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Cases: Zoelsch v. Arthur Andersen & Co.**

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SUBJECT MATTER JURISDICTION OVER TRANSNATIONAL SECURITIES FRAUD CASES: *ZOELSCH v. ARTHUR ANDERSEN & CO.*

When American securities laws are applied in the context of international transactions, complex jurisdictional issues arise.¹ Although section 27² of the Securities Exchange Act of 1934 ("Exchange Act")³ confers on the federal courts exclusive jurisdiction

¹ See Note, *Extraterritorial Boundaries of Federal Securities Law*, 50 ST. JOHN'S L. REV. 417, 417 (1975) [hereinafter Note, *Extraterritorial Boundaries*]; Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PA. L. REV. 1363, 1370 (1973). Recognizing that international securities transactions may involve conduct both within and without the United States, one commentator noted, "[t]he relevant question, then, becomes: what event or combination of events within the United States is sufficient to establish subject matter jurisdiction?" *Id.* See also Note, *The Extraterritorial Application of the Antifraud Provisions of the Securities Acts*, 11 CORNELL INT'L L.J. 137, 137 (1978) [hereinafter Note, *The Extraterritorial Application of the Antifraud Provisions*] (increasing international security transactions mandate application of United States law where jurisdiction exists in order to "protect American investors and safeguard the integrity of domestic securities markets").

² 15 U.S.C. § 78aa (1982). This section provides that, "[t]he district courts of the United States . . . shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder." *Id.*

³ Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982 & Supp. 1987)) [hereinafter Exchange Act]. The Exchange Act was promulgated "in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets." 15 U.S.C. § 78b (1982). One commentator has divided the purposes of the Exchange Act into four categories: (1) disclosure; (2) prevent and afford remedies for fraud or market manipulation; (3) regulate securities markets; and (4) control the amount of the Nation's credit which goes into those markets. 1 L. LOSS, *SECURITIES REGULATION* 130-31 (2d ed. 1961); see *Peoples Sec. Co. v. SEC*, 289 F.2d 268, 271 (5th Cir. 1961) (the basic purposes of the Exchange Act were: to force disclosure of information to investors, to regulate markets, and to control the Nation's credit in such markets); see also *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 154 (1976) (primary purpose to assure fair dealing without undue preferences or advantages among investors); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975) ("The primary purpose . . . was to eliminate serious abuses in a largely unregulated securities market.").

Prior to the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77mm (1982 & Supp. 1987)) [hereinafter Securities Act], the federal government's sole recourse for securities fraud was criminal prosecution under the mail fraud statute. See 3 L. LOSS, *supra*, at 1421. The Exchange Act must be distinguished from the Securities Act which "is concerned by and large with the initial distribution of securities rather than subsequent trading." 1 L. LOSS, *supra*, at 130. See *Peoples Sec. Co.*, 289 F.2d at

over violations of the act, it indicates no jurisdictional perimeters.⁴ Because of the paucity of information as to the legislative intent⁵ and the failure of the Securities and Exchange Commission⁶ to clarify the jurisdictional scope of section 10⁷ or Rule 10b-5,⁸ federal

271; Tracy & MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1037-38 (1934).

⁴ See, e.g., *Continental Grain (Australia) Party, Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 415 (8th Cir. 1979) (scheme of fraudulent nondisclosure involving the use of mail and telephone will provide a jurisdictional basis in the United States); *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir.) (jurisdictional basis exists when at least activity in furtherance of a fraudulent scheme occurs in the United States), *cert. denied*, 431 U.S. 938 (1977); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 987 (2d Cir.) (no jurisdictional basis exists when acts abroad outweigh preparatory acts and acts of nonfeasance in the United States), *cert. denied*, 423 U.S. 1018 (1975).

The Exchange Act exempts from coverage the securities transactions of a foreign business. 15 U.S.C. § 78dd(b) (1982 & Supp. 1987). Section 30(b) provides:

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

Id. See also *Schoenbaum v. Firstbrook*, 405 F.2d 200, 207 (2d Cir.) (purpose of § 30(b) is "to permit persons in the securities business to conduct transactions in securities outside of the United States without complying with the burdensome reporting requirement of the Act"), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). The *Schoenbaum* court held that section 30's exemption "does not preclude extraterritorial application of the Exchange Act to persons who engage in isolated foreign transactions." *Id.* at 207. The SEC has not promulgated any rules or regulations under section 30. *Id.* at 207 n.4. See 2 L. Loss, *supra* note 3, at 1170 n.2. See also *Goldman & Magrino, Some Foreign Aspects of Securities Regulation: Towards a Reevaluation of Section 30(b) of the Securities Exchange Act of 1934*, 55 VA. L. REV. 1015, 1020 (1969) ("Although no rules or regulations have been promulgated . . . under Section 30(b), SEC rules promulgated under various other statutory provisions may impliedly serve to prevent 'evasion of this title'"); Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 COLUM. L. REV. 94, 101-03 (1969) (discussing § 30 and *Schoenbaum*).

⁵ See *Kasser*, 548 F.2d at 114 n.21. See generally Mizrack, *Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities and Exchange Act of 1934*, 30 BUS. LAW. 367, 368 (1975).

⁶ 15 U.S.C. § 78d (1982 & Supp. 1987). Section 4 created the Securities and Exchange Commission. *Id.* See generally 1 L. Loss, *supra* note 3, at 131 (SEC given considerable rule-making authority).

⁷ 15 U.S.C. § 78j (1982). Section 10 of the Exchange Act provides, *inter alia*:

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 —

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

courts have themselves determined the reach of American law over cases involving transnational transactions.⁹ In an effort to ascertain proper boundaries, the courts have drawn upon international law¹⁰

Id. Interstate commerce is broadly defined in section 78c to include "trade, commerce, transportation, or communication among the several [s]tates, or between any foreign country and any State." *Id.* § 78c(a)(17). Section 10 is a general provision, proscribing fraud and manipulation on the national exchange and over-the-counter markets. *See* 1 L. Loss, *supra* note 3, at 131.

⁹ 17 C.F.R. § 240.10b-5 (1987). Rule 10b-5, promulgated under section 10, makes it unlawful:

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 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.

Id.

⁹ *See* *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972) ("language of § 10(b) of the Securities Exchange Act is much too inconclusive to lead us to believe that Congress meant to impose rules governing conduct throughout the world in every instance where an American company bought or sold a security"). *See also* *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1018 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975) ("the line has to be drawn somewhere if the securities laws are not to apply in every instance where something has happened in the United States"); Note, *Extraterritorial Boundaries*, *supra* note 1, at 417-18 nn.3-8 (discussion of federal court decisions on jurisdictional issues in cases involving foreign parties).

¹⁰ *See* Comment, *supra* note 1, at 1369-70. Under international law a state can predicate jurisdiction on the following bases: (1) the territorial principle—a state has jurisdiction over conduct within its territory; (2) the objective territorial principle—a state can regulate conduct occurring outside its territory if the conduct produces an effect within its territory; (3) the nationality principle—a state has jurisdiction over the conduct of its citizens whether or not the conduct occurs within its territory; (4) the passive personality principle—a state has jurisdiction over conduct which injures its citizens; (5) the protective principle—a state may attach legal consequences to conduct that threatens its national security; or (6) the universality principle—a state has jurisdiction over an act if it has custody of the person who committed the act. *See id.* at 1368-69. *See generally* RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 10, 17, 18, 19, 20, 26, 27, 30, 33 (1965 & Supp. 1986-87) (discussing various bases of jurisdiction) [hereinafter RESTATEMENT].

Of these jurisdictional guidelines, the territorial or "conduct" approach and the objective territorial or "effects" approach have been used by the courts to determine subject matter jurisdiction over transnational claims under the antifraud provisions of the Exchange Act. *See, e.g., Leasco*, 468 F.2d at 1334, 1339 (subject matter jurisdiction recognized in place where conduct has occurred); *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir.) (subject matter jurisdiction "to protect the domestic securities market from the effects of improper foreign transactions in American securities"), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969). *See also* Note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553, 554-57 (1976) (discussion of subjective and objective territorial principles as applied in Second Circuit cases).

to formulate tests focusing on the "effects"¹¹ of and the "conduct"¹² constituting, the alleged violation. Although the "effects" test has been uniformly applied throughout the federal circuits,¹³

¹¹ See *supra* note 10. The "effects" test is formulated in the RESTATEMENT which states: 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.

RESTATEMENT, *supra* note 10, § 18. See also *Schoenbaum*, 405 F.2d at 206 ("effect" on American securities market sufficient to confer jurisdiction).

¹² See *supra* note 10. The RESTATEMENT's "conduct" test provides:

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.

RESTATEMENT, *supra* note 10, § 17. See also *Leasco*, 468 F.2d at 1334, 1339 (place where conduct occurred used to determine jurisdiction).

¹³ See, e.g., *Continental Grain (Australia) Party, Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 417 (8th Cir. 1979) (jurisdiction based on effects test); *Des Brisay v. Goldfield Corp.*, 549 F.2d 133, 135 (9th Cir. 1977) (jurisdiction over securities transaction outside United States involving foreign parties where American buyers, sellers and holders of those securities were adversely affected); *Schoenbaum*, 405 F.2d at 208-09 (serious effect on United States commerce supported jurisdiction).

The Second Circuit established the effects test in *Schoenbaum*, holding that an American court has jurisdiction over violations of the Exchange Act where the conduct, outside the United States, was intended to produce and did produce detrimental effects within the United States. *Schoenbaum*, 405 F.2d at 208-09. The transaction in *Schoenbaum*, involved stock registered and listed on a national securities exchange and the court limited the "effects" test's applicability to transactions which involved stock listed on a national exchange and which were "detrimental to the interests of American investors." *Id.* at 208. The conduct cannot be entirely outside the United States; the use of interstate commerce, the mails, or a national securities exchange is a prerequisite for subject matter jurisdiction under the antifraud provision of the Exchange Act. See *id.* at 207 n.2. See also 15 U.S.C. § 78j (1982) (use of mails or national securities exchange for deceptive purposes is prohibited). See generally 3 L. Loss, *supra* note 3, at 1519-24 (much of the SEC's ability to prevent fraudulent activity is dependent upon showing use of the mails or national securities exchange).

In subsequent cases the Second Circuit clarified the "effect" necessary to predicate jurisdiction. In *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975), generalized effects, such as the ability of American firms to obtain investment capital from foreign sources, or deterioration of investor confidence in American underwriters at home and abroad, were held to be insufficient to confer subject matter jurisdiction. See *Bersch*, 519 F.2d at 987-88. The Second Circuit's formulation has been applied by other

varying degrees of "conduct" in the United States have been required to confer subject matter jurisdiction.¹⁴ Recently, in *Zoelsch v. Arthur Andersen & Co.*,¹⁵ the United States Court of Appeals for the District of Columbia held that subject matter jurisdiction over transnational fraud cases, involving a foreigner as plaintiff, requires domestic conduct that constitutes all of the elements of a 10b-5 violation.¹⁶

In *Zoelsch*, a citizen of the Federal Republic of Germany brought an action in the District of Columbia on behalf of himself and other West German investors¹⁷ against Arthur Andersen & Co., an American general partnership.¹⁸ Zoelsch asserted that he relied upon false representations and material omissions in an audit report, distributed with a package of materials describing an intricate investment and tax shelter plan.¹⁹ The investment vehicle was offered exclusively in West Germany, to West German citizens.²⁰ Zoelsch alleged federal jurisdiction on the basis of claims under United States securities laws and diversity of citizenship.²¹

The district court dismissed the action for lack of subject matter jurisdiction.²² On appeal, the circuit court affirmed.²³ Judge Bork, writing for the court, analyzed the statutory language and

federal circuits. See, e.g., *Continental Grain*, 592 F.2d at 417 (losses by foreign subsidiary of American corporation not a substantial effect under the effects test).

¹⁴ Compare *ITT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975) (jurisdiction based on "conduct" limited to perpetration of fraudulent act) with *SEC v. Kasser*, 548 F.2d 109 (3d Cir.) (activity designed to "further a fraudulent scheme" can justify jurisdiction), *cert. denied*, 431 U.S. 938 (1977).

¹⁵ 824 F.2d 27 (D.C. Cir. 1987).

¹⁶ *Id.* at 35.

¹⁷ *Id.* at 28. There were at least thirty-one other West German citizens who, along with Zoelsch, invested their funds directly with Dr. Loescher and Co. KG ("Loescher") or indirectly through a West German limited partner of Loescher with the understanding that the funds would be funneled through these entities to First American International Real Estate Limited Partnership ("FAIR"). *Id.* FAIR was to invest the money in property and condominium conversions in Tennessee and Georgia. *Id.*

¹⁸ *Id.* Zoelsch brought the action in the United States only against Arthur Andersen & Co. ("AA-USA") and filed, in West Germany, another suit against Arthur Andersen & Co. GmbH ("AA-GmbH"), a West German limited liability corporation. *Id.* at 29.

¹⁹ *Id.* at 28. Loescher commissioned AA-GmbH to prepare an audit report on the entire investment plan, including the American investments. *Id.* AA-USA's sole connection with the package of solicitation materials distributed by Loescher was one minor reference to Arthur Andersen & Co., Memphis in the audit report prepared by AA-GmbH. *Id.* at 29.

²⁰ *Id.* at 28.

²¹ *Id.*

²² *Id.* Plaintiff did not challenge the denial of subject matter jurisdiction based on diversity of citizenship; he appealed only the lack of jurisdiction over the federal claims. *Id.*

²³ *Id.*

case law supporting the "conduct" tests.²⁴ Based on its analysis, the court adopted the Second Circuit's restrictive test by requiring that solely domestic acts comprise the elements of a 10b-5 violation.²⁵ The court offered three rationales to support its decision: unless a contrary intent appears, legislation "is meant to apply only within the territorial jurisdiction of the United States";²⁶ American judicial resources should be preserved for the "adjudication of domestic disputes and the enforcement of domestic law";²⁷ and the circuits adopting more permissive tests did so for "reasons that were essentially legislative."²⁸

Although concurring in the majority's decision to dismiss the action for lack of subject matter jurisdiction, Chief Judge Wald rejected the majority's rationale, which had classified the adoption of the permissive approach as essentially legislative.²⁹ Furthermore, Chief Judge Wald found it "unnecessary . . . to adopt the Second Circuit's restrictive test" because federal jurisdiction would not exist under the less restrictive approaches.³⁰

While the court in *Zoelsch* reached the correct decision on these specific facts, it is submitted that the adoption of a more rigorous standard was unnecessary and will diminish the Exchange Act's significance in regulating the securities industry. This Comment will examine the disparate "conduct" tests which have emerged in the federal circuits. In addition, it will be asserted that the *Zoelsch* court's reason for rejecting the permissive test was inherently flawed. Lastly, a three-prong test will be proposed to enable the courts to effectuate the Exchange Act's purpose, while still addressing incidental problems in applying American laws to transnational activities.

²⁴ See *id.* at 29-33. The court reviewed the restrictive Second Circuit interpretation and the Third, Eighth, and Ninth Circuits' more lenient approaches, see *infra* notes 30-50 and accompanying text, and concluded that the Second Circuit's test "provides the better approach to determining when American courts should assert jurisdiction." *Zoelsch*, 824 F.2d at 31.

²⁵ See *Zoelsch*, 824 F.2d at 31.

²⁶ *Id.* (quoting *Foley Bros. v. Filardo*, 336 U.S. 281 (1949)).

²⁷ *Id.* at 32.

²⁸ *Id.*

²⁹ *Id.* at 36 (Wald, C.J., concurring).

³⁰ *Id.* (Wald, C.J., concurring); see also *infra* notes 43-50 and accompanying text (discussion of less restrictive approaches).

VARYING THE REQUIRED DEGREE OF CONDUCT

In a line of cases from *Leasco Data Processing v. Maxwell*³¹ to *Bersch v. Drexel Firestone, Inc.*,³² the Second Circuit, using international law as a benchmark,³³ developed a test basing jurisdiction on domestic conduct.³⁴ Although the Second Circuit relied on the *Restatement (Second) of Foreign Relations Law of the United States* ("Restatement"),³⁵ it did not extend jurisdiction to the *Restatement's* limits.³⁶ Instead, *Bersch* restricted jurisdiction by requiring different degrees of conduct, for resident Americans, nonresident Americans and foreigners.³⁷ The *Bersch* court distinguished between these classes of plaintiffs because of a "concern for overburdened federal courts."³⁸ Under this distinction, domes-

³¹ 468 F.2d 1326 (2d Cir. 1972).

³² 519 F.2d 974 (2d Cir.), cert. denied, 423 U.S. 1018 (1975).

³³ See *supra* note 10. See also Note, *The Extraterritorial Application of the Antifraud Provisions*, *supra* note 1, at 138 (jurisdictional theories of international law serve as guidance for the court).

³⁴ See *supra* note 10. The test is an extension of the subjective territorial principle of foreign relations law, which gives a state jurisdiction to prescribe and enforce a rule of law "attaching legal consequences to conduct that occurs within its territory." RESTATEMENT, *supra* note 10, § 17. See also *supra* note 12 (text of § 17).

³⁵ RESTATEMENT, *supra* note 10.

³⁶ See *supra* note 12. Under the Restatement approach, conduct within a territory is sufficient for jurisdiction. *Id.* In *Leasco*, the court recognized that under the *Restatement* the court was not precluded from applying the Exchange Act but added, "[t]he question remains whether we should." *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1335 (2d Cir. 1972). In *Bersch*, the court reiterated *Leasco's* contention that a court must determine if Congress meant to go to the "full extent permitted." *Bersch*, 519 F.2d at 985 (quoting *Leasco*, 468 F.2d at 1334). The *Bersch* court then addressed this concern and limited the *Restatement's* approach by requiring increased degrees of conduct for different categories of plaintiffs. See *id.* at 993; *infra* note 36 and accompanying text.

³⁷ *Bersch*, 519 F.2d at 993. A tripartite test was established, providing:

anti-fraud provisions of the federal securities laws:

(1) Apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country; and

(2) Apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but

(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.

Id.

³⁸ *Id.* at 985. After analyzing foreign relations law, the court stated that a court "must seek to determine whether Congress would have wished [that] the precious resources of United States courts . . . be devoted to [predominantly foreign transactions] rather than leave the problem to foreign countries." *Id.* But see *infra* note 68 and accompanying text.

tic conduct that is "merely preparatory" is sufficient to confer jurisdiction in a nonresident American's action; whereas, domestic conduct must "directly cause" the injury in an action brought by foreign parties.³⁹ In *IIT v. Vencap, Ltd.*,⁴⁰ *Bersch's* companion case, the court further defined "directly caused," holding that conduct sufficient for jurisdiction over claims by foreigners is limited to the "perpetration of fraudulent acts themselves."⁴¹ Although the other circuit courts agree that jurisdiction can be premised on conduct occurring in the United States,⁴² they are not in accord as to the conduct necessary to trigger the application of American securities laws to actions brought by foreign citizens.⁴³

The Third and Eighth Circuits have not applied as stringent a definition for "directly caused" as was enunciated by the Second Circuit.⁴⁴ In *SEC v. Kasser*,⁴⁵ the Third Circuit, noting that jurisdiction would be found under the Second Circuit's test,⁴⁶ set forth a more permissive test requiring only "some activity designed to further a fraudulent scheme" be conducted in the United States.⁴⁷ The *Kasser* court suggested that a more permissive test would further the purpose of the Exchange Act⁴⁸ by: discouraging the use of the United States as a base of operations for the defrauding of for-

³⁹ *Bersch*, 519 F.2d at 992.

⁴⁰ 519 F.2d 1001 (2d Cir. 1975).

⁴¹ *Id.* at 1018. The court noted that jurisdiction "does not extend to mere preparatory activities or the failure to prevent fraudulent acts where the bulk of the activity was performed in foreign countries." *Id.* But see *SEC v. Kasser*, 548 F.2d 109, 114-15 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977); FEDERAL SECURITIES CODE § 1604 (Proposed Official Draft 1978); see also Loss, *Externality in the Federal Securities Code*, 20 HARV. INT'L L.J. 305 (1978) (discussion of type of activity generally required to find jurisdiction in the United States).

⁴² See, e.g., *Continental Grain (Australia) Party, Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409 (8th Cir. 1979); *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976); *SEC v. United Fin. Group*, 474 F.2d 354 (9th Cir. 1973).

⁴³ Compare *ITT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir. 1975) (jurisdiction in action brought by foreigner requires domestic conduct to be fraudulent act itself) with *Continental Grain (Australia) Party, Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409 (8th Cir. 1979) (requires domestic conduct to significantly further fraudulent scheme's accomplishment) and *Grunenthal GmbH v. Hotz*, 712 F.2d 421 (9th Cir. 1983) (adopting Eighth Circuit test).

⁴⁴ See *supra* notes 31-41 and accompanying text.

⁴⁵ 548 F.2d 109 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977).

⁴⁶ *Id.* at 113-15. In obvious deference to the Second Circuit, the *Kasser* court struggled to reconcile its holding with "the prior pronouncements of . . . the Second Circuit, a court with especial expertise in matters pertaining to securities." *Id.* at 115.

⁴⁷ *Id.* at 114.

⁴⁸ See *supra* note 3.

eigners;⁴⁹ encouraging international cooperation against fraudulent schemes;⁵⁰ and, increasing the SEC's ability to vigorously police the conduct of securities transactions within the United States.⁵¹

The Eighth Circuit, in *Continental Grain (Australia) Party, Ltd. v. Pacific Oilseeds, Inc.*,⁵² also repudiated the Second Circuit's restrictive test⁵³ and instead required that the conduct in the United States significantly advance a fraudulent scheme's accomplishment and involve the mails or other instrumentalities of interstate commerce.⁵⁴ The Eighth Circuit noted that policy reasons postulated in *Kasser* supported the adoption of a more permissive test, but the court declined to adopt a requirement as permissive as was suggested by the Third Circuit.⁵⁵

ANALYSIS OF *Zoelsch*

The D.C. Circuit's adoption of the Second Circuit test is flawed in three respects: the court adopted a more demanding test than that of the Second Circuit; the court's rationale for rejecting the permissive test was inherently defective; and the court's distinction between foreigners and nonresident Americans raises constitutional objections.

In *IIT v. Cornfeld*,⁵⁶ the Second Circuit retreated from its prior holdings.⁵⁷ The court stated that in determining whether

⁴⁹ *Kasser*, 548 F.2d at 116. The *Kasser* court realized that: to deny such jurisdiction may embolden those who wish to defraud foreign securities purchasers or sellers to use the United States as a base of operations. . . . We are reluctant to conclude that Congress intended to allow the United States to become a "Barbary Coast," as it were, harboring international securities "pirates."

Id.

⁵⁰ *See id.* Seeking to further international cooperation, the *Kasser* court recognized that "a holding of no jurisdiction might induce reciprocal responses on the part of other nations. . . . By finding jurisdiction here, we may encourage other nations to take appropriate steps against parties who seek to perpetrate frauds in the United States." *Id.* It is submitted that this rationale is applicable where the defendant is an American citizen or entity but might not be appropos where the defendant is a foreign citizen or entity. *See generally* 3 L. Loss, *supra* note 3, at 1852-61; 6 *id.* at 4004-07 (2d ed. Supp. 1969) (enforceability of SEC liabilities in foreign forums).

⁵¹ *Kasser*, 548 F.2d at 116.

⁵² 592 F.2d 409 (8th Cir. 1979).

⁵³ *See id.* at 413-19.

⁵⁴ *Id.* at 421.

⁵⁵ *Id.* at 418-20. While the *Kasser* court found the conduct in the United States was significant to the completion of the fraud, the court interpreted the holding to require only "some activity designed to further a fraudulent scheme." *Kasser*, 548 F.2d at 114.

⁵⁶ 619 F.2d 909 (2d Cir. 1980).

⁵⁷ *Compare* *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980) (finding subject matter juris-

American activities "directly caused" the injury it must balance the quantity of conduct in the United States against the quantity of conduct abroad.⁵⁸ The court also noted that it was not inclined to extend *Bersch's* holding to include "cases where conduct was predominantly in the United States and the securities were American in practical effect."⁵⁹ In *AVC Nederland B.V. v. Atrium Investment Partnership*,⁶⁰ the court further distanced itself from its prior holdings by applying the *Tentative Draft of the Restatement (Second) of Foreign Relations Law of the United States ("Tentative Draft")*⁶¹ analysis, in determining the reasonableness of exercising jurisdiction,⁶² even though the fraud was consummated

diction where a foreign plaintiff purchased convertible debentures in the European aftermarket, since the prospectus was drafted and the accounting done in the United States, though the debentures were not offered in the United States) *with F.O.F. Proprietary Funds, Ltd. v. Arthur Young & Co.*, 400 F. Supp. 1219 (S.D.N.Y. 1975) (denying jurisdiction where foreign plaintiff purchased debentures, issued and guaranteed by American companies, from a foreign underwriter, even though defendants had drafted a misleading circular and letter in the United States; fraud held to consist of the communication of the misleading information and the sale to the foreigners—both of which had occurred abroad).

⁵⁸ *IIT*, 619 F.2d at 920-21.

⁵⁹ *Id.* at 921 n.13.

⁶⁰ 740 F.2d 148 (2d Cir. 1984).

⁶¹ RESTATEMENT (SECOND) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES (Tent. Draft No. 2, 1981) [hereinafter TENTATIVE DRAFT].

⁶² *AVC Nederland B.V.*, 740 F.2d at 154-55. Although the fraud was consummated abroad, the court found jurisdiction would exist under the TENTATIVE DRAFT's approach. *Id.* But see *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 32 n.2 (D.C. Cir. 1987) (declined to adopt the TENTATIVE DRAFT's approach contending that it would make "jurisdiction turn on a welter of specific facts" and yet adopted a test which also turns on the specific facts of the case). The court in *Cornfeld* noted that "'the presence or absence of any single factor which was considered significant in other cases dealing with the question of federal jurisdiction in transnational securities cases is not necessarily dispositive' in future cases." 619 F.2d at 918 (quoting *Continental Grain (Australia) Party, Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 414 (8th Cir. 1979)).

The Second Circuit's "fact specific" approach is exemplified by seemingly contradictory results. Compare *F.O.F. Proprietary Funds, Ltd. v. Arthur Young & Co.*, 400 F. Supp. 1219 (S.D.N.Y. 1975) (misleading circulars and reports drafted in United States, with distribution of circulars and sale of debentures outside the United States, considered actual 10(b) violation) *with IIT v. Vencap, Ltd.*, 411 F. Supp. 1094 (S.D.N.Y. 1975) (drafting of a memorandum with misstatements and omissions in the United States, with the distribution to European purchasers from the Bahamas, considered a violation within United States), *on remand from 519 F.2d 1001* (2d Cir. 1975). See also Comment, *Securities Law—Subject Matter Jurisdiction in Transnational Securities Fraud*, 9 INT'L L. & POL. 113, 136-37 (1976) (fraud committed when misleading information was given to the victim) [hereinafter Comment, *Transnational Securities Fraud*]. It is submitted that, under the Second Circuit's approach, a company could manufacture fraudulent securities devices in the United States, send them abroad to another company, and defraud foreigners with no fear of retribution as long as they do not keep assets in the foreign country.

abroad.⁶³ It is submitted that by requiring domestic conduct to constitute all the elements of a 10b-5 violation, the D.C. Circuit adopted a test for a foreign plaintiff's action no longer followed in the Second Circuit.

The D.C. Circuit justified utilization of a stricter standard by citing a canon of statutory construction,⁶⁴ expressing a concern for the overburdening of the courts,⁶⁵ and characterizing the more permissive circuits' reasoning as "legislation."⁶⁶ The canon, that unless a contrary intent appears legislation is meant to apply only within the territorial jurisdiction of the United States, has been found by the Second Circuit itself to be inapposite where there has been significant conduct within the territory.⁶⁷ The second policy

⁶³ *AVC Nederland B.V.*, 740 F.2d at 148, 153. Jurisdiction was denied, however, because of a choice of forum and law clause in the agreement. *See id.* Section 403(2) of the TENTATIVE DRAFT provides:

Whether the exercise of jurisdiction is unreasonable is judged by evaluating all the relevant factors including:

(a) the extent to which the activity (i) takes place within the regulating state, or (ii) has substantial, direct, and foreseeable effect upon or in the regulating state;

(b) the links, such as nationality, residence, or economic activity, between the regulating state and the persons principally responsible for the activity to be regulated, or between that state and those whom the law or regulation is designed to protect;

(c) the character of the activity to be regulated, the importance of the regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted;

(d) the existence of justified expectations that might be protected or hurt by the regulation in question;

(e) the importance of regulation to the international political, legal or economic system;

(f) the extent to which such regulation is consistent with the traditions of the international system;

(g) the extent to which another state may have an interest in regulating the activity;

(h) the likelihood of conflict with regulation by other states.

TENTATIVE DRAFT, *supra* note 61, § 403(2). For a discussion of the TENTATIVE DRAFT's approach, using "reasonableness" as the determinative factor for subject matter jurisdiction, see Note, *Subject Matter Jurisdiction Over Transnational Securities Fraud: A Suggested Roadmap to the New Standard of Reasonableness*, 71 CORNELL L. REV. 919 (1986).

⁶⁴ *See supra* note 26 and accompanying text.

⁶⁵ *See supra* note 27 and accompanying text.

⁶⁶ *See supra* note 28 and accompanying text.

⁶⁷ *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1334 (2d Cir. 1972).

The court stated:

Conduct within the territory alone would seem sufficient from the standpoint of jurisdiction to prescribe a rule. It follows that when, as here, there has been sig-

rationale—preventing the overburdening of the federal courts—may be valid; however, it seems relatively insignificant if the plaintiff will be denied a remedy,⁶⁸ or the failure to find jurisdiction will allow a defendant to continue to defraud foreigners with impunity.⁶⁹ The final rationale offered censures the other circuits as usurping the role of Congress.⁷⁰ The cases categorically state that the legislative intent of the extraterritorial applications cannot explicitly be found in the statute or the legislative history.⁷¹ In construing an ambiguous statute, a court should look to the statute's purpose.⁷² It is submitted that the circuit courts adopting the more permissive tests examined the overall purpose of the statute and construed it properly, and the D.C. Circuit erred in classifying such efforts as essentially legislative.⁷³

nificant conduct within the territory, a statute cannot properly be held inapplicable simply on the ground that, absent the clearest language, Congress will not be assumed to have meant to go beyond the limits recognized by foreign relations law.

Id. The court added that reliance on *Foley Bros. v. Filardo*, 336 U.S. 281, 285 (1949), which stated that regulatory statutes will generally not be construed as applying to conduct wholly outside the United States, is misplaced. *Id.*

⁶⁸ See Note, *Expanding the Jurisdictional Basis for Transnational Securities Fraud Cases: A Minimal Conduct Approach*, 6 *FORDHAM INT'L L.J.* 308, 315 n.47 (1983). One commentator has noted that "concern of overburdening the federal courts may be valid. However, it is not so strong an argument as to deny a plaintiff his right to a remedy, especially if this is the only country in which personal jurisdiction may be obtained over the defendant." *Id.*

⁶⁹ See Petition for Rehearing for SEC as Amicus Curiae at 10, *IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980). The SEC argued, "the possibility of the wastefulness of a court in this country adjudicating conduct which may be better policed by a foreign state must be weighed against the possibility that abstention by the court would create gaps in international regulation through which a modern-day pirate may safely sail." *Id.*

⁷⁰ See *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 36-37 (D.C. Cir. 1987) (Wald, C.J., concurring).

⁷¹ See *supra* note 5 and accompanying text.

⁷² *Day v. North Am. Rayon Corp.*, 140 F. Supp. 490, 493 (E.D. Tenn. 1956). See also *Holy Trinity Church v. United States*, 143 U.S. 457, 463 (1892) (the evil the statute was designed to remedy is a guide to its meaning); *Commonwealth v. Maxwell*, 271 Pa. 378, 390, 114 A. 825, 829 (1921) ("[s]tatutes framed in general terms apply to new cases that arise, and to new subjects that are created from time to time, and which come within their general scope and policy") (quoting 25 *Ruling Case Law* 778); Note, *Subject Matter Jurisdiction in Transnational Securities Frauds*, 3 *OHIO N.U.L. REV.* 1305, 1314 (1976) (must look to purpose of the statute). But see also *People ex rel. Fyfe v. Barnett*, 319 Ill. 403, 408-09, 150 N.E. 290, 292 (1926) ("statutes are to be construed as they were intended to be understood when they were passed. Statutes are to be read in the light of attendant conditions and that state of the law existent at the time of their enactment").

⁷³ *Zoelsch*, 824 F.2d at 37 (Wald, C.J., concurring) (rejecting the court's rationale for disregarding the more permissive approaches and labeling their efforts as an attempt to usurp the role of Congress).

A final criticism of the D.C. Circuit's decision is its perpetuation of the foreigner/nonresident-American dichotomy by the imposition of a more exacting requirement on foreign plaintiffs.⁷⁴ This oppressive provision raises constitutional issues, specifically, infringement on equal protection rights.⁷⁵

It is submitted that the adoption of a stricter standard was unnecessary and will diminish the fundamental purpose of the Exchange Act; namely, "to achieve a high standard of business ethics in the securities industry."⁷⁶ Therefore, it would have been preferable for the court to adopt the Eighth Circuit's permissive test⁷⁷ or alternatively to adopt a new three-prong test employing the restrictive and permissive tests coupled with the *Tentative Draft's* proposals to determine whether jurisdiction would be "unreasonable."⁷⁸

AN ALTERNATIVE TEST FOR DETERMINING JURISDICTION

An alternative test initially would determine whether jurisdiction exists under the restrictive test developed in *Leasco Data Processing Equipment Corp. v. Maxwell* and its progeny.⁷⁹ If jurisdiction is established, the court would be required to exercise it.⁸⁰

⁷⁴ See *id.* at 32.

⁷⁵ See U.S. CONST. amend. V. See also Note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553, 569 (1976) ("[t]he Second Circuit's distinction between Americans and foreigners seems . . . unwise as a matter of United States constitutional law"); Comment, *Transnational Securities Fraud*, *supra* note 62, at 133 ("[e]qual protection questions are raised by the imposition on foreigners of more onerous requirements for jurisdiction"); Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PA. L. REV. 1363, 1378 (1973) ("classifications of aliens . . . have been held to be suspect classifications which can only be justified by a showing of a compelling state interest").

⁷⁶ SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963). See also *supra* note 3 (discussion of Exchange Act).

⁷⁷ See *Zoelsch*, 824 F.2d at 33 n.3. The Third Circuit's approach may be an aberration, justified only by the fact that the SEC had brought the action and therefore different standards may be applicable in private actions. See *id.* But see *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017-18 (2d Cir. 1975) (where there is "subject matter jurisdiction over a suit by the SEC to prevent . . . securities frauds . . . there would also seem to be jurisdiction over a suit for damages or rescission by a defrauded foreign individual").

⁷⁸ TENTATIVE DRAFT, *supra* note 61, § 403(2). See also *AVC Nederland B.V. v. Atrium Inv. Partnership*, 740 F.2d 148, 154-55 (2d Cir. 1984) (applied TENTATIVE DRAFT's factors for determining unreasonableness).

⁷⁹ See *supra* notes 31-41 and accompanying text.

⁸⁰ It is submitted that by limiting mandatory jurisdiction to defendants who pass the restrictive test the court will be able to weigh the problem of overburdened courts as a factor in the third prong and thereby allow a court to address the policy which permeated the Second Circuit's decisions.

However, if jurisdiction is not established, the Eighth Circuit's more permissive test⁸¹ would be applied in the second prong. A finding of jurisdiction under this second prong would then require the court to apply the *Tentative Draft's* factors to determine whether the assertion of jurisdiction would be unreasonable under the third prong.⁸² It is suggested that if jurisdiction is not established under the permissive test or the exercise of jurisdiction is unreasonable under the *Tentative Draft's* balancing test, the case should then be dismissed for lack of subject matter jurisdiction. Moreover, making jurisdiction discretionary under the third prong would enable the court to evaluate the burden on the courts and weigh that along with other relevant interests; thereby, addressing the concerns of the Second Circuit, without losing sight of the Exchange Act's underlying purpose.

CONCLUSION

The D.C. Circuit has perpetuated the foreigner/nonresident-American dichotomy by requiring foreigners to satisfy a stricter test to gain access to American forums. By denying access to foreign plaintiffs, the court will, in effect, encourage unscrupulous individuals to use the United States as a base for fraudulent schemes,⁸³ and thereby undermine the purpose of the Exchange Act; namely, "to achieve a high standard of business ethics in the securities industry."⁸⁴ It is urged that under the position adopted by the D.C. Circuit, America will soon become a "Barbary Coast," as it were, harboring international securities 'pirates,'⁸⁵ an outcome not beneficial to American interests and one the other circuits have attempted to prevent.

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⁸¹ See *supra* notes 52-55 and accompanying text.

⁸² See *supra* note 63 (listing of TENTATIVE DRAFT's factors).

⁸³ See, e.g., *F.O.F. Proprietary Funds, Ltd. v. Arthur Young & Co.*, 400 F. Supp. 1219 (S.D.N.Y. 1975) (rejecting subject matter jurisdiction where misleading offering circulars prepared in the United States were used to defraud investors abroad).

⁸⁴ *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963). See *supra* note 3.

⁸⁵ See *SEC v. Kasser*, 548 F.2d 109, 116 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977).