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## Subject Matter Jurisdiction in Transnational Securities Fraud Cases

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## SUBJECT MATTER JURISDICTION IN TRANSNATIONAL SECURITIES FRAUD CASES

In recent years there has been a great increase in the number of securities transactions involving persons or events linked with foreign countries and the United States.<sup>1</sup> In the aftermath of some of these transnational transactions, various participants have often claimed that fraudulent practices occurred in the course of the transaction. When the allegedly defrauded party has attempted to bring suit under the antifraud provisions of the Securities Acts,<sup>2</sup> the federal courts have been faced at the outset with difficult questions regarding subject matter jurisdiction. There is no expression of congressional intent as to the reach of these provisions over transactions involving foreign elements.<sup>3</sup> Therefore, the issue of jurisdiction has turned largely on the court's understanding of the policies behind the Acts and of the considerations of international law.<sup>4</sup> Two recent Second Circuit cases, *Bersch v. Drexel Firestone, Inc.*<sup>5</sup> and *IIT v. Vencap, Ltd.*<sup>6</sup> have provided the most definitive statement in this area to date and present an important step in the evolving solution to this difficult issue.

In *Bersch v. Drexel Firestone, Inc.*, plaintiff, an American purchaser of the common stock of Investors Overseas Services, Ltd. (IOS), brought an action individually and on behalf of a class<sup>7</sup> of all persons who purchased common stock through three interrelated offerings by IOS.<sup>8</sup> The defendants were an international accounting firm, various American and foreign financial institutions, and an international financial service organization and its chief officer.<sup>9</sup> The

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<sup>1</sup> See Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PENN. L. REV. 1363, 1364 (1974).

<sup>2</sup> 15 U.S.C. § 77q(a), § 78j (1970).

<sup>3</sup> See *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir.), cert. denied, 96 S. Ct. 453 (1975).

<sup>4</sup> See, e.g., *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1016-18 (2d Cir. 1975); *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334-39 (2d Cir. 1972).

<sup>5</sup> 519 F.2d 974 (2d Cir.), cert. denied, 96 S. Ct. 453 (1975).

<sup>6</sup> 519 F.2d 1001 (2d Cir. 1975).

<sup>7</sup> The plaintiff class numbered no more than 25,000. Allegedly, 386 of this number were American. 519 F.2d at 977-78 n.2.

<sup>8</sup> *Id.* at 981. The district court found that the three offerings were "sufficiently integrated and intertwined" to be considered as one for the purposes of subject matter jurisdiction. *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 451-53 (S.D.N.Y. 1974). The primary offering was intended to create a market so as to enable IOS management personnel to dispose of their own IOS stock in the secondary offering. The district court found this aspect to be a "relatedness of purpose." *Id.* at 453. The circuit court did not resolve this point but left for remand the determination of whether the primary offering could be considered "essential to the carrying out" of the secondary offering. 519 F.2d at 991-92 n.41.

<sup>9</sup> In particular, the defendants were IOS, an international sales and financial service organization formed under the laws of Canada and having a principal place of business in Geneva, Switzerland, 519 F.2d at 978; its chief officer and stockholder, Bernard Cornfeld, 389 F. Supp. at 449; two American banking houses; one foreign bank; five foreign underwriters; and an international accounting firm, 519 F.2d at 978-80.

plaintiffs alleged that the defendants violated the securities laws by failing to reveal material facts in the prospectus, pursuant to which the offering was made, concerning IOS's poor financial position, illegal activities, chaotic bookkeeping and mismanagement, and actual looting and plundering of its treasury.<sup>10</sup>

The offerings were prepared, in part, in the United States. They were discussed and partially initiated and organized in this country during numerous meetings and telephone conversations between the major underwriters, their American attorneys, and IOS officials and accountants.<sup>11</sup> A portion of the basic prospectus was also prepared in the United States.<sup>12</sup> Finally, a draft of this prospectus was circulated in the United States among prospective underwriters.<sup>13</sup> The three offerings were issued from abroad, but each contained substantially identical prospectuses based on the United States draft.<sup>14</sup> Each prospectus disclaimed sales to Americans except IOS employees, associates, and certain clients.<sup>15</sup> Although the offerings were fully subscribed, the stock soon became worthless.<sup>16</sup>

The named plaintiff, Howard Bersch, a United States citizen living in New York, purchased 600 shares of IOS in one of the offerings,<sup>17</sup> apparently in reliance on the prospectus.<sup>18</sup> Although the exact circumstances of the sale are unclear, a foreign office of IOS apparently mailed a subscription form to Bersch in New York because he was an officer of a company doing substantial business with IOS.<sup>19</sup> The circumstances of sales to other American residents are equally unclear. However, it was shown that there were sales to at least 22 Americans who had had some business relationship with IOS. Based on these American sales, the court assumed that prospectuses must have been mailed into the United States to these people.<sup>20</sup>

The primary issue before the court was whether it has subject matter jurisdiction to hear the suit. The district court concluded that it did have subject matter jurisdiction with regard to the entire action.<sup>21</sup> The court based its decision on (1) the significance of the defendant's activity in the United States, (2) the impact of the stock offering upon the American purchasers and (3) the general adverse

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<sup>10</sup> 389 F. Supp. at 449.

<sup>11</sup> *Id.* at 455-57.

<sup>12</sup> *Id.* at 456.

<sup>13</sup> *Id.* at 457.

<sup>14</sup> 519 F.2d at 980.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 981. The stock was sold for \$10 per share, rose to a high of \$14, and declined swiftly thereafter.

<sup>17</sup> *Id.* at 981.

<sup>18</sup> *Id.* at 990-91.

<sup>19</sup> *See id.* at 980, 990. Plaintiff Bersch stated that his office in New York had copies of all three prospectuses, but he was not sure how he came to receive them.

<sup>20</sup> *Id.* at 991. The court also stated that it would assume that there was reliance on the prospectuses, though this fact could be disproved upon remand. *Id.*

<sup>21</sup> *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 455 (S.D.N.Y. 1974).

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effects upon the American securities market resulting from the collapse in the price of the IOS stock offered.<sup>22</sup>

On interlocutory appeal, the Court of Appeals for the Second Circuit held that the district court had subject matter jurisdiction as to the resident American plaintiffs, based on the direct effect which the fraudulent prospectus had upon purchasers who relied on it,<sup>23</sup> and as to non-resident American plaintiffs, based on preparatory activities<sup>24</sup> of the defendants which took place in the United States and which "significantly contributed" to the plaintiffs' losses.<sup>25</sup> However, the suit as to foreign plaintiffs outside the United States was dismissed since there was no activity of the defendants within the United States which directly caused their losses.<sup>26</sup>

In the companion case to *Bersch, IIT v. Vencap, Ltd.*,<sup>27</sup> plaintiff liquidators of IIT, an international investment trust organized under the laws of Luxembourg, brought an action against Vencap, a Bahamian venture capital firm; its president Pistell, an American residing in the Bahamas; and Vencap's American legal representatives.<sup>28</sup> IIT had approximately 150,000 fundholders of whom about 300 were Americans.<sup>29</sup> The plaintiffs alleged that the defendants violated the antifraud provisions of the securities laws by failing to reveal material facts in a memorandum pursuant to which IIT purchased from Vencap three million dollars of Vencap's preferred securities.<sup>30</sup> Plaintiffs also alleged that the defendants subsequently misappropriated the proceeds of the sale of the securities.<sup>31</sup>

Pistell organized Vencap in 1972. Shortly thereafter, he met in London with Graze, the American president of the English corporation which managed IIT. They orally agreed that IIT would invest in Vencap.<sup>32</sup> A three page memorandum was prepared in Nassau by Vencap's lawyers detailing the purposes of Vencap and the specifics of the transaction.<sup>33</sup> The final agreement for the purchase by IIT of

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<sup>22</sup> *Id.* at 457-58.

<sup>23</sup> 519 F.2d at 991, 993. On remand, defendants would be able to overturn this ruling if they proved that the resident Americans did not rely on the prospectus in making their purchase. *Id.* at 991.

<sup>24</sup> *Id.* at 992. The court interchanges terms somewhat, stating first that "preparatory" activities would be enough, *id.* at 992, and then stating that acts "of material importance" must occur in the United States. *Id.* at 993.

<sup>25</sup> *Id.* at 992-93. These activities are detailed in text at notes 9-11 *supra*.

<sup>26</sup> *Id.* at 993, 997. This result is implicit in the court's holding. See *id.* at 993. However, problems of maintaining a large class action with a preponderance of foreign members were also determinative of this result. *Id.* at 997-98.

<sup>27</sup> 519 F.2d 1001 (2d Cir. 1975).

<sup>28</sup> *Id.* at 1003, 1005.

<sup>29</sup> *Id.* at 1016 n.28.

<sup>30</sup> *Id.* at 1011-12.

<sup>31</sup> *Id.* at 1013-14.

<sup>32</sup> *Id.* at 1004-05.

<sup>33</sup> *Id.* at 1005-07. See *id.* at 1021-24, Appendix A for full text of memorandum.

three million dollars in Vencap's preferred securities<sup>34</sup> was drafted in New York by IIT's lawyers and thereafter exchanged in New York with Vencap's lawyers.<sup>35</sup> The sale was closed in the Bahamas.<sup>36</sup> Pistell subsequently caused Vencap to enter into several questionable transactions involving dispositions of Vencap funds which the plaintiffs alleged were inconsistent with the operation of a *bona fide* venture capital firm and which may also have been injurious to shareholder interests.<sup>37</sup>

Once again the issue before the court was whether subject matter jurisdiction existed to hear the suit. The district court held that it had subject matter jurisdiction over the alleged violations since, *inter alia*, (1) the defendants prepared much of the final agreement in the United States<sup>38</sup> and (2) the plaintiff trust had United States citizens and residents as fundholders.<sup>39</sup>

On interlocutory appeal, the Court of Appeals for the Second Circuit reversed the district court on both grounds.<sup>40</sup> It held that the

<sup>34</sup> This agreement made Vencap highly leveraged. *See id.* at 1012. 5,000 common shares of Vencap were originally authorized. Blocks of 2,000 shares each at \$1 per share were issued to Pistell and De Reincourt, a French investor who served as a straw man in the Vencap organization. *Id.* at 1005. IIT paid three million dollars, which equalled 99.9% of Vencap's total capital. IIT received 30,000 preferred shares redeemable at \$100 each. IIT received no voting rights and thus no representation on the Board of Directors. IIT was to receive a 6% annual dividend and a one third profit distribution, but only if these were declared by the Board. *Id.* at 1021-24. Since the shares were redeemable at par value plus accrued dividends, and since the dividends and profit rights were non-cumulative, it would be to Pistell's benefit not to declare dividends or profit distribution and to redeem the shares when accumulated earnings caused the value of the stock to exceed par.

It was these notorious aspects of the deal which influenced the plaintiffs to proceed in the district court on the theory that the sale was a result of a conspiracy between IIT's management and Pistell to defraud the IIT fundholders. The district court found that this theory was not supported by sufficient evidence and could not therefore serve as the basis for the issuance of a preliminary injunction. *See id.* at 1012-13. The plaintiffs did not pursue this theory in the circuit court.

<sup>35</sup> *Id.* at 1006. However, Charles Murphy, Vencap's lawyer, drafted the stock redemption provisions of the agreement in New York. *Id.*

<sup>36</sup> *Id.* at 1007.

<sup>37</sup> *Id.* at 1008-09, 1013-14. By an involved and circuitous process, Pistell used a "loan" of \$590,000 from Vencap to pay his federal and state taxes, several personal loans, and to satisfy a judgment against him. *Id.* at 1009. The loan was routed to Pistell through a Swiss bank and a Netherlands Antilles corporation (whose chief shareholders were Pistell and a colleague) which held no assets. *Id.* at 1008. Although Vencap did get 7% interest from the Swiss bank, *id.* at 1009, the loan was hardly the "sophisticated investment" producing the "high return" which the Vencap memorandum promised. *See id.* at 1021-22, Appendix A. Also, Vencap funds were used to grant a \$155,000 loan to Chibex, a Canadian gold mine corporation controlled by Conservative Capital, Ltd., which was controlled by Pistell and an associate. *Id.* at 1010. Plaintiffs claimed that \$672,000 more of Vencap's funds were invested in the Lincoln American Corporation of which Pistell was chairman of the executive committee and whose stock was traded on the American Stock Exchange. *Id.* n.16.

<sup>38</sup> *See* text at note 35 *supra*.

<sup>39</sup> *See id.* at 1016.

<sup>40</sup> *Id.* at 1011-12, 1016-17.

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memorandum was not fraudulent; therefore, the defendants' activities in the United States regarding the memorandum are not significant for jurisdictional purposes.<sup>41</sup> The court also held that the fact that 300 Americans were fundholders of IIT is not a sufficient basis for finding subject matter jurisdiction since the effect of the sale upon the Americans as a group was both indirect and insubstantial in comparison to the effect upon the foreign fundholders of IIT.<sup>42</sup> The court then offered guidance to the plaintiffs as to alternative theories of fraud upon which subject matter jurisdiction could be more easily based.<sup>43</sup> It remanded the case for further findings as to the factual basis supporting such alternative theories.<sup>44</sup> Significantly, the court stated that if the foreign plaintiff trust could establish that the defendants actually perpetrated fraudulent acts within the United States, then subject matter jurisdiction would exist despite the foreign nationality of the plaintiffs.<sup>45</sup>

It is seldom clear whether a federal court has subject matter jurisdiction over a complex transnational transaction. Many factors affect the decision regarding jurisdiction and it is the purpose of this comment to discuss those factors. First, the jurisdictional framework within which the federal courts make the decision as to whether they have subject matter jurisdiction over a transnational securities fraud case will be reviewed. Then an examination will be made of the two bases on which the jurisdictional issue is ultimately determined: defendant's activity within the United States, and the effects within the United States of defendant's foreign activity. Throughout, a thorough analysis of *Bersch* and *IIT* will be undertaken. It will ultimately be submitted that *Bersch* and *IIT* are the two most significant cases in this area of transnational securities fraud, having by their refinements greatly elucidated the complex issue of the international reach of the American securities laws.

### I. JURISDICTIONAL FRAMEWORK

Section 27 of the Securities Exchange Act of 1934,<sup>46</sup> the general jurisdictional section of the Act, provides in broad terms that the federal courts shall have exclusive jurisdiction of "violations" of the Act.<sup>47</sup>

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<sup>41</sup> *Id.* at 1011-12, 1018.

<sup>42</sup> *Id.* at 1016-17.

<sup>43</sup> *Id.* at 1012-14, 1018.

<sup>44</sup> *Id.* at 1018-19.

<sup>45</sup> *Id.* at 1017-18.

<sup>46</sup> 15 U.S.C. § 78aa (1970).

<sup>47</sup> *Id.* Section 27 provides in pertinent part:

The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter . . . may be brought in

The "violations" referred to in section 27 which are the subject of this comment are violations of the antifraud sections of the Securities Act of 1933<sup>48</sup> and the Securities Exchange Act of 1934.<sup>49</sup> These violations often involve application of SEC Rule 10b-5<sup>50</sup> which provides, insofar as is relevant to jurisdictional bases, that the plaintiff must prove some use of the mails or of the instrumentalities of interstate commerce.<sup>51</sup> The antifraud sections of the Securities Acts contain similar language.<sup>52</sup> This reference to the use of interstate commerce and the mails was inserted for the purpose of invoking Congress' power to legislate under the Commerce Clause.<sup>53</sup> It was not intended to be the basis for subject matter jurisdiction.<sup>54</sup>

any such district or in the district wherein the defendant is found or is an inhabitant or transacts business . . . .

Section 22(a) of the Securities Act of 1933, 15 U.S.C. § 77v(a) (1970), contains similar language and its scope is construed to be the same as that of section 27. *See, e.g.,* Bersch v. Drexel Firestone, Inc., 389 F. Supp. 446, 453 (S.D.N.Y. 1974).

Interpreting section 27 of the 1934 Act requires an initial distinction between venue language and general subject matter jurisdiction language. While some courts have looked to language regarding where the action "may be brought" as pertaining to subject matter jurisdiction, *see, e.g.,* Finch v. Marathon Sec. Corp., 316 F. Supp. 1345, 1348 (S.D.N.Y. 1970), it seems that this language was intended to refer to venue. *See, e.g.,* Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969), where the court emphasized the language regarding exclusive jurisdiction of "violations" in discussing subject matter jurisdiction. *Id.* at 206. The requirement that the defendant be "found" in the district where the action is brought is an easy one to meet and would not be sufficient to assert subject matter jurisdiction. *See* text at notes 93-94 *infra*. Where the defendant may be "found" or where he transacts business are traditionally venue considerations. *See* 28 U.S.C. § 1391 (1970). Thus, the parallel language regarding the bringing of criminal proceedings in districts where an "act or transaction constituting the violation occurred" could more consistently be interpreted as allowing venue in districts where the use of the facilities of interstate commerce is shown, since such use is a necessary element in the proof of a Securities Act antifraud violation, 17 C.F.R. 240.10b-5 (1975). The antifraud provisions as well as Rule 10b-5 make it a violation to use the facilities of interstate commerce to commit fraud. *See* 15 U.S.C. §§ 77q(a), 78j (1970).

<sup>48</sup> 15 U.S.C. § 77q(a) (1970).

<sup>49</sup> *Id.* § 78j (1970).

<sup>50</sup> 17 C.F.R. 240.10b-5 (1975). This 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 facility of any national securities exchange

(a) to employ any device, scheme, or artifice to defraud,

(b) 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 the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

<sup>51</sup> *Id.* Note that "interstate commerce" is defined in the statute as including commerce "between any foreign country and any state." 15 U.S.C. § 78c(a)(17) (1970).

<sup>52</sup> *See* 15 U.S.C. §§ 77q(a), 78j (1970).

<sup>53</sup> *United States v. Robertson*, 181 F. Supp. 158, 164 (S.D.N.Y. 1959).

<sup>54</sup> *See Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1333 (2d Cir. 1972). *See* text at notes 93-94 *infra*.

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Section 27 does not expressly grant jurisdiction over transnational cases.<sup>55</sup> Further, it seems clear that in the days following the Great Depression, when Section 27 was enacted, Congress did not even consider the problem of transnational securities fraud.<sup>56</sup> On the other hand, section 27 does not contain any limitations which preclude jurisdiction over transnational cases.<sup>57</sup> Since the Securities Acts define "interstate commerce" as including commerce "between any foreign country and any state,"<sup>58</sup> extension of federal court jurisdiction into the transnational area would seem to be within the purview of the Acts.<sup>59</sup> However, since the jurisdictional language of section 27 is so vague, federal courts have been forced to consider factors external to the provision to decide the jurisdictional issue presented in transnational cases. Among these factors are principles of statutory construction and international law, remedial goals which the Securities Acts were designed to effectuate, and policy considerations in the area of conflicts of law.

To avoid conflict with international law, federal courts have created a presumption that federal statutes do not apply to activity which transpired outside the United States.<sup>60</sup> However, federal courts will not construe federal statutes in a manner contrary to the legislative intent.<sup>61</sup> Thus, the presumption against extraterritorial application is rebutted when the requisite Congressional intent appears in the legislative history.<sup>62</sup> Since Congress did not specifically address the question of the extraterritorial applicability of the antifraud provisions of the securities laws,<sup>63</sup> federal courts have attempted to divine the legislative intent by speculating in each fact situation what Con-

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<sup>55</sup> See 15 U.S.C. § 78aa (1970).

<sup>56</sup> See *Bersch*, 519 F.2d at 993.

<sup>57</sup> See 15 U.S.C. § 78aa (1970).

<sup>58</sup> 15 U.S.C. § 78c(a)(17) (1970).

<sup>59</sup> See *Schoenbaum v. Firstbrook*, 405 F.2d 209-10 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

<sup>60</sup> See, e.g., *American Banana Co. v. United Fruit Co.*, 213 U.S. 347, 355-57 (1909).

<sup>61</sup> See, e.g., *Foley Bros. v. Filardo*, 336 U.S. 281, 285 (1940). Courts will also look to analogous statutory provisions and overall legislative policy to determine legislative intent.

<sup>62</sup> *Id.* at 285; *Blackmer v. United States*, 284 U.S. 421, 437 (1932). Moreover, if the legislative command is clear, federal courts will apparently give extraterritorial effect to the American statute even if such an effect violates international law. *United States v. Aluminum Co. of America*, 148 F.2d 416, 443 (2d Cir. 1945); *accord*, *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972).

<sup>63</sup> *Bersch*, 519 F.2d at 993. The legislative history of section 10(b) of the 1934 Act, 15 U.S.C. § 78j (1970) does not consider this issue. See generally 78 CONG. REC. 7701-06, 7861-69, 7920-29, 8295-8301 (1934). Congress did, however, consider the question of subject matter jurisdiction over transnational securities transactions in the limited area of securities transactions conducted over foreign securities exchanges. Thus, in section 30(b) of the 1934 Act, 15 U.S.C. § 78dd(b) (1970), Congress provided that:

The provisions of this chapter 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



gress would have done had it thought about the problem.<sup>64</sup> The result has been a strong judicial desire to effectuate the remedial purposes of the Securities Acts<sup>65</sup> by broadly asserting jurisdiction under the Acts while still remaining within the limits of international law.<sup>66</sup> Thus, a starting point for analyzing the scope of the antifraud provisions in the transnational setting is to understand the applicable international law principles.

International law gives wide latitude to a country's power to prescribe rules of jurisdiction (prescriptive jurisdiction) over conduct occurring within its borders. The doctrine underlying this power is called the "subjective territorial principle."<sup>67</sup> This principle requires only the occurrence of some activity within the country which relates to some national interest:<sup>68</sup> the activity need not produce an effect

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in contravention of such rules and regulations as the commission may prescribe to prevent the evasion of this chapter.

(Emphasis added). The SEC has not promulgated any rules or regulations under this section. The purpose of this section is to allow professionals in the securities business to conduct transactions outside the United States without complying with the Act's burdensome regulatory provisions. *Schoenbaum v. Firstbrook*, 405 F.2d 200, 207 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). Thus, dealers, brokers, and banks, though probably not investment companies, *see* *Roth v. Fund of Funds*, 405 F.2d 421, 422 (2d Cir. 1968) (dictum), *cert. denied*, 394 U.S. 975 (1969), can invoke this section. *Schoenbaum v. Firstbrook*, *supra* at 207. Further, this provision is limited to professionals who regularly transact their business abroad, and not to persons who engage in isolated foreign transactions. *Id.*

The key words in the provision are "without the jurisdiction of the United States." The courts have interpreted "jurisdiction" in section 30(b) to mean subject matter or prescriptive jurisdiction, rather than territorial "jurisdiction." *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 459 (S.D.N.Y. 1974); *SEC v. United Fin. Group, Inc.*, 474 F.2d 354, 357-58 (9th Cir. 1973). *Bersch* would define the 'jurisdiction' referred to in section 30(b) as coextensive with normal subject matter jurisdiction. 389 F. Supp. at 459. Two cases where section 30(b) was cited to dismiss a claim under the Securities Acts are *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 F.R.D. 385, 386 (S.D.N.Y. 1969) and *Kook v. Crang*, 182 F. Supp. 388, 390 (S.D.N.Y. 1960). In each case it would appear that there would have been no subject matter jurisdiction even absent section 30(b). *See Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra* at 386; *Kook v. Crang*, *supra* at 390. The section thus seems little more than a convenient ground for dismissing cases in which subject matter jurisdiction was otherwise lacking.

<sup>64</sup> *See, e.g., IIT*, 519 F.2d at 1016-17; *Bersch*, 519 F.2d at 985, 993; *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972).

<sup>65</sup> *See Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); 15 U.S.C. § 78b (1970) and text accompanying notes 80-83 *infra*.

<sup>66</sup> *See, e.g., Bersch*, 519 F.2d at 985, 991. Of course, courts must still construe statutes within the limits of the Constitution. In this context, the legislative intent will, if necessary, be ignored. Thus, Fifth Amendment Due Process protection is available to limit jurisdiction. *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972); *cf. International Shoe Co. v. Washington*, 326 U.S. 310 (1940), showing the influence of due process in the in personam jurisdiction area.

<sup>67</sup> *See Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 454 (S.D.N.Y. 1974).

<sup>68</sup> *RESTATEMENT (SECOND) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES* § 17 (1965) [hereinafter cited as *RESTATEMENT (SECOND)*] states:

Jurisdiction to Prescribe with Respect to Conduct, Thing, Status, or Other Interest Within Territory

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within the country.<sup>69</sup> The Second Circuit has indicated that under the Securities Acts, the international law requirements are satisfied by proof of the use of the mails or facilities of interstate commerce within the United States.<sup>70</sup> Since proof of such use is always a necessary part of any antifraud claim,<sup>71</sup> the assertion of subject matter jurisdiction in such transnational cases based on defendant's activity within the United States will not violate international law.<sup>72</sup>

International law also accords broad power to a State to prescribe rules with respect to the conduct of its own nationals. The doctrine which gives rise to this power is called the "nationality principle."<sup>73</sup> Under this principle, a State can assert subject matter jurisdiction over any act of one of its nationals even if the act occurred outside the State and had no impact within the State.<sup>74</sup> Al-

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A state has jurisdiction to prescribe a rule of law

(a) attaching legal consequences to conduct that occurs within its territory, whether or not such consequences are determined by the effects of the conduct outside the territory, and

(b) relating to a thing located, or a status or other interest localized, in its territory.

While the RESTATEMENT (SECOND) is not the final word on international law, federal courts have adopted it as the international law standard. See, e.g., *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 454 (S.D.N.Y. 1974).

<sup>69</sup> RESTATEMENT (SECOND), *supra* note 68, at § 17(a). Thus, where X in State A shoots across the border into State B killing Y, State A has jurisdiction even though the effect occurred in State B. See *id.*, comment a at 45.

<sup>70</sup> See *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1335 (2d Cir. 1972) (dictum). For a discussion on this point, see Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PENN. L. REV. 1363, 1373-74 (1973). It is suggested that § 17 of the RESTATEMENT (SECOND), *supra* note 68, should not be read so broadly. The language that a State has prescriptive jurisdiction to attach "legal consequences to conduct that occurs within its territory," *id.*, could be read to preclude jurisdiction over challenged activity that occurred without the State. Thus where the substance of the fraud occurs outside the State and only the use of interstate commerce facilities occurs within the State, international law might bar application of that State's law to the fraud itself. This argument is merely academic where federal courts have already chosen to follow such an approach in the subject matter jurisdiction area, see *Bersch*, 519 F.2d at 985, and to ignore as determinative of subject matter jurisdiction the mere use of interstate commerce. See text at notes 93-94 *infra*. However, any extension by the federal courts of subject matter jurisdiction principles under § 17 which would approach the minimal prescriptive jurisdiction limits (use of interstate commerce) might violate § 17 under the more restrictive interpretation suggested above.

<sup>71</sup> See note 47 *supra*.

<sup>72</sup> However, note that the federal courts have required proof of more activity than the jurisdictional minimum. See text at notes 93-94 *infra*.

<sup>73</sup> See *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 455 n.8 (S.D.N.Y. 1974).

<sup>74</sup> RESTATEMENT (SECOND), note 68 *supra*, § 30. This section provides in pertinent part:

Jurisdiction to Prescribe with Respect to Nationals

(1) A state has jurisdiction to prescribe a rule of law

(a) attaching legal consequences to conduct of a national of the state wherever the conduct occurs or

(b) as to the status of a national or as to an interest of a national, wherever the thing or other subject matter to which the interest relates is located

though application of the "nationality principle" has often been urged in cases where American defendants have defrauded plaintiffs abroad, the federal courts have rejected such an application, finding an insufficiency of American interests in comparison to potential international conflicts.<sup>75</sup>

Finally, international law recognizes the right of a State to prescribe rules over conduct which occurs outside the State but which produces an effect within the State.<sup>76</sup> This doctrine is called the "objective territorial principle."<sup>77</sup> The effect must be "substantial" and must occur as a "direct and foreseeable result" of the extraterritorial conduct.<sup>78</sup> Under this principle, a federal court would have subject matter jurisdiction over a violation of the securities laws which occurred in a foreign country but which had effects in the United States. As a practical matter, however, difficulties arise in the application of this principle to establish jurisdiction. These difficulties, which will be discussed later,<sup>79</sup> significantly limit the principle's utility.

Other factors, external to section 27, which the federal courts consider in deciding the jurisdictional issue are the purposes which Congress sought to effectuate in enacting the Securities Acts. In general, federal courts will apply the Securities Acts broadly to promote the remedial purposes behind them.<sup>80</sup> Among those purposes are (1) the protection of American investors,<sup>81</sup> (2) the maintenance of fair and honest domestic markets in securities transactions,<sup>82</sup> and (3) the

<sup>75</sup> See, e.g., *ITT*, 519 F.2d at 1016.

<sup>76</sup> RESTATEMENT (SECOND), *supra* note 68, § 18, provides:

Jurisdiction to Prescribe with Respect to Effect within Territory

A state has jurisdiction to prescribe a rule of law 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 under the law of states that have reasonably developed legal systems, or

(b)(i) the conduct and its effect are constituent elements of activity to which the rule applies;

(ii) the effect within the territory is substantial;

(iii) it occurs as a direct and foreseeable result of the conduct outside the territory; and

(iv) the rule is not inconsistent with the principles of justice generally recognized by states that have reasonably developed legal systems.

<sup>77</sup> *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 454 (S.D.N.Y. 1975).

<sup>78</sup> RESTATEMENT (SECOND), *supra* note 68, §§ 18(b) (ii), (iii).

<sup>79</sup> See text at note 223 *infra*.

<sup>80</sup> See, e.g., *Supt. of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10, 12 (1971).

<sup>81</sup> *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

<sup>82</sup> 15 U.S.C. § 78b (1970) provides in pertinent part:

[t]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto . . . to insure the maintenance of fair and honest markets in such transactions.

prevention of manipulation of the prices of securities.<sup>83</sup> Where the transnational plaintiff can demonstrate that the finding of subject matter jurisdiction in his case is necessary to further any of these purposes of the Acts, his case is strengthened considerably.<sup>84</sup>

Moreover, it appears that Congress' purpose in prohibiting fraudulent practices was especially broad. The antifraud provisions seek to protect both purchasers and sellers of securities.<sup>85</sup> The language of section 10(b) and its legislative history make it clear that such protection is not limited to transactions conducted over the national exchanges but is afforded to any securities transaction.<sup>86</sup> Application of the antifraud provisions to all securities transactions strongly suggests a remedial purpose even broader in scope for the antifraud area of the securities laws than for other areas.<sup>87</sup>

Jurisprudential considerations may, however, exert a conservative influence on the courts' decisions regarding subject matter jurisdiction. Arguably, the "precious resources of United States courts and law enforcement agencies" should not be devoted to regulating essentially foreign transactions.<sup>88</sup> Also, the refusal of a foreign court to give *res judicata* effect to an American judgment might unfairly subject a defendant to double liability, or at least force him to defend the same action a second time against the same plaintiff.<sup>89</sup> On the other hand, an American plaintiff should not be forced to litigate his claim overseas, especially in a country which might not police fraud as strictly as the United States does under Rule 10b-5. In such a situation, a federal court may have the obligation to provide a forum at least for

<sup>83</sup> 15 U.S.C. § 78b(3) (1970).

<sup>84</sup> See, e.g., *Investment Properties Int'l, Ltd. v. I.O.S., Ltd.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,011, at 90,735 (S.D.N.Y.), *aff'd without opinion* (2d Cir. 1971) (unreported), where Judge Frankel, dismissing a Securities Act suit against IOS for lack of subject matter jurisdiction, stated that where a foreign transaction has no impact upon domestic interest, federal courts "have no reason to become involved, and compelling reason *not* to become involved, in the burdens of enforcement and the delicate problems of foreign relations and international economic policy that extraterritorial application may entail."

<sup>85</sup> Protection does not extend, however, beyond purchasers and sellers. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

<sup>86</sup> 15 U.S.C. §§ 77q(a) and 78j (1970). See discussion in *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1336 (2d Cir. 1972). Of course, protection can only be afforded to those transactions over which the courts have jurisdiction.

<sup>87</sup> See, e.g., SEC Release No. 33-4708, 29 Fed. Reg. 9828 (1964) exempting from the registration requirements of the 1933 Act certain offers and sales to foreign nationals living abroad, notwithstanding the use of the instrumentalities of interstate commerce in connection with such offers and sales. On the other hand, the SEC has consistently urged application of the antifraud provisions in such situations. Brief of SEC as *Amicus Curiae* on Petition for Rehearing 4-6, *IIT v. Vencap, Ltd.*, 519 F.2d 974 (2d Cir. 1975).

<sup>88</sup> *Bersch*, 519 F.2d at 985.

<sup>89</sup> *Id.* at 996-97.

American based claims.<sup>90</sup> Abstention in such cases might create "gaps in international regulation through which a modern-day pirate may safely sail."<sup>91</sup> Perhaps none of these considerations alone will determine subject matter jurisdiction in a clear case; however, their absence or presence can become crucial in a close case.

In sum, the resolution of the jurisdictional issue in transnational cases involves a subtle accommodation of many different factors, no one of which seems critical by itself. The statutory jurisdictional sections of the Securities Acts afford little assistance in determining the issue. International law principles provide an end point near which federal courts have refused to tread. The outcome has been that the courts have applied the Securities Acts broadly by taking jurisdiction where interests sought to be protected by the Acts are at stake. Nonetheless, countervailing conflicts of laws policy considerations may influence this result critically where considerations of comity are involved.<sup>92</sup>

## II. BASES FOR SUBJECT MATTER JURISDICTION

### A. Subject Matter Jurisdiction Based on Domestic Activity

The antifraud provisions of the Securities Acts require a use of domestic interstate commerce facilities before they can be properly invoked.<sup>93</sup> However, in most cases the minimal activity necessary to satisfy this requirement will not be enough to support subject matter jurisdiction in the federal courts where the remainder of the allegedly fraudulent transaction took place in a foreign country.<sup>94</sup> Thus, the central question under the activities approach is precisely what type of activities must be shown to establish subject matter jurisdiction.<sup>95</sup>

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<sup>90</sup> See discussion in Mizrack, *Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities and Exchange Act of 1934*, 30 BUS. LAWYER 367, 385-86 (1975).

<sup>91</sup> Brief of SEC as *Amicus Curiae* on Petition for Rehearing 10, *IIT v. Vencap, Ltd.*, 519 F.2d 974 (2d Cir. 1975).

<sup>92</sup> See, e.g., *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 996-97 (2d Cir. 1975); *Investment Properties Int'l, Ltd. v. I.O.S., Ltd.*, [1970-71 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,011, at 90.735 (S.D.N.Y.), *aff'd without opinion*, (2d Cir. 1971) (unreported).

<sup>93</sup> 15 U.S.C. § 77q (1970); 15 U.S.C. § 78j (1970); see *Hooper v. Mountain States Sec. Corp.* 282 F.2d 195, 204 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

<sup>94</sup> See *Kook v. Crang*, 182 F. Supp. 388, 390-91 (S.D.N.Y. 1960). Where activities sufficient to meet the interstate commerce requirement of the antifraud provisions are shown but are insufficient to confer subject matter jurisdiction, the federal courts must base a finding of subject matter jurisdiction on the domestic effects of the fraudulent transaction. *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206-09 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

<sup>95</sup> This comment will not deal with factual problems involved in determining where a particular act took place. Such problems are largely a matter for the factfinder. An interesting question is raised, however, by the facts of *Ferraioli v. Cantor*, 259 F. Supp. 842 (S.D.N.Y. 1966), where the fraud involved a failure to disclose rather than an active misrepresentation. *Id.* at 845. The defendant, residing in Canada, was

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First, the activities must relate to the allegedly fraudulent transactions sued upon. In *Kook v. Crang*,<sup>96</sup> the district court dismissed for want of subject matter jurisdiction an action brought by an American stock purchaser against a Canadian brokerage house.<sup>97</sup> The defendant made margin loans to the plaintiff in accordance with Canadian margin requirements, but in a manner that would have been in violation of the requirements of the Securities Exchange Act if the Act were held to apply to the transactions.<sup>98</sup> The court held that the Exchange Act did not apply, however, because the domestic activity upon which the plaintiff sought to base jurisdiction, in large part merely the acquisition of stock quotations from defendant's New York office, was unrelated to the credit extensions that constituted the violation.<sup>99</sup> Thus, where the United States conduct is not connected with the acts which constitute the violation alleged, it cannot be the basis for subject matter jurisdiction.

In *Leasco Data Processing Equipment Corp. v. Maxwell*,<sup>100</sup> the United States Court of Appeals for the Second Circuit refined this relationship as it pertains to antifraud violations. In *Leasco*, the American plaintiff purchased stock over the London Stock Exchange in reliance upon misrepresentations made both in New York and abroad, by the defendants.<sup>101</sup> In holding that this domestic activity, coupled with the effect of the misrepresentation on American investors, provided a basis for subject matter jurisdiction,<sup>102</sup> the court stated the relationship test in terms of proximate causation:<sup>103</sup> to be relevant to a determination of jurisdiction, the domestic activity must have caused a risk that encompassed the ultimate harm to the plaintiff.<sup>104</sup> The court specifically indicated that the risk created was not to be limited by a foreseeability requirement.<sup>105</sup> Stated differently, the court said that the American activity would be relevant where it was an essential link in the fraudulent transaction alleged in the complaint.<sup>106</sup>

This formulation of the relationship test, by not requiring reasonable foreseeability, provides the courts with wide discretion to

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charged with a duty of notifying minority shareholders, many of them American residents, of a sale of his stock and a subsequent transfer of control. *Id.* at 846. Since the court found that control of the corporation was transferred in the United States, *id.*, it was not required to determine the locus of the failure to act.

<sup>96</sup> 182 F. Supp. 388 (S.D.N.Y. 1960).

<sup>97</sup> *Id.* at 389, 391.

<sup>98</sup> *Id.* at 389, 390.

<sup>99</sup> *Id.* at 391.

<sup>100</sup> 468 F.2d 1326 (2d Cir. 1972).

<sup>101</sup> *Id.* at 1331-32. Some of the shares purchased by the plaintiff were allegedly sold by the defendants over the exchange. *Id.*

<sup>102</sup> *Id.* at 1337.

<sup>103</sup> *Id.* at 1335.

<sup>104</sup> *Id.* It is interesting to note that the court did not regard as important defendants' contention that the critical misrepresentations all occurred abroad. *See id.* at 1334-35.

<sup>105</sup> *Id.* at 1335.

<sup>106</sup> *Id.*, citing *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970).

decide whether to consider specific conduct a basis for jurisdiction. Generally, the courts have exercised this discretion liberally and have recognized a broad scope of activities as related to the fraud alleged. For example, the Second Circuit in *Bersch* determined that preliminary meetings and discussions occurring in the United States were relevant to the subject matter jurisdiction issue even though the essential elements of the fraudulent transaction—the misrepresentations and sales—occurred abroad.<sup>107</sup> Likewise, the Ninth Circuit in *SEC v. United Financial Group, Inc.*<sup>108</sup> held that domestic acts in preparation of a prospectus that was to be distributed abroad were significant to a determination of jurisdiction.<sup>109</sup>

A critical factor in determining whether there exists the necessary relationship between specific activities and an alleged violation is the manner in which this violation is characterized.<sup>110</sup> The significance of proper characterization of the fraud is demonstrated in *IIT*. In examining the allegations of the complaint, the *IIT* court identified five possible theories of the fraud, each raising somewhat different jurisdictional problems.<sup>111</sup> The first and second theories postulated that the fraudulent acts occurred in the actual sale of the stock; the first theory contending that the sale was fraudulent because the memorandum describing the offer contained significant misrepresentations,<sup>112</sup> and the second theory because the security itself was by its nature a "device, scheme, or artifice to defraud" within Rule 10b-5(a).<sup>113</sup> In both of these characterizations, the fraudulent transaction would be regarded as completed with the execution of the sale.<sup>114</sup> Therefore, while the post-sale activities would be relevant as evidence of a fraudulent intent on the defendant's part, they would not be relevant to a consideration of jurisdiction.<sup>115</sup>

Theories four and five<sup>116</sup> did not proceed on such a limited basis. Under the fourth theory the fraudulent acts alleged were misrepresentations by Vencap that it was a *bona fide* venture capital firm when, in fact, the subsequent misuse of funds indicated that it was not.<sup>117</sup> The fifth theory postulated a derivative action by IIT in the name of Vencap alleging an improper use of funds by Vencap's direc-

<sup>107</sup> 519 F.2d at 987, 993.

<sup>108</sup> 474 F.2d 354 (9th Cir. 1973).

<sup>109</sup> *Id.* at 356-57.

<sup>110</sup> *See IIT*, 519 F.2d at 1011-18.

<sup>111</sup> *Id.* at 1018. In characterizing the fraud, the court did not make any conclusion as to the basis for each theory in fact. *Id.* at 1011-14.

<sup>112</sup> *Id.* at 1011-12.

<sup>113</sup> *Id.* at 1012.

<sup>114</sup> *Id.* at 1018.

<sup>115</sup> *See id.*

<sup>116</sup> The third theory, alleging a conspiracy between the managements of the purchaser and the seller, was dealt with summarily by the court. *Id.* at 1012-13, 1018.

<sup>117</sup> *Id.* at 1013.

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tors in loaning money to Pistell.<sup>118</sup> Neither of these frauds would be completed with the sale of the preferred securities to IIT but rather would encompass the activities occurring subsequent to the sale. Because such post-sale activities of the defendants would constitute a consummation of the respective frauds, they must be considered as a part of the challenged transaction.<sup>119</sup> As such, they would be relevant in determining whether jurisdiction existed.<sup>120</sup>

Once it is determined that the activities which took place in the United States are related to the fraudulent transaction, it must be further decided into which of the two categories defined by the *Bersch* and *IIT* courts the domestic conduct must be placed: preparatory or substantial.<sup>121</sup> Different jurisdictional consequences attach to each category.<sup>122</sup>

As the court in *IIT* noted, this distinction between preparatory and substantial acts is often a difficult one to make.<sup>123</sup> Some clues as to the limits of each category were given in the two cases, however. In most situations, the determinative factor in characterizing the United States conduct as either substantial or preparatory will be the *quality* of the activities that occur domestically, not merely their quantity.<sup>124</sup> The court in *IIT* indicated that activity comprising one of the central elements of the violation, for example, the misrepresentation or the sale, would be classed as substantial.<sup>125</sup> Activity in preparation for such an elemental act, on the other hand, would be merely preparatory regardless of the frequency of its occurrence.<sup>126</sup> This distinction is made clearer by the discussion of two different factual configurations by the *IIT* court.

The court stated that, in addition to misrepresentations and sales which are obvious elements of a fraudulent transaction, domestic activities that are the consummation of a Rule 10b-5 violation are elemental and are to be included in the substantial category.<sup>127</sup> The court was presented with two theories of fraud which involved activity

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<sup>118</sup> *Id.* at 1013-14. This theory relies heavily on *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971). In *Bankers Life*, the defendant purchasers acquired a controlling interest in an insurance company through a sale of securities. *Id.* at 7-8. They used their newly acquired corporate position to cover the purchase price with the corporation's assets. *Id.* at 8. The sale itself was lawful, but the subsequent actions were not. The court stated that the entire transaction, including the sale of securities, was covered under Rule 10b-5 since the scheme, to succeed, necessarily included the sale of securities. *Id.* at 9-12.

<sup>119</sup> 519 F.2d at 1018. The *IIT* court said that since the plaintiffs could not have sued until the funds were misused, and the misuse was the conduct which actually caused the loss, the misuse was part of the fraud. *Id.*

<sup>120</sup> *See id.*

<sup>121</sup> *IIT*, 519 F.2d at 1017-18; *Bersch*, 519 F.2d at 987, 993.

<sup>122</sup> *IIT*, 519 F.2d at 1017-18; *Bersch*, 519 F.2d at 987, 993.

<sup>123</sup> 519 F.2d at 1018.

<sup>124</sup> *See Bersch*, 519 F.2d at 987; *accord, IIT*, 519 F.2d at 1018.

<sup>125</sup> *See* 519 F.2d at 1018.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at 1018.



by the defendant subsequent to the sale.<sup>128</sup> The court stated that these subsequent consummating acts were an essential part of the transaction and therefore would be classed as substantial.<sup>129</sup>

The *IIT* court also commented on the fact situation presented in the Ninth Circuit case of *SEC v. United Financial Group, Inc.*<sup>130</sup> In *United Financial Group*, the defendant American corporation prepared a prospectus used abroad in a fraudulent security transaction and substantially supervised the transaction from this country.<sup>131</sup> The Ninth Circuit, in noting the existence of a small degree of injury to American investors,<sup>132</sup> found subject matter jurisdiction.<sup>133</sup> In analyzing these facts, the *IIT* court stated that the finding of a detrimental impact to Americans was probably unnecessary to the Ninth Circuit's result<sup>134</sup> since the domestic supervision of a foreign fraud would be sufficiently important to make it a substantial act.<sup>135</sup>

A further question as to the substantiality of domestic conduct is presented where elemental activity that would normally be classed as substantial occurs both domestically and abroad. In this situation the courts must quantitatively compare the domestic activity with the foreign conduct.<sup>136</sup> Such split activity was present in *Leasco*, but the existence of an extensive impact on American investors in that case made a weighing of domestic and foreign activity unimportant to the holding.<sup>137</sup> The *Bersch* court gave some indication of a test applicable to such determinations, implying that the United States conduct will be classed as substantial so long as it is not small in comparison to the conduct occurring abroad.<sup>138</sup>

Preparatory activities were found by the *Bersch* court when it examined the domestic activities alleged by the plaintiff in that case—retention of counsel, meetings with the SEC, and preliminary construction of the offerings.<sup>139</sup> It is noteworthy to compare this view with that of the lower court in *Bersch*. In examining the same domestic activity the district court found that this conduct was highly significant in the fraud, noting that "substantial elements of the offering were structured as a result of this activity."<sup>140</sup> The court of appeals there-

<sup>128</sup> *Id.* See text at notes 116-120 *supra*.

<sup>129</sup> *Id.*

<sup>130</sup> 474 F.2d 354 (9th Cir. 1973).

<sup>131</sup> *Id.* at 356.

<sup>132</sup> *Id.*

<sup>133</sup> *Id.* at 357.

<sup>134</sup> 519 F.2d at 1017.

<sup>135</sup> *Id.*

<sup>136</sup> See 519 F.2d at 987.

<sup>137</sup> 468 F.2d at 1337.

<sup>138</sup> 519 F.2d at 987.

<sup>139</sup> 519 F.2d at 985 n.24, 987. The situation was compared to the shooting of a gun across state lines, the court saying that the *Bersch* acts were comparable to neither the shooting of the gun nor the hitting of the bullet. Only the preparation of the gun was analogous, and this would not be enough to justify jurisdiction on its own. *Id.* at 987.

<sup>140</sup> *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 456-57 (S.D.N.Y. 1974).

fore seems to have taken a less functional view of the conduct. Its characterization of the domestic activity was based on its formal position in the transaction, rather than on its actual significance to the violation.

Thus, the *Bersch* and *IIT* decisions indicate that domestic activities that comprise an essential element of the violation—for example, the misrepresentation, the sale, the supervision of the fraud, or the consummation—will be classed as substantial, while activities not meeting this standard, but which are nevertheless related to the fraud—such as meetings with counsel or government authorities—are preparatory. The consequences which flow from the substantial preparatory categorization are significant. Once a court concludes that substantial activities have occurred in the United States, subject matter jurisdiction is established regardless of the existence of a detrimental domestic impact.<sup>141</sup> The *IIT* court noted that this country would disapprove of another country's permitting the export of misrepresented securities to the United States.<sup>142</sup> Therefore, Congress must have intended to give courts the power to prevent similar frauds from being based in this country for distribution elsewhere:<sup>143</sup> "[W]e do not think 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."<sup>144</sup> Thus a finding of substantial domestic activity in a foreign fraud determines the question of subject matter jurisdiction.<sup>145</sup>

On the other hand, when the conduct within the United States is found to be merely preparatory to an essentially foreign transaction, jurisdiction will vest only if the fraud produces a detrimental effect on persons in whom the United States has an interest.<sup>146</sup> The *Bersch* court rested this conclusion on the policy of the Securities Acts in protecting American investors.<sup>147</sup> This type of jurisdiction, based on preparatory activities coupled with a detrimental effect,<sup>148</sup> is to be distinguished from jurisdiction based *solely* on detrimental effects *in the United States*. Where there exists some domestic conduct that can be classed at least as preparatory to the fraud, the courts will assume authority where the effect is far more attenuated than is required in the absence of preparatory activities.<sup>149</sup> The court did this in *Bersch*, in granting jurisdiction over the transactions involving American citizens residing abroad.<sup>150</sup>

<sup>141</sup> 519 F.2d at 1017-18.

<sup>142</sup> *Id.* at 1017.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> This is at least the case where the plaintiffs are named individuals. Class actions and derivative suits may be treated differently, however. *IIT*, 519 F.2d at 1018 n.31; *Bersch*, 519 F.2d at 993-98. See note 153 *infra*.

<sup>146</sup> *Bersch*, 519 F.2d at 993.

<sup>147</sup> See *id.* at 992.

<sup>148</sup> *Id.* at 993.

<sup>149</sup> *Id.* at 992-93.

<sup>150</sup> *Id.*

Other courts have also treated this effects requirement liberally once preparatory activities are established. Sufficient domestic impact has been found where proceeds from a foreign subsidiary's transaction were funnelled into a United States corporation in order to improve the parent's financial situation and to increase its attractiveness to American investors.<sup>151</sup> Similarly, courts have looked beyond the party technically harmed by a transaction to an American who is the real party in interest in order to find the requisite effect.<sup>152</sup> It seems that the courts are willing to go far to find a detrimental impact on investors, either residents or citizens living abroad, and therefore to find jurisdiction, so long as significant activities in preparation for the fraudulent transaction occurred domestically.

In sum, the activities approach to subject matter jurisdiction focuses on the United States conduct that occurred in the allegedly fraudulent transaction. If that conduct was highly significant to the transaction, jurisdiction in the federal courts exists regardless of the domestic impact involved. If the domestic conduct was less substantial, but nevertheless related to the transaction, jurisdiction will vest where the plaintiff can show resulting harm to investors in whom the United States has an interest. This analytical framework was developed largely by the *Bersch* and *IIT* courts. In distinguishing the two classes of domestic activity and assigning different jurisdictional consequences to each, *Bersch* and *IIT* provide a significant contribution to the resolution of the question of subject matter jurisdiction for transnational securities fraud.<sup>153</sup>

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<sup>151</sup> See *United States v. Clark*, 359 F. Supp. 131, 134 (S.D.N.Y. 1973). The court stated that the fraud resulted from United States activity, but did not detail that activity. *Id.*

<sup>152</sup> See, e.g., *Leasco*, 468 F.2d at 1338; *Selzer v. Bank of Bermuda, Ltd.*, 385 F. Supp. 415, 418 (S.D.N.Y. 1974). In *Leasco*, the court looked through the Netherlands Antilles subsidiary, *Leasco, N.V.*, which technically purchased the stock, to the parent which had been acknowledged by the defendants during the course of the transaction to be the real party in interest. 468 F.2d at 1338.

<sup>153</sup> In *Bersch*, a further jurisdictional issue arose because of the class status of the plaintiffs. 519 F.2d at 993. Plaintiff *Bersch* sought to represent all purchasers of the IOS offering: United States residents, United States citizens resident abroad, and foreigners. *Id.* at 977-78. The district court certified the class, *id.* at 982, but the court of appeals reversed, excluding the foreign members. *Id.* at 997. The circuit court stated that the necessity of protecting the defendant from duplicative actions required such a result. *Id.* at 996-98. In class action suits where foreign members are included, the courts should consider the potential binding effect of a judgment for the defendant, or an inadequate plaintiff's judgment, on foreign class members who might subsequently bring a claim in a foreign court based on the same cause of action. See *id.* at 996. Even where United States conduct is substantial enough to support jurisdiction over a named foreign plaintiff, jurisdiction should be declined as to absent foreign class members unless it is shown that a judgment will bind them in a foreign court. *Id.* at 996-97. The *Bersch* court noted that such recognition of a federal court judgment by a foreign court would be more likely if an "opt in" form of notice, whereby class members must affirmatively indicate their willingness to be represented in order to be included in the class, were used. *Id.* at 997 n.48. If the United States activity is of itself insufficient to support a Rule 10b-5 claim by a foreigner, requiring that the claims of foreign class members be based on state law and therefore cognizable in the federal courts only because of pen-

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### B. Subject Matter Jurisdiction Based on Domestic Effects of Foreign Activity

The Supreme Court, in the landmark case *Strassheim v. Dailey*,<sup>154</sup> formulated the concept of domestic effects jurisdiction:<sup>155</sup>

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.<sup>156</sup>

As noted earlier, principles of international law somewhat restrict the utility of this type of jurisdiction by requiring that the effect be substantial and occur as a direct and foreseeable result of the foreign conduct.<sup>157</sup> However, as will be demonstrated, the federal courts do not usually strictly apply these international law restrictions.<sup>158</sup> Instead, the courts focus upon the legislative purpose of the Securities Acts to determine whether Congress intended jurisdiction to exist over the particular foreign transactions involved in a given case.<sup>159</sup>

The two major questions which arise under the effects approach in making this determination are: (1) what is the nature of the interest which must be affected, and (2) what is the nature of the effect which must operate on that interest. In the securities area, the interest must be one which Congress sought to protect in enacting the Securities

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dent jurisdiction, the resulting complexity of the litigation may by itself be enough to justify the exclusion of the foreign class members. *See id.* at 995-96.

Similar problems with the need to protect defendants from duplicative suits arise in derivative actions where both foreign and American shareholder interests are involved. These are more difficult to resolve because the foreign interests cannot be excluded as easily as in the class action situation; therefore, the question becomes whether to dismiss the entire suit and refuse even the Americans a forum, or litigate all interests, including those of the foreign shareholders. Given the traditional reluctance of the federal courts to force an American to bring suit in a foreign court, *Burt v. Isthmus Dev. Co.*, 218 F.2d 353, 357 (5th Cir. 1955), the courts should hear these derivative actions when brought by an American shareholder. The court in *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969), indicated, however, that under appropriate circumstances, where the American clearly has a right of action under foreign law, a federal court may decline jurisdiction on a *forum non conveniens* basis. *Id.* at 209 n.5.

<sup>154</sup> 221 U.S. 280 (1913).

<sup>155</sup> Note that there can never be an instance of a federal court hearing a Rule 10b-5 claim where there is *no* activity in the United States. Proof of the use of the mails or of some facility of interstate commerce must always be made in a Rule 10b-5 claim. However, proof of this minimal activity—which does not rise to the level of substantial or preparatory activity—is insufficient to establish subject matter jurisdiction. *See text at notes 93-94 supra.*

<sup>156</sup> 221 U.S. at 285.

<sup>157</sup> RESTATEMENT (SECOND) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 18 (1965). *See text at notes 80-83 supra.*

<sup>158</sup> *See, e.g., Bersch*, 519 F.2d at 988, 991. *See text at notes 76-78 supra.*

<sup>159</sup> *See, e.g., Schoenbaum v. Firstbrook*, 405 F.2d 200, 206-08 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

Acts, such as the protection of domestic investors and the protection of the integrity of the domestic securities market.<sup>160</sup> In his message to Congress in 1934, President Roosevelt gave his strong support for the Securities Act bill, stating: "[T]his is but one step in our broad purpose of protecting investors."<sup>161</sup> It was this purpose that led the Court of Appeals for the Second Circuit in *Schoenbaum v. Firstbrook*<sup>162</sup> to hold that the normal presumption against extraterritorial application of federal legislation<sup>163</sup> is rebutted where "extraterritorial application of the Act is necessary to protect American investors."<sup>164</sup>

In *Schoenbaum*, an American stockholder in a Canadian corporation whose stock was registered on the American Stock Exchange brought a derivative suit under Rule 10b-5 alleging fraud by the directors of the corporation in the sale of the corporation's treasury stock. It was claimed that the price at which the stock was sold did not reflect the value of undisclosed oil findings recently made by the corporation.<sup>165</sup> The court found 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."<sup>166</sup> Since the sale of the corporation's treasury stock at too low a price was determined to adversely affect both domestic investors and domestic securities markets, the court held that a sufficient interest had been affected and that subject matter jurisdiction thus existed to hear the suit.<sup>167</sup> The court did, however, restrict its holding to foreign transactions involving "stock registered and listed on a national securities exchange [which] are detrimental to the interests of American investors."<sup>168</sup>

<sup>160</sup> See notes 80-83 and accompanying text *supra*.

<sup>161</sup> 78 CONG. REC. 7702 (1934).

<sup>162</sup> 405 F.2d 200 (2d Cir.), *rev'd on other grounds*, 405 F.2d 215 (1968) (en banc), *cert. denied*, 395 U.S. 906 (1969).

<sup>163</sup> See note 61 and accompanying text *supra*.

<sup>164</sup> 405 F.2d at 206. The court also held that to rebut the presumption, the transactions must involve stock traded in the United States. *Id.* The protection of this interest is discussed in text at notes 180-88 *infra*.

<sup>165</sup> 405 F.2d at 204-05. There was some dispute as to whether the price was actually too low, but this was not relevant to the majority's disposition of the subject matter jurisdiction issue. *Id.* at 214 (concurring opinion).

<sup>166</sup> 405 F.2d at 206 (emphasis added).

<sup>167</sup> *Id.* at 208-09.

<sup>168</sup> *Id.* Note, however, that the interest in domestic investor protection has been sharply limited by *Bersch*. See text at notes 176-178 *infra*. It does not appear, however, that the plaintiff must himself be within the scope of investor protection afforded by Congress. *Schoenbaum* did not require that it be a domestic or American shareholder who asserts the effect as plaintiff, but only that domestic investors' interests be affected. See 405 F.2d at 206-08. Most cases have looked beyond the identity of the actual plaintiff asserting the claim to assess the total effect of the fraud upon American interests. See, e.g., *IIT*, 519 F.2d at 1016-17. Thus, in *IIT*, the plaintiffs were three Luxembourgish liquidators suing on behalf of IIT, a Luxembourgish trust. *Id.* at 1003. The court recognized the domestic effect and did not apparently deem it fatal or even relevant

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*Schoenbaum* determined that activities abroad that affect the interest of investor protection satisfy jurisdictional requirements.<sup>169</sup> However, the sufficiency for jurisdictional purposes of the interest in investor protection may vary if the investor is not an American citizen living at home. Where the investor is an American citizen residing abroad, the interest in investor protection is diminished in importance, and the court may require additional proof of significant activity in the United States to support a finding of subject matter jurisdiction.<sup>170</sup> This situation was presented in *Bersch*. In attempting to prove an effect resulting from the defendants' acts, the plaintiff argued that the purchases of IOS stock by Americans residing abroad must be considered as part of the domestic effect.<sup>171</sup> The court held that Americans residing abroad are not entitled to the same protection as Americans residing at home, and that absent "preparatory" activities by the defendant within the United States, subject matter jurisdiction will not be found.<sup>172</sup> Thus, it would appear that although effects upon American investors abroad are cognizable for subject matter jurisdiction purposes, they are not given the same status as effects upon American investors within the United States.

Where the investor is not an American citizen, but resides in America, it is arguable that the interest in investor protection is the same as in the case of an American citizen living at home. It would seem that equal protection requirements, as applied to the federal government by the Fifth Amendment,<sup>173</sup> would require that a federal court or the SEC treat resident alien shareholders and citizen shareholders the same, affording both the full protection of the Securities Acts.<sup>174</sup> Moreover, the policy of the Act to provide for fair and honest domestic markets in securities<sup>175</sup> would be furthered by extending full protection to resident alien purchasers, since the denial of such protection would create loopholes in the enforcement of Rule 10b-5 by allowing culpable defendants to escape liability merely be-

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that it was non-Americans who had argued that there was an effect upon Americans. *See id.* at 1016-17. It is only important, then, that there are identifiable domestic investors who have been injured by the foreign fraud.

<sup>169</sup> 405 F.2d at 208.

<sup>170</sup> *Bersch*, 519 F.2d at 992-93.

<sup>171</sup> *Id.*

<sup>172</sup> *Id.* at 992. Specifically, the court concluded that:

Congress surely did not mean the securities laws to protect the many thousands of Americans residing in foreign countries against securities frauds by foreigners acting there, and we see no sufficient reason to believe it would have intended otherwise simply because an American participated so long as he had done nothing in the United States.

*Id.*

<sup>173</sup> U.S. CONST. amend. V; *see Bolling v. Sharpe*, 347 U.S. 497, 499 (1954).

<sup>174</sup> Classification of resident aliens is "suspect" and can only be justified by a compelling state interest. *Graham v. Richardson*, 403 U.S. 365, 372 (1971). *See a discussion of related equal protection questions in Comment, The Transnational Reach of Rule 10b-5*, 121 U. PENN. L. REV. 1363, 1376-78, 1386 (1973).

<sup>175</sup> *See text accompanying notes 80-83 supra.*

cause the defrauded resident-investors did not have United States citizenship.

*Bersch* illustrated another significant characteristic of the interest in investor protection by holding that this interest extends only to persons who are purchasers or sellers of the securities involved in the transaction or holders of other securities of the same issue as the securities actually involved in the transaction.<sup>176</sup> This limitation narrows the holding in *Schoenbaum* which had seemingly provided for protection to American investors in general.<sup>177</sup> Henceforth, the detrimental effect cannot be claimed on behalf of American investors in general.<sup>178</sup>

In addition to the detrimental impact upon interests of American investors,<sup>179</sup> *Schoenbaum* also required the foreign transactions to "involve stock registered and listed on a national securities exchange."<sup>180</sup> Although it is not certain why the court considered this element critical to its holding, an emphasis on the interest of protecting the integrity of the American securities markets was implicit in the court's opinion.<sup>181</sup> In *Schoenbaum*, a foreign corporation whose stock was widely traded in America sold its treasury stock at too low a price;<sup>182</sup> as a result, other holders of that stock necessarily suffered a diminution of the value of their stock, resulting in lower prices bid for the stock.<sup>183</sup> It would seem that the court in *Schoenbaum* viewed American interests as extending to control over such fraudulently induced fluctuations in the prices of securities that are traded in the United States. As noted earlier, this interest in the protection of domestic markets was among the interests which the Securities Acts were intended to protect.<sup>184</sup>

Recent Supreme Court interpretations of Rule 10b-5<sup>185</sup> indicate, however, that effects jurisdiction should not be limited to situations involving stock registered and listed on a national exchange. Section 10(b) of the Act applies to any purchase or sale of a security whether registered on a national exchange or not.<sup>186</sup> It is submitted that limiting effects jurisdiction in such a manner would irrationally frustrate the purposes of the Act by denying application of the Act to transactions where the stock does not happen to be traded on an exchange but where the domestic effect is significant. Foreign fraudulent prac-

<sup>176</sup> *Bersch*, 519 F.2d at 989. "These securities may be either the very securities sold or bought or other securities of the same issue as in *Schoenbaum*." *Id.* n.34.

<sup>177</sup> See note 168 and accompanying text.

<sup>178</sup> This limitation also bears upon the nature of the effect which must operate on the interest. See discussion in text at notes 210-22 *infra*.

<sup>179</sup> See text accompanying notes 161-68 *supra*.

<sup>180</sup> 405 F.2d at 208.

<sup>181</sup> See *id.* at 206.

<sup>182</sup> *Id.* at 205.

<sup>183</sup> *Id.* at 208.

<sup>184</sup> See text at note 83 *supra*.

<sup>185</sup> Cf. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10-12 (1971). See note 118 *supra*.

tices in securities transactions will have the same domestic effect upon American holders of other securities of the same issue, regardless of whether those holders acquired their shares over a national exchange or through less formal sources, such as the over-the-counter market. Moreover, in either situation the fraud will result in lower, artificial prices bid for the stock. Thus, the effect upon the American securities market—the quotation of prices that do not reflect the true value of the stock they represent—will be the same in either situation. In each instance, the effect is to an interest which the Securities Acts were intended to protect.<sup>187</sup> Thus, in cases where an effect upon the domestic securities market is asserted, and the security is not listed on a national exchange, the existence of a domestic market in those securities should be sufficient to establish subject matter jurisdiction.

In sum, it appears that the federal courts, in determining whether subject matter jurisdiction exists over a foreign fraudulent transaction, have looked first to see whether that transaction had a detrimental impact upon an interest sought to be protected by the Securities Acts. This interest may be the protection of domestic investors<sup>188</sup> or the protection of the domestic securities market. Having identified that interest, the courts will then look to the nature of the effect upon that interest.

The key distinction in differentiating the types of effect over which subject matter jurisdiction exists is whether the effect upon domestic investors is direct or indirect. In *Schoenbaum*, the foreign fraud operated directly on a foreign corporation.<sup>189</sup> Because the fraud was on the corporation, however, the effect upon American shareholders was *indirect*. In this situation, where the effect on the interest of investor protection is indirect, a direct effect must be shown upon the American securities market. Specifically, the plaintiff must show that the foreign fraud depressed the prices bid for that security in the American market.<sup>190</sup>

This analysis is supported by the court's approach in *IIT v. Ven-cap, Ltd.*<sup>191</sup> There the effect of the foreign fraud was upon a foreign investment trust—IIT.<sup>192</sup> Thus, the fraud upon the American fundholders of IIT was "indirect." The court noted this distinction<sup>193</sup> and, postulating a *Schoenbaum*-type derivative suit by the American fundholders of IIT alleging that IIT management had conspired in the

<sup>186</sup> 15 U.S.C. § 78j(b) (1970).

<sup>187</sup> See *id.* § 78b(3) (1970).

<sup>188</sup> This interest is qualified by the requirement that the domestic investor be a purchaser or seller of the subject securities. See text at notes 176-78 *supra*.

<sup>189</sup> See 405 F.2d at 208.

<sup>190</sup> See *id.* *Schoenbaum* required that the securities be traded on a national exchange. *Id.* The discussion in text at notes 185-188 *supra* suggests that the trading of the securities in less formal domestic markets is sufficient for purposes of demonstrating an effect upon the market.

<sup>191</sup> 519 F.2d at 1016-18.

<sup>192</sup> *Id.* at 1016.

<sup>193</sup> *Id.*



fraud, emphasized the virtual absence of American fundholders of IIT.<sup>194</sup> Had IIT sought American investment by listing its shares on an American exchange or selling them in an American market, then it would appear that subject matter jurisdiction would exist under the *Schoenbaum* rationale.

This does not mean, however, that subject matter jurisdiction exists whenever a corporation whose shares are traded widely in the United States is defrauded abroad. To lend this broad interpretation to *Schoenbaum* would mean that the Securities Acts would apply every time such a corporation purchased or sold a security abroad. *Schoenbaum* should be read in light of the dictum in *Leasco* which states that the effect of a foreign fraud upon an American corporate plaintiff and its stock will not by itself establish subject matter jurisdiction.<sup>195</sup> It is suggested that the foreign transaction in this situation should be analyzed in terms of its effect upon the actual security exchanged. In *Schoenbaum*-type fact situations, the price of the security will go down.<sup>196</sup> Having identified this detrimental effect upon the security, the question then becomes whether that security is held widely enough in America so that it can be said that the depressing effect upon the security has sufficient impact upon the United States securities market to find that subject matter jurisdiction exists.<sup>197</sup> Under *Schoenbaum*, if the security is listed and traded on a national exchange, such a depressing effect will be assumed.<sup>198</sup> Without such listing and trading, however, an analysis of the number of American holders of the security involved in the foreign fraudulent transaction should be made to determine whether the effect upon the United States securities markets is sufficient to find that subject matter jurisdiction exists to hear the case.

A different situation is presented where the interest in investor protection is directly affected. In such cases, the existence of a domestic market in the securities involved in the fraud need not be shown. Thus, the Second Circuit in *Bersch* held that reliance by a United States resident upon a fraudulent statement sent into the United States from abroad was the type of effect over which federal courts have subject matter jurisdiction.<sup>199</sup> The plaintiff did not have to show

<sup>194</sup> *Id.* at 1016-17. Approximately 300 of IIT's 150,000 fundholders were American. *Id.* at 1016.

<sup>195</sup> 468 F.2d at 1334.

<sup>196</sup> See *Schoenbaum*, 405 F.2d at 208-09. The court stated that the foreign fraud will "necessarily" result in lower prices bid for the shares of the same issue as exchanged in the fraud. *Id.*

<sup>197</sup> See *id.*

<sup>198</sup> See *id.* The court stated simply that the foreign fraud had "sufficient" impact without explicitly indicating how this finding was made.

<sup>199</sup> 519 F.2d at 991. The court in *Bersch* expressly noted that an "action in the United States is not necessary when subject matter jurisdiction is predicated on a direct effect here." *Id.* However, note that mailing of materials into the United States has been characterized by a different circuit as conduct within the country rather than the induction of a domestic effect. *Travis v. Anthes Imperial Ltd.*, 473 F.2d 515 (8th Cir. 1973).

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that the securities involved in the fraud were traded either on a national exchange or in the domestic market.<sup>200</sup>

Judicial emphasis on the direct-indirect effect distinction may be attributed to a "fairness" policy of applying the Securities Acts to defendants transacting business abroad where they have committed acts from which may be found a submission to federal jurisdiction under the Securities Acts, or a necessary effect on interests protected by the Securities Acts. Thus, in *Schoenbaum* the court noted that "the Act seeks to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges."<sup>201</sup> To hold subject to the Act the directors of the Canadian corporation who chose to list the corporation's shares on an American exchange was not unfair. They should have foreseen the effects of their foreign fraud upon American holders of those shares<sup>202</sup> and they properly were held to the duty of complying with the Securities Acts once they sought out American investment by selling those shares in the United States.

In *Bersch*, the requirement of a direct effect is analogous to the Second Circuit's requirement of intent in *United States v. Aluminum Company of America (Alcoa)*,<sup>203</sup> the leading case in the area of extraterritorial application of the antitrust laws. In *Alcoa*, one issue presented was whether subject matter jurisdiction under the Sherman Act existed over alleged participation by the Canadian affiliates of Alcoa in an international cartel as a means of protecting its domestic position.<sup>204</sup> This cartel, formed in Switzerland, elaborately regulated the means by which aluminum imports would be made to many countries, including the United States.<sup>205</sup> The court found that subject matter jurisdiction would exist if the cartel was "intended to affect imports and did affect them."<sup>206</sup> The court concluded that the requirement of intent was necessary to exclude application of the antitrust laws to the many foreign limitations on the supply of goods abroad which, though not intended to affect imports into the United States, do have such repercussions.<sup>207</sup> Similarly, in the Securities Act area, many foreign securities transactions will have an incidental effect

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<sup>200</sup> The court does not directly state this conclusion. However, in holding that subject matter jurisdiction can exist solely where there is a mailing of the fraudulent prospectuses into the United States and a resulting detrimental reliance on them by domestic purchasers, the court implicitly indicates that for this type of effect, proof of trading on a national exchange or in an organized domestic market is not necessary. See 519 F.2d at 991.

<sup>201</sup> 405 F.2d at 206 (emphasis supplied).

<sup>202</sup> *Id.* at 208. Note that the court in *Schoenbaum* stated that the foreign fraud "necessarily" affected American shareholders. *Id.*

<sup>203</sup> 148 F.2d 416, 444 (2d Cir. 1945). The court in *Bersch* found the *Alcoa* case, *id.*, analogous. As in *Bersch*, the effect in *Alcoa*—the restriction on the free flow of imports—was a direct one. Compare *Bersch*, 519 F.2d at 991, with *Alcoa*, 148 F.2d at 444.

<sup>204</sup> 148 F.2d at 439-43.

<sup>205</sup> *Id.* at 442-43.

<sup>206</sup> *Id.* at 444.

<sup>207</sup> *Id.* at 443.

upon American investors which the parties abroad may not have intended or may even have taken steps to avoid.<sup>208</sup> However, without a stronger nexus to the United States, such as the listing of the securities on a national exchange,<sup>209</sup> subject matter jurisdiction should not exist over these foreign transactions. In *Bersch* the sellers of securities to resident Americans certainly must have intended that these residents rely on the fraudulent prospectus to make their purchase. Surely they did not intend that the prospectuses be ignored. It is not unfair for a court which has identified such an intent to extend the Securities Acts to cover such sales by the defendant.

The court in *Bersch* also held that a *generalized* effect upon the interest either in protection of investors or protection of domestic markets is insufficient to establish subject matter jurisdiction.<sup>210</sup> This holding was similarly based on the desire to exclude application of the Securities Acts to foreign transactions which had only an indirect effect upon American interests. The court in *Schoenbaum* had emphasized that the general effects of the foreign fraud present in that case were sufficient to "impair the value of American investments" and to affect United States commerce, thereby allowing the court to assume subject matter jurisdiction.<sup>211</sup> The plaintiffs in *Bersch* relied on this approach when they attempted to demonstrate that the IOS offerings resulted in widespread effects on the American securities market and the American economy in general.<sup>212</sup> Indeed, the plaintiffs submitted an affidavit by a Professor of Finance which described a two-fold effect from the IOS fraud. First, it resulted in a deterioration in investor confidence in American underwriters at home and abroad. Second, it caused large scale redemption of shares in the IOS-related mutual funds, requiring those funds to sell substantial parts of their portfolios—mainly United States securities—causing a depression in prices leading ultimately to a steep decline in the purchase of United States securities by foreigners.<sup>213</sup> Seemingly, these effects were as great as the impairment of American investments and the impact upon United States commerce noted by the court in *Schoenbaum*.<sup>214</sup> However, the court in *Bersch* stated that such "generalized" effects upon the American economy or American investors would not confer subject matter jurisdiction.<sup>215</sup> Rather, the court would only consider the effects of the foreign fraud upon those "purchasers and sellers of those securities in whom the United States has an interest;"<sup>216</sup> namely,

<sup>208</sup> See, e.g., *IIT*, 519 F.2d at 1017.

<sup>209</sup> See also text at notes 184-86 *supra*.

<sup>210</sup> *Id.* at 987-89.

<sup>211</sup> *Schoenbaum*, 405 F.2d at 208-09. The court emphasized the generalized effects of the foreign fraud upon the American securities market. *Id.* at 206, 208.

<sup>212</sup> 519 F.2d at 987-88.

<sup>213</sup> *Bersch v. Drexel Firestone, Inc.*, 389 F. Supp. 446, 458 (S.D.N.Y. 1974).

<sup>214</sup> See 405 F.2d at 208-09.

<sup>215</sup> 519 F.2d at 989.

<sup>216</sup> *Id.*

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purchasers or sellers of the involved securities, or holders of other securities of the same issue.<sup>217</sup>

This approach is consistent with a "fairness" approach to subject matter jurisdiction under the Securities Acts.<sup>218</sup> As the district court in *Bersch* recognized, it is sometimes difficult to establish a clear correlation between the defendant's acts and the negative impact of these acts upon the American securities market.<sup>219</sup> This was not the situation in *Schoenbaum*, where the securities involved in the fraud were actually traded on a national exchange and the correlation could be presumed.<sup>220</sup> In *Schoenbaum*-type situations, the domestic effect may be said to flow necessarily from the foreign fraud.<sup>221</sup> In *Bersch*, on the other hand, the chain of causation was far more attenuated. To hold the defendants responsible for the ultimate domestic effect—the generalized reduction in the prices bid for United States securities held and then redeemed by the IOS-related mutual funds—would require a showing that (1) the IOS fraud directly caused a redemption by the public of IOS-related mutual funds, (2) that the mutual funds therefore had to sell their holdings in United States securities to meet the redemption and (3) that these sales caused the price of the securities to decline. This chain of causation falls far short of the intent required in *Alcoa*<sup>222</sup> or the foreseeability in *Schoenbaum*. The circuit court in *Bersch* was thus arguably correct in not finding subject matter jurisdiction over foreign transactions which can only be traced speculatively to the acts of the defendants, and which have at most only a generalized effect upon American interests.

In *Bersch* and *Schoenbaum*, the Second Circuit focused mainly on the qualitative aspects of the detrimental effect upon American interests, ignoring the international law requirement that the effect be "substantial."<sup>223</sup> However, in *IIT*, the court did indicate that a quan-

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<sup>217</sup> *Id.*

<sup>218</sup> See text at notes 201-02 *supra*.

<sup>219</sup> 389 F. Supp. at 458. The district court was willing to presume the correlation inasmuch as IOS's subsidiaries held large amounts of American securities which these subsidiaries would have to redeem to meet the large scale redemptions in their own funds resulting from the IOS offerings. The district court believed that such a large-scale redemption of securities would have the natural effect to depress the prices bid for these securities. *Id.*

<sup>220</sup> See 405 F.2d at 208.

<sup>221</sup> See note 202 *supra*.

<sup>222</sup> Note in *Alcoa*, the effect upon imports into the United States would only be presumed if the requisite intent to affect imports was demonstrated. 148 F.2d at 444-45.

<sup>223</sup> RESTATEMENT (SECOND) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 18(b)(ii). See *Bersch*, 519 F.2d at 991; *Schoenbaum*, 405 F.2d at 208-09. Presumably, a direct effect causing stock losses from fraud, *Bersch*, 519 F.2d at 991, will not necessitate a consideration of "substantiality." Where the securities exchanged in the fraud are traded on a national exchange, it seems that the courts will assume the "substantiality" of the effect. See *Schoenbaum*, 405 F.2d at 208-09, where the court said without more that the effect upon United States investments and commerce was "sufficient" to find subject matter jurisdiction.

titative approach based upon the number of American fundholders and the size of their investments may be appropriate where the fraud operates directly upon a foreign investment trust, with only an indirect effect upon the American fundholders.<sup>224</sup> The *IIT* court emphasized that the "substantiality" of the American effect was very small.<sup>225</sup> However, the court seemed to view substantiality in terms of the percentage of American ownership in the trust. The court stressed that the 300 American fundholders of *IIT* constituted only 0.2% of the 150,000 total number of fundholders. Arguably these Americans held no more than 0.5% of the outstanding funds.<sup>226</sup> By this analysis the court may have been suggesting that at some point the effect on American fundholders would be substantial enough, in terms of the percentage of American ownership, to establish subject matter jurisdiction.<sup>227</sup> When this point would be reached was not made clear. Moreover, the absence of any such indication may indicate that the court's mathematical analysis was for illustrative purposes and no more.

An alternative interpretation of the court's approach in *IIT* to the substantiality question is that the court examined the percentage of American ownership for the purpose of determining whether the foreign business entity could be considered American, even though technically foreign.<sup>228</sup> At the appropriate level of American ownership, the corporation might be treated as the hypothetical American corporate plaintiff in *Leasco*<sup>229</sup> or as the non-resident American purchasers in *Bersch*.<sup>230</sup> Realistically, the required percentage of American ownership would have to be quite high in order not to unduly prejudice defendants transacting abroad who may have no idea that they are dealing with an "American" corporation.

Despite their uncertainties, *Bersch* and *IIT* contribute significant guidelines to aid in the analysis of effects-based jurisdiction. *Bersch* is

<sup>224</sup> 519 F.2d at 1016-17. Note that the American effect was "indirect." See text at notes 191-194 *supra*.

It is somewhat unclear whether the court in *IIT* considered the discussion of the percentage of American ownership relevant only if *IIT* fundholders brought the action derivatively on a *Schoenbaum*-type theory. See 519 F.2d at 1017. This discussion will assume that it did not. The percentage of American ownership in the derivative action situation would be relevant to prove the existence of a domestic market in the securities involved in the fraud. See text at notes 196-98 *supra*.

<sup>225</sup> 519 F.2d at 1017.

<sup>226</sup> *Id.*

<sup>227</sup> See also *Selzer v. Bank of Bermuda*, 385 F. Supp. 415, 418 (S.D.N.Y. 1974), where the court found a domestic effect upon the American beneficiary of a foreign trust. In *Selzer*, however, the American was the sole beneficiary; thus, the percentage of American ownership was 100%. *Id.*

<sup>228</sup> See note 227 *supra*.

<sup>229</sup> 468 F.2d at 1334. See text at note 195 *supra*. The *Leasco* court postulated a situation where an American business was defrauded abroad. 468 F.2d at 1334.

<sup>230</sup> 519 F.2d at 992-93. Under this view, *IIT* would assert its claim as an American transacting business abroad. Here the effect would be direct and *IIT* would only have to show that "preparatory" activities took place in the United States. See *id.*

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an expansive decision which directs emphasis away from the strict requirement of *Schoenbaum* that the transactions involve stock registered and listed on a national exchange. Under *Bersch*, courts will focus on whether the defendants may be said to have submitted to United States jurisdiction either by selling the corporation's shares in the United States or by fraudulently trading in securities held widely in the United States. Subjecting the defendants to liability under the Securities Acts in these instances is justified, on the ground that the defendants can be said to have foreseen, if not intended, a detrimental effect upon protected American interests. *IIT*, on the other hand, is a contractive decision. Under *IIT*, foreign corporations transacting business outside the United States cannot expect the protection of the Securities Acts merely because a small percentage of its shareholders are American.

### CONCLUSION

The recent increase in the number of transnational security transactions has brought with it a concomitant increase in attempts to apply the antifraud provisions of the Securities Acts to securities transactions involving foreign elements. The courts have had difficulty handling the jurisdictional problems that have resulted. The *Bersch* and *IIT* decisions are the first to attempt to provide a comprehensive set of guidelines for analyzing these issues. The courts were moderately successful in defining the relevant factors involved in determining jurisdiction; however, many unclear areas remain. The crucial line between substantial and preparatory activities is as yet only vaguely defined, as is the type of effect in the United States that, by itself, would be sufficient to establish subject matter jurisdiction. The approach that the federal courts have chosen to take on the issue of subject matter jurisdiction involves such subtle balancing that the law will have to develop on a case-by-case basis, with broad outlines being provided only in sweeping decisions such as *Bersch* and *IIT*. A complete set of guidelines in this area, however, can only result from amendments to section 27 of the Securities Act of 1934 made in light of considerations of international relations.

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