the international law boundaries on Congressional action as well. SEC rule-making and exemption granting powers is also explained.]

II. THE FRAUD-ON-THE-MARKET CAUSE OF ACTION

The logical starting point for studying the fraud-on-the-market cause of action against foreign issuers is to review its domestic origins. This history helps us understand much of the confusion in the case law concerning the reach of the fraud-on-the-market cause of action against foreign issuers. The fraud-on-the-market cause of action that is the basis of class action claims for secondary market trading losses caused by issuer misstatements arose through legal evolution from the standard fraud action based on traditional reliance concepts. The fraud-on-the-market cause of action and the traditional reliance based cause of action are very different, however. Their differences are important because, as will be discussed in Part III, the conduct test/effects test conceptual framework for determining extra-territorial reach was originally developed to deal with traditional reliance based fraud claims. The courts have not fully thought through the differences between the two causes of action in their attempt to apply the same framework to the question of the reach of the transnational fraud-on-the-market actions.

A. The Development of a Claim for Damages from Corporate Misstatements

Consider an established U.S. issuer whose shares trade in an efficient market. This issuer makes with scienter a material misstatement but neither it, nor its insiders, engage in any trading

of the issuer's shares. For most of the history of the U.S. securities laws, the ordinary portfolio investor who suffered a loss from transacting in the shares of this issuer at a price unfavorably influenced by the misstatement would not, as a practical matter, have a claim for the resulting damages. Three principles needed to be established before this situation could change: that an issuer making such a statement under these circumstances violates the law, that such a violation can give rise to a private right of action by those damaged by the violation, and that the right of action could be established without the plaintiff having the burden to affirmatively show that he relied on the misstatement, a burden that makes class actions impractical.

1. The Illegality of Corporate Misstatements

Rule 10b-5 provides in part “it shall be unlawful for any person, directly or indirectly, ... to make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading ... in connection with the purchase or sale of a security.” On the face of the rule, it is not obvious that an issuer that makes a material misstatement, but does not purchase or sell any securities, violates the rule because it is not clear that the misstatement was made “in connection with the purchase or sale of a security.” In 1968, however, in *S.E.C. v Texas Gulf Sulphur*, the Second Circuit found that whenever an issuer makes a statement that is “reasonably calculated to influence the investing public,” for example by making the statement to the media, such statement satisfies Rule 10b-5's requirement that it be “in connection with the purchase or sale of a security,” even if neither the issuer nor its managers buy or sell shares themselves.⁴ The theory is that issuer would know that

⁴*S.E.C. v Texas Gulf Sulphur*, 401 F.2d 833, 859--61 (2d Cir. 1968)

persons trading in the secondary market would be affected in their trading decisions by the statement.

2. *Private Right of Action*

Rule 10b-5 does not explicitly provide for a private right of action in the event of its violation. Nevertheless, as early as 1946, in the seminal case *Kardon v. National Gypsum*,⁵ a court found the existence of an implied private right of action available to those persons intended to be protected by the Rule who suffer an injury to the interest intended to be protected.⁶ The theory behind this finding was that under the common law, a violation of a legislative enactment is a tort against any such protected person who suffers an injury to such protected interest.⁷

3. *Presumption of Reliance on the Integrity of the Market and the Possibility of Class Actions*

By the end of the 1960s, a material public corporate misstatement made with scienter would have been considered, under *Texas Gulf Sulfur*, to violate Rule 10b-5 and a private right of action for this violation of the Rule had been clearly established. This potential liability had not yet typically become a serious threat to the issuer that made the misstatement, however. The stumbling block for plaintiffs was the requirement that they show “reliance,” as that term was traditionally understood. As described below, a major portion of the issuer’s investors in all likelihood in fact did not rely in this traditional sense on the issuer’s misstatement. Even for each of those who did, traditional reliance is individualistic and so the requirement that it be shown

⁵*Kardon v. National Gypsum Co.*, 69 F.Supp. 512 (E.D.Pa. 1946)

⁶*Id.* at []

⁷*Id.* at []. The Supreme Court ultimately affirmed the existence of this right 25 years later in *Supt. of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, [] (1971).

makes a class action against an issuer impractical.

a. The traditional reliance requirement. The seminal case defining traditional reliance is the Second Circuit’s 1965 opinion in *List v. Fashion Park*.⁸ The district court in *List* found that the plaintiff, with regard to one of his allegations, would have purchased even if he had known the true situation.⁹ On the basis of this finding, the district court dismissed the claim relating to this allegation. The Second Circuit affirmed.¹⁰ In reaching its decision, the Second Circuit started with a ruling that the requirement in common law misrepresentation cases that the plaintiff show “reliance” “carried over into civil suits under Rule 10b-5.”¹¹ Citing common law authorities, the court found that “the test of ‘reliance’ is whether ‘the misrepresentation is a substantial factor in determining the *course of conduct* which results in (the recipient’s) loss.”¹² The court stated “the reason for this requirement is to certify that the conduct of the defendant actually caused the plaintiff’s injury.”¹³ Given the district court’s finding that the plaintiff would have purchased anyway, which the appeals court did not find clearly erroneous, the plaintiff clearly failed the test.

⁸*List v. Fashion Park*, 340 F.2d 457 (2d Cir. 1965). *List* was a non-disclosure case where the plaintiff claimed injury because an insider stayed silent when he allegedly had a duty to speak, not a case based on an affirmative misleading statement. The court’s analysis, however, drew upon affirmative misleading statement cases in the common law and its definition of reliance has been regularly cited as controlling in subsequent Rule 10b-5 affirmative misleading statement cases.

⁹340 F.2d at 464

¹⁰*Id.*

¹¹340 F.2d at 462-63.

¹²340 F.2d. at 462 (citations omitted) (emphasis added).

¹³*Id.*

b. The fraud-on-the-market theory of reliance. The fraud-on-the-market theory of reliance was first enunciated in the lower courts in the 1970s and was affirmed by the Supreme Court in the *Basic v. Levinson* in 1988.¹⁴ Under the theory, a material public misstatement by an official of an issuer whose shares trade in an efficient market will, consistent with the efficient market hypothesis (EMH), affect the issuer’s share price. This effect on price provides a plaintiff with a way of showing “the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”¹⁵ Traditional reliance — showing that the misstatement induced the plaintiff into purchasing or selling the security — was previously the only way of establishing this causal link. With the ruling in *Basic*, the court established an alternative way of doing so.

The Court insisted in *Basic* that its ruling maintained the need for plaintiff to show reliance, just in the form of “reliance on the integrity of [the market] price”¹⁶ instead of reliance on the misstatement itself. The case establishes a presumption of this new kind of reliance on the integrity of the market price.¹⁷ There is big difference between these two forms of reliance, however. Unlike traditional reliance, the plaintiff no longer needs to show she would have acted differently — i.e., not purchased the security — if the defendant had not made the misstatement.

c. Availability of class actions. Allowing the plaintiff to establish reliance in this alternative way — by a showing in the case of a positive misstatement that it caused the plaintiff

¹⁴*Basic Inc. v Levinson*, 485 U.S. 224 (1988)

¹⁵*Id.* at 243.

¹⁶*Id.* at 247.

¹⁷ [Explain how can be rebutted]

to pay too much rather than by a showing that the misstatement caused the plaintiff to enter into what turned out to be an unfavorable transaction — eliminates the need to make particularized claims of reliance for each purchaser. Thus common issues of fact predominate and class actions become possible.

Given the high costs of securities litigation, the ordinary portfolio investor will rarely find the prospective recovery of just her own damages sufficient to justify the cost of bringing suit. Through bundling together many claims against the same issuer for the same misstatement, class actions permit realization of very substantial economies of scale such that the prospective recovery is sufficient to justify the cost of bringing suit. Thus the establishment of the fraud-on-the-market presumption of reliance, by making class actions possible, made practical for the first time the pursuit of the the claims of ordinary portfolio investors who suffer losses from share transactions at prices unfavorably influenced by issuer misstatements.

B. Traditional Reliance Based Claims Compared to Fraud on the Market Claims

Fraud-on-the-market actions and traditional reliance based fraud actions arise from two distinctly different claims of injury. As discussed above, the plaintiff in a traditional reliance based action needs to show that she would have *acted* differently but for the wrongful misstatement and that she would have been better off if she had. At a minimum, this requires that the plaintiff have been aware of the statement. The plaintiff in the fraud-on-the-market action needs to show that the *price* at which she transacted would have been more favorable but for the misstatement.

An action based on a showing of traditional reliance typically grows out of a face-to-face

purchase of shares of a non-publicly traded issuer or a purchase at or about the time of an IPO, because these are the only situations where investors are likely to be able to show that they would have acted differently. The focus on the effect of the misstatement on the decision of the plaintiff whether to enter into the transaction is appropriate in these situations. The price that the plaintiff pays is not one established in an efficient secondary market. As a consequence, the value of the security is much more subjective and the relationship between the misleading statement and the price which the plaintiff paid is unclear.¹⁸

In a fraud-on-the-market action, the typical plaintiff is a portfolio investor or an index fund which has engaged in an impersonal transaction in the secondary market on the NYSE or NASDAQ. The plaintiff may well not even have been aware of the misstatement. Even if she were, the misstatement is unlikely to have been decisive in her decision to purchase, since the misstatement, while making the stock appear more attractive than it really is, would also have made it commensurately more expensive. Thus, whether she was aware of the statement or not, she likely would have made the purchase even if the misstatement had not been made, just at a lower price. Consequently, the misstatement is not likely to be a “but for” cause for the purchase. But a genuinely material misstatement will likely affect the price paid.

III. THE EFFECTS TEST/CONDUCT TEST CONCEPTUAL FRAMEWORK

Four seminal Second Circuit cases are the origins of the conceptual framework that has been used since to determine the jurisdictional reach with regard to all Rule 10b-5 claims,

¹⁸As one district court, quoted in *Basic*, put it, “In face-to-face transactions, the inquiry into an investor’s reliance upon information is in the subjective pricing of that information by that investor.” *In re LTV Securities Litigation*, 88 F.R.D. 134, 143 (ND Tex. 1980) (quoted in *Basic*, 485 U.S. at 244).

including fraud-on-the-market claims: *Shoenbaum v. Firstbrook*,¹⁹ *Leasco v. Maxwell*,²⁰ *Bersch v. Drexel v. Firestone*,²¹ and *ITT v. Vencap*,²² Commentators and later court decisions subsequently distilled the results of these seminal cases down to two tests: the “effects test” and the “conduct” test. This Part will discuss the specifics of the cases and then the tests that have been subsequently derived from them. As will become clear, although these tests are what the courts consistently use to determine the reach of fraud-on-the-market claims, the cases from which the tests were derived all involve traditional reliance based claims.

A. The Four Seminal Cases

It is worthwhile discussing briefly the particulars of each of the four seminal cases. These cases do not themselves use the terms “effects test” and “conduct test” and both their reasoning and their holdings are more nuanced than this subsequently developed conceptual framework suggests. A focus on these particulars reveals that the underlying causes of action in these cases are fundamentally different from the fraud-on-the-market cause of action. Because of these important differences, these seminal cases constitute an unclear guide for determining the reach of the fraud-on-the-market cause of action. Use of this unclear guide has meant that the subsequent case law on the reach of fraud-on-the-market claims is a jumble of confusion. Its use has also deflected the attention of courts from what are in fact the true key policy issues at stake

¹⁹*Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir. 1968) , *rev'd* on other grounds on rehearing en banc, 405 F.2d 215 (2d Cir. 1968).

²⁰*Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1326).

²¹*Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir. 1975).

²²*ITT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975).

as they have fashioned a new body of court made law that has substantial social impact.

1. Schoenbaum v. Firstbrook.

Schoenbaum was a shareholder derivative suit filed on behalf Banf Oil Ltd., a Canadian corporation, against its controlling shareholder, Acquitaine of Canada, Ltd., also a Canadian corporation. Banf, however, was an Exchange Act registered company whose shares traded on the American Stock Exchange as well as the Toronto Stock Exchange. Banf and its controlling shareholder Acquitaine were aware of successful oil drilling operations by Banf, but the public was not aware. Banf issued to Acquitaine Banf shares at the then market price of Banf shares, a price that did not reflect these successful drilling operations. The suit claimed that this stock transaction was fraudulent in violation of Rule 10b-5. The defendants moved for summary judgment on the ground, among others, that the Exchange Act did not apply extraterritorially to this stock transaction occurring in Canada between two Canadian corporations. The district court granted the motion but the Second Circuit reversed, holding that the district did have subject matter jurisdiction for transactions violating the Act that take place outside of the United States, “at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors.”²³

The Second Circuit begins its argument by noting that since Banf was registered under the Exchange Act, it was required, in order to protect U.S. shareholders, to comply with various requirements of the Act, including making periodic mandatory disclosure filings with the SEC,

²³405 F.2d [FN 4]

even though Banf is located outside of the United States.²⁴ It then says:

Similarly, the anti-fraud provisions of §10(b) ... reaches beyond the territorial limits of the United States and applies when a violation of the Rules is injurious to United States investors. “Acts done outside a jurisdiction, but intended to produce and producing detrimental *effects* within it, justify a state in punishing the cause of the harm as if [the actor] had been present at the [time of the detrimental effect].²⁵

The Second Circuit dismissed the district court’s finding that the issuance of the shares to Acquitaine had no effect within the United States because the only resulting harm occurred to a foreign corporation. The Second Circuit found that such harm would reduce the value of the corporation’s shares and the price at which they were trading in the U.S. market, concluding, “this impairment of value of American investments ... has ... a sufficiently serious effect upon United States commerce to warrant assertion of jurisdiction for the protection of American investors.”²⁶

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

²⁴405 F.2d [FN 1].

²⁵405 F.2d [FN 2] (quoting *Strassheim v. Daily*, 221 U.S. 280 , 285 (1911)) (emphasis added).

²⁶405 F.2d [FN 3]

foreign buyer.

The second notable feature is that this decision on the reach of Rule 10b-5 occurs within the within the context of a derivative suit. Thus, while the court's concern is with its conception of what it believes Congress would have wanted in terms of regulatory protection for U.S. investors, non-U.S. investors will receive the same treatment. From a recovery point of view, non-U.S. investors will derivatively share equally on a pro-rata basis with the U.S. investors any damages received by Banf if the action succeeds on the merits. More generally, the decision implies that non-U.S. shareholders in foreign corporations registered under the Exchange Act will have their investments subject to the kind of regulation that the U.S. believes is best for investors, whether or not the issuer's home country, or the home country or countries of the non-U.S. shareholders, would agree. This is a striking result given that the non-U.S. shareholders of the typical foreign issuer, even if Exchange Act registered, will way outnumber the U.S. shareholders and often a substantial portion of these non-U.S. shareholders will be from the same country as the issuer.

The third notable feature of the decision is that the regulatory aspect of Rule 10b-5 alleged to be violated in *Shoenbaum* primarily concerns corporate governance, not the trading of shares. In reality, agents of both parties to the transaction – directors and officers of Banf and the officials of Aquitaine – knew of the successful drilling operations. Thus, if the court had followed the usual rule of attributing to the principal the knowledge of its agents, there could be no securities fraud because parties on both sides of the transaction were equally informed and so there was no deception. The real underlying issue is a corporate governance one of whether it

was appropriate for the Banf to sell something of value to its controlling shareholder at the price that it did. Acquitaine, in addition to its claim of no subject matter jurisdiction, moved for summary judgment as well on the theory that Rule 10b-5 did not govern corporate governance issues of this kind. The Second Circuit, in an *en banc* decision, denied the motion. In its view, there were genuine issues of fact with respect to the plaintiff's claim that given Acquitaine's control position in Banf, the process by which Banf's board approved the transaction was insufficient to legitimate the price at which the transaction occurred. Based on this alleged defect in the process of approval, the court decided that it should not attribute to Banf knowledge of the successful drilling, at least at the summary judgment stage of the litigation. With Banf being considered uninformed of material information possessed by Acquitaine, a claim of securities fraud could then be made out.

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

2. *Leasco v. Maxwell*

According to the complaint in this case, the late British press mogul Robert Maxwell made material misstatements to executives of Leasco, a U.S. corporation, in connection with

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

We must ask ourselves whether, if Congress had thought about the point, it would not have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him purchase foreign securities abroad ... We doubt that impact on an American company and its shareholders would suffice to make the statute applicable if the misconduct had occurred solely in England, we think it tips the scales in favor of applicability when substantial misrepresentations were made in the United States.²⁷

Again the case has several notable features in terms of our subsequent discussion of the reach of fraud-on-the-market claims against foreign issuers. To start, the ultimate effect of the

²⁷468 F.2d [FN 1].

misconduct — the diminution in the wealth position of a United States person as the result of a securities transaction — is as much located in the United States as it is in *Shoenbaum*. In *Schoenbaum*, none of the misconduct occurred in the United States but the court nevertheless finds subject matter jurisdiction. In contrast, Friendly says that the court would not have found subject matter jurisdiction if none of the conduct in *Leasco* occurred in the United States. The fact that the issuer of the shares is not registered under the Exchange Act is thus important.²⁸ Therefore, *Shoenbaum* does not exactly establish an “effects” test for finding subject matter jurisdiction and *Leasco* an alternative “conduct” test. Rather, both cases involve effects that occur in the United States and both have something more in addition. In *Shoenbaum*, the something more is registration under the Exchange Act. In *Leasco*, the something more is the fact that some of the conduct occurred in the United States.

Judge Friendly’s opinion is also interesting for its reasoning in refusing to find the location of the transaction or the nationality of the issuer to be critical in the subject matter jurisdiction determination, even for an issuer not registered under the Exchange Act. In dismissing the portion of the defense argument that there is no subject matter jurisdiction based on the fact that the place of the transaction is abroad, he observes “in [the] closely related context of choice of law, the mechanical test that, in determining the *locus delecti*, ‘The place of the wrong is in the state where the last event necessary to make an actor liable for an alleged tort takes place’ ... has given way in the case of fraud and misrepresentation to a more extensive and

²⁸Judge Friendly explicitly uses Banf’s Exchange Act registration “to differentiate the problem here presented [in *Leasco*] from the point decided in *Shoenbaum*.” 468 F.2d [FN2].

sophisticated analysis.”²⁹ In dismissing the portion of the parallel defense argument based on the fact that the nationality of issuer is foreign, he says that given that §10(b) is not limited to securities listed on organized public markets in the United States, there is no reason why Congress “should have wished to limit the protection to securities of American issuers.” His rationale goes back, for issuers not registered under the Exchange Act, to the combined importance of effect and conduct in the United States, saying “The New Yorker who is the object of fraudulent misrepresentations in New York is as much injured if the securities are of a mine in Saskatchewan as in Nevada.”³⁰

3. *Bersch v. Drexel Firestone*

This case involved a class action by purchasers of shares of IOS, Ltd., a company that managed mutual funds, in what were three simultaneous, coordinated public offerings of IOS shares - the “Primary offering,” the “IOB offering” and the “Crang offering,” each of which was aimed at a different set of offerees in terms of residency or employment status. There had previously been no organized public trading of IOS shares³¹ and so the overall three-offering deal was equivalent to an IPO. IOS had a somewhat blurred national identity: it was incorporated in

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

³⁰468 F.2d [FN 5]

³¹Prior to the offering, there was no organized market for IOS shares. 519 F.2d [FN 1]

Canada, headquartered in Switzerland, and founded and headed by a U.S. citizen, Bernard Cornfeld. The funds it managed, while marketed to persons abroad, invested primarily in the shares of U.S. companies. Indeed their purpose was to be vehicles by which persons from abroad could, indirectly, invest in the U.S. stock market.³² The offering of IOS stock purported to be structured so as not to extend to residents of the United States. The vast majority of the class members were non-U.S. citizens residing outside the United States, but 22 U.S. resident Americans acquired IOS shares through the deal and were included in the class. The record does not reveal how these U.S. resident Americans acquired their shares.³³ The complaint alleged that the prospectus in each of the three offerings contained material misstatements in violation of Rule 10b-5.

a. Non-U.S. resident foreigners. Judge Friendly found that the court does *not* have subject matter jurisdiction with respect to the claims of the non-U.S. resident foreign members of the class.³⁴ Clearly, with respect to these plaintiffs, the materially misleading statements had no effects in the United States. The inquiry therefore is focused on whether there was conduct within the United States by any of the defendants that was sufficient by itself to create subject matter jurisdiction.

The activities that were undertaken in the United States in connection with the deal were primarily undertaken by the defendant Drexel. Drexel, a U.S. headquartered investment bank,

³²519 F.2d [FN 4].

³³519 F.2d [FN 5]

³⁴519 F.2d [FN 6]

was a managing underwriter for the Primary offering. The Primary offering was aimed at investors in Europe, Asia and Australia. Drexel, and the lawyers and accountants that it retained, undertook a number of activities in the United States that were associated with the Primary offering. These activities included meeting with representatives of IOS and their attorneys and accountants to organize and structure the offering, discussing preliminarily underwriting discounts and commissions, and drafting parts of the prospectus.³⁵ The place from which the final prospectus was sent out to potential investors was abroad, however, as was the place where orders were received and where shares were exchanged for cash.

Friendly's conclusion that there was not subject matter jurisdiction with respect to the foreign non-U.S. resident class members flows from his statement "The fraud, if there was one, was committed by placing the allegedly false and misleading prospectus in the purchaser's hands. Here the final prospectus emanated from a foreign source."³⁶ In his summary of his opinion, he states "the federal securities laws ... do not apply to losses from sales of securities to foreigners outside the United States unless acts ... within the United states *directly* caused such losses"³⁷ In other words, conduct in the United States, without any effects there, can by itself give rise to subject matter jurisdiction if the U.S. conduct is sufficiently extensive relative to the total set of

³⁵519 F.2d [FN 7]

³⁶519 F.2d [FN2] (emphasis added). The court said it had no doubt that Drexel's activities in the United States were sufficient for the United States to have jurisdiction to prescribe under international law and if it wished impose its rules as to whatever consequences might flow from such activities. *Id.* at [FN 8]. The question of jurisdictional reach, however, is one of statutory interpretation and the court suggests it would be a mistake that the legislature necessarily intended the reach of its regulation to extend as far as would be permitted under international law. *Id.*

³⁷519 F.2d [FN3]

acts constituting the fraud. Friendly breaks new ground by suggesting the existence of such a threshold, the crossing of which would result in subject matter jurisdiction despite no effects being felt in the United States by the plaintiffs. But the suggestion is only *dicta* because he finds that Drexel's U.S. conduct did not reach this less than fully defined threshold.

b. U.S. resident Americans. Judge Friendly found that the court *does* have subject matter jurisdiction with respect to the claims of the U.S. resident American members of the class.³⁸ All of the U.S. resident American members of the class acquired their shares in the IOB offering, not the Primary offering, but the two offerings had essentially identical prospectuses. Judge Friendly “see[s] no reason there would not be subject matter jurisdiction ... on the part of defendants IOS and Cornfeld who were responsible for the IOB Offering,”³⁹ even though their conduct appears to have largely taken place outside the United States. As for Drexel, which underwrote only the Primary Offering, not the IOB offering, subject matter jurisdiction depends “on whether their activities, whether in the United States or abroad, can be considered essential to the carrying out of the IOB offering”⁴⁰ because of the coordinated, simultaneous nature of the two offerings. Friendly adds, “on the material before the district judge we think they can properly be, although this would be open to disproof at trial.”⁴¹

Recall that in *Leasco*, the Second Circuit said that where the conduct is primarily abroad

³⁸519 F.2d [FN 9].

³⁹*Id.*

⁴⁰519 F.2d [FN 10]

⁴¹519 F.2d [FN 11]

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

[A]t the present stage we must assume that there was some mailing of the prospectuses into the United States and some reliance upon them ... [A]ction [by defendants] in the United States is not necessary when subject matter jurisdiction is predicated on a direct effect here"⁴²

Thus in *Leasco* Judge Friendly said in *dicta* that conduct abroad by a foreign issuer not registered under the Exchange Act could give rise to subject matter jurisdiction, but only if it had a "direct effect" in the United States. A mere diminution in U.S. investor wealth would not be such a "direct effect." In *Bersch* he shows us what in his view would constitute a "direct effect."

c. Notable features. *Bersch* adds to the jurisprudence of the reach of Rule 10b-5 in two ways that will be relevant to our later discussion. First, it establishes, though in *dicta*, that conduct alone in the United States, without any effects occurring in the United States or the defendant being a U.S. person, is sufficient to establish subject matter jurisdiction. Second, the

⁴²519 F.2d [FN 12] The court concluded that it had subject matter jurisdiction with respect to the claim by U.S. resident Americans against Arthur Andersen also, based on this reasoning. Andersen permitted its report on the IOS financials to be used in the prospectuses of the IOB offering. While the preparation of the report and the granting of permission may have occurred abroad, the IOB offering prospectus is assumed by the court to have been mailed into the United States.

court holds that there is subject matter jurisdiction, despite the conduct being primarily abroad and the issuer being foreign and not Exchange Act registered, where the effect in the United States goes beyond a mere diminution of wealth of U.S. persons and includes the misstatement reaching investors located in the United States who are induced into acting by purchasing the issuer's securities.

4. *IIT v. Vencap*

This case involved an appeal from a district court ruling appointing a receiver for IIT, an international investment trust, and enjoining certain defendants from utilizing the assets of IIT or of certain corporations in which IIT had invested. The suit was brought by the liquidators of IIT based on a claim that the defendants had fraudulently funneled funds from the trust in violation of Rule 10b-5.

IIT was organized under the laws of Luxembourg and the liquidators were appointed by Luxembourg citizens appointed by the District Court of Luxembourg. IIT was not registered under the Exchange Act or other U.S. securities laws. IIT shares “apparently were not intended to be offered to American residents or citizens”⁴³ and only a tiny fraction of IIT’s investors were Americans.⁴⁴

The “leading player” among the defendants was Richard Pistell,⁴⁵ a U.S. citizen who resided in the Bahamas. He was the organizer of the defendant Vencamp Limited, which was

⁴³519 F.2d 1017.

⁴⁴At most, Americans constituted .2% of IIT’s fundholders and their holdings constituted at most .5% of the total amount invested in IIT. 519 F.2d 1016.

⁴⁵519 F.2d 1004.

purported to be a venture capital company organized under the laws of the Bahamas. IIT invested in Vencap, the funds of which were subsequently allegedly misused by Pistell and entities that he controlled. While the facts concerning how IIT's investment in Vencamp transpired are very complex and to some extent disputed, it appears that the transaction was largely negotiated outside the United States and that the closing, where IIT exchanged funds for an interest in Vencamp, occurred in the Bahamas. After Vencap obtained its financing, however, it appears to have used its law firm's office in New York as its base. This period after the IIT financing was obtained is when the alleged funneling of funds occurred.

Among several theories presented by plaintiffs as to how the events related in the complaint constituted a violation of Rule 10b-5, Judge Friendly finds two potentially plausible. One theory is that IIT, as a shareholder of Vencamp, is essentially bringing a derivative suit on Vencamp's behalf.⁴⁶ This theory similar to that in *Shoenbaum* except that, unlike in *Shoenbaum*, the issuer is not registered under the Exchange Act. Under this theory, the securities transactions in connection with which the fraud occurred were the transactions between Vencamp and Pistell and his other controlled entities that, because of their unfair non-arms-length terms, funneled off funds from Vencamp to Pistell's advantage. The other theory is that Vencamp implicitly represented to IIT in connection with obtaining IIT's funds that Vencamp "would be run solely as a bona fide venture capital enterprise whereas in truth and fact it was intended, at least in part, to be used for Pistell's private benefit."⁴⁷ Under this theory, the securities transaction in connection

⁴⁶519 F.2d 1013.

⁴⁷519 F.2d 1013.

with which the misstatement occurred was IIT's investment in Vencamp.

Judge Friendly rejects two possible bases for subject matter jurisdiction. The first rejected idea is that subject matter jurisdiction in this case could be based solely on the defendant Pistel's U.S. citizenship. He notes that while under international law jurisdiction to prescribe, the United States clearly has the authority to prohibit a U.S. citizen anywhere in the world from behaving in a way that would, if it occurred in an entirely domestic situation, violate Rule 10b-5, it is "unimaginable that Congress would have wished [§10(b)] ... to apply ... if Pistell while in London had done all the acts here charged and had defrauded only European investors."⁴⁸ As for basing subject matter jurisdiction on effects in the United States, Friendly finds that given the tiny percentage of American ownership in IIT, the United States, under international jurisdiction to prescribe, would not even have the authority to prohibit the behavior with which Pistell was charged based solely on its effects in the United States.⁴⁹

Friendly concludes, however, that, depending on further findings by the district court, conduct in the United States could be the basis for subject matter jurisdiction in the case. Under the derivative suit theory, given that Vencap appears to have used its lawyers' offices in New York as its base after the financing from IIT was obtained, the defendants' alleged acts of

⁴⁸519 F.2d 1016.

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

inducing of Vencap into the securities transactions by which Pistell funneled off money may have occurred in New York. Under the theory that Vencap was misrepresented as being a legitimate venture capital firm in order to induce IIT to invest, the subsequent acts that resulted in the use of part of Vencap's funds instead being used for Pistell's personal benefit may, given Vencap's apparent base, also have occurred in New York. These acts "would not only be evidence of the misrepresentation but the cause of the damage."⁵⁰ Under either theory, if the requisite acts were in fact found to have occurred in New York, this conduct in the United States would be sufficient, apparently by itself, for there to be subject matter jurisdiction.⁵¹

Friendly's rationale for finding subject matter jurisdiction solely on the basis of conduct in the United States was one of good neighborliness and the increased likelihood of reciprocal regulation by other countries of behavior abroad that would damage the United States:

We do not think that Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners. This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States. By the same token it is hard to believe Congress meant to prohibit the SEC from policing similar activities within this country.⁵²

In sum, the most notable feature of the *Vencap* decision thus was a holding to the effect

⁵⁰519 F.2d 1018.

⁵¹519 F.2d 1018.

⁵²519 F.2d 1017 (citations omitted).

that even where the issuer was foreign and not registered under the Exchange Act, the transaction occurred abroad, and the ultimate effects were essentially entirely abroad, conduct alone in the United States could give rise to subject matter jurisdiction.

B. Distillation into the Effects Test/Conduct Test Framework

The jurisprudence developed in these four seminal cases concerning the transnational reach of Rule 10b-5 has been distilled in numerous subsequent traditional reliance cases into two tests. In accordance with the “effects test,” U.S. courts have “asserted jurisdiction over extraterritorial conduct that produces substantial effects within the United States.”⁵³ In accordance with the “conduct test,” U.S. courts have asserted jurisdiction in cases involving “acts done in the United States that ‘directly caused’ the losses suffered by investors outside this country.”⁵⁴

The conduct test/effects test framework is reasonably workable for these traditional fraud cases, which typically involve a face-to-face transaction in the shares of a non-publicly traded issuer or an IPO. In these cases the false statement is specifically placed in the hands of the investor and the statement induces the investor into making the purchase. The cause of action thus resembles the classic “shooting a bullet across state lines” hypothetical, cited by Judge Friendly in *Bersch*, that is a key illustration in the discussion that gives rise to these two tests in the international law jurisdiction to prescribe jurisprudence.⁵⁵ As developed below, however, the

⁵³ See, e.g., *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 30 (D.C. Cir. 1987) [citing *Shoenbaum*].

⁵⁴ *Id* [citing *Bersch*].

⁵⁵ See ALI Restatement (3rd) of Foreign Relations Law, §§402, 403; *Bersch*, 519 F.2d at [].

framework does not provide a coherent way to determine the jurisdictional reach of the distinctly different, and later developed, fraud-on-the-market cause of action, which relates to damages suffered by an investor transacting in the secondary market in shares of an established, publicly traded issuer.

C. Application of the Framework to Fraud-on-the-Market Cases

Fraud-on-the-market cases involve the quite different claim that the plaintiff is injured by a material misstatement circulated in the public media that unfavorably influences the price at which the plaintiff transacted. Consider a misstatement made by a substantial established foreign issuer whose shares are held by in significant numbers by investors resident in many countries of the world, including the United States. The misstatement is inevitably going to circulate globally in the financial media in the same way regardless of where the announcement is actually made. Whether a German firm makes the misstatement at a press conference in New York or Frankfurt seems unimportant: many of the ultimate recipients will not even know the place of the announcement and the effect on the price is the same. There are no strong rationales for making the particular geographic location of the misstatement's introduction into the global web of communication have critical legal importance for a claim based on the misstatements effect on price.

Similarly, the issuer's shares will have the same distorted price at whatever place or places in the world that they are traded and the misstatement will have no impact on an investor's choice of where to trade. Thus, to the extent that "effect" is measured by the location at which the plaintiff executed her transaction at this unfavorable price, the place of such an effect seems

unrelated to the rationale for the cause of action. The ultimate damaging effect of the misstatement is simply that the plaintiff is less wealthy than if she had transacted at an price undistorted by the misstatement. This is an effect which, to the extent that identifying its physical location is even meaningful, presumably occurs in the plaintiff's country of residency, not where the transaction occurs.

These difficulties leave the courts without bearings in fraud-on-the-market cases and the result has been a jumble of confusion.

[Discussion to come that will be a summary of some of the findings of the courts applying the conduct/effects test to FOM actions against foreign issuers to show the inconsistencies. As for the conduct test, some courts maintain that filing with the SEC an Exchange Act periodic disclosure form containing a material misstatement is sufficient "conduct" in the United States to give rise to jurisdiction over a claim against the foreign issuer. Other courts maintain that such a filing is merely ministerial and would not give rise to jurisdiction unless the foreign issuer has more actively come to the United States and disseminated the misstatement. Others focus on where the filing was prepared. Still others focus on where the decision as to the content of the filing was made. Some courts find that there is conduct in the United States if actions or matters that are the subject of the misstatement occur in the United States even if the statements themselves were issued abroad, whereas others reject this idea. As for the effects test, some courts define the location of an "effect" in terms of the residency of persons who are damaged, whereas others define it in terms of where the transaction that gave rise to the damage occurred.]

D. The Need for a Clear Policy-Based Alternative

Use of the ill fitting effects/conduct conceptual framework for determining jurisdictional reach to fraud-on-the-market cases has led to a body of case law that fails both to provide clear guidance as to what is needed for there to be jurisdiction in a fraud-on-the-market class action claim against a foreign issuer and to grapple with the underlying policy issues at stake. Both these consequences are unfortunate. What is needed is a clear, policy-based alternative framework.

1. Failure to provide clear guidance

As just demonstrated, the current body of case law on the transnational reach of fraud-on-the-market actions fails to provide a clear guide as to when U.S. courts will and will not exercise jurisdiction. As a result, when foreign issuers choose whether or not to undertake any of a wide variety of actions – ranging from whether to list their shares on a U.S. exchange to the wording and methods for disseminating their disclosures – they are unsure of the consequences in terms of the potential for incurring very substantial liability imposed by the U.S. courts. This uncertainty not only increases their need to consume legal resources, it may cause them to change behavior from what they believe is optimal without any corresponding U.S. benefit.

Lack of clarity also has negative effects in terms of the litigation process in the United States. Scarce resources are wasted by both sides in litigation because more suits are brought that ultimately fail. At the same time, there are suits that ultimately could have succeeded, but the lack of legal clarity makes them too risky to bring. As a result, the cause of action's deterrence and compensatory objectives are eroded. Scarce resources are also wasted because

lack of clarity increases the likelihood that plaintiffs and defendants will assess differently the odds of plaintiff succeeding in the litigation, which increases the odds that settlement will be delayed at least until the litigation has proceeded to the point where the court has ruled on the questions of jurisdiction and class certification. Lack of clarity also erodes a sense of justice, because like cases are often not treated in a like fashion.

2. Lack of attention to policy

U.S. courts, as they use this ill fitting effects/conduct conceptual framework to rule in the cases coming before them, have been fashioning a new body of law with substantial social impact, but their attention to the key policy issues at stake has been deflected by their struggle to apply this conceptual framework to cases that it does not fit. In essence, the doctrinal boxes into which they need to fit the facts of each case do not fit the underlying policy issues with which they should be grappling. Courts may still be making decisions based on policy considerations, but they are doing so in an undisciplined way that makes the development of reasoned precedent particularly difficult.

3. A new approach

The alternative approach, suggested here, is a simple rule that no class action fraud-on-the-market claims should be allowed against any genuinely foreign issuer — one with its economic center of a gravity outside the United States — unless the issuer has agreed, as a form of bonding, to be subject to the U.S. regime, in which case all claims should be allowed regardless of the nationality or residence of the plaintiff and the place that she executed the transaction. This simple rule is not only relatively clear in its application, it also maximizes U.S.

economic welfare as the discussion of policy considerations in Part IV immediately below, reveals. By promoting global economic welfare too, the proposed rule is good U.S. foreign relations as well.

IV. POLICY CONCERNS AND THEIR IMPLICATIONS FOR TRANSNATIONAL REACH

Five areas of policy concern appear to be impacted by decisions on jurisdictional reach and class certification with regard to fraud-on-the-market actions: provision of investor protection through compensation, improving corporate governance and market liquidity by deterring issuers from making misstatements, avoiding provision of non-pro rata benefits to issuer shareholders, competitiveness of U.S. capital markets, and advantages of resolving similar claims in one place in terms of economies of scale and consistency of treatment. Each of these policy concerns provides a perspective for thinking about the appropriate range of allowable class action fraud-on-the-market claims against foreign issuers. The starting point for thinking about each of these concerns, however is a fundamental analysis of what are, and are not, good reasons for permitting the claims even in the entirely domestic context.

A. An Economic Analysis of Fraud-on-the-Market Actions

When an issuer not offering securities makes a material misstatement that inflates its share price in the secondary trading market, the persons who purchase the issuer's shares during the period prior to the market realizing the truth pay more than they otherwise would have but for the violation. The following analysis shows that the fairness and efficient risk allocation arguments for providing compensation for any resulting losses are weak, as are deterrence arguments based on concerns with investor protection. Deterrence arguments based on concerns

with corporate governance and market liquidity, however are stronger.

1. Fairness Arguments for Compensation

One argument for providing compensation is fairness. Issuer misstatements, however, work no systematic unfairness among outside investors as traders when the issuer and its insiders are not themselves trading. On an expected basis, traders in the secondary market are no better off transacting in the shares of an issuer that never makes misstatements than in the shares of one that does make misstatements from time to time. If a falsely positive misstatement increases an issuer's share price by \$5, every buyer pays \$5 more per share than if there had been no misstatement. But every seller receives \$5 more per share. For every share traded, the buyer's loss because of the misstatement is exactly counterbalanced by the seller's gain. More generally, the overall effect of a misstatement on investors trading in the secondary market is a zero-sum game: the winners' winnings just equal the losers' losses. Each winner and loser is in her position purely by reason of chance. The expected impact on an investor from trading in shares of an issuer that from time to time makes price-inflating misstatements is therefore zero.

It might be argued that it is still unfair *ex post* when the investor in fact turns out to be a loser even if there is no unfairness *ex ante*. The losing investor is, after all, innocent and the loss would not have occurred but for the wrongdoing of others. Issuer civil liability does not provide a satisfactory way of curing this *ex post* unfairness, however. If the losers have a cause of action against the issuer, it will ultimately be paid for by the shareholders at the time the suit is brought, thereby passing on the *ex post* losses from one innocent chance group to another. As has been widely recognized for some time, this means that if a regime is in place by which the losers are

compensated by the issuers that make the misstatements, the damages are in some sense “circular.”⁵⁶

2. Risk Reallocation Arguments for Compensation

There is another argument for requiring an issuer to compensate traders who suffer losses from purchasing the issuer’s shares at prices inflated its misstatements: reducing the amount of disutility in society arising from the risk of suffering such a loss. Providing compensation through fraud-on-the-market suits will in fact have this effect to a limited extent, but these suits consume substantial amounts of legal and other real resources in society. Compared to the alternative way of dealing with this risk – investor diversification – fraud-on-the-market suits are far less effective and far more expensive.⁵⁷

3. Investor Protection Arguments for Deterrence

The threat of a fraud-on-the-market suit will tend to deter a corporate manager from making material misstatements because, everything else being equal, he will be worse off if his company needs to pay out a large damages award. The argument, however, that such actions are, because of their deterrence effect, needed to protect investors is also weak, for reasons closely

⁵⁶See, e.g., Paul Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 632 (1992); John C. Coffee, Jr., *Reforming the Class Action*, 106 COLUM. L. REV. 1534, 556—66 (2006). Both authors express skepticism concerning the compensation rationale for civil liability imposed on issuers to provide damages to those who trade in the secondary market at disadvantageous prices due to issuer misstatements. The U.S. Chamber of Commerce has used this idea of damage circularity as a key element in its recent attack on class action fraud-on-the-market litigation. See, e.g., Anjan V. Thakor with Jeffrey S. Nielsen & David A. Gulley, U.S. Chamber Inst. for Legal Reform, *The Economic Reality of Securities Class Action Litigation* 5 (2005), available at <http://www.instituteforlegalreform.com/pdfs/EconomicRealityNavigant.pdf>; Anjan V. Thakor, U.S. Chamber Inst. for Legal Reform, *The Unintended Consequences of Securities Litigation* 14 (2005), available at <http://www.instituteforlegalreform.com/pdfs/UnintendedConsequencesThakor.pdf>.

⁵⁷The inadequacy of the efficient risk reallocation argument for compensation is consider in detail in Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers do not Trade*, 2008 WISC. L. REV. [] (forthcoming).

related to the fairness and risk allocation discussions above. Many provisions in the securities laws, including important parts of broker-dealer regulation, have important investor protection purposes. It is not, however, a persuasive rationale for the regulation of the disclosure of established issuers trading in efficient markets. Disclosure by such issuers is not necessary to protect investors against either unfair prices or risk.⁵⁸ According to the efficient market hypothesis, the price of such a share is unbiased – as likely to be below the share’s actual value as above – whether there is a great deal of accurate information is publicly available about the issuer or very little. In other words, greater transparency is not necessary to protect investors from buying its shares at prices that are, on average, unfair, i.e., greater than their actual values. Greater transparency may reduce risk – on average bringing price closer, on one side or the other, to actual value – but the only kind of risk that it reduces is *unsystematic* risk. Again, simply by being diversified, investors can protect themselves from this unsystematic risk much more effectively and at less social cost than by improvements in the quality of issuer disclosure.

4. Corporate Governance and Liquidity Arguments for Deterrence⁵⁹

As just noted, deterring material misstatements can improve an issuer’s transparency. This is especially true when the issuer operates within an regulatory environment requiring significant periodic disclosure so that it is making many material statements relevant to predicting future cash flows available to shareholders.

⁵⁸ I have considered the points discussed here in significantly more detail elsewhere. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2532–44 (1997).

⁵⁹ A more detailed account of these efficiency enhancing effects of issuer transparency can be found in Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237 (2009).

Greater transparency enhances efficiency by improving the selection of proposed new investment projects in the economy and the operation of existing projects. A corporation is well governed if it makes these decisions in share value maximizing ways. Transparency prompts managers of established corporations to make share value maximizing decisions through its beneficial effects on the workings of both the legal mechanisms for assuring quality of corporate governance and the existing market mechanisms that help align managerial interests with those of shareholders. Transparency also enhances efficiency by increasing the liquidity of an issuer's stock through the reduction in the bid/ask spread demanded by the makers of the markets for these shares.

1. Legal mechanisms

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

2. Market mechanisms.

Transparency has beneficial effects on the operation of three of the economy's key market

based mechanisms for controlling managerial behavior: the market for corporate control, share price based managerial compensation, and the terms at which new funding is available to the corporation.

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

b. Share price based compensation. Transparency strengthens the usefulness of share price based compensation as a way of motivating management by inducing management to accept a larger portion of its total compensation in share price based form. The problem for managers with share price based compensation, compared to straight salary with the same expected value, is the undiversifiable unsystematic risk that it imposes on the manager. More transparency makes share prices more accurate, which reduces this unsystematic risk. More accurate share prices also make such compensation a more focused reward mechanism.

c. Terms of funding new projects. Transparency, by improving share price accuracy, also improves the allocation of scarce capital among the proposed real investment projects in the economy. This is clearest when a firm is considering funding a project through the issuance of new equity. Transparency affects the terms at which such funds can be obtained. An inaccurately high price may encourage managers to invest in negative net present value projects i.e., to invest in projects with prospects inferior to the prospects of some proposed projects in the economy that do not get funding. An inaccurately low price may discourage investments in positive net present value projects, i.e., to pass up projects with prospects better than some project proposals in the economy that do get funding. There is evidence that share price affects the terms demanded by other available external sources of funds as well.⁶⁰ Share price also appears to affect management's willingness to use internal funds to implement a new project.⁶¹

3. Liquidity

More transparency reduces illiquidity in the secondary market for an issuer's shares. Insiders and their tippees can make supranormal profits by engaging in trades based on non-public information. Since market makers and specialists have difficulty knowing whether they are dealing with such inside-information-informed traders or with uninformed outsiders, they cover the expected costs of being on the other side of trades with informed traders through the "bid/ask" spread they offer all traders, i.e., the difference between the price at which they accept

⁶⁰ See HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 123 (1979).

⁶¹ See MERRITT B. FOX, *FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY* 282-87 (1987).

buyer orders and the price at which they accept seller orders.⁶² The bigger the spread, the less liquid are the issuer's shares, and the less valuable they are to hold. Greater transparency, by reducing the amount of non-public information and hence the opportunities for insiders and tippees to engage in trades based on such information, reduces bid/ask spreads, increases liquidity, and, as a consequence, reduces the cost of capital.⁶³

B. Investor Protection

The policy rationale most commonly articulated in court opinions for imposing fraud-on-the-market liability is the desirability of providing investor protection through compensation. Providing compensation is supposed to reverse the purportedly unfair trading losses suffered by investors who purchased at a price inflated by an issuer's material misstatement and sold after the inflation has dissipated. The analysis above, however, shows that providing such compensation is not strongly justified on fairness grounds and does not to furnish any benefits in terms of enhancing economic welfare.⁶⁴

This policy concern, therefore, should not play a role in terms of determining the range of allowable claims. In other words, while the United States is particularly interested in the welfare of its own residents, this concern should not be a reason put weight on the national residency of a

⁶² Lawrence R. Glosten and Paul Milgrom, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. FIN. ECON. 71 (1985). LARRY HARRIS, TRADING & EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 287 – 91, 299 – 302 (2003).

⁶³ For models working these points out more rigorously, see Robert E. Verrecchia, *Essays on Disclosure*, 32 J. ACCOUNTING & ECON. 91 (2001) (disclosure reduces information asymmetries and lowers a firm's cost of capital); David Easley & Maureen O'Hara, *Information and the Cost of Capital*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=300715&high=%20maureen%20ohara (same).

⁶⁴ See IV. A.1, IV.A.2 and IV. A.3 *supra*.

plaintiff in determining whether there is subject matter jurisdiction over the plaintiff's claim or whether the plaintiff should be included in a class. This is an important conclusion because much of the discussion relating to the properly allowable range of fraud-on-the-market cause of action against foreign issuers, in both court opinions and commentary, relies on this concern to favor the claims of U.S. resident investors.

C. Deterring Misstatements to Improve Corporate Governance and Liquidity

The threat of fraud-on-the-market liability, by deterring issuer misstatements and as a consequence enhancing transparency, limits the extent to which the managers of a public corporation place their own interests above those of their shareholders - the "agency costs of management." Thus class action fraud-on-the-market suits are a corporate governance device.

The gain from using this device is real, but the extent of the gain varies across countries depending on their issuers' typical share ownership structures and their larger overall systems of corporate governance.⁶⁵ Whether it is desirable in terms of economic welfare to have this device involuntarily imposed on issuers of any given country depends on weighing this gain against the very substantial amount of real resources used in connection with litigating such claims.

⁶⁵The ownership pattern of the typical publicly traded corporation in the United States is dispersed, with no single controlling shareholder. Raphael La Porta, et al. *Corporate Ownership Around the World*, 54 J. FIN. 471, 491—95 (1999). With such a corporation, the primary corporate governance problem is the divergence of interests between management and shareholders, i.e., the agency costs of management. *See supra* note [] and accompanying text. As discussed, disclosure can be very helpful in ameliorating this problem. *Id.* In a substantial majority of other countries, most corporations are controlled by families or the state. La Porta et al., at 496. As a consequence, the corporate governance problems are different. These differences may affect disclosure's usefulness for improving corporate governance and hence disclosure's level of social benefits. John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 16—17 (2001); COFFEE, GATEKEEPERS, *supra* note 16 at 78—83 (explaining that dispersed ownership creates managerial incentives to exaggerate reported income while concentrated ownership tends to lead to the extraction of private benefits of control).

The foreign issuer's home country government is better positioned in terms of knowledge to do this weighing. It is also better positioned in terms of motivation. In an efficient market, an issuer's share price takes into account the effect on the issuer's future expected cash flow of the forces determining the quality of the issuer's corporate governance, including, if part of the mix, the benefits and costs of being subject to fraud-on-the-market actions. At the same time, because globalization makes capital relatively mobile internationally, competitive forces push capital toward receiving a single global expected rate of return (adjusted for risk). Thus investors in all the world's issuers tend to get the same risk adjusted expected return even though the quality of corporate governance, and the costs of the devices use to promote it, may vary widely from one country to the next. The higher returns that result from a country's issuers being subject to an optimal mix of good corporate governance prompting devices therefore go largely to the suppliers of the issuers' less mobile factors of production. These are their entrepreneurs, who will get higher prices when they sell shares in the firms they founded, and labor, who are likely to enjoy higher wages in an economy where capital is allocated and used efficiently. Thus, the persons in the world who primarily benefit from higher real returns from a country's issuers being subject to an optimal mix of good corporate governance prompting devices are the country's entrepreneurial talent and labor, who are residents of the country, not the investors in these issuers.⁶⁶

⁶⁶ If a country's issuers represent only a small portion of all equities available to investors in the world, investors would share in none of these gains. The country would be analogous to a single small firm in a perfectly competitive industry. Such a firm's level of production has no effect on price. Following this analogy, what the country produces is investment opportunities—dollars of future expected cash flow—just like the firm produces products. A disclosure improvement's positive effects on managerial motivation and choice of real investment projects will increase the number of dollars of future expected cash flow that the country has to sell. This benefits

This reasoning shows that if issuers with a U.S. economic center of gravity are subject to fraud-on-the-market suits, the ultimate impact of both the benefits of improved corporate governance and the costs of the associated litigation will be concentrated in the United States, regardless of how global their shareholders are. Similarly, if issuers with an economic center of gravity in another country are subject to fraud-on-the-market suits, the ultimate impact of both the benefits of improved corporate governance and the costs of the associated litigation will be concentrated that country. The United States does not have a large stake in the matter even if its investors own substantial shareholdings in these issuers.⁶⁷ This same reasoning shows as well

the entrepreneurs, who are selling the cash flow, and labor, who gain from the overall increase in the country's economic efficiency. See *Fox Disclosure in a Globalizing Market*, *supra* note [] at 2561-69. Because the country is like a small firm, however, the increase in the amount supplied is not great enough to lower the price at which a dollar of future expected cash flow is sold. Thus there is no benefit to investors, the “buyers” of these dollars of expected future cash flow.

If a country's issuers represent a substantial portion of all equities available to investors in the world, as is the case with the United States, its investors will share in some of these gains. A movement toward the optimal mix of corporate governance devices would increase the number of dollars of future expected cash flow that the country has to offer enough to lower the price at which a dollar of future expected cash flow is sold, at least slightly. Thus investors would gain from the improvement. This is equally true of foreign investors as U.S. investors, however, and foreign investors own almost two-thirds of all the shares of publicly traded issuers in the world. *Id.* at 2525 n. 51. And it would be equally true of movement toward the optional mix of corporate governance devices by U.S. issuers whose shares are primarily sold to, or traded among, only foreign investors as it is of U.S. issuers with primarily U.S. shareholders. For more detailed discussions of these points, see, *id.* at 2552-2580 and Fox, *Political Economy*, note [] *supra* at 732-739.

⁶⁷ To the extent that globalization has not yet proceeded far enough to fully result in a single global risk adjusted expected rate of return on capital, the remaining market segmentation simply reinforces the point. The gains from a country's issuers being subject to an optimal mix of good corporate governance prompting devices will be concentrated at home. A country whose issuers are subject to an optimal mix will have capital utilizing enterprises that produce higher returns on their real investments net of the costs of these corporate governance devices. If the single rate assumption is correct, the gains from getting the mix right will primarily be enjoyed by the less mobile claimants on these returns, domestic entrepreneurs and labor, not by the suppliers of capital, who, wherever in the world they live, will at best enjoy a slight increase in the overall global expected return on capital. See *supra* note [one above] If the assumption is incorrect, the reason would be that each country's investors still have a degree of bias against issuers from other countries. In that event, U.S. investors, for example, might share disproportionately in the gains from moving the mix imposed on U.S. firms toward the optimum. The bias of foreign investors against U.S. issuers would mean that the increase in the number of expected dollars of future cash flow resulting from moving the mix would be offered to a somewhat restricted market and push the price for them down more for U.S.

that the location of where an issuer's shares are traded is simply irrelevant to where is felt the ultimate impact of the benefits and costs of the mix of good corporate governance prompting devices to which the issuer is subject.

The transparency enhancing impact of fraud-on-the-market suits on liquidity leads to the same conclusion. If an issuer's shares are more liquid, they are more valuable to hold and will be priced higher in the market. If the improvements in liquidity exceed the expected costs of being subject to the associated litigation, the issuer's shares will be priced higher in the market at the time of their original offering and thereafter. The beneficiaries will be the entrepreneurs who take the firm public, who again are likely to be located in the country where the issuer has its economic center of gravity, not subsequent holders of the shares.

In sum, the policy concern with the transparency enhancing impact of fraud-on-the-market suits on corporate governance and liquidity implies that no fraud-on-the-market class actions claims should be allowed against any foreign issuer, even claims by U.S. resident purchasers and purchasers who purchased the shares in a U.S. market. The exception is a foreign issuer that, as a form of bonding, voluntarily agrees to be subject to the U.S. system. All claims should be allowed against those firms that do voluntarily agree, regardless of the nationality or residence of the plaintiff and the place she executed the transaction. Concern with the

investors than for other investors. *Id.* To the extent that a U.S. issuer has U.S. shareholders, the fact that U.S. investors will share disproportionately in the gains simply creates an additional U.S. interest in the mix of good corporate governance prompting devices imposed on U.S. issuers. As for U.S. issuers whose shares are sold to and traded among only foreign investors, entrepreneurs and labor in the United States would, just as if there were a single global expected rate of return on capital, enjoy most of the gains. See Fox, *Securities Disclosure in a Globalizing Market*, *supra* note [] at 2561-2569. Thus, the United States interest in the corporate governance of this second set of issuers would be as strong as it is shown to be under the assumption in the text.

transparency enhancing impact of fraud-on-the-market suits on liquidity leads to the same conclusion. If an issuer's shares are more liquid, they are more valuable to hold and will be priced higher in the market. If the improvements in liquidity exceed the expected costs of being subject to corporate governance, the issuer's shares will be priced higher in the market.

D. Pro-Rata Distribution of Benefits to Shareholders

A core principle in corporate law around the world that common shareholders should receive benefits arising from their status as shareholders on a pro rata basis in accordance with the number of shares that they hold.⁶⁸ Thus, for example, if dividends are paid, they are paid on a per share basis to all holders. One of the advantages of such a rule is that it permits a single, more liquid market for the shares bought and sold in portfolio investment amounts because they offer the same expected cash flow to all shareholders, whoever holds them or however they are acquired. It also prevents resources from being wasted on conflicts over corporate decisions that could affect the division of a distribution.

The right to receive fraud-on-the-market damages is a benefit related to an investor's status as a shareholder that should conform to this rule. To see why, consider a regime where all shareholders are entitled to be paid compensation from the corporate treasury for any losses they suffer if they unknowingly purchase shares at a price that has been inflated as a result of an issuer's material misstatement made with scienter. This is essentially an insurance benefit that the investor acquires when the investor acquires each of his shares, and so, ex ante, the benefit is received pro rata. The expected value of this insurance benefit is equal for all shareholders

⁶⁸FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 143-44 (1991),

because they are equally likely to have made a purchase that would result in their collecting on it. Whenever payment has to be made out of the treasury, all shareholders pay derivatively pro rata as well. Now imagine a regime where some only shareholders — ones who have a certain national residency or who purchase their shares in a market located in a certain country — are entitled to this benefit. The insurance benefit is not distributed pro rata, since shareholders who do not have this residence or do not buy in this country's market do not receive it. Yet whenever payment of compensation has to be made out of the treasury, all shareholders still derivatively pay pro rata.

The policy concern with pro rata distribution of benefits therefore also implies that either no class action fraud-on-the-market claims should be allowed against a foreign issuer (unless the issuer voluntarily agrees to be subject to them as a form of bonding), or that all claims should be allowed against the foreign issuer regardless of the nationality or residence of the plaintiff and the place she executed the transaction.

E. U.S. Capital Market Competitiveness

The United States has an interest in keeping its capital markets competitive so as to benefit U.S. residents in professions whose rents depend on the number of listings and volume of trading in the United States. It also has an interest in U.S. investors being able to diversify internationally, free from distortions that make such diversification unnecessarily inconvenient or costly.

If the United States permits fraud-on-the-market claims against foreign issuers, but only by investors who execute their purchases on a U.S. market or only by investors who are U.S.

residents, fear of U.S. class action fraud-on-the-market liability will deter foreign issuers from having their shares trade in U.S. markets. This will hurt U.S. capital market competitiveness because of the reduced number of listings. And it will discourage international diversification because it is more costly and inconvenient for a U.S. investor to trade in a foreign market than in a domestic one.

This policy concern thus also implies either that no class action fraud-on-the-market claims should be allowed against a foreign issuer (unless the issuer voluntarily agrees to be subject to them as a form of bonding), or that all claims should be allowed against the foreign issuer regardless of the nationality or residence of the plaintiff and the place she executed the transaction.⁶⁹

F. Advantages of Resolving Similar Claims in One Place

There are economies of scale in resolving similar claims in one place. It is also desirable that similar claims be treated in similar fashion rather than depending on inconsistent findings of

⁶⁹The Committee on Capital Markets Regulation, also known as the “Paulson Committee”, claims, for example, that there has been a reduction in the competitiveness of U.S. capital markets versus markets abroad as a result in part of the costs imposed on issuers by fraud-on-the-market class actions and the uncertainty that they create. The Committee calls for reforms that would effectively reduce or eliminate such actions on all issuers, foreign and domestic alike. For example, it calls upon the SEC to impose a stricter standard than most courts have adopted concerning what must be shown to demonstrate that the market for a security is sufficiently efficient to justify application of the fraud on the market theory. INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 81-82 (Nov. 30, 2006), http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. (calling for adoption of the rule in *In re Polymedica Securities Litigation* that plaintiffs must show that the market price fully reflects *all* publicly available information. 432 F.3d 1, 26 (1 Cir. 2005) (emphasis added)). More importantly, the Committee calls for the SEC to permit managers, with the approval of shareholders, to adopt charter amendments barring shareholders from bringing fraud-on-the-market damage actions in court at all. Such claims would instead be heard in arbitration. If the charter amendment so provided, the claims could only be brought individually by each shareholder, not by a class action. *Id.* at 109–10. This would largely eliminate issuer liability altogether since, for most investors, individual actions do not have the prospect of sufficiently large recovery to merit the costs of bringing the action. There is no need, however, to mix the issues of the desirability of having fraud-on-the-market actions imposed on domestic U.S. issuers and the competitiveness consequences of imposing them of foreign issuers that utilize U.S. capital markets. See **Fox**,

fact arising from multiple triers of fact. As a general matter, this concern would argue in favor of permitting class action status for all claims against foreign issuers that are decided to be within U.S. jurisdictional reach. A genuinely realistic prospect that a claim would be re-litigated abroad after a U.S. judgment or court approved settlement would erode this rationale for inclusion of the claimant within the class. Given , however, the general absence abroad of “opt out only” class actions or of contingent fee arrangements, combined with the prevalence of “loser pay” rules, the likelihood of a fraud-on-the-market type claim being brought against a foreign issuer in a foreign court is in fact very low, except perhaps by an investor that has engaged in some significant portion of all the affected trading. This likelihood is further reduced by the fact that payment to investors under the claims process associated with the U.S. judgment or settlement can be conditioned upon agreement not to re-litigate the claim abroad. Thus this final policy concern suggests that class action status should be permitted for all claims against foreign issuers that are decided to be within U.S. jurisdictional reach regardless of the nationality or residency of the plaintiff or the place of execution.

G. Convergence on a Simple Rule

Putting the properly analyzed implications of these five policy concerns together is surprisingly straightforward and involves no difficult tradeoffs. The ultimate conclusion is that no class action fraud-on-the-market claims should be allowed against any genuinely foreign issuer unless the issuer has agreed, as a form of bonding, to be subject to the U.S. regime, in which case all claims should be allowed regardless of the nationality or residence of the plaintiff and the place that she executed the transaction. This simple rule both maximizes U.S. economic

welfare and, by promoting global economic welfare too, is good U.S. foreign relations as well.

V. COMPARISON WITH OTHER COMMENTARY

[Discussion to come concerning, for example, the Jack Coffee idea of including U.S. resident purchasers of foreign issuer shares if made on a U.S. exchange but excluding in class certification foreign purchasers of the issuer's shares purchased on a foreign exchange. Also, the Hannah Buxbaum idea of basing jurisdiction on where the transaction occurs. Also, the Paulson Committee Report idea of limit FOM actions with respect to all issuers, U.S. and foreign alike, in order to enhance the competitiveness of U.S. capital markets.]

VI. IMPLEMENTATION

[to come]

VII. CONCLUSION

[to come]