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The Securities Exchange Act of 1934,[1] as implemented by rules and regulations[2] of the Securities and Exchange Commission (SEC) and as interpreted by the courts, was enacted to provide protection for the American investor against abusive securities practices. In recent years, a great deal of litigation has arisen under rule 10b-5,[3] which provides relief for fraud in the "purchase or sale" of securities.[4] As a result of such actions, rule 10b-5 has given rise to a body of federal law which provides the SEC and private investors with an arsenal of weapons against fraudulent practices by securities dealers and corporate management.[5] To decide whether these weapons can and should be directed toward activities outside the United States requires a twofold examination of the extraterritorial reach of such legislation: first, whether extraterritorial appli-

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1. The Securities Exchange Act of 1934, 15 U.S.C. §§78a-78hh (1964).
2. *See, e.g., id.* §10(b), 15 U.S.C. §78j(b) (1964) and §30(b), 15 U.S.C. §78dd(b) (1964) (Congressional authorization to the SEC to promulgate rules and regulations).
3. Rule X-10B-5, 17 C.F.R. §240.10b-5 (1968) (known as the "anti-fraud rule") which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facilities of any national securities exchange,
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> (1) to employ any device, scheme, or artifice to defraud,
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> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
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> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated by the SEC to implement section 10(b), 15 U.S.C. §78j(b) (1964) (manipulative or deceptive devices in contravention of the SEC rules and regulations).

The federal courts have implied a civil right of action under rule 10b-5. *See* Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947), *modified,* 83 F. Supp. 613 (E.D. Pa. 1947); Lorenz v. Watson, 258 F. Supp. 724, 730 (E.D. Pa. 1966); *see also* Dystra, *Civil Liability Under Rule 10b-5,* UTAH L. REV. 207 (1967).

4. An actual "purchase or sale" is no longer required. *See* Securities and Exchange Commission v. Nat'l Securities Inc., 393 U.S. 453 (1969) (a misleading proxy statement in the merger of two insurance companies held to involve a "purchase" of securities under rule 10b-5); Ruckle v. Roto American Corp., 339 F. 2d 24 (2d Cir. 1964) (the issuance by a corporation of its own shares held, in a derivative action, to be a "sale" under rule 10b-5).
5. *See* Securities and Exchange Commission v. Texas Gulf Sulfur Co., 401 F. 2d 833 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969). Many former shareholders also sued the company for their losses in prematurely selling their securities.

cation would violate international law; second, the effect of statutory interpretation regulating the conduct of foreigners in securities transactions.

I. PRINCIPLES OF INTERNATIONAL LAW WHICH LIMIT LEGISLATIVE JURISDICTION OF THE UNITED STATES

Any statute which may have effects outside the United States will generally be construed with deference to established principles of international law.[6] A brief examination of the principles upon which legislative jurisdiction has been based in criminal and civil actions indicates the present limitations upon the effect of the Securities Acts.[7] The relevant accepted bases of legislative jurisdiction in international law are enumerated following.

A. TERRITORIAL PRINCIPLES.

A state may legislate to control conduct within its boundaries, even if the effects of such conduct are felt only outside the country.[8] This "territorial principle" has gradually been expanded to produce valid jurisdiction in the reverse situation. International law now considers a state to have:

> jurisdiction to prescribe a rule attaching legal consequences to conduct that occurs outside its territory and causes an effect within its territory, if either (a) the conduct and its effect are generally recognized as constituent elements of a crime or tort . . . or (b) . . . the effect within the territory is substantial . . . as a direct and foreseeable result of the conduct. . . .[9]

This extension, termed the "objective territorial principle," provides little guidance for the courts in their attempts to delineate legislative jurisdiction. The basic problem raised by such a principle stems from judicial difficulty in interpreting the meaning of "substantial effects."[10]

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6. United States v. Aluminum Co. of America, 148 F. 2d 416, 443 (2d Cir. 1945) ("[W]e are not to read general words, such as those in this [Sherman] Act, without regard to the limitations customarily observed by nations upon the exercise of their powers. . . .")

7. *See generally* H. STEINER AND D. VAGTS, TRANSNATIONAL LEGAL PROBLEMS 799-801 (1968).

8. *See* RESTATEMENT (SECOND), FOREIGN RELATIONS LAW OF THE UNITED STATES §17 (1965). (Hereinafter cited as "RESTATEMENT.")

9. *Id.* §18 (1965); *See also* Strassheim v. Daily, 221 U.S. 280, 285 (1911); United States v. Aluminum Co. of America, 148 F. 2d 416, 443 (2d Cir. 1945).

10. Before deciding the question of substantial effects, the courts are usually faced with the problem of whether due process requirements prohibit the acquisition of personal jurisdiction when there has been extraterritorial service of process. In Securities and Exchange Commission v. Briggs, 234 F. Supp. 618 (N.D. Ohio 1964), the Commission sought an injunction for violation of the fraud and registration provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Defendant argued that service of process in Vancouver, Canada by mail and by a Deputy Sheriff

Consequently, the courts have not sufficiently clarified this issue of how substantial an effect on domestic commerce must be in order to give legislative jurisdiction in the field of economic regulation. This obscurity arises because in the eyes of the domestic courts things which could be said to affect commerce of the United States *by definition* have a "substantial effect."[11] Such an assumption, however, may be too easily made since it is not clear under international legal standards what effects are indeed "substantial."[12] Furthermore, with the recent increase of foreign multinational enterprises owned by United States citizens,[13] the courts are likely to find that a relatively small effect on domestic markets would be enough to attach legal consequences to extraterritorial conduct.

The basic "objective territorial principle," as utilized by the courts, is effectively exemplified by the *Case of the S. S. Lotus*.[14] The French steamer *Lotus* and the Turkish collier *Boz-Kourt* collided on the high seas, the latter ship sinking with loss of life. The *Lotus* continued on

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of British Columbia violated the due process requirements of the United States Constitution. The district court found that since the defendant was a United States citizen and had been involved in transactions in Ohio, these "contacts" were sufficient to satisfy due process.

Securities and Exchange Commission v. V.T.R. Inc., 39 F.R.D. 19 (S.D.N.Y. 1966), involved sales by a German bank of unregistered stock by its New York agent on the American Stock Exchange. Process was served on the defendant-bank in Germany. The court stated that "defendant's activity within the forum in the selling of unregistered stock was substantial" and found there was personal jurisdicion especially since "there clearly was business transacted by the defendants in this state." *Id.* at 22-23.

In Ferraioli v. Cantor, 259 F. Supp. 842 (S.D.N.Y. 1966), defendant objected to service of process on an officer of the corporation in Ontario as invalid. The court, in deciding whether due process prevented acquiring jurisdiction over the defendant without the United States, stated that since "Denison controlled a United States corporation whose executive offices are in this district . . . there cannot be any doubt that the minimum contacts which are necessary for due process purposes exist, especially where the present case arises from that control. . . ."

Briggs, V.T.R. and *Ferraioli,* in effect, based their findings of personal jurisdiction on a "substantial contacts" test, that is, a substantial act or connection within the territorial limits of the United States.

11. *See, e.g.,* Schoenbaum v. Firstbrook, 405 F. 2d 200, *rev'd on rehearing on other grounds,* 405 F. 2d 215 (2d Cir. 1968) (en banc), *cert. denied,* 395 U.S. 406 (1969):

> A fraud upon a corporation which has the effect of depriving it of fair compensation for the issuance of its stock would necessarily have the *effect* of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices bid for the shares on the domestic stock market. This impairment of the value of American investments by sales by the issuer in a foreign country, allegedly in violation of the Act, has in our view, a sufficiently serious *effect* upon United States commerce to warrant assertion of jurisdiction for the protection of American investors and consideration of the merits of plaintiff's claim.
> *Id.* at 209-210. (Emphasis added).

12. A domestic court could easily justify the extraterritorial reach of securities laws in the light of such a broad legal standard.

13. *See generally* Vagts, *Multinational Enterprise: A New Challenge For Transnational Law,* 83 HARV. L. REV. 739 (1970).

14. [1927] P.C.I.J., ser. A, No. 9.

to Constantinople where the French officer of the watch was arrested, tried and convicted of manslaughter under the Turkish Penal Code. The Permanent Court of International Justice concluded that the extension of legislative jurisdiction over conduct outside the territory of a state is permissable unless it violates a principle of international law.[15] In dicta, the Court implied that international law does impose limits on the extraterritorial assertion of jurisdiction. If jurisdiction is to be based on the fact that "one of the constituent elements of the offense, and more especially its effects,"[16] have taken place within the state asserting jurisdiction, then such effects must be "legally and entirely inseparable" from the conduct outside the territory, "so much so that their separation renders the offence nonexistent."[17] This formulation of the "objective territorial principle" by the Court in *Lotus* would appear to require more than a minimal effect within the United States in order to support legislative jurisdiction. Moreover, section 18 of the Restatement requiring a "substantial effect" within the territorial boundaries is a similar formulation to that of the *Lotus* "objective territorial principle." The problem raised by this principle as stated by section 18 and *Lotus* is that the courts are tempted to use a "substantial contacts" test which has dubious value with regard to answering the question of legislative jurisdiction under the territoriality principles.[18] It would be helpful to the courts if Congress or preferably the SEC provided some guidelines delineating the applicability of legislation when dealing with complex economic regulations which regulate the conduct of citizens in other countries. An agency such as the SEC is in a position where it could make extensive studies and suggest policy alternatives so that both American and foreign interests would be accommodated.[19]

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15. The court also held that the Turkish vessel could be considered as Turkish territory. However, this holding was reversed by article 11 (1) of the Convention on the High Seas, April 29, 1958, 2 U.S.T. 2312, T.I.A.S. No. 5200. (If ships collide on the high seas, and a person is responsible, such person cannot be subjected to penal measures except by the flag state or state of which the person is a national.)

16. [1927] P.C.I.J., ser. A, No. 9, at 23.

17. *Id.* at 30.

18. In Ferraioli v. Cantor, 259 F. Supp. 842 (S.D.N.Y. 1966), a rule 10b-5 action was brought against a Canadian corporation. Even though the negotiations and "sale" had taken place in Canada, the court stressed that the

> alleged violation is a transfer of control at a premium without disclosing the premium offered and without obtaining equal opportunity for other shareholders; that is the course of conduct which is alleged to violate rule 10b-5. *Id.* at 846.

The court found that an integral part of the challenged transaction, that is, the transfer of control, took place within the United States and therefore rule 10b-5 was applicable. Rather than determine if the "sale" had "substantial effects" within the United States, the court was more interested in finding a "substantial contact" or act within the United States.

19. *See* Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 COLUM. L. REV. 94, 111 (1969); *But see* Buxbaum, *Securities Regulation and the Foreign*

As can be observed from the above construction of the territorial principles, international law does not limit the application of legislation such as the Securities Exchange Act of 1934 to the territorial boundaries of the United States. Fraudulent conduct relating to securities transactions in a foreign country, such as Canada, could generally be considered to have a "substantial effect" on American investors and a detrimental effect upon the investor's confidence in the government's power to police the markets. Therefore, regulation of this conduct would be considered within the limitations as set by the "objective territorial principle."

B. NATIONALITY

Nationality is another recognized basis for the application of domestic law outside of territorial boundaries. "A state has jurisdiction to prescribe a rule of law . . . attaching legal consequences to conduct of a national of the state wherever the conduct occurs. . . ."[20] Although this is well settled, problems often arise involving the determination of the nationality of the parties involved. It is not usually difficult to determine the nationality of a natural person and this note is not concerned with the problem. Difficulties are more often found when a corporation is involved. Although most countries generally attribute to a corporation the nationality of the state where it was organized,[21] in the cases and statutes, varying combinations of additional factors have been considered determinative:[22] the principal place of business, the nationality of the shareholders, the overall investment, the management, and control. A recent trend in domestic law has been to abandon the rigid place of incorporation formula and adopt a more realistic approach of appraising corporate affiliations with different jurisdictions.[23] In particular, international

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Issuer Exemption: A study in the Process of Accommodating Foreign Interests, 54 CORNELL L. REV. 358 (1969).

20. RESTATEMENT §30 (1965); *see* Lauritzen v. Larsen, 345 U.S. 571, 587 (1953) ("A state 'is not debarred by any rule of international law from governing the conduct of its own citizens upon the high seas or even in foreign countries when the rights of other nations or their nationals are not infringed.'"); Blackmer v. United States, 284 U.S. 421, 436 (1932) ("By virtue of the obligations of citizenship, the United States retained its authority over him, and he was bound by its laws made applicable to him in a foreign country.")

21. RESTATEMENT §27 (1965).

22. *See* Vagts, *The Corporate Alien: Definitional Questions in Federal Restraints on Foreign Enterprise*, 74 HARV. L. REV. 1489, 1530-50 (1961); Comment, *The Nationality of International Corporations under Civil Law and Treaty*, 74 HARV. L. REV. 1429 (1961).

23. *See* H. STEINER & D. VAGTS, TRANSNATIONAL LEGAL PROBLEMS 172 (1968); *See also* RESTATEMENT, Reporter's Note No. 3 at 519: "[T]here may be situations where a corporation, organized under the law of one state is also a national of another state, under the latter's law, by reason of local activities. . . ." *See, eg.*, 28 U.S.C. §1332 (c):

> [A] corporation shall be deemed a citizen of any State by which it has been incorporated and of the state where it has its principal place of business. . . .

agreements and codifications have given more consideration to the injured shareholder, and to his nationality. For example, the United States will allow an action on behalf of American shareholders in a foreign corporation if they come under section 172 of the Restatement.[24] A number of bilateral agreements settling expropriation claims are an example of such practice.[25]

Doubt might have been cast upon the force of this trend minimizing the importance of the place of incorporation formula by the recent decision in the *Barcelona Traction Light and Power Company*[26] case. The Belgian government had claimed a right to represent in a Spanish litigation certain Belgian nationals who owned the controlling interest in the Barcelona Traction Company, a holding company with extensive investments in Spain. The company and its subsidiaries were incorporated in Canada. Belgium asserted that after Barcelona Traction was declared bankrupt in Spain, the subsequent cancelling of shares located outside Spain and the sale of new shares of the Spanish subsidiary companies caused direct and immediate injury to the rights and interests of the Belgian shareholders. The World Court held that the Belgian government did not have the right to assert diplomatic claims on behalf of the corporation or its shareholders. In establishing the nationality of the company, the Court looked only to the place of incorporation.

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24. RESTATEMENT §172 (1965):
When a domestic corporation, in which an alien is directly or indirectly a shareholder, is injured by action attributable to a state that would be wrongful under international law if the corporation were an alien corporation, the state is not responsible under international law for the injury to the corporation. The state is, however, responsible for the consequent injury to the alien to the extent of his interest in the corporation, if

(a) a significant portion of the stock of the corporation is owned by the alien or other aliens of whatever nationality,

(b) the state knows or has reason to know of such ownership at the time of the conduct causing the injury to the corporation,

(c) the corporation fails to obtain reparation for the injury,

(d) such failure is due to causes over which the alien or other alien shareholders cannot exercise control, and

(e) a claim for the injury to the corporation has not been voluntarily waived or settled by the corporation.

Stock ownership is "significant" if it is 25% or greater. *Id.*, Reporter's Note No. 2, at 524.

25. *See, e.g.*, Treaty of Friendship, Establishment and Navigation with Luxembourg, February 23, 1962, [1963] 1 U.S.T. 251, T.I.A.S. No. 5306; Treaty of Friendship and Commerce with Pakistan, Nov. 12, 1959, [1961] 1 U.S.T. 110, T.I.A.S. No. 4683. *See generally* Bagge, *Intervention on the Ground of Damage Caused to Nationals, with Particular Reference to Exhaustion of Local Remedies and the Rights of Shareholders*, 34 BRIT. Y.B. INT'L L. 162 (1958).

26. Case Concerning the Barcelona Traction, Light and Power Company, Limited (Belgium v. Spain) [1970] I.C.J. ______, 9 INTERNATIONAL LEGAL MATERIALS 227 (1970).

It is difficult to make a realistic assessment of how American courts are likely to react to *Barcelona Traction*. The issue in that case involved the right of a country to make a diplomatic claim, the Court deciding Canada had this exclusive right. That domestic courts will use this to rule in favor of a strict place of incorporation test in all cases seems somewhat doubtful. The courts of the United States are likely to continue to determine the nationality of a corporation by looking to the nationality, domicile or residence of the controlling individuals (aggregate test) or by looking to the place of incorporation, place of board meetings or place of business (entity test).[27] Such methods would not appear to conflict with the nationality principle of *Barcelona Traction* if that case is read narrowly by the court on its facts. Furthermore, such a reading would not seem to hinder the United States from exerting control through its securities laws over corporations incorporated abroad but controlled by American shareholders or a board of directors located in the United States. A corporation in this latter position could probably be considered a national of the United States under the aggregate test.[28] Situations may arise in which attempted control of the conduct of foreign corporations substantially connected with the United States could prove to be fruitless.[29] In many such cases, control might better be effectuated through control of United States nationals involved with these corporations.

C. PROTECTIVE PRINCIPLE

Under this recently accepted principle of legislative jurisdiction, a state may prescribe a rule of criminal law "attaching legal consequences to the conduct outside its territory that threatens its security as a state" or has an adverse effect upon its "governmental functions."[30] Even though this principle has been seldom used, its significance lies in its breadth due to the varied possibilities for jurisdiction which it raises. Such broad notions could potentially be used to allow a state to prescribe a rule of law applicable to conduct outside its territory which only has a slight effect within, if the conduct obstructs government "functions." If the maintenance of confidence in securities exchanges and the corporate

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27. *See* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES, 128 (1970).

28. *See, e.g.*, 31 C.F.R. §300.329 (1968) (giving jurisdiction to the United States over corporations outside the United States if owned or controlled by United States' citizens).

29. *See* McCulloch v. Sociedad Nacional de Marineros de Honduras, 372 U.S. 10, 19 (1963) (an "ad hoc weighing of contacts basis . . . would inevitably lead to embarrassment in foreign affairs and be entirely infeasible in actual practice.").

30. RESTATEMENT §33 (1965). The Restatement uses as illustrations of this principle the counterfeiting of currency and false statements made to diplomatic officials. *Id.* §33 (2).

financing mechanism were considered to be government functions, it is conceivable that this principle would provide a basis for legislating extraterritorially. In a 10b-5 action, however, a court would probably prefer to use one of the territorial bases, those principles being more widely recognized.

Under these accepted bases of jurisdiction for prescribing rules of law, United States legislation such as the Securities Exchange Act of 1934 can be applied to certain conduct occurring without the United States. Nevertheless, it is not clear what limits are imposed on the extraterritorial application of the Act under the "objective territorial principle" test of "substantial effects". For clarification, it is necessary to consider domestic decisions which purport to clarify the intent embodied in the Securities Exchange Act, and the exemption which the terms of that Act extend to some foreign activities.[31]

II. EXTRATERRITORIAL APPLICATION OF THE SECURITIES EXCHANGE ACT OF 1934

In general, Congressional enactments are presumed to apply only within the territorial limits of the United States unless a contrary intent is clearly evidenced.[32] The concern of Congress, especially in the field of economic regulation,[33] is usually with domestic affairs. This presumption is borne out by the terms of section 30(b) of the Exchange Act, which provides:

> The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title.[34]

The SEC has not to date promulgated any regulations pursuant to this section.

A problem arises in determining the scope of this exemption in the light of other provisions which do not seem to manifest an intent that the Exchange Act should apply to certain transactions outside of the United States. Section 2 of the Exchange Act states that because transactions in securities are affected with "a national public interest," it is

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31. 1934 Act §30(b), 15 U.S.C. §78dd(b) (1964).

32. Blackmer v. United States, 284 U.S. 421, 437 (1937); American Banana Co. v. United Fruit Co., 213 U.S. 347, 357 (1909) ("All legislation is prima facie territorial.") For a discussion of the extraterritorial application of the Sherman Act, *see* Note, *Extraterritorial Application of the Securities Exchange Act of 1934,* 69 COLUM. L. REV. 94, 97-99 (1969).

33. Foley Bros. v. Filardo, 336 U.S. 281, 285 (1949).

34. Securities Exchange Act of 1934 §30(b), 15 U.S.C. §78dd(b) (1964); *see* Goldman & Magrino, *Some Foreign Aspects of Securities Regulation: Towards a Reevaluation of Section 30(b) of the Securities Exchange Act of 1934,* 55 VA. L. REV. 1015 (1969).

"necessary to provide for regulation and control of such transactions and of matters related thereto . . . and to insure the maintenance of fair and honest markets in such transactions."[35] Although this statement might give the courts some support for extending the investor protections offered by the Act to foreign transactions, it is unclear whether Congress intended such a result.[36]

Until recently, the courts were reluctant to extend securities legislation to foreign countries by reading such an intent into the statute. For example, in *Kook v. Crang*,[37] an American investor brought an action for money damages against the partners of a Canadian brokerage firm alleging a violation of the Federal Reserve margin rules promulgated by the SEC under the authority conferred by section 7 (c) of the Securities Exchange Act.[38] The brokerage firm, after negotiations with the plaintiff in its Toronto office, bought the stock of a Canadian Corporation on margin on the Toronto exchange. This stock was traded solely on the Canadian exchange, orders were placed and payment made in Canada, and credit was extended and stock held as collateral in Canada. The defendant partners had used the United States mail for negotiations, were registered as broker-dealers under section 15 of the Exchange Act,[39] and maintained an office in New York to deal solely with the New York exchanges.

Plaintiff maintained that the registration under section 15 by itself brought defendants within the prohibitions of section 7 (c) while defendant argued that section 30 (b) exempted the transaction from the coverage of the Securities Exchange Act since it took place "without the jurisdiction of the United States." The court held on neither ground, but stated that the transaction in Canada did not fall within section 7 (c) in the first place, since the statute required a connection between the extension of credit and the "business transacted with a member" of a national (American) securities exchange.[40] The extension of credit was connected only with a member of a Canadian exchange.

The court did discuss section 30 (b), which it felt specifically restricted the Act to the transaction of business within the United States.[41] It was the opinion of the court that although Congress could have legis-

35. Securities Exchange Act of 1934 §2, 15 U.S.C. §78b (1964).
36. Schoenbaum v. Firstbrook, 405 F. 2d 200, *rev'd on rehearing on other grounds*, 405 F. 2d 215 (2d cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).
37. 182 F. Supp. 388 (S.D.N.Y. 1960).
38. Section 7 (c) forbids any broker or dealer "who transacts a business in securities through the medium of" a member of a national securities exchange to extend credit except in accordance with the rules of the Board of Governors of the Federal Reserve System. Securities Exchange Act of 1934 §7 (c), 15 U.S.C. §78g (c) (Supp. IV, 1969).
39. 15 U.S.C. §78*o* (a) (1964).
40. Kook v. Crang, 182 F. Supp. 388, 390 (S.D.N.Y. 1960).
41. *Id.*

lated extraterritorially, "jurisdiction" as used in the section 30(b) exemption meant the territorial limits of the United States. Thus, for a transaction to be "within the jurisdiction of the United States," the Statute required a "necessary and substantial act"[42] within the borders of the United States. In effect the court concluded that all provisions of the '34 Act, not explicitly extended extraterritorially by a rule or regulation of the SEC, could only be applied to a transaction of which a "substantial," "necessary," and integral part was performed in the United States.[43] Moreover, *Kook* shows that the Act must be more substantial than activities merely coming within the Securities Acts jurisdictional clauses, by means of the mails or facilities of interstate commerce.

In *Ferraioli v. Cantor*,[44] the same general approach as was used in *Kook* was followed. A shareholder of a New York corporation brought an action under rule 10b-5 against a Canadian corporation which had owned the controlling interest in the New York corporation, and had transferred that interest at a premium in Canada without informing the other shareholders or giving them an opportunity to obtain the favorable price. On rehearing, the court reversed its earlier opinion,[45] holding in favor of the defendant. The decision was based to a large degree on rationale similar to *Kook*, that the 30(b) exemption applied to persons involved in a single transaction outside of the jurisdiction.[46] The court also agreed that persons outside the jurisdiction could be subjected to the liabilities of the Act only if they performed some substantial act within the jurisdiction in connection with the allegedly wrongful transaction.[47] The court seemed to employ a more liberal meaning of "substantial" than that delineated by the court in *Kook*. Here application of the Act in *Ferraioli* was based upon the transfer of control occurring in New York where the corporation was located, in spite of the fact that the actual sale took place in Canada. The court found that there was use of the mails in connection with the transaction,[48] and held, in contrast to

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42. *Id.*
43. *Id.*
44. 259 F. Supp. 842 (S.D.N.Y. 1966).
45. Ferraioli v. Cantor, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶91,615 (S.D.N.Y. 1965) (mem.).
46. *Id.* at 95,311.
47. Ferraioli v. Cantor, 259 F. Supp. 842, 846 (S.D.N.Y. 1966).
48. In a rule 10b-5 action, for a federal court to have jurisdiction, instrumentalities of interstate commerce, the mails, or facilities of a national securities exchange must be used. Even though the substance of a rule 10b-5 violation is a fraudulent scheme employed in the purchase or sale of securities, the use of the mails or other interstate facilities is the jurisdictional base of a complaint or prosecution. *See* SEC v. Gulf Intercont'l Fin. Corp., 223 F. Supp. 987, 995 (S.D. Fla. 1963). In other words, if it is determined that the '34 Act is to apply to the allegedly fraudulent foreign activities,

Kook, that this use of interstate commerce was an inseparable part of the transfer of control, thus a substantial act had occurred within the jurisdiction.[49]

In *Schoenbaum v. Firstbrook,*[50] plaintiff, an American shareholder in Banff Oil, a Canadian corporation, brought a derivative suit against Aquitaine Company of Canada Ltd. which owned a controlling interest in Banff. The complaint alleged that the directors of the two corporations had been guilty of nondisclosure to the shareholders of Banff in a sale of a large quantity of Banff treasury stock to Aquitaine shortly before the announcement of a Banff oil strike sent the value of its shares sharply upwards. Banff carried out all of its business in Canada, although its shares were registered on the American Stock Exchange.

In an opinion by Chief Judge Lumbard, the court held in favor of the extraterritorial application of 10b-5 on broad policy grounds, rejecting the approaches of *Kook* and *Ferraioli.*

> We believe that Congress intended the Exchange Act to have extraterritorial application in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities. In our view, neither the usual presumption against extraterritorial application of legislation nor the specific language of Section 30 (b) show Congressional intent to preclude application of the Exchange Act to transactions regarding stocks traded in the United States when extraterritorial application of the Act is necessary to protect American investors.[51]

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the issue then to be determined is whether there is a use of the mails or interstate commerce sufficient to meet the requirements of rule 10b-5. *See* Schoenbaum v. Firstbrook, 405 F. 2d 200, 210, *rev'd on rehearing on other grounds,* 405 F. 2d 215 (2d Cir. 1968) (en banc), *cert denied,* 395 U.S. 906 (1969). It has recently been recognized that the use of the mails need not be central to the fraudulent scheme and may be entirely incidental and indirect. *See* United States v. Cashin, 281 F. 2d 609, 673 (1960) (mail was used to confirm purchases already induced by defendants deceit). This notion is confirmed by the fact that all the SEC fraud provisions use the language "directly or indirectly." So if a rule 10b-5 defendant caused another person to use the mails, a court would have jurisdiction.

49. *See also* SEC v. Gulf Intercont'l Fin. Corp. 223 F. Supp. 987 (S. D. Fla. 1963) where citizens of Florida, who controlled a number of Florida corporations, organized a Canadian corporation in Canada and sold the shares of this latter corporation. Offers were made through Canadian newspapers which were sold in the United States and Canada. The SEC sought an injunction alleging violations of §17 (a) of the 1933 Act, 15 U.S.C. §77q (a) (1964) and §10 (b) of the 1934 Act. *Id.* §78j (b). The court found that it was sufficient for subject matter jurisdiction that fraudulent offers were made in the United States. In dicta, the court indicated that the offers need not have been made in the United States since jurisdiction under the fraud provisions of the '33 and '34 Acts required only the use of the mails or facilities of interstate commerce. *Id.* at 995.

50. 405 F. 2d 200, *rev'd on rehearing on other grounds,* 405 F. 2d 215 (2d Cir. 1968) (en banc), *cert. denied,* 395 U.S. 906 (1969).

51. *Id.* at 206. *See also* Strassheim v. Daily, 221 U.S. 280, 285 (1911) ("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, if the state should succeed in getting him within its power.")

Since the corporation had not come "within the jurisdiction" under the *Kook* analysis by a substantial act within the territorial boundaries of the United States, the decision rested on a narrower interpretation of the exemption which section 30(b) grants to those persons transacting "a business in securities without the jurisdiction of the United States." Contrary to the previous cases, the *Schoenbaum* decision limited the exemption to its explicit statutory terms, stating that it applied only where the person actually engaged in a regular "business in securities," that is, brokers, dealers, and banks.[52] The court noted that the SEC had still not promulgated any regulations or rules which might bring within the scope of the Securities Exchange Act transactions outside the United States and currently exempted under 30(b).[53] However, in line with its holding that 30(b) did not exempt defendants who maintained no securities business, the court pointed out that the SEC also had the authority to exempt foreign conduct ordinarily covered by rule 10b-5, but had not done so.[54]

The court's discussion of whether foreign conduct was included under rule 10b-5 assumed the requisite "effects" within the jurisdiction needed to allow the exercise of legislative jurisdiction under international law,[55] and also the use of the facilities of interstate commerce or the mails necessary to trigger the provisions of section 10 in the first instance.[56]

It has been suggested that the *Schoenbaum* view of the 30(b) exemption while correct as far as it goes, should be carried a step further.[57] This view agrees with the limitation of the exemption to those actually engaged in a securities business.[58] However, this should not be strictly construed as an absolute exemption which prevents application of the provisions of the Exchange Act to such persons without exception. It should only protect brokers or dealers[59] in situations in which no other

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52. Schoenbaum v. Firstbrook, 405 F.2d 200, 208, *rev'd on rehearing on other grounds*, 405 F. 2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).
53. *Id.* at 207.
54. *Id.*
55. *Id.* at 208-209.
56. *Id.* at 209-210.
57. Brief for the SEC as Amicus Curiae on rehearing, Schoenbaum v. Firstbrook, 405 F. 2d 200, *rev'd on rehearing on other grounds*, 405 F. 2d 215 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).
58. *Id.* at 20-21.
59. Securities Exchange Act of 1934 §3(a) (4), 15 U.S.C. §78c(a) (4) (1964):

The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

Id. §3(a) (5), 15 U.S.C. §78c(a) (4) (1964):

The term 'dealer' means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys and sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.

use of the mails or interstate commerce triggers the application of any section of the Act. Thus a broker, dealer, or bank which uses the mails in connection with a transaction which is fraudulent under rule 10b-5 could be reached because his identity as a broker, dealer, or bank while protecting him under section 30 (b), would not prevent the attachment of jurisdiction under other sections of the statute.

The identity of a person as a broker-dealer in the securities industry has generally been thought to be sufficient jurisdictional grounds upon which to base the application of the Act.[60] It is well established that a security is an article in interstate commerce.[61] A person dealing in securities is thus engaged in interstate commerce whether or not the individual transaction involved is actually carried out across state boundaries. Because of this, the Exchange Act provisions which rely on the commerce clause of the Constitution can attach solely through the identity of the person as a broker-dealer. Thus the broker-dealer identity is the jurisdictional basis of several sections of the Exchange Act.[62] However, where a foreign broker or dealer is involved, the assumption that interstate commerce is involved is not so easily justified, for the transaction may have nothing to do with United States securities markets. In such a case, the application of the Exchange Act would be outside the scope of the Constitution, since the commerce power of Congress could not reasonably extend to such transactions.[63] The fact that a broker or dealer was involved in the transaction would offer no basis for the assumption of sufficient contacts with, or effects within, the jurisdiction to sustain the validity of the application of the legislation under principles of legislative jurisdiction. Even if the broker or dealer were registered under section 15 (a),[64] this infirmity under international legal principles would

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60. Certain provisions of the 1934 Act rely on the identity of the person involved. *Id.* §7 (c), 15 U.S.C. §78g (c) (Supp. IV, 1969) (margin requirements which apply to members, brokers or dealers who transact business on a national securities exchange); *id.* §8 (a) - (d), 15 U.S.C. §78h (a) - (d) (1964) (restrictions on borrowing by members, brokers and dealers); *id.* §15 U.S.C. §78*o* (1964) (registration of brokers and dealers); *id.* §17, 15 U.S.C. §8q (1964) (accounts, records, reports, examination of exchanges, members and others); *id.* §19 (a) (3), 15 U.S.C. §78s (a) (3) (1964) (member suspension and expulsion from an exchange).

61. *See* 15 U.S.C. §77 (b) (7) (1964). *See also* U.S. CONST. art. I, §8. "The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States. . . ."

62. *See* note 60 *supra.*

63. The commerce power only extends to foreign commerce if there is a substantial effect on United States commerce. *See, e.g.,* Vanity Fair Mills, Inc. v. J. T. Eaton Co., 234 F. 2d 633, 641-42 (2d Cir.), *cert. denied,* 352 U.S. 871 (1956).

64. 15 U.S.C. §78*o* (a) (1964) provides:

No broker or dealer (other than one whose business is exclusively interstate) shall make use of the mails or of a means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security . . . otherwise than on a national securities exchange, unless such broker or dealer is not be cured without sufficient contacts within the United States to become bound by its courts under the "territorial principle". Moreover, the "objective territorial principle" would clearly require that the specific transaction have substantial effects within the jurisdiction. Finally, while one can maintain that the protective principle could apply, since private transactions are related to a protection of a national interest, still no case has directly so held. The government's interest in maintaining investor confidence in securities markets might also appear to be a make-weight when compared to the severe disruption caused by activities such as counterfeiting which traditionally come under the protective principle. However, it would seem reasonable to argue that the protective principle could be extended to civil cases, even though national interests or governmental functions would imply criminal sanctions, since private individuals may effectuate national policy by holding the threat of damages over misbehaving corporate executives.

The possibility of violation of both the Constitution and international law was apparently viewed as the basis underlying the 30(b) exemption by the SEC. In its *amicus curiae* brief in *Schoenbaum,* the SEC stated:

> The final group of operative provisions of the original version of the Act was applicable to persons in the securities business even in the absence of a registered security or a use of the jurisdictional means. Under these provisions the "triggering" element was the identity of the person involved in the transaction itself, and any particular foreign transaction might or might not have a sufficient impact on American interests to justify the direct application of the Act to the transaction irrespective of the participation or nonparticipation of someone in the securities business. In other words, although the United States might have power over a participant in a foreign transaction the transaction itself might not have sufficient impact on American interests and therefore not be within the direct legislative jurisdiction of Congress under the Constitution and the Law of Nations. It was this problem to which Section 30(b) was addressed.[65]

If this is the rationale behind the exemption, it would appear to be an exemption which necessity demands. There would be no need to extend it to protect brokers or dealers when they had used the mails or the facilities of interstate commerce in connection with allegedly wrongful transactions. Such persons could be reached in a manner consistent with the Constitution and international law. Thus, according to the interpretation by the SEC, a "person transacting a business in securities" would only be "without the jurisdiction" under section 30(b) when not involved in a transaction which utilized the facilities of interstate commerce.[66] Where use of such facilities, or a registered security, or use of the mails were involved, such persons would not be exempt, since the

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registered. . . .

65. *See* Brief for SEC as Amicus Curiae on rehearing, *supra* note 57 at 20-21.

66. *Id.* at 23-24. One commentator has suggested that the SEC's reading of "without the jurisdiction of the United States" should be rejected. *See* Note, *United States Taxation and Regulation of Offshore Mutual Funds,* 83 HARV. L. REV. 404, 451 (1969).

exemption would apply only to those sections of the Act which rely exclusively on the identity of the person as a broker or dealer as a basis for jurisdiction.[67]

III CONCLUSION

The interpretation of the 30 (b) exemption made by the *Schoenbaum* court follows a different rationale than that employed by the SEC. The court construed the exemption as being premised upon a rule of convenience for brokers and dealers.[68] Because of the difficulties involved in registration and attempted regulation of foreign persons transacting "business in securities," and the negligible results which could accrue, the court intimates that the best line of conduct would be the creation of a clear exemption of such broker-dealers from the Securities Exchange Act.[69] This rationale, if followed, would logically lead to the exemption of all foreign persons transacting "business in securities" regardless of what section of the Act was being utilized against them. Such an exemption would seem to be what the *Schoenbaum* court would grant were a case to arise under rule 10b-5 which actually involved a broker or dealer. As it was, the court did not reach that specific issue since the suit before it was not against a person engaged in a securities business. On the other hand, the SEC indicated in its *amicus* brief that the broker or dealer would be outside the protection of the exemption in cases in which he had used the mails or instrumentalities of interstate commerce in connection with the transaction complained of.[70] If this SEC intrepretation were accepted by the courts, foreign broker-dealers would rarely receive the benefit of an exemption since it is almost inevitable that some use of the United States mails would have been made. Though the SEC interpretation may be the more logically consistent, it could create damaging uncertainty in international securities' law for the courts might be tempted to overextend the limits of legislative jurisdiction under international law by finding "substantial effects" within the United States where, practically speaking, only insubstantial effects exist.

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67. *See* note 60 *supra.*

68. 405 F. 2d at 207, *rev'd on rehearing on other grounds,* 405 F. 2d 215 (2d. Cir. 1968), *cert. denied,* 395 U.S. 906 (1969). In the course of its opinion, the court stated that the purpose of section 30 (b) is:

> [T]o permit persons in the securities business to conduct transactions in securities outside of the United States without complying with the burdensome reporting requirement of the Act and without being subject to its regulatory provisions, except insofar as the Commission finds it necessary and appropriate to regulate such transactions to prevent evasion of the Act.

69. *Id.* at 207-208.

70. *See* Brief for SEC as Amicus Curiae on Rehearing at 23-24; *see also* text accompanying note 66.