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EXTRATERRITORIAL APPLICATION OF THE UNITED STATES SECURITIES LAWS: THE NEED FOR A BALANCED POLICY

An Address by
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NOTE: This is the final draft of Commissioner Thomas' remarks. Although this draft may be quoted, the Commissioner might have made minor revisions during her oral presentation.

Assume the following facts: You are the director of a hypothetical British Steel Corporation, a public company incorporated and conducting all of its business in the United Kingdom. Your company's stock is listed on the London Stock Exchange, as well as on the American Stock Exchange in New York. In order to finance a joint business venture with a controlling English shareholder the board of directors authorizes the sale of company stock to the shareholder. The transaction takes place in London. British Steel and the board of directors are subsequently sued by a shareholder who resides in the United States. The shareholder alleges that the board violated the United States securities laws by fraudulently authorizing the sale of stock of British Steel at an unreasonably low price.

Would you be surprised to discover, as a director of British Steel, that you were subject to the antifraud provisions of the United States securities laws for authorizing the sale of stock at bargain prices to an English shareholder in a transaction that occurred in London? Under analogous circumstances, a U.S. court applied the antifraud provisions of the U.S. securities laws to directors of a Canadian corporation doing absolutely no business in the United States. 1/

1/ See Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), rev'd in part & remanded, 405 F.2d 215 (1968)(en banc), cert. denied sub nom., Manley v. Schoenbaum, 395 U.S. 906 (1969).

Today I am pleased to have the opportunity to discuss how foreign corporations -- that is, corporations located and incorporated outside the U.S. -- may be subjected, perhaps much to their surprise, to the extraterritorial reach of the U.S. securities laws. This topic is of growing interest to U.S. courts, the Securities and Exchange Commission ("SEC" or "Commission"), foreign corporations, and the international financial community at large.

As transnational communication and transportation become ever more sophisticated and multinational corporations continue to emerge, the world's capital markets, as we are all aware, have become increasingly international, and securities transactions have become global in scope. Consequently, U.S. courts, similar to those in other countries, are frequently called upon to apply their domestic law to securities transactions that involve foreign parties.

When foreigners voluntarily enter the United States and seek access to the U.S. capital markets or trade with U.S. investors, the U.S. courts have shown little reluctance to subject such foreigners' conduct to the U.S. securities laws and SEC regulations. Courts have been more reserved, however, with respect to the extraterritorial application of the securities laws to transactions involving foreigners that take place <u>outside</u> the United States.

Over the past decade, in response to the proliferation of multinational securities transactions, and the concomitant

increase in transnational fraud, the U.S. securities laws -- especially the antifraud provisions -- have been applied extraterritorially with greater frequency. 2/ The stated justification has been the strong domestic interest in protecting United States investors, and in preventing the United States from being used as a base for fraudulent conduct in transactions abroad involving U.S. or foreign investors.

In addition to domestic interests, however, I believe that international policies should be weighed very carefully before U.S. laws are applied extraterritorially. For example, in today's world, domestic economic growth has become increasingly dependent upon the ability to cross national boundaries to raise capital. Application of domestic laws to foreign securities transactions (where foreign countries may have substantial interests in the transactions, and differing regulatory practices and national policies), may create antagonism and cause adverse reaction. This, in turn, ultimately may impede the free flow of capital and affect world commerce.

Moreover, with respect to transnational fraud, we have seen in the past that effective extraterritorial enforcement of the U.S. securities laws requires cooperation among the international financial and law enforcement community.

2/ See, e.g., IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.), cert. denied sub nom., Bersch v. Arthur Anderson & Co., 423 U.S. 1018 (1975).

Accordingly, U.S. courts must be sensitive to the fact that overzealous assertion of extraterritorial jurisdiction may, by alienating foreign countries, impede the SEC's ability to investigate fraud and enforce the securities laws. Indeed, at least one nation already has passed a law which could prevent its corporations from cooperating with U.S. investigations. 3/

In my discussion today, I will first describe how U.S. courts traditionally have approached and defined the international boundaries of the U.S. securities laws. I will then propose an alternative methodology which seeks to avoid international conflicts by balancing the interests of all nations connected to a transnational securities transaction before the U.S. securities laws are applied extraterritorially. Finally, I will explain how the SEC is seeking to eliminate regulatory barriers that impede the international free flow of capital by accommodating foreign issuers who offer and trade securities in the United States.

I. An Overview of the U.S. Securities Laws

As many of you probably know, the SEC is the agency vested with the responsibility for administering the United States securities laws. Although the SEC administers six federal statutes, my discussion this afternoon generally

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3/ See Address by Attorney General William French Smith, before the 29th Congress of the Union Internationale des Avocates, at the United Nations General Assembly, New York, New York, August 31, 1981.

will pertain to the extraterritorial scope of only two of them, the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act" or "Exchange Act").

The 1933 Act seeks to protect investors by prohibiting fraud and misrepresentation in the sale of securities. The Act also mandates registration of publicly offered securities with the Commission, and the delivery of a prospectus to each purchaser, that is a truthful disclosure document about the issuer and the transaction.

The Exchange Act also seeks to protect investors as well as to maintain the integrity of the U.S. markets. Generally, the 1934 Act prohibits fraud in the purchase and sale of securities, and requires companies listed on U.S. stock exchanges or having a certain minimum amount of assets and shareholders to file periodic reports with the SEC which are publicly available to all interested persons. The Exchange Act also imposes registration, reporting and bookkeeping requirements upon broker-dealers.

II. Judicial Developments with Respect to the Extraterritorial Application of the U.S. Securities Laws

A. A Review of the Case Law

Certain language in the 1933 and 1934 Acts suggests that these laws may be applied to any transnational securities transaction that has some nexus to the United States. 4/

4/ See, e.g., Section 10(b) of the Exchange Act, which provides that it is unlawful for any person, "by the use of any means or instrumentality of interstate

(footnote continued on the next page)

U.S. courts, however, have interpreted the scope of the securities laws somewhat more narrowly. In addition, although most judicial cases in this area have involved only those sections of the securities acts that prohibit fraud in the purchase and sale of a security, these cases may provide an analytical framework to help evaluate the extraterritorial scope of all the federal securities laws.

Generally, U.S. courts have applied two tests -- which I will refer to as the "conduct" and the "effects" tests -- to determine whether the antifraud provisions apply extraterritorially. Under the conduct test, these provisions have been applied to foreign transactions taking place abroad when fraudulent conduct, such as a misrepresentation inducing a purchase or sale of a security, or conduct in preparation of a fraud, such as the drafting of a misleading prospectus used to sell stock, occurred within the United States. 5/ In

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4/ (footnote continued from the preceding page)

commerce," to employ in connection with the purchase or sale of any security any manipulative or deceptive device or contrivance in contravention of Commission rules. Section 3(a)(17) of the Act defines "interstate commerce" broadly to encompass "commerce, transportation, or communication . . . between any foreign country and any State." Thus, any minimum contact with the United States in connection with a foreign transaction arguably would bring the transaction within the jurisdictional scope of Section 10(b).

5/ See, e.g., Bersch, supra note 2.

addition, under the effects test, courts have applied the antifraud provisions when foreign securities transactions had substantial and foreseeable injurious effects in the U.S., such as decreasing the value of stock held by U.S. investors and listed on a U.S. stock exchange, even though no conduct, preparatory or otherwise, occurred in the U.S. with respect to the transaction abroad. 6/

The extraterritorial application of the U.S. securities laws under either the "conduct" or "effects" tests may vary according to the nationality, location, and number of injured investors, the identity of the defendants, and the type and amount of conduct that takes place both in the United States and abroad. For example, under the conduct test, courts have held that a foreign corporation is liable under the U.S. securities laws for defrauding a U.S. citizen residing abroad, because the foreign corporation engaged in conduct in the U.S. that was preparatory to the transnational fraud. 7/ These courts have been unwilling, however, to apply the securities laws when a foreign investor is defrauded in the same transaction abroad unless conduct occurs in the U.S. that directly causes the foreigner's loss. 8/ Similarly,

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6/ See, e.g., Schoenbaum, supra note 1.

7/ See, e.g., Bersch, supra note 2.

8/ Id. See Cornfeld, supra note 2. Cf. IIT v. Vencap, Ltd., 519 F.2d 1001, 1018 (2d Cir. 1975); SEC v. Kasser, 548 F.2d 109 (3d Cir.), cert. denied sub nom., Churchill Forest Indus. (Manitoba), Ltd. v. SEC, 431 U.S. 938 (1977).

under the effects test, some courts have suggested they would not apply the U.S. securities laws extraterritorially where only a few U.S. residents are defrauded in a foreign transaction by a foreign company whose securities are not listed on a U.S. stock exchange because the transaction would have an insubstantial effect in the United States. 9/

In applying either the conduct or the effects test to determine the extraterritorial application of the U.S. securities laws -- tests premised upon a foreign transaction's nexus with the United States -- U.S. courts are seeking to effectuate the intent of Congress, as embodied in the U.S. securities laws, to protect U.S. investors from fraudulent activity abroad, and to prevent the U.S. from being used as a base for securities transactions where U.S. or foreign investors are defrauded outside the United States. Few can quarrel with such laudable policies.

Conflicts may arise, however, when U.S. courts seek to apply the U.S. securities laws in situations where nations other than the United States have an interest in regulating transnational securities transactions. A foreign country might well view application of U.S. law to a securities transaction that takes place within the foreign country's borders and that involves non-U.S. citizens as interference with the foreign country's regulatory practices, economic

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9/ See Vencap, id.; Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972).

philosophy or national policies.

For example, while the U.S. securities laws require full disclosure of material information to provide investors with maximum protection in a securities transaction, some countries may not adopt this principle and may rely on different modes of investor protection; such as direct regulation of corporate sales activity, soundness of financing, and the internal operations of a company. A country, therefore, might quite understandably be affronted when a company incorporated within its territory is found liable under the U.S. securities laws for failing to disclose information that is not required to be disclosed under the laws of the home country. Likewise, some foreign countries deliberately have reduced disclosure requirements to stimulate market activity. Thus, application of U.S. disclosure laws to transactions occurring in these countries might well be viewed as an undesirable impediment to that nation's economic growth.

B. A Proposed Standard

Some U.S. courts, sensitive to the potential for international conflict in transnational securities cases, have weighed the policies of other interested countries before these courts have determined to apply the U.S. securities laws extraterritorially. 10/ As a general matter, I believe this

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10/ See, e.g., Cornfeld, supra note 2.

emerging approach to adjudication of transnational securities cases is a positive development. I also believe that this approach should be expanded and refined so that the laws, regulatory practices, and national policies of all foreign countries interested in a transnational securities transaction are carefully balanced before U.S. laws are applied extra-territorially.

Some of the relevant factors to be weighed in the balance might include the location of the transnational transaction, domicile of the parties, the importance to each interested country of having its laws applied in a given situation and the public policies that would be furthered by the application of its laws, the likelihood that a country's laws would be applied to a transaction, and the expectations of the parties with respect to the applicable governing laws.

To illustrate the application of this balancing test, let us return to the hypothetical situation that I posited at the outset of this discussion. As you will recall, the directors of British Steel Corporation authorized the sale of company stock to an English shareholder in a transaction that took place in London. The company's stock was listed on the London and American Stock Exchanges. A U.S. shareholder sued the directors for violating the antifraud provisions of the U.S. securities laws by authorizing the sale of stock at bargain prices.

While a U.S. court held that a foreign transaction similar to the one described in the hypothetical situation was within the reach of the U.S. securities laws because the transaction had an injurious effect upon U.S. shareholders, 11/ such an outcome would not be as certain if a court applied the balancing test that I propose. Under this test, a court would still determine that the U.S. had a interest in the foreign transaction because British Steel voluntarily entered the U.S. markets by listing its stock on the American Stock Exchange and by registering with the SEC. In addition, a court would still recognize the U.S. interest in protecting U.S. shareholders of British Steel whose stock declined in value as a result of the foreign transaction.

Notwithstanding the interests of the United States, however, a U.S. court might decide, on balance, not to assert its jurisdiction because the United Kingdom had a greater interest in applying its law to the transaction. Such a decision might be influenced by the fact all of the parties to the transaction were English, the transaction took place in a foreign country, and the parties expected English law to apply to a transaction occurring in England and involving only English residents. In addition, a court might consider whether English law actually prohibited the conduct of the British Steel directors and, if so, provided a remedy to defrauded shareholders.

11/ See Schoenbaum, supra note 1.

I firmly believe that applying a balancing test before applying U.S. laws extraterritorially will demonstrate a sensitivity to the concerns and sovereignty of foreign countries, encourage international comity, and foster cooperation and mutual respect among nations. In a world where transnational transactions have become commonplace and where increased potential for international conflict is an inevitable result, the need for this type of cooperation and accommodation between countries has never been greater.

Moreover, I believe that deference to the interests of other countries will enhance investor protection by encouraging countries to lend the cooperation necessary to pursue international enforcement actions for transnational securities fraud. This approach, by decreasing the potential for alienation and retaliation among countries, and by reducing international barriers, should also promote the free flow of capital among nations and facilitate the expansion of international commerce and growth in the world's capital markets.

III. SEC Efforts to Remove Regulatory Barriers

Consistent with my proposal today concerning adjudication of transnational securities cases, I also believe that countries must seek to avoid erecting regulatory barriers that impede the free flow of capital by inhibiting foreign corporations from gaining access to the world's captial markets. The SEC, in my opinion, has set a good example by

harmonizing conflicting domestic and international policies and accommodating concerns of foreign issuers in prescribing registration and reporting requirements for foreign issuers whose securities are publicly offered and traded in the United States.

In promulgating regulations for these foreign issuers, the Commission, on the one hand, was urged to impose reporting requirements equivalent to those demanded of U.S. issuers in order to maintain adequate protection for investors and to avoid competitive disadvantage to U.S. companies. 12/ On the other hand, some commentators argued that imposing equivalent disclosure requirements for foreign issuers would be insensitive to the different business practices and customs of foreign countries, and that the cost of compliance would deter foreign issuers from seeking access to the U.S. markets. 13/ Such a result, it was argued, would be inconsistent with the United States policy of encouraging the free flow of capital, international free trade, and the efficient allocation of world resources.

A. Voluntarism as the Basis for Regulation

The Commission, in developing a regulatory framework for foreign issuers, attempted to harmonize these seemingly conflicting policies by basing registration and reporting requirements in part upon the extent to which a foreign issuer

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12/ See Securities Exchange Act Release No. 16371 (November 29, 1979); 44 Fed. Reg. 70,132 (1979).

13/ Id.

voluntarily enters the U.S. market. Thus, an issuer who makes a public offering of its securities in the U.S. or who has listed its securities on a U.S. stock exchange is deemed to have entered the U.S. market voluntarily and, accordingly, must comply with registration and disclosure requirements very similar to those applicable to domestic issuers. 14/ Foreign issuers whose securities are listed on a U.S. stock exchange also must comply with the exchange's listing requirements, which may be more demanding than the SEC's disclosure rules. Foreign issuers whose securities are traded in the U.S. and who neither engage in a distribution in the U.S. nor list on a U.S. stock exchange are deemed not to have voluntarily entered the United States. As such, they do not have to comply with U.S. registration or reporting requirements if they furnish to the Commission certain information that has been distributed to shareholders or otherwise disclosed pursuant to foreign law. 15/

While the SEC has determined that foreign issuers who voluntarily seek access to the U.S. markets should disclose information that U.S. investors need in order to make an informed investment decision, the Commission has sought to accommodate foreign issuers by relaxing certain disclosure requirements considered by these issuers to be particularly burdensome. For example, foreign issuers who publicly offer

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14/ See Commission Form S-1, and Form 20-F.

15/ See Rule 12g3-2(b) under the Exchange Act.

their securities through distributions in the U.S. may now disclose management remuneration in an S-1 registration statement on an aggregate, rather than individual, basis. Foreign issuers may also use the abbreviated Form S-16 to register securities to be offered to shareholders upon the exercise of outstanding rights in order to reduce the cost of compliance with the disclosure requirements of a full registration form.

The adoption of Form 20-F in 1979 was perhaps the most significant effort by the Commission to accommodate foreign issuers who voluntarily trade their securities in the United States. Before adopting Form 20-F, the Commission seriously considered the comments of foreign issuers which pointed out that certain proposed requirements would put these issuers at a competitive disadvantage with respect to other foreign corporations and that some of the proposed requirements were inconsistent with the commercial practices, privacy concepts and accounting principles of other countries. 16/ In addition to these comments, the SEC carefully examined the disclosure rules and guidelines of the Organization for Economic Cooperation and Development, European Economic Community, and other international organizations. 17/

16/ See Securities Exchange Act Release No. 16371, supra note 12.

17/ Id.

In response to the concerns of foreign issuers and in conformity with the directives and guidelines of various international organizations, the SEC significantly modified the proposed disclosure requirements of Form 20-F. First, the Commission reduced industry segment disclosures by requiring foreign issuers to report only revenues by segment, with a narrative discussion if revenue and profit contributions from the respective segments materially differ. In addition, disclosure of management remuneration was required on an aggregate, rather than individual, basis. Requirements for the disclosure of management's interest in certain transactions with the issuer also were limited to information required to be disclosed by foreign law. Finally, foreign issuers were permitted to use their own financial statements in Form 20-F irrespective of their conformity with the generally accepted accounting principles ("GAAP") of the U.S., if material differences between GAAP and the accounting principles used in preparing the foreign financial statements are disclosed.

B. An Integrated Disclosure System for Foreign Issuers

It is also noteworthy that the Commission recently has proposed an integrated disclosure system that would permit domestic issuers to make public offerings of securities in the U.S. under the 1933 Act using abbreviated disclosure documents that incorporate by reference information in a company's annual report and other periodic reporting documents filed with the

Commission under the 1934 Act. 18/ This proposal is intended to streamline the disclosure process for an issuer by eliminating duplicative disclosure in 1933 and 1934 Act documents, reducing the costs of raising capital, and facilitating timely access to the increasingly volatile capital markets.

The Commission is also planning to propose an integrated disclosure system for foreign issuers which will provide some of the same benefits accorded to domestic issuers. Developing an integrated system for foreign issuers, however, is more difficult because Form 20-F, the reporting document used by many foreign issuers under the Exchange Act, does not contain all of the information presently required in a registration statement under the 1933 Act. 19/

Nevertheless, we have been encouraged by the high quality of disclosure in most of the annual reports filed on Form 20-F. In fact, many issuers do disclose, on a voluntary basis, substantially the same information as would be required in a 1933 Act registration statement. Accordingly, I believe that with some innovation and creativity, an integrated disclosure

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18/ See Securities Act Release Nos. 6331, 6332, 6333, 6334, 6335, 6336, 6337 (August 6, 1981); 46 Fed. Reg. 41,902; 41,925; 41,971; 42,001; 42,015; 42,024; and 42,029 (1981).

19/ For a more extensive discussion of these issues see Address by Barbara S. Thomas, The Integrated Disclosure System for Foreign Issuers: An Introduction for Foreign Lawyers, before the New York University School of Law Workshop on Business Acquisitions and Finance in the United States, New York, New York, July 24, 1981.

system can be developed to benefit foreign issuers making public offerings in the United States.

IV. Conclusion

In closing, I believe that as our world becomes more economically interdependent each day, countries can no longer afford to ignore the international repercussions of domestic policies. Such disregard runs the risk of frustrating legitimate, internationally beneficial, business transactions and alienating foreign governments. With respect to adjudicating transnational securities cases, I believe courts should consider carefully the interests of all nations connected to a multinational transaction before applying domestic laws extraterritorially. Similarly, I believe countries should be flexible and attempt to accommodate foreign issuers who seek access to their capital markets by developing regulatory structures for foreign issuers that recognize the differing business practices of other nations. This type of international sensitivity, by ensuring the free flow of capital and the expansion of world commerce, will benefit all nations.