THE ACCIDENT OF EFFICIENCY: FOREIGN EXCHANGES, ADRs, AND SPACE ARBITRAGE

By: Brian P. Murray and Maurice Pesso*

I. INTRODUCTION

Starting in the 1930s, Congress enacted numerous laws to protect the public from misrepresentations concerning publicly-traded securities.[1] However, with limited resources available to the government watchdogs and individual losses often too small to make a private action feasible, a class action often offers the only meaningful enforcement and means of redress for violations of these laws for private litigants.[2] In the past decade, the emergence of the internet has created a global marketplace for securities where information is transmitted instantaneously all over the world.[3] With the increasing

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* Mr. Murray, B.A., University of Notre Dame (1983); M.A., University of Notre Dame (1986); J.D., *cum laude*, St. John's University School of Law (1990), is a member of Rabin & Peckel LLP. Mr. Pesso, B.A., State University of New York at Binghamton (1997); J.D., Boston University School of Law (2000), is an associate at Rabin & Peckel LLP.

[1] *See, e.g.*,15 U.S.C. § 77 et seq.; 15 U.S.C. § 78 et seq.

[2] *See* Testimony of Stanley M. Grossman Before the Subcommittee on the Judiciary U.S. House of Representatives on H.R. 3789, "The Class Action Jurisdiction Act of 1998" (June 18, 1998), at http://www.house.gov/judiciary/42032.htm; *see also Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) ("implied private actions provide a most effective weapon in the enforcement of securities laws and are a necessary supplement to Commission action"); *In re Arakis Energy Corp. Sec. Litig.*, 2001 WL 1590512, at *9 (E.D.N.Y. Oct. 31, 2001) ("actions for violations of the securities laws are often viable only through the economies of scale of a class action").

[3] Not only does the Edgar SEC filing system offer on-line access to most SEC filings (www.sec.gov), but most press releases issued by companies are available either at the firm's website or at a financial website such as Yahoo.

transnationalization of securities markets,[4] securities fraud now reaches investors both domestically and abroad,[5] posing the question of whether foreign investors should be included as class members in securities class action litigation in the United States.

The threshold consideration in determining the scope of the class is whether the federal securities laws provide for subject matter jurisdiction over foreign plaintiffs or purchases made on foreign exchanges. In making this determination, the efficiency of the market for the stock at issue will often be a dispositive factor. In a fraud case, if the market is not sufficiently efficient, i.e. it does not quickly absorb and reflect new information, the presumption of reliance on the integrity of the market may not apply, class certification is denied, and for all practical purposes, the victim of the misrepresentations is without a meaningful remedy.[6]

Securities which trade on the New York Stock Exchange trade in sufficiently efficient markets for class certification purposes.[7] However, many foreign exchanges are

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[4] Globalization of securities markets occurs as securities transactions involve issuers of different nationalities, transactions that are executed in more than one country, or securities purchasers and sellers that reside in more than one country. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498, 2502 (1997).

[5] Illegal activities causing securities fraud can span two or more continents, and litigants can include foreign nationals and corporations. The vagaries of transnational securities fraud are limitless, and only the facts of each particular case lead to the characterization of a given transaction as 'transnational.' *See* Michael J. Calhoun, *Tension on the High Seas of Transnational Securities Fraud: Broadening the Scope of United States Jurisdiction*, 30 LOY. U. CHI. L.J. 679, 679-80 (Summer 1999).

[6] "[I]n the context of a claim for secondary market securities fraud, this device [class action] is virtually meaningless without having fraud-on-the-market substitute for individual reliance." *Trafton v. Deacon Barclays de Zoete Wedd Ltd.*, 1994 WL 746199, at *12 (N.D. Cal. Oct. 21, 1994).

[7] *See In re Sunbeam Sec. Litig.*, 2001 WL 899658, at *1 (S.D. Fla.
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not considered efficient markets. Therefore, the efficiency of foreign exchanges and the propriety of including purchasers on such foreign exchanges in the class, as well the propriety of conferring subject matter jurisdiction over such purchasers on foreign exchanges, is a matter of debate.

It is the authors' contention that if a stock trades on an efficient domestic exchange, arbitrageurs will force an inefficient foreign exchange into an accident of efficiency with regard to that stock, even if that foreign exchange is not efficient with regard to its other listed stocks. Thus, if a stock trades both domestically and abroad, and the domestic exchange is efficient, any misstatement disseminated which affects the domestic market will affect the stock abroad. Therefore, for purposes of conferring subject matter jurisdiction over the claims of purchasers on foreign exchanges, conduct in the United States which inflates the price on a U.S. exchange necessarily causes inflated prices and thus compensable losses for purchasers on foreign exchanges. Such conduct in the United States, which directly causes losses to foreign exchange purchasers, should be sufficient to satisfy the requirements of subject matter jurisdiction under the federal securities laws. Likewise, given the unity of information with which the foreign and domestic markets now trade, and the effect each exchange has on the pricing of the other exchange, the purchasers on the foreign exchanges should also be entitled to the presumption of reliance on an efficient market.

II. THE "INEVITABLE LINK": EFFICIENT MARKETS AND SUBJECT MATTER JURISDICTION FOR FOREIGN PLAINTIFFS

[7](...continued)
July 3, 2001) ("It is well-settled that investors in an efficient market are entitled to a rebuttable presumption of reliance and defendants make no argument that the NYSE was not an efficient market."); *Serafty v. Int'l Automated Sys., Inc.*, 180 F.R.D. 418, 421 (D. Utah 1998) (presumption of market efficiency is well-suited to stocks traded in national markets such as the NYSE).

A. The Importance of Efficient Markets in Proving Securities Fraud Claims Under 10(b).

1. The Efficient Market Hypothesis.

The Efficient Market Hypothesis states that at any given time, security prices fully reflect all available information.[8] An efficient market is defined as a market where there are a large number of rational profit-maximizers actively competing with each other trying to predict future market values of individual securities and where important current information is almost freely available to all participants. In efficient markets such as the NYSE and the Nasdaq, competition among many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future.[9] Any false statement disseminated into the market, if the market for the stock in which the stock trades is efficient, presumably affects the price of the stock, and in relying on the market to set a fair price, the purchaser is injured by any false statement.[10]

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[8] *See* Eugene Fama, "Random Walk in Stock Market Prices", Financial Analysts Journal, September/October 1965. The efficient market hypothesis evolved in the 1960's from the doctoral dissertation of Eugene Fama. Dr. Fama previously made the argument that in an active market that includes many well-informed and intelligent investors, securities will be appropriately priced and reflect all available information. If a market is perfectly efficient, no information or analysis can be expected to result in the out-performance of an appropriate benchmark.

[9] *See id.*

[10] *See id.*

2. Factors in Evaluating the Efficiency of the Market for an <u>Individual Stock</u>

In evaluating whether the market for an individual stock is sufficiently efficient, courts have looked to a number of factors.[11] One of the most influential decisions in this regard is *Cammer v. Bloom*,[12] in which the court identified five factors relevant to the determination of market efficiency: (1) the stock's average trading volume; (2) the number of analysts that followed and reported on the stock; (3) the number of market makers; (4) eligibility to file an S-3 Registration Statement;[13] and (5) the reaction of the stock price to

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[11] *See, e.g.*, *In re Resource America Sec. Litig.*, 2001 WL 892597, at *12 (E.D. Pa. Aug. 6, 2001) ("Typically, courts look to a number of factors in determining whether or not a market is efficient. While there is no definitive list, the court in *Cammer* listed five factors which lead to the presumption that there is an efficient market"); *O'Neil v. Appel*, 165 F.R.D. 479, 502-03 (W.D. Mich. 1996) ("if a plaintiff can empirically demonstrate that stock prices regularly rose or fell in prompt response to market information, this fact would be significant in establishing an efficient market."); *Simpson v. Specialty Retail Concepts*, 823 F. Supp. 353, 354 (M.D.N.C. 1993) ("This court finds the *Cammer* factors instructive and will follow its lead."); *Cammer v. Bloom*, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989) (holding there are five factors that are relevant for the purpose of determining whether an over-the-counter market is open and efficient).

[12] 711 F. Supp. 1264 (D.N.J. 1989).

[13] Forms S-1, S-2, and S-3 provide a basic framework for the registration of securities under the Securities Act. The same information is required to be part of Securities Act registration statements in all categories, either presented in, or delivered with, the prospectus or incorporated by reference from another document. Form S-3 relies on the efficient market theory and thus allows maximum use of incorporation by reference of Exchange Act reports and requires minimal disclosure in the prospectus. For an issuer to file an S-3 registration statement, the current eligibility rules require the aggregate market value for the voting stock held by non-affiliates to be $75 million or more (for a primary offering of stock for cash). *See* Form S-3, General Instruction B1. The rationale for abandoning the prospectus delivery and allowing incorporation by reference works only if the issuer is followed

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unexpected news events.[14] "Other courts have applied additional factors, including: the capitalization of the company; the bid-ask spread of the stock; and the percentage of stock held by insiders."[15]

3. Requirements for a Fraud Action Under Section 10(b): Presumption of Reliance.

To state a claim under section 10(b) of the Exchange Act, a plaintiff must allege that, in connection with the purchase or sale of securities, the defendant, acting with scienter, made a false material representation or omitted to disclose material information and that plaintiff's reliance on defendant's actions caused him injury.[16]

The idea of an efficient market plays an important role in alleging and proving fraud claims in class action cases brought under section 10(b) of the Exchange Act. In class action securities litigation, where there may be thousands of individual plaintiffs, the reliance element of section 10(b) would ordinarily be the most cumbersome element to prove. However, in these cases, the reliance element of the fraud claim is usually supplied by the presumption of reliance for a "fraud on the market."[17] The fraud on the market theory

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by a sufficient number of analysts so that public statements may move its market price. *See* John Coffee, *Securities Act Reform: Of Babes and the Bath*, New York Law Journal, November 15, 2001, at pg. 8.

[14] *See Cammer*, 711 F. Supp. at 1286-87.

[15] *Serfaty v. Int'l Automated Sys.*, 180 F.R.D. 418, 423 (D. Utah 1998).

[16] *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 531 U.S. 978, 981 (2001).

[17] *See Basic Inc. v. Levinson,* 485 U.S. 224, 248 (1988).

obviates the need to prove subjective reliance because of the interposition of an efficient market between the buyer and seller.[18]

The Supreme Court, in *Basic Inc. v. Levinson,* summed up the fraud on the market presumption as such: "An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because publicly available information is reflected in market price, an investor's reliance on any information is presumed for purposes of a Rule 10b-5 action."[19] Investors are entitled to a rebuttable presumption of reliance under the "fraud on the market theory" because "in an efficient market the misinformation directly affects the stock prices at which the investor trades and thus, through the inflated or deflated price, cause injury even in the absence of direct reliance."[20]

In an efficient market the "fraud on the market presumption" dispenses with the direct reliance requirement and instead presumes that each class member relied on the integrity of the market when buying a particular security.[21] The fraud on the market

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[18] *Id.* at 247.

[19] *Id.* Put another way, no one "would knowingly roll the dice in a crooked crap game." *Schlanger v. Four-Phase Sys. Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982).

[20] *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1419 n.8 (3d Cir. 1997) (citing *Basic Inc.*, 485 U.S. at 241-42).

[21] *See Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986); *Krogman v. Sterritt*, 2001 WL 313963, at *6 (N.D. Tex. Mar. 29, 2001). Another court stated "[t]he fact that a purchaser may have also considered a number of other factors in making his decision to purchase does not render him subject to a unique defense, so long as he substantially or significantly relied upon either the challenged statements or the integrity of the market." *In re AM Int'l, Inc. Sec. Litig.*, 108 F.R.D. 190, 195 (S.D.N.Y. 1985); *see also Grossman v. Waste Management, Inc.*, 100 F.R.D. 781, 788 (N.D. Ill. 1984) (if the plaintiff relied on statements of third parties that merely reiterated, digested, or reflected the

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presumption is a critical factor in getting the class certified since proving individual subjective reliance is often so cumbersome as to make the prosecution of the action as a class action unmanageable. However, when a stock trades simultaneously on both an efficient domestic market and a foreign market that may be inefficient with regard to other stocks, with regard to purchasers on the foreign exchange both subject matter jurisdiction and the propriety of class certification has been questioned.[22]

4. __American Depository Receipts__.

Some investors desire to diversify their portfolios with international equities. This demand for a medium for international investment, as well as the attractiveness of the U.S. equity market to foreign private companies, was the impetus for the development of American Depository Receipts ("ADRs").[23] An ADR is a negotiable security, quoted in

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misstated information that forms the basis of the securities fraud claims, the plaintiff has not relied on "factors wholly extraneous to the market"). "The market price of stock is taken to be the basis for investment decisions; because the price reflected all available information, investors are presumed to have been misled by the nondisclosure." *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 27 (1st Cir. 1987).

[22] The fraud on the market theory cannot be applied logically to securities that are not traded in efficient markets. An inefficient market, by definition, does not incorporate into its price all the information about the security. Investors, therefore, cannot be presumed to rely reasonably on the integrity of the market of a security that is traded in such a market. *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 198 (6th Cir. 1990).

[23] *See* Travis A. Wise, __American Depository Receipts__, at __http://www.twise.com/__
__writings /adr.htm__; *see also Pinker v. Roche Holdings Ltd.*, 2002 WL 1086684, at *2 (3d Cir. May 30, 2002) ("[ADRs] offered

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U.S. dollars and traded freely on domestic exchanges. A foreign company deposits shares of its stock with a depository in the United States and American investors are issued receipts (the ADRs) for these shares.[24] To the investor, there is no difference between purchasing an ADR and shares of a domestic corporation's stock, except for the country of origin of the shares underlying an ADR.[25] However, when a stock trades simultaneously on both a foreign and domestic exchange, a situation is created where some investors bought their shares in efficient domestic markets and some in foreign markets whose efficiency may be questioned.

When confronted with whether these transactions on foreign exchanges confer subject matter jurisdiction under the federal securities laws, the Second Circuit, in *Bersch v. Drexel Firestone*, *Inc.*, stated that courts must consider the policy question of "whether

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significant benefits to foreign companies, allowing them to tap into the American capital market. They have since become one of the preferred methods for trading foreign securities in the United States, with the value of ADRs bought and sold annually in the hundreds of billions.")

[24] Joseph Velli, American Depository Receipts: An Overview, 17 FORDHAM INT'L. L.J. 48, 50 (1993).

[25] "ADR's are, in substance, 'receipts' issued by a domestic bank for shares of foreign corporations that have been deposited in an overseas bank. The 'receipts' can then be traded in the United States without any of the complications that ordinarily arise because of currency conversions and customs requirements." *Nomura Secs. Int'l, Inc. v. Citibank, N.A.*, 81 N.Y.2d 614, 616 (N.Y. 1993). ADRs are regulated by the SEC. These regulations ensure investors that the securities which they are buying are regulated according to a standard with which they are familiar, regardless of the country from which the security originated. Therefore, while shares of a public foreign corporation can be traded simultaneously on both foreign and domestic exchanges (as an ADR), there is often more information available to the U.S. investor. The more information that is required and available, the more likely the stock price will reflect the true value of the holding.

Congress would have wished the precious resources of the U.S. courts to be devoted to them rather than leave the problem to the foreign country."[26] However, when a case involves securities traded on both domestic and foreign exchanges, the resource allocation dilemma is of little concern. If U.S. courts choose to allocate resources in a securities class action case brought on behalf of domestic investors, foreign investors who bought shares of the same company on a foreign exchange should also be included as class members. The "precious resources" of U.S. courts are already being expended on the case, regardless of whether foreign purchasers are included. However, the burden of federal courts is only one consideration, and subject matter jurisdiction for foreign transactions is usually vigorously contested.

III. TESTS FOR SUBJECT MATTER JURISDICTION OVER FOREIGN PLAINTIFFS

While courts agree that the reach of anti-fraud provisions of the federal securities laws is quite broad,[27] and that Congress provided little or no guidance as to the extraterritorial application of anti-fraud provisions of the Exchange Act,[28] there is

[26] *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975).

[27] *See, e.g.*, *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252, 262 (2d Cir.), *cert. dismissed*, 492 U.S. 939 (1989); *Bersch*, 519 F.2d at 986.

[28] *See SEC v. Banner Fund Int'l*, 211 F.3d 602, 608 (D.C. Cir. 2000) ("The Congress has not indicated clearly whether section 10 of the Securities Exchange Act of 1934 is applicable to cases involving predominately foreign securities transactions affected to some degree from outside the United States."); *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 663-64 (7th Cir. 1998) (stating that Congress provided 'little meaningful guidance on the issue' of extraterritorial application of federal securities laws), *cert. denied,* 525 U.S. 1114 (1999); *Robinson v. TCI/US W. Communications Inc.*, 117 F.3d 900, 904 (5th Cir. 1997) (remarking that the plaintiff's allegations required the court 'to confront the rather nebulous issue of the extent to which the American securities laws may be applied extraterritorially'); *Zoelsch v. Arthur*

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considerable debate over just how far United States jurisdiction extends. While the federal securities laws are silent as to their extraterritorial application,[29] there is copious case law on the issue of foreign application of subject matter jurisdiction. Courts have traditionally applied two tests, the conduct and effects tests, for determining whether it is appropriate to exercise subject matter jurisdiction over claims under federal securities laws between foreign parties and/or involving extraterritorial transactions.[30] In an influential trilogy of cases, the Second Circuit established the "conduct" test and the "effects" test to determine subject matter jurisdiction.[31] Most circuits have adopted some variation of the Second Circuit tests in deciding if U.S. courts have subject matter jurisdiction in cases involving foreign plaintiffs.

A. <u>The Effects Test.</u>

[28](...continued)
Anderson & Co., 824 F.2d 27, 30 (D.C. Cir. 1987) ("If the text of the 1934 Act is relatively barren, even more so is the legislative history. Fifty years ago, Congress did not consider how far American courts should have jurisdiction to decide cases involving predominately foreign securities transactions with some link to the United States. The web of international connection in the securities was then not nearly as extensive or complex as it has become.").

[29] *See Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir.), *cert. denied,* 502 U.S. 1005 (1991); *MCG, Inc. v. Great Western Energy Corp.*, 896 F.2d 170, 173 (5th Cir. 1990).

[30] *See generally* Paul Hamilton, *The Extraterritorial Reach of the United States Securities Laws Towards Initial Public Offerings Conducted Over the Internet*, 13 ST. JOHN'S J. LEGAL COMMENT. 343, 349 (Winter 1998).

[31] *See Bersch*, 519 F.2d at 993; *Leasco Data Processing Equipment v. Maxwell*, 468 F.2d 1326, 1335-38 (2d Cir. 1972); *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1015-18 (2d Cir. 1975).

The effects test originated in *Schoenbaum v. Firstbrook.*[32] In *Schoenbaum*, Banff Oil Ltd. ("Banff"), a Canadian corporation, was controlled by Aquitaine Corporation, also a Canadian corporation. Banff shares were traded on both the American Stock Exchange and the Toronto Stock Exchange. Aquitaine purchased Banff treasury shares in Canada at market prices on the Toronto Stock Exchange at a time when it knew and withheld information concerning the value of Banff's oil holdings.[33] Subsequently, an American shareholder who purchased Banff treasury shares on the American Stock Exchange brought a derivative action in the United States to recover the loss allegedly suffered by Banff when Aquitaine purchased Banff's treasury shares at undervalued prices.[34]

The district court dismissed the action, holding that the Exchange Act did not apply to a foreign transaction between foreign buyers and sellers.[35] The Second Circuit reversed. The court held:

> Congress intended the [Securities] 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.[36]

As a result,

> [w]e hold that the district court has subject matter jurisdiction over violations of the Securities Exchange Act, although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve

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[32] 405 F.2d 200 (2d Cir.), *rev'd with respect to holding on merits*, 405 F.2d 215 (2d Cir. 1968) (in banc), *cert. denied*, 395 U.S. 906 (1969).

[33] *Id.* at 204.

[34] *Id.* at 205.

[35] *Id*. at 206.

[36] *Id.*

> stock registered on a national securities exchange, and are detrimental to the interests of American investors.[37]

In deciding whether American investors were harmed, the court held that if Banff received insufficient consideration for its stock, the equity of its shareholders was adversely affected and therefore reduced the value of shares traded on the AMEX. The court noted that:

> this impairment of the value of American investments by sales by the issuer in a foreign country, allegedly in violation of the [Exchange] Act, has in our view, a sufficiently serious effect upon United States commerce to warrant assertion of jurisdiction for the protection of American investors and consideration of the merits of plaintiff's claim.[38]

Thus, under *Schoenbaum,* an American federal court has subject matter jurisdiction under section 10(b) for foreign conduct that has a negative effect on American investors.

B. <u>The Conduct Test.</u>

The conduct test was first introduced in *Leasco Data Processing Equipment Corp. v. Maxwell*.[39] *Leasco* involved an American corporation listed on the London Stock Exchange.[40] The case arose due to the significant misrepresentations made by Leasco in the United States that artificially inflated the price of Leasco shares on the London Stock Exchange.[41] In deciding whether an American plaintiff had adequately alleged subject

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[37] *Id.* at 208 (emphasis added).

[38] *Id*. at 208-09.

[39] 468 F.2d 1326 (2d Cir. 1972).

[40] The stock was not traded in the United States.

[41] The negotiations were held over an extended period and in New York as well as in England. They were in the context of a possible merger transaction in which the defendants, allegedly made misstatements about the financial condition and performance of Pergamon. *Id*. at 1330-33.

matter jurisdiction, the court noted "it was understood from the outset that all the transactions would be executed in England," but asked whether, "if Congress had thought about the point, it would not have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him to purchase foreign securities abroad—a purpose which its words can fairly be held to embrace."

Judge Friendly used the "essential link" concept to decide if the assertion of jurisdiction would run counter to foreign relations law.[42] In *Leasco*, "abundant misrepresentations" were made in the United States, including meetings in New York and telephone calls and letters to New York that were an "'essential link'" in inducing the plaintiff to sign (in the United States) the merger documents which, in turn, was an "essential link" in leading the plaintiff to make the market purchases. Thus, it did not matter where the damages were felt. The court held that if an American is injured in the purchase or sale of a security abroad when an "essential link" to the defendant's fraud occurred in the United States, an American district court has jurisdiction to apply section 10(b) of the Exchange Act.[43]

The court explained that "the New Yorker who is the object of fraudulent misrepresentations in New York is as much injured if the securities are of a mine in

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[42] *Leasco,* 468 F.2d at 1335. While the United States may have the authority to "prescribe the conduct of its nationals everywhere in the world," Congress has not done so. *Leasco* noted that the ultimate, outside assertion of power was determined by due process. *Id*. at 1334. In determining subject matter jurisdiction, the "essential link"concept is an objective test that looks at the circumstances that induces the plaintiff's transaction, rather than the alleged misrepresentation or omission. *See Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970).

[43] *Id.* at 1336.

Saskatchewan as in Nevada."[44] Judge Friendly concluded that "[w]hile, as earlier stated, we doubt that impact on an American company and its shareholders would suffice to make the statute applicable if the misconduct had occurred solely in England, we think it tips the scales in favor of applicability when substantial misrepresentations were made in the United States."[45]

The core holdings of *Leasco*, however, are subject to many interpretations. "The circuits are divided as to precisely what sort of activities are needed to satisfy the conduct test, although all agree that it is based on the idea that Congress did not want 'the United States to be used as base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners'."[46] The Second Circuit and the District of Columbia Circuit adhere to the more restrictive position– that the domestic conduct must have been of "material importance" to or have "directly caused" the fraud complained of.[47] In contrast, the Third, Eighth, and Ninth Circuits generally require some lesser quantum of conduct.[48] The Fifth Circuit has held "[t]o the extent that the cases represent a common

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[44] *Id*. at 1336.

[45] *Id*. at 1337 (emphasis added).

[46] *Robinson v. TCI/US W. Communications*,117 F.3d 900, 905 (5th Cir. 1997) (quoting *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975)).

[47] *Id.* at 905.

[48] *See id.* at 906; *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir.) (holding that the test is whether "at least some activity designed to further a fraudulent scheme occurs within this country"), *cert. denied*, 431 U.S. 938 (1977); *Continental Grain Pty.(Australia) Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 421 (8th Cir. 1979) (holding that jurisdiction lies where defendants used instrumentalities of interstate commerce and their "conduct in the United States was in furtherance of a fraudulent scheme and was significant with respect to its accomplishment"); *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 425 (9th Cir. 1983) (expressly

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position it appears to be that the domestic conduct need only be significant to the fraud rather than a direct cause of it."[49]

C. Foreign Plaintiffs.

Bersch v. Drexel Firestone, Inc.[50] was the first case to address subject matter jurisdiction of foreign plaintiffs. In *Bersch,* the company involved was IOS, a Canadian company with its main offices in Switzerland. Three simultaneous offerings were made of IOS stock: an initial public offering underwritten by six firms, to be sold to foreigners in Europe, Asia, and Australia;[51] a secondary offering in Canada, with no shares to be sold to Americans residing in Canada; and a secondary offering sold by a Bahamanian entity to people with relationships with IOS. The latter prospectus provided that the shares "are not being offered in the United States of America or any of its territories or possessions or any area subject to its jurisdiction."[52] After the shares became worthless, an American who bought despite the restrictions on such sale brought suit, alleging a claim under section 10(b) for alleged false and misleading statements in the prospectuses.[53]

A considerable amount of activity took place in New York concerning the offerings. A number of meetings were held in connection with the offerings, an American

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[48](...continued)
adopting the *Continental Grain* test).

[49] *See Robinson*, 117 F.3d at 906 (citations omitted).

[50] 519 F.2d 974 (2d Cir. 1975).

[51] The prospectuses were to be delivered in those countries. *Id*. at 980.

[52] *Id.* at 978-80 (quoting prospectus).

[53] *Id*. at 980-81. The prospectuses for the three offerings were essentially the same insofar as alleged misstatements are concerned.

accounting firm was retained to review IOS's operations, the accounting firm met with the underwriters (two of whom were American) to discuss the scope of its services, preliminary discussions about discounts and commissions on the offerings were held, and parts of the prospectuses were drafted in New York. In addition, the proceeds of the sales were deposited in an account in New York and a New York law firm represented the underwriters and met with IOS. Furthermore, meetings were held between underwriters and their counsel and the SEC in New York.[54] The Second Circuit held that these activities were sufficient to allow jurisdiction under principles of foreign relations law, regardless of where the effects were felt.[55] The court then examined if Congress intended to assert such jurisdiction.

The court held that jurisdiction over the claim of a foreign plaintiff was inappropriate because the U.S. activities were merely preparatory to the offerings (assuming the three could be treated as a single underwriting) and "relatively small in comparison to those abroad."[56] The court further stated that because section 10(b) is limited to cases where "fraudulent acts . . . committed abroad . . . result in injury to purchasers or sellers of those securities in whom the United States has an interest,"[57] a foreign citizen's claim would not be permitted under these facts. However, the court explained that claims asserted by American citizens (even residing abroad) would be heard, provided any conduct, however

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[54] *Id*. at 985 n.24.

[55] *Id.* at 985.

[56] *Id*. at 986-87.

[57] *Id.*

preparatory, was committed in the United States.[58] Thus, the *Bersch* court provided that federal securities laws:

> (1) Apply to losses from sales of securities to Americans residing in the United States whether or not acts (or culpable failures to act) of material importance occurred in the country; and
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> (2) Apply to losses from sales of securities to Americans residing abroad if, but only if, acts of material importance in the United States have significantly contributed thereto; and
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> (3) Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses.[59]

Therefore, under *Bersch*, an American plaintiff need only show that the defendant's conduct "significantly contributed" to his losses while a foreign plaintiff must to show that the defendant's conduct "directly caused" the loss. However, this distinction was discussed in *IIT v. Vencap, Ltd*,[60] decided on the same day as *Bersch*. *IIT* held that because the Second Circuit does "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 to foreigners," where "fraudulent acts themselves," and not merely preparatory activities, take place in the United States, a federal district court has jurisdiction over section 10(b) actions of foreigners in such circumstances.[61]

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[58] *Id*. at 992. *Bersch* was a class action. As a result of its holding on jurisdiction and the distinct treatment for foreign as opposed to American plaintiffs, the Second Circuit ordered that the class not include those who were neither citizens nor residents of the United States. *Id*. at 995-97.

[59] *Id.* at 993.

[60] 519 F.2d 1001 (2d Cir. 1975).

[61] *Id.* at 1017.

While the courts mentioned above tried to set guidelines for subject matter jurisdiction of foreign plaintiffs, they could not have reasonably foreseen the technological changes that were rapidly taking place. Issues of "effect," "conduct," and "significant contribution" became much harder to determine as the world moved toward a broader global economy.

D. *Itoba Ltd. v. Lep Group PLC.*

1. *ITOBA LTD. V. LEP GROUP PLC*: A BRIEF SUMMARY.

Itoba Ltd. v. Lep Group PLC,[62] presented the Second Circuit with a scenario where both the conduct and effects tests were implicated. The defendant, Lep Group PLC, a London-based holding company,[63] had its ordinary (i.e. common) shares registered in the United Kingdom and traded on the London Stock Exchange.[64] Its shares also traded as ADRs on the Nasdaq.[65] Since its ADRs traded on the Nasdaq, Lep was subject to the periodic reporting requirements of the Exchange Act.

The plaintiff, Itoba Ltd., was a Channel Islands company whose parent company was A.D.T. Ltd. ("ADT"), a Bermuda company. ADT's shares traded on the New York Stock Exchange and approximately half of its shareholders of record resided in the

[62] 54 F.3d 118, 120 (2d Cir. 1995), *cert. denied*, 516 U.S. 1044 (1996).

[63] *Id*.

[64] *Id*.

[65] Each ADR represented five ordinary shares.

United States.[66] ADT was also the parent of A.D.T. Securities Systems, Inc., a Delaware corporation engaged in the security services industry, one of whose largest competitors was National Guardian, a Lep subsidiary.[67] ADT owned shares in Lep and thus had an indirect ownership interest in National Guardian.[68] After plans for a joint venture with Lep failed, ADT began to purchase Lep ordinary shares on the London Stock Exchange in order to increase its ownership interest in National Guardian.[69] ADT used its subsidiary Itoba to make the stock purchases. In deciding to purchase Lep stock, ADT relied on ADT's chief financial officer's review of a Lep SEC filing[70] and on a report prepared by a financial adviser (whose intern relied on the same SEC filing, as well as U.K. reports and broker reports).[71] Before the acquisition was completed, Lep's stock price collapsed, allegedly due to fraud, and the value of Itoba's $114 million investment in Lep dropped by nearly $111 million.[72]

Thus, ADT, a foreign company, through Itoba, a foreign off-shore subsidiary, was defrauded in purchasing Lep stock (another foreign company) on the London Stock Exchange, in part in reliance on Lep's required SEC filings in the United States. Under the *Schoenbaum* "effects" test, there was an insufficient effect in the United States to justify the

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[66] *Id*. The court does not specify what percentage of outstanding shares was held by U.S. residents.

[67] *Id*.

[68] *Id*.

[69] *Id*. at 121.

[70] *Id.* The particular filing was an annual report on Form 20-F, which is a foreign issuer's equivalent of a Form 10-K.

[71] *Id.*

[72] *Id*.

assertion of jurisdiction. However, the purchase of the stock was caused in part, by the false SEC report,[73] and the Second Circuit held that was some conduct in the United States because of the nature of ADRs. The court stated:

> The ADRs were simply a grouping into one security of five ordinary shares. Inevitably, there was a direct linkage between the prices of the ADRs representing five ordinary shares and the prices of the single ordinary shares themselves. If the ordinary share price fell on the London Exchange, the market price of an ADR would decrease in similar manner, and vice versa.[74]

The court did not say that if the conduct involved was enough to confer subject matter jurisdiction, but instead melded the conduct and effects tests, noting that "there is no requirement that these two tests be applied separately and distinctly from each other."[75] The court went on to explain that, "indeed, a mixture or combination of the two often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court."[76] Using this formulation, the court found that there was subject matter jurisdiction because "Lep's uncorrected non-disclosure [in SEC filings] played as much a role in Itoba's purchase as the price listings on the London Exchange and NASDAQ. In view of the deleterious effect this continued non-disclosure had on the thousands of ADT shareholders in the United States, it cannot be described correctly as incidental or preparatory [to the fraud]."[77]

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[73] *Itoba*, 54 F.3d at 121. Although Itoba's board did not read the report, Itoba was merely a tool of ADT, which did read the report, and thus derivative reliance was adequate. *Id.* at 122.

[74] 54 F.3d at 123.

[75] *Id*. at 122.

[76] *Id.*

[77] *Id*. at 124.

2. **<u>Precedents Concerning Foreign Purchases.</u>**

Itoba dealt with American Depository Shares, which by their nature are convertible into a different security traded on a foreign exchange.[78] But there is no reason why *Itoba*'s view on the interrelationship of markets should not apply generally to securities which are not necessarily convertible, such as shares of a Canadian company registered in the United States. Even without ADRs, international arbitrageurs do not allow the price of shares traded on a foreign exchange to vary from the price in the United States.[79] This causes the "inevitable" link between the price of ADRs traded in the Unite States and the corresponding common (or "ordinary") stock traded abroad. If the stock is traded on an efficient exchange in the United States (thereby reflecting all publicly available information in the stock price), the stock will necessarily be trading on an efficient exchange abroad, at least with regard to that one stock. If the price at which it trades in the United States reflects all publicly available information, and the prices in the U.S. and abroad move in tandem, the price abroad will reflect all publicly available information *for that stock,* regardless of whether the foreign exchange is efficient with regard to other stocks. Therefore, domestic conduct such as filing documents with the SEC, which artificially inflates prices on domestic exchanges, will necessarily inflate prices abroad.

Unfortunately, the relatively straight-forward reasoning of *Itoba* is not always followed to its logical ends. While even before *Itoba* some courts reached the same conclusions with as little fanfare,[80] three reported decisions, *Kaufman v. Campeau Corp.*,[81]

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[78] *Id.*

[79] This is the classic sense of arbitrage: "The purchase of securities in one market for immediate resale on another in order to profit from a price discrepancy." WEBSTER'S II NEW RIVERSIDE UNIVERSITY DICTIONARY 121 (1ST ed. 1984).

[80] *See Holtz v. National Business Sys.*, Civ. No. 88-1755 (D.N.J. May 22, 1989),
(continued...)

In re Laidlaw Sec. Litig.,[82] and *Nathan Gordon Trust v. Northgate Exploration, Ltd.*,[83] did not.

3. Pre-Itoba Decisions.

In *Kaufman*, the court examined whether it had subject matter jurisdiction over Canadians who bought shares on Canadian exchanges. The majority of defendants' actions took place in Canada, but they also filed documents with the SEC and issued press releases in America.[84] The plaintiffs cited the "unitary nature of the Canadian and domestic markets" in support of their argument that the conduct test for subject matter jurisdiction was satisfied, but the court "fail[ed] to discern how inclusion of alleged misrepresentations and omissions in materials filed or circulated in the United States could have played a significant role in any losses sustained by the Canadian investors."[85] The *Kaufman* court either rejected the "inevitable link" between the prices on the two exchanges as sufficient to confer subject matter jurisdiction or didn't think such a link existed.

In *Laidlaw*, the plaintiff sought to have a class certified which included purchasers on the NYSE, Toronto Stock Exchange, and Montreal Stock Exchange.[86] The

(...continued)
transcript at 48-49 (accepting plaintiff's argument that "as a result of the false statements being filed with the SEC in the United States it had a direct effect upon the market in the United States market which in turn had an effect on the Canadian market which caused Canadian buyers to buy. Therefore, [purchasers on Canadian exchanges] should be included for purposes of the class action.").

[81] 744 F. Supp. 808 (S.D. Ohio. 1990).

[82] 1992 WL 68341 (E.D. Pa. Mar. 31, 1992).

[83] 148 F.R.D. 105 (S.D.N.Y. 1993).

[84] 744 F. Supp. at 810.

[85] *Id*.

[86] 1992 WL 68341, at *1.

court refused to certify a class which included purchasers on the Toronto or Montreal Exchanges, and certified a class of NYSE purchasers only.[87] The court found that the named plaintiff (a purchaser on the NYSE) had antagonistic interests to the foreign purchasers. According to the court, while the American investor would have to show the effect of the misrepresentations on the price of Laidlaw stock on the NYSE to prevail at trial, he would have no interest in demonstrating the effect of the misrepresentations on the foreign markets.[88] The court held the plaintiff would have no interest in demonstrating how the alleged fraud affected the price of Laidlaw stock in Montreal or Toronto.[89] "As an American investor, [the plaintiff] would naturally focus on the price changes on the New York Stock Exchange; price fluctuations on the Toronto and Montreal exchanges would be of little to no importance to him."[90] Further, while the efficiency of the NYSE was uncontested, defendants argued that the Canadian investors would have to show individual reliance because the Montreal and Toronto exchanges were not efficient for the purposes of the fraud on the market theory and the plaintiff would have no interest in demonstrating they were efficient.[91]

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[87] *Id.* at *6.

[88] *Id*.

[89] *Id*.

[90] *Id*.

[91] *Id*. The same logic was applied in *Smith v. Dominion Bridge Corp.*, 1998 WL 98998 (E.D. Pa. Mar. 6, 1998), with the same result. In *Smith*, the plaintiff sought to represent a class of purchasers on both the Vancouver Stock Exchange and Nasdaq. The court refused to certify a class of purchasers on the Vancouver exchange, holding "[b]ecause Smith did not purchase stock on the Vancouver Stock Exchange, he has no interest in establishing the efficiency of the [VSE] . . . . Thus, unlike Smith, purchasers on the Vancouver Exchange would have to establish individual reliance in their purchasing decisions on the alleged misrepresentations. . ." *Id*. at *4.

The fallacy of the *Laidlaw* court's holding is premised on the fact that the plaintiff would have had to do something to demonstrate that the prices moved on the Toronto or Montreal exchanges in response to the misrepresentations in America. In reality, the efficiency of the NYSE, and the opportunity for space arbitrageurs to profit if the foreign exchanges did not move in lockstep, would have assured that the prices would move abroad if there were misrepresentations made in America that affected the stock price in America. Thus the plaintiff would have had to do nothing to demonstrate prices moved on the Toronto or Montreal exchanges in response to misrepresentations in America.

In *Nathan Gordon Trust v. Northgate Exploration*, Ltd.,[92] the plaintiff, a United States trust which purchased stock on the NYSE, sought to certify a class of purchasers of Northgate Exploration stock on the NYSE, London, Toronto, and Montreal exchanges. The defendants argued that the court had no subject matter jurisdiction over purchasers on the foreign exchanges due to a lack of conduct in the United States relating to the foreign exchanges.[93] The plaintiff alleged the conduct in the United States–filing false and misleading statements with the SEC–necessarily inflated the price on the foreign

[92] 148 F.R.D. 105.

[93] *Id.* at 107-08. Prior to *Itoba*, the test for extraterritorial application of the federal securities laws was *either* the conduct or effect test, whereas now a lesser combination of the two tests may suffice. *See Itoba*, 54 F.3d at 122; *see also Europe and Overseas Commodity Traders v. Banque Paribas London*, 147 F.3d 118, 127 (2d Cir. 1998); *Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, 663-64 (7th Cir. 1998); *In re Gaming Lottery Sec. Litig.*, 58 F. Supp. 2d 62 (S.D.N.Y. 1999); *see generally* Joseph P. Garland and Brian P. Murray, *Subject Matter Jurisdiction Under the Federal Securities Laws: The State of Affairs after Itoba*, 20 MARYLAND J. OF INT'L L. AND TRADE 235 (1996).

exchanges.[94] The court did not directly address this argument but apparently rejected it, as it declined to include purchasers on foreign exchanges in the class.[95]

4. *Nathan Gordon Trust* Revisited.

Almost a decade ago, the *Nathan Gordon Trust* court rejected plaintiff's argument concerning the interrelationship between domestic and foreign exchanges. The plaintiff's theory in *Nathan Gordon Trust* on "space arbitrageurs" unfortunately pre-dated *Itoba*. With the advent of the internet and the undisputed globalization of the stock markets, the arguments posed in *Nathan Gordon Trust* are stronger than ever.

While defendants in *Nathan Gordon Trust* argued that shareholders who bought their shares on foreign exchanges should not be included as class members, the plaintiff argued otherwise. Plaintiff's rationale was as follows:

> Given the free flow of information, any price discrepancies between exchanges will quickly disappear to the price in the efficient markets. For example, even if the Montreal Exchange were itself inefficient, if Company X sold for $10.00 on the Montreal Exchange and $10.50 in New York, there would quickly be buyers in Montreal who would buy at $10.00 there and sell at $10.50 in New York. These are "space arbitrageurs.". . . . But the lure of such easy money would

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[94] The *Itoba* court distinguished the *Nathan Gordon Trust* case on the grounds that it involved class certification (which is discretionary), rather than subject matter jurisdiction issues. 54 F.3d at 123. However, it seems that a court bound by *Itoba* would have to decide the issue differently than did the *Nathan Gordon Trust* court. The *Itoba* court did not explain why the exercise of discretion would allow a different result.

[95] *Id.* at 108. The argument that domestic conduct and inflated prices on domestic exchanges causes inflated prices on foreign exchanges was apparently not raised in *McNamara v. Bre-X Minerals Ltd.*, 32 F. Supp. 2d 920 (E.D. Tex. 1999). In *McNamara*, the plaintiffs made seven arguments why the court had subject matter jurisdiction over Canadian purchasers on a Canadian exchange, one of which was the filing of false documents with the SEC. *Id.* at 924. However, plaintiffs did not make the final argument that the inflation on the Nasdaq inevitably caused inflation on the Toronto exchange, and the court declined to find that any domestic conduct "contributed to the losses of which they complain." *Id.* at 925.

> increase the demand for shares in Montreal, which would raise the price; one who could buy in Montreal and New York will do so as long as the price variance is no greater than transaction costs (which are minimal), and if many are seeking to buy in Montreal, the price will be bid up until pressure will stop, the New York market, awakened to the undervalued Montreal market, will continue to buy in Montreal as long as the market values the stock below $10.50. This increase in the demand in Montreal will eventually cause the price to rise to the price of $10.50 set by the efficient New York market.[96]

Today, this theory is firmly supported by the fact that the internet facilitates the transmission of information all over the world. It would only take seconds for someone in New York to realize that Company X's shares where trading for less on the Montreal Exchange than they were on the NYSE. As Plaintiff's counsel explained in *Nathan Gordon Trust*, the prices on both exchanges (regardless of the efficiency of the foreign exchange) would eventually be the same. Due to advances in technology this equilibrium would now be achieved in a fraction of the time it would have taken 10 years ago. The inefficient market would almost instantaneously match the price of the efficient market, making the inefficient and efficient market the same for all applicable purposes (class certification and subject matter jurisdiction).

5. <u>Post-Itoba Cases.</u>

In recent years, it seems as if the courts have begun to accept the idea of "space arbitrage" and the interrelationship between efficient and inefficient markets. For example, the court in *In re Gaming Lottery Securities Litigation*[97] rejected *Nathan Gordon Trust* and followed *Itoba*, conferring subject matter jurisdiction over Canadian purchasers on the Toronto Exchange. In that case, the plaintiffs alleged "a single fraudulent scheme

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[96] *See* Plaintiff's Reply Brief in Support of Motion for Class Certification at 21, *Nathan Gordon Trust v. Northgate Exploration Ltd.* (S.D.N.Y.) (on file with author).

[97] 58 F. Supp. 2d 62 (S.D.N.Y. 1999).

which included misstatements and omissions in both countries and the inflation of [the defendants'] stock price on both the Canadian and American exchanges."[98] The court found that there was subject matter jurisdiction "[d]ue to the efficiencies of market pricing and the ever-present possibility of arbitrage, the price of GLC stock on the TSE and the Nasdaq unsurprisingly moved in tandem during the class period."[99]

In contrast to *Gaming Lottery*, one court distinguished *Itoba* on its facts and refused to find subject matter jurisdiction over foreign transactions. In *In re Baan Co. Sec. Litig.*[100] the stock was traded on domestic and foreign exchanges, and the defendants contested subject matter jurisdiction over foreign plaintiffs who purchased on foreign exchanges. The court held that finding subject matter jurisdiction on a fraud on the market theory when a stock is traded domestically and abroad would "extend the reach of the 1934 Act too far."[101] The court also noted that finding subject matter jurisdiction "would allow a foreign plaintiff to sue a foreign defendant based on an extraterritorial transaction whenever a foreign defendant had filed a fraudulently misleading document with the SEC."[102] While the *Baan* court was absolutely correct in this statement, it failed to explain why such a holding would run afoul of the conduct or effects tests (or a combination of both). In fact, that scenario seems to describe the facts of *Itoba.*

The *Baan* court distinguished *Itoba* on the grounds that the plaintiff in *Itoba* alleged a specific, if somewhat indirect, chain of events showing that it relied on SEC filings

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98 *Id*. at 75.

99 *Id*.

100 103 F. Supp. 2d 1 (D.D.C. 2000).

101 *Id.* at 10.

102 *Id.*

(satisfying part of the conduct test) and the plaintiff's parent company was American (satisfying part of the effects test), facts not present in the *Baan* case.[103] The *Baan* plaintiffs made the argument that Baan shares traded in tandem on the world markets, but apparently made the argument that this satisfied the effects test, not the conduct test. Since the shares traded in tandem, the value of Baan shares owned by Americans were affected by the fraud.[104] Relying on *Bersch*, the *Baan* court rejected this argument, holding that the effects test only extends jurisdiction to American plaintiffs who are affected.[105] The *Baan* court thus did not directly address the argument that conduct in the United States (filing false and misleading documents with the SEC) caused the injury to foreign plaintiffs when stocks trade in tandem on world markets.

IV. <u>ORBITAL ENGINE: A CASE STUDY.</u>

Cases like *Itoba* and *Gaming Lottery* take a seemingly sound premise–space arbitrageurs will ensure that a stock traded on multiple exchanges will move on both markets in response to news–and follow it to the conclusion that there is sufficient conduct to confer subject matter jurisdiction over purchasers on foreign exchanges or that a foreign stock trades on an efficient market abroad for purposes of class certification. To test the validity of the premise, we consider the case of Orbital Engine Co. Ltd.

Orbital Engine was a large Australian company whose stock was publicly traded on the Australian Stock Exchange ("ASX") for seven years before the initial public offering of its ADRs on the NYSE.[106] The offering price on the NYSE was predicated on

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[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *See Cosmas v. Merrill Lynch & Co.*, 1993 WL 800778, at *2 (S.D.N.Y. July 2,
(continued...)

the price in Australia: a mathematical calculation based on the closing price of the stock on the ASX on the day of the U.S. offering (due to time zone differences, the ASX closed before the NYSE opened). The stock was thinly traded in Australia,[107] meaning that the stock may not have been priced efficiently. If the ordinary shares on the ASX were inefficiently priced, the initial offering price in the United States would also be inefficient.

The ADRs opened on the NYSE at the Australian equivalent of $4.92[108] on the NYSE (Orbital's closing price that day in Australia), while Australian investors slept during the Australian night.[109] The traders on the NYSE bid down the price of the ADRs to $4.30 by the time trading closed on the NYSE on the first day. When the Australian market woke up the next day (literally and figuratively), they had no choice but to follow the price set by the NYSE; the closing price on the ASX that day (while traders in New York slept) was $4.48 (from $4.92 the previous day).[110]

Over time, the trading volume on the NYSE exceeded that of the ASX on a proportionate basis. In 1992, Orbital had a trading volume of 42 million shares on the Australian Stock Exchange and 2.67 million ADRs (representing 21.3 million shares) on the

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(...continued)
1993).

[107] Approximately 42 million shares of Orbital Engine were traded on the Australian Stock Exchange in 1992, out of approximately 313 million shares outstanding.

[108] For comparison purposes, prices reflect the per ordinary share price, not the ADR price which is 8 time higher due to the 8:1 ratio for the ADRs.

[109] There is a 13 hour time difference between Sydney and New York.

[110] Stewart Cameron, *Orbital Shares in Spiral After Wall St. Listing,* Australian Financial Review, June 12, 1991 ("The local share price of Mr. Ralph Sarich's Orbital Engine Corp. slumped by 9 percent yesterday after a disappointing debut on the New York Stock Exchange.").

NYSE. In 1996, Orbital had approximately 300 million shares outstanding and a volume of 90 million shares on the ASX, for an annual turnover rate of 30%.[111] The ADRs, of which there are 3.4 million outstanding,[112] had volume of 26.5 million in 1996 (representing 212 million ordinary shares), for an annual turnover rate of almost 800% on the NYSE. Orbital Engine's turnover rate on the NYSE was almost 27 times higher than on the ASX. The turnover rate, which is one of the most important indicators in gauging the efficiency of the market for a particular stock,[113] clearly showed that Orbital Engine shares traded efficiently on the NYSE.

The Orbital Engine case is an example of an efficient exchange perhaps forcing another exchange (with questionable efficiency) into an accident of efficiency. This was helped in part by the difference in trading hours in the exchanges involved. The inefficient market could not exercise an effect on the efficient market during market hours in New York, allowing traders in New York to set an efficient price.

CONCLUSION

As financial markets move increasingly towards globalization, more and more companies will be traded on both domestic and foreign exchanges. Furthermore, the public

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[111] The turnover rate is the volume of shares traded as a percentage of a company's listed shares. An annual turnover rate of 100% or more is indicative of an efficient market. *Cammer v. Bloom*, 711 F. Supp. 1264, 1286 (D.N.J. 1989) ("turnover measured by average weekly trading of two percent or more of the outstanding shares would justify a strong presumption that the market for the security is an efficient one").

[112] Representing 27.2 million ordinary shares.

[113] *See Krogman v. Sterritt*, 2001 WL 313963, at *5 (N.D. Tex. Mar. 29, 2001).

notice requirements of the PSLRA,[114] coupled with the internet and e-mail, mean more investors, including foreign purchasers on foreign exchanges, will be aware of pending class actions and will want to participate. Rather than allowing the United States and its securities exchanges to be used as a base for exporting fraud, courts should recognize that the "inevitable linkage" between prices on efficient domestic exchanges and foreign exchanges provide a basis for conferring subject matter jurisdiction over purchasers on foreign exchanges, and such purchasers on foreign exchanges should be entitled to the presumption of reliance due to the fraud on the market theory when certifying classes.

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[114] 15 U.S.C. § 77z-1(a)(3)(B)(l), 15 U.S.C. § 78u-4(a)(3)(B)(l).