Washington and Lee Law Review

Volume 33 | Issue 2 Article 4

Spring 3-1-1976

Extraterritorial Application Of § 10(B) Of The Securities Exchange Act Of 1934-The Implications Of Bersch V. Drexel Firestone, Inc. And Lit V. Vencap, Ltd.

NOTES & COMMENTS

EXTRATERRITORIAL APPLICATION OF § 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934—THE IMPLICATIONS OF *BERSCH V. DREXEL FIRESTONE, INC.* AND *IIT V. VENCAP, LTD.*

Section 10(b)[1] of the Securities Exchange Act of 1934 and Rule 10b-5,[2] promulgated thereunder, proscribe use of the mails or instrumentalities of commerce in furtherance of any scheme to defraud involving the purchase or sale of a security. The purpose of the Act is to protect domestic securities markets and American investors from fraudulent securities transactions.[3] The extent of protection afforded by § 10(b) to extraterritorial transactions has continuously created difficulties among the courts.

Although a presumption exists that regulatory acts of Congress apply only within the territorial limits of the United States,[4] the

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[1] 15 U.S.C. § 78j(b) (1970). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> (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.

[2] 17 C.F.R. § 240.10b-5 (1975). This rule provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (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.

[3] Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969).

[4] American Banana Co. v. United Fruit Co., 213 U.S. 347, 357 (1909). The Court held that the Sherman Act did not apply when all of the acts committed in furtherance of the conspiracy to restrain trade occurred outside of the territorial limits of the

traditional view is that Congress has the power to impose liability for the extraterritorial conduct of persons subject only to the due process limitations of the fifth amendment.[5] In implementing congressional intent to exercise this power, the courts have been reluctant to impose liability to the greatest possible extent. They have, however, imposed liability when the extraterritorial acts of the defendant were intended to produce a detrimental effect within the United States and when such an effect was the actual result of the prohibited activities.[6] While no language in the Exchange Act expressly indicates an intent to apply the Act extraterritorially,[7] the courts have so applied § 10(b)

United States and were not considered violations of law by the country in which they were committed.

[5] Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1334 (2d Cir. 1972).

[6] *Cf.* Strassheim v. Daily, 221 U.S. 280 (1911). In *Strassheim* Mr. Justice Holmes stated:

> Acts done outside a jurisdiction, but intended to produce and producing detrimental effects within it, justify a State in punishing the cause of the harm as if he [the actor] had been present at the effect . . . .

Id. at 285. For applications of this principle on an international level, *see* Travis v. Anthes Imperial, Ltd., 473 F.2d 515 (8th Cir. 1973); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969); Rivard v. United States, 375 F.2d 882 (5th Cir.), *cert. denied*, 389 U.S. 884 (1967); United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945).

[7] Whether the Exchange Act is to apply extraterritorially is a question of subject matter jurisdiction. However, the only reference in the act to subject matter jurisdiction is § 27, 15 U.S.C. § 78aa (1970), which provides in pertinent part:

> The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

This is the only sentence in § 27 which deals with subject matter jurisdiction. *See* Leasco Data Processing Corp. v. Maxwell, 468 F.2d 1326, 1340 (2d Cir. 1972). Therefore, the extent of the Exchange Act's international applicability remains unclear.

The only express limitation on the extraterritorial application of the Act is contained in § 30(b), 15 U.S.C. § 78dd(b) (1970), which provides:

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

Id. While the SEC has not promulgated any rules under this section, § 30(b) has been literally construed, exempting only those who conduct a business in securities; namely, brokers, dealers and banks. *See* Roth v. Fund of Funds, Ltd., 405 F.2d 421, 422 (2d

of the Act.[8] The extent of this application has been clarified by two recent Second Circuit decisions.

In *Bersch v. Drexel Firestone, Inc.*,[9] plaintiff, a United States citizen and resident, brought a class action on behalf of all American and foreign purchasers of stock of a Canadian financial organization, Investors Overseas, Ltd. (I.O.S.). The complaint alleged that the prospectuses distributed in furtherance of an I.O.S. stock offering were false and misleading in that they omitted certain material facts relevant to I.O.S.'s financial position.[10] The offering involved three separate distributions[11] which were intended solely for the benefit of foreigners. Nevertheless, significant acts in preparation of the allegedly fraudulent prospectuses had taken place within the United States.[12] Moreover, sales were made to Americans despite defendant's attempt to limit sales to foreigners. Therefore, collapse of the I.O.S. offering adversely affected American securities markets.[13] The district court found that the significant acts in preparation of the pros-

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Cir. 1968), *cert. denied*, 394 U.S. 975 (1969); Schoenbaum v. Firstbrook, 405 F.2d 200, 207-8 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969).

[8] *See* text accompanying notes 38-66 *infra*.

[9] 519 F.2d 974 (2d Cir.), *cert. denied*, 44 U.S.L.W. 3341 (U.S. Dec. 9, 1975) (No. 75-596), *rev'g* 389 F. Supp. 446 (S.D.N.Y. 1974).

[10] 389 F. Supp. 446, 449 (S.D.N.Y. 1974). The substance of the complaint was "that the prospectuses pursuant to which the offering was made were false and misleading in that they failed to reveal material facts concerning I.O.S.'s finances, illegal activities, chaotic bookkeeping and mismanagement, and the actual looting and plundering of I.O.S.'s treasury . . . ." *Id.*

[11] *Id.* at 451. The three part distribution of common stock by I.O.S. involved a primary offering of 5,600,000 shares underwritten by six of the defendants, collectively referred to as the Drexel group; a secondary offering underwritten by J. H. Crang & Company; and another secondary offering underwritten by Investors Overseas Bank, Ltd. (I.O.B.), a subsidiary of I.O.S. The accounting firm of Arthur Anderson & Co., along with I.O.S. and Bernard Cornfeld, were also named as defendants. *Id.* at 449. This action arose from the I.O.B. secondary offering. *Id.*

[12] Among the activities within the United States which the district court found were: numerous meetings in New York of the major underwriters in the Drexel Group, their attorneys and accountants and I.O.S. representatives; retention of a New York law firm to represent the underwriters; meetings of the Drexel Group with the SEC; retention by the underwriters of accountants in New York; and parts of the prospectus which were drafted and displayed in New York. 519 F.2d at 985 n.24.

[13] 389 F. Supp. at 458. The district court accepted as evidence of an adverse effect on American securities markets the testimony by affidavit of an economist. This testimony was essentially that the I.O.S. collapse had impaired foreign investor confidence in Ameriran markets resulting in decreased sales of domestic securities abroad, and that this collapse of a mutual fund holding substantial amounts of American securities caused a general depression in American security prices. *Id.*

pectuses which occurred in the United States were an essential element in the fraudulent scheme. Consequently, the court asserted subject matter jurisdiction over the claims of both the foreign and American members of the plaintiff class.[14]

On appeal, the Second Circuit reversed in part, holding that the significant acts in preparation of the prospectuses were not actual fraudulent activities and were therefore insufficient to confer subject matter jurisdiction over the claims of the foreign plaintiffs resident abroad.[15] However, the acts were sufficient to confer subject matter jurisdiction over the claims of American plaintiffs resident abroad because the harm done to these class members would not have occurred but for the activities of the defendants in the United States.[16] Consequently, while significant acts in preparation of the fraud which occurred within this country conferred subject matter jurisdiction over the claims of Americans resident abroad, the same acts were insufficient as to the claims of foreigners so resident.[17]

Moreover, the Second Circuit found subject matter jurisdiction over the claims of the American plaintiffs residing in the United States who had relied on misleading prospectuses mailed into this country by defendants acting abroad.[18] The court, however, stressed that such fraudulent acts committed abroad would not be a basis for subject matter jurisdiction when there is no injury to a purchaser or seller of securities in whom the United States has an interest.[19]

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[14] *Id.*

[15] 519 F.2d at 987. The case was brought before the Court of Appeals pursuant to 28 U.S.C. § 1292(b) (1970) on review of the district court order finding subject matter jurisdiction as to the claims of the entire plaintiff class. *Id.* at 993-95.

[16] *Id.* at 992-93.

[17] The Second Circuit discussed the problems which would result if the foreigners resident abroad were permitted to remain in the class. The choice of law problems would likely have led to the use of the law of several foreign countries. Further, the burden of enforcing the judgments, some of which would not be held binding in foreign countries, along with the problem of managing such a large and diverse class, would have to be taken into account. Moreover, due to the quantity of the harm involved, the court found that it would be an abuse of discretion to treat those predominantly state law claims as pendent. After discussing these problems, the court dismissed the claims of the members of the class who were not American citizens or residents. *Id.* at 993-98.

[18] *Id.* at 991-92.

[19] *Id.* at 989. The courts have continuously required that there be a showing of harm to an American interest before extending liability to persons who, acting abroad, have caused harm within this country. Since Congress intended § 10(b) to apply to protect American securities markets and American investors from fraudulent transactions in securities, these markets and investors are presumably the protected American interests. *Compare* Travis v. Anthes Imperial, Ltd., 473 F.2d 515, 527-28 (8th cir. 1973)

In a companion case, *IIT v. Vencap, Ltd.*,[20] an action was brought under § 10(b) by IIT, a foreign investment trust, and its receivers in liquidation, alleging fraud, conversion and corporate waste.[21] Defendants were Vencap, a Bahamian venture capital enterprise, and Robert Pistell and Walter Blackman, American citizens resident in the Bahamas. Pistell organized Vencap after inducing IIT to invest $3,000,000 in Vencap's preferred stock. The common stockholders, principally Pistell and Blackman, controlled the issuance of Vencap dividends while supplying only a nominal portion of the initial investment.[22] Although Vencap represented itself as a legitimate venture capital concern, Pistell caused a substantial amount of Vencap's capital to be used for his personal benefit.[23] In furtherance of its activities, Vencap maintained offices in New York City to house its records and to initiate, direct, and consummate its business transactions.[24]

Although the Second Circuit noted insufficient findings of fact for a determination of the subject matter jurisdiction issue, it examined two theories upon which subject matter jurisdiction would exist. The first possibility analyzed was a derivative suit by IIT as a shareholder of Vencap charging that Vencap had been fraudulently induced to purchase securities for Pistell's personal benefit. Since a substantial part of Vencap's corporate activities was carried on from its base in New York, the acts constituting fraud under this theory could be considered as having been performed within this country.[25] The second theory involved a claim that Vencap, although representing itself as a legitimate venture capital enterprise, was from its inception a device for enhancing Pistell's private benefit. Under this approach, Vencap's activities in New York might be seen as essential parts of the fraudulent scheme.[26] Thus, if upon remand the district court were to find that the American activities involved in the scheme support

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and Schoenbaum v. Firstbrook, 405 F.2d 200, 206-8 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969), *with* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1333-34 (2d Cir. 1972). However, further extension of the concept of protected American interest never seems to have been considered. *But see* text accompanying notes 94-95 *infra*.

[20] 519 F.2d 1001 (2d Cir. 1975).

[21] *Id.* at 1003.

[22] *Id.* at 1003-8.

[23] *Id.* at 1013.

[24] *Id.* at 1018.

[25] *Id.* at 1013-18.

[26] *Id.* at 1013. The court discussed three other possible theories upon which claims could be based. *Id.* at 1011-18. However, under these theories, the court held that there were insufficient activities within the United States to support subject matter jurisdiction. *Id.* at 1018.

one of these theories, subject matter jurisdiction would exist over the IIT claim.

When applying an act of Congress to transactions with transnational aspects, such as those in *Bersch* and *IIT*, a court must ascertain whether Congress intended the regulatory scheme to apply transnationally.[27] In making this determination, the courts have relied on principles of foreign relations law to infer the extent of the particular statute's application as intended by Congress. These principles establish the limitations imposed by international law on the application of domestic law to extraterritorial activities.[28] Thus, while Congress has the power to impose liability beyond the limitations of Foreign relations law,[29] the courts will not impute such application absent express congressional intent.

In *United States v. Aluminum Co. of America*,[30] the Second Circuit recognized that Congress has the power to attach liability to persons for their conduct outside of the United States. However, the court stated that the crucial issue in cases attaching liability was not power, but the limitations Congress intended to place on the liability once attached.[31] the *Alcoa* court held that the Sherman Act applied extraterritorially where conduct outside the United States was intended to produce, and did in fact produce, detrimental effects within this country.[32] This combination of intent plus detrimental effects is

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[27] The question of whether an act is to apply extraterritorially is deemed one of congressional intent. Foley Bros. v. Filardo, 336 U.S. 281, 285 (1949); Blackmer v. United States, 284 U.S. 421, 437 (1932).

[28] *See* Harvard Research in International Law, *Jurisdiction With Respect to Crime*, 29 AM. J. INT'L L. 435, 443-7 (Supp. 1935); Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 COLUM. L. REV. 94, 95-9 (1969); Note, *The Transnational Reach of Rule 10b-5*, 121 U. PA. L. REV. 1363, 1368-70 (1973).

[29] *See* text accompanying note 5 *supra*.

[30] 148 F.2d 416 (2d Cir. 1945).

[31] With respect to the limitations imposed by the courts in interpreting acts of Congress, the court stated:

> [T]he only question open is whether Congress intended to impose the liability, and whether our own Constitution permitted it to do so: as a court of the United States, we cannot look beyond our own law. Nevertheless, it is quite true that we are not to read general words, such as those in this Act, without regard to the limitations customarily observed by nations upon the exercise of their powers; limitations which generally correspond to those fixed by the "Conflict of Laws." We should not impute to Congress an intent to punish all whom its courts can catch, for conduct which has no consequences within the United States.

Id. at 443.

[32] *Id.*

known as the "objective territorial principle."[33] Under this principle courts will not extend the application of a regulatory staututе to every transaction which has substantial foreign aspects. They will, however, impose liability under this principle when intent and detrimental effects are present.

The first case to consider the extraterritorial application of the securities acts was *Kook v. Crang*.[34] In this case, a suit was instituted under § 7(c) of the Exchange Act by an American stockholder who had purchased securities through a Canadian stockbroker on the Toronto Stock Exchange.[35] The *Kook* court held that the Exchange Act did not apply to transnational transactions in securities unless a "necessary and substantial" act in the fraudulent scheme occurred within the United States.[36] Under this test, the courts examined the

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[33] *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, 372 (1975); Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 COLUM. L. REV. 94, 95-9 (1969). The objective territorial principle is stated in the RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 18 (1965), which provides:

> 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.
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> (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
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> (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.

Id. The courts have relied on § 18 in a number of cases. *See, e.g.*, Travis v. Anthes Imperial, Ltd., 473 F.2d 515, 528 (8th Cir. 1973); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1333-34 (2d Cir. 1972).

[34] 182 F. Supp. 388 (S.D.N.Y. 1960).

[35] *Id.* at 338-89. Plaintiff argued that Crang, the broker, had violated the provisions of § 7(c) of the Exchange Act, 15 U.S.C. § 78g(c) (1970), by extending credit to him at excessive margins. *Id.*

[36] *Id.* at 390-91. Since all the essentials of the transaction occurred in Canada, the court found no necessary and substantial act in the United States and therefore held that subject matter jurisdiction was lacking. *Id.*

The court did find contacts between the defendant and this country which would have been sufficient to fulfill the § 10(b) requirements. However, the court concluded that Congress did not intend the Exchange Act to apply without the jurisdiction of the United States. *Id.* This was based on the court's restrictive reading of § 30(b) to exempt all foreign transactions in securities. Section 30(b) has subsequently been interpreted more strictly. *See* note 7 *supra*. Nevertheless, Crang would have benefitted from the §

acts culminating in the fraud in order to determine whether the acts within this country were essential to the execution of the fraudulent scheme despite the fact that the elements of the fraudulent transactions had substantially taken place without the territorial limits of the United States.[37]

The limitations on extraterritorial application of the Exchange Act imposed under the *Kook* "necessary and substantial" act test were modified with respect to § 10(b) violations in *Schoenbaum v. Firstbrook*.[38] In *Schoenbaum* the Second Circuit held § 10(b) applicable to essentially extraterritorial transactions. An American citizen residing within the United States who was a shareholder of Banff, Ltd., a Canadian corporation, brought a derivative action against Banff's directors and named foreign corporations.[39] The complaint alleged that defendants had conspired to defraud Banff by inducing it to sell its treasury shares at the market price while possessing inside information that enabled the defendants to know that this price did

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30(b) exemption as a broker. *See* Schoenbaum v. Firstbrook, 405 F.2d 200, 208 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969).

[37] In two cases subsequent to *Kook*, a necessary and substantial act within this country was found even though the transactions involved were substantially foreign. In S.E.C. v. Gulf Intercontinental Finance Corp., 223 F. Supp. 987 (S.D. Fla. 1963), jurisdiction was found in a suit by the SEC to enjoin defendant from selling securities in an allegedly fraudulent scheme in violation of § 10(b) and Rule 10b-5. The court found that Canadian newspaper advertisements constituting offers for sale of the securities involved had been distributed within this country, and that the money obtained in exchange for the securities was sent to the defendants in Florida by the use of instrumentalities of commerce. *Id.* at 990-91. Even though the corporate offeror and the sales themselves were located in Canada, the court found that these uses of instrumentalities of commerce and the mails within the United States were a necessary part of the scheme and therefore jurisdiction existed. *Id.* at 994-95.

In the second case, Ferraioli v. Cantor, 259 F. Supp. 842 (S.D.N.Y. 1966), one Canadian corporation sold its controlling interest in an American corporation to a second Canadian corporation at an alleged premium without disclosing the offer to buy to minority shareholders in the United States, in violation of § 10(b) and Rule 10b-5. *Id.* at 845. The actual sales transaction took place entirely within Canada. *Id.* at 845. However, the court found that use of instrumentalities of commerce and the mails was necessary in order to change directors and officers of the American corporation and in relaying control. These activities were necessary and substantial elements of the scheme within the United States and thus subject matter jurisdiction was found. *Id.* at 846.

[38] 405 F.2d 200 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969).

[39] *Id.* at 204. Defendants were Banff, Ltd., and its individual directors; Aquitaine Company of Canada, Ltd., Banff's controlling shareholder; and Paribas Corporation, a New York corporation. The suit was dismissed as to Paribas. *Id.* at 219.

not represent the stock's true value.[40] While the transactions occurred entirely outside the United States, there was sufficient use of the United States mails and instrumentalities of commerce to satisfy the § 10(b) jurisdictional requirements.[41] Furthermore, Banff shares were traded on the American Stock Exchange.[42] The Second Circuit held that on these facts § 10(b) had extraterritorial application.[43] In reaching this conclusion, the court found that Congress intended the Exchange Act to protect domestic investors who purchase securities on American markets and to "protect the domestic securities market from the effects of improper foreign transactions in American securities."[44]

To assure this protection of domestic investors and markets, the court relied on *Alcoa* to establish the applicability of the objective territorial principle when violations of § 10(b) and Rule 10b-5 were alleged in connection with extraterritorial securities transactions.[45] Applying the objective territorial principle to the facts before it, the court in *Schoenbaum* found the detrimental effect to be the decrease in value of Banff stock still held by American investors[46] and inferred the intent because this effect was a reasonably foreseeable result of the acts done in another country.[47] Thus, *Schoenbaum* extended ex-

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[40] 405 F.2d at 204.

[41] *See* note 2 *supra*.

[42] 405 F.2d at 204-6.

[43] *Id.* at 204. The district court granted summary judgment in favor of the defendants, finding insufficient allegations of fraudulent activities to support a § 10(b) violation. Schoenbaum v. Firstbrook, 268 F. Supp. 385, 392-96 (S.D.N.Y. 1967).

[44] 405 F.2d at 206.

[45] 405 F.2d at 208-10. The court stated:

> We 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 stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors.

Id. at 208.

[46] *Id.* The court found that:

> A fraud upon a corporation which has the effect of depriving it of fair compensation for the issuance of its stock would necessarily have the effect of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices bid for the shares on the domestic stock market.

Id.

[47] The intent requirement of the objective territorial principle is similar to that in tort law where a person is presumed to intend the reasonably foreseeable consequences of his acts. *See* RESTATEMENT (SECOND) OF TORTS § 8A (1965); Becker,

traterritorial application of the Exchange Act to transactions fulfilling both the § 10(b) requirements and the intent and detrimental effect requirements of the objective territorial principle.[48]

A new dimension was added to the extraterritorial application of § 10(b) and Rule 10b-5 in *Leasco Data Processing Equipment Corp. v. Maxwell.*[49] Leasco, an American corporation, alleged that defendants had conspired to cause it to buy stock of a British corporation at prices in excess of the stock's value. The sales transactions took place in England and the stock was neither registered with the SEC nor traded on an American exchange.[50] Nevertheless, the Second Circuit held that essential elements of the fraudulent scheme—misrepresentations concerning the value of the stock—occurred within this country. Thus, the district court acquired subject matter jurisdiction based on what is termed the "subjective territorial principle."[51] The finding of subject matter jurisdiction in *Leasco* was based solely on the occurrence within this country of significant conduct essential to the furtherance of the fraudulent scheme.[52] Although the *Leasco* court found that significant conduct within the United States would be a sufficient basis for subject matter jurisdiction, it did not enunciate a test for determining whether

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Extraterritorial Dimensions of the Securities Exchange Act, 2 N.Y.U.J. INT'L L. & POL. 233, 236-37 (1969).

[48] 405 F.2d at 210. While the Second Circuit disagreed with the district court's finding of lack of subject matter jurisdiction, it affirmed the lower court's grant of defendants' motion for summary judgment based on the district court's finding that the complaint had not alleged sufficient facts to show that the corporation had been defrauded. *See* note 42 *supra*. On rehearing, the Second Circuit en banc reversed this finding, holding that the complaint had stated a triable issue under § 10(b) except as to the sale to Paribas. 405 F.2d at 218-19.

[49] 468 F.2d 1326 (2d Cir. 1972).

[50] *Id.* at 1330-33.

[51] *Id.* at 1334-35. The subjective territorial principle is set out in the RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 17 (1965), which states:

> A state has jurisdiction to prescribe a rule of law
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> (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
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> (b) relating to a thing located, or a status or other interest localized, in its territory.

Id. See Mizrack, *Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities and Exchange Act of 1934*, 30 BUS. LAW. 367, 372-84 (1975); Note, 6 VAND. J. TRANSNAT'L L. 687 (1973); Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PA. L. REV. 1363, 1366-68, 1373-78 (1973).

[52] The court stated in dicta that it would have had difficulty in finding jurisdiction on the *Leasco* facts if none of the fraudulent misrepresentations had been made in the United States. 468 F.2d at 1334.

particular activities would constitute such significant conduct.[53]

Schoenbaum and *Leasco* thus established two general principles under which § 10(b) would be applied extraterritorially. The "objective territorial principle" applies when acts occurring without the United States are intended to produce, and do in fact produce, detrimental effects upon a protected interest within this country. This principle allows application of § 10(b) even though the substance of the fraudulent transaction occurs abroad, provided only that the jurisdictional requirements of § 10(b) are fulfilled.[54] On the other hand, the "subjective territorial principle" applies when significant activity essential to the furtherance of the fraudulent scheme occurs within this country. This principle extends the application of § 10(b) to fraudulent transactions when the actual locus of the harm is outside the territorial limits of the United States.

Both the objective and the subjective territorial principles were applied by the Eighth Circuit in *Travis v. Anthes Imperial, Ltd.*[55] Plaintiffs, American citizens resident in the United States, brought an action against Molson, a Canadian corporation, alleging that Molson made a tender offer to Canadian holders of Anthes securities, but did not extend that offer to the American stockholders.[56] While Anthes stock had never been registered with the SEC or listed on an American exchange, the transaction through which the American shareholders originally obtained the Anthes stock had occurred within the United States.[57] Further, several misrepresentations were made through use of the United States mails and instrumentalities of commerce.[58] Plaintiffs alleged that they were induced to retain their shares by these misrepresentations which promised increased

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[53] While the *Leasco* court found that misrepresentations which were an essential part of the fraudulent scheme had occurred within this country) it failed to formulate a test by which future determinations could be made as to which activities would be essential. The activities within the United States which were found to be an "essential link" in inducing Leasco to purchase the Pergamon stock were those that "whetted Leasco's interest." 468 F.2d at 1335. It was therefore not clear how substantial the nexus of contact with persons in the United States must be before it would be considered essential.

[54] *See* note 2 *supra*.

[55] 473 F.2d 515 (8th Cir. 1973). *See* Note, 7 VAND. J. TRANSNAT'L L. 770 (1974).

[56] *Id.* at 518-20. Plaintiffs were Glen. L. Travis and his family, and the St. Louis Union Trust Company, trustee of the Travis family trust. Defendants were Anthes Imperial, Ltd., Molson Industries Limited, and Dominion Securities Limited, the broker handling the tender offer. *Id.*

[57] *Id.*

[58] *Id.* at 523-26. The court enumerated several instances in which Molson operatives contacted plaintiffs by phone or letter or met with them in person. *Id.*

compensation at a later time.[59]

The Eighth Circuit found subject matter jurisdiction. It relied on *Leasco* for the conclusion that the misrepresentations made in inducing the Americans to retain their shares constituted significant conduct within this country.[60] Moreover, the court asserted jurisdiction based on the objective territorial principle because the plaintiffs, a protected American interest within the United States, sustained substantial harm.[61] Since the Anthes stock was not traded on an American exchange, the court's decision extended application of § 10(b) beyond the limits of *Schoenbaum*, where the harm was done to persons owning securities traded on a domestic exchange.[62]

In *Schoenbaum, Leasco*, and *Travis*, the courts based their analysis on the proposition that Congress intended the securities acts to protect American investors and securities markets. In order to assure protection of these interests, these cases established that § 10(b) and Rule 10b-5 were intended to be applied extraterritorially. These courts, in finding subject matter jurisdiction, indicated a trend toward a more expansive extraterritorial application.[63] *Schoenbaum*

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[59] *Id.*

[60] *Id.* at 526. The court made it clear that it was immaterial who initiated the communications which eventually led to the misrepresentations when ascertaining whether these communications represented significant conduct within the United States.

[61] *Id.*

One commentator has argued that the courts should undertake a further analysis in applying § 10(b) extraterritorially. This analysis would require not only a showing of a detrimental effect caused by a foreign activity within this country under the objective principle, or a significant activity within this country under the subjective principle, along with the § 10(b) jurisdictional requirements, but should also apply a balancing test of national interests before extending § 10(b)'s extraterritorial application. Under this test the court would weigh such factors as the nationalities of the parties, the situs of the activities involved, whether a foreign forum is available and what the law of the forum would be. Note, 7 VAND. J. TRANSNAT'L L. 770, 776-79 (1974). These additional factors may take into consideration the class problems recognized by Judge Friendly in *Bersch*. *See* note 19 *supra*.

[62] 405 F.2d at 206.

[63] Subsequent applications of § 10(b) to transnational transactions indicated that the intent of Congress was not to bring *any* fraudulent securities transaction into the jurisdiction of American courts. The courts would not have jurisdiction when:

> (1) the substance of the allegedly fraudulent conduct occurred outside of the United States; (2) the parties are predominantly foreign; (3) the subject shares are securities in a foreign corporation neither registered nor traded on a national securities exchange; and (4) there is no showing of any domestic injury.

Finch v. Marathon Securities Corp., 316 F. Supp. 1345, 1349 (S.D.N.Y. 1970). *See* MANUS v. BANK OF BERMUDA, LTD., [1971-1972 TRANSFER BINDER] CCH FED. SEC. L.

established the existence of subject matter jurisdiction when a fraudulent scheme pursued outside this country produced detrimental harm to purchasers of securities on an American exchange.[64] *Travis* expanded application of the objective principle to a case where no American securities market was involved.[65] Similarly, the *Leasco* court's failure to enunciate a test for a determination of the elements of significant activity[66] supports an inference of a more expansive application of the objective territorial principle. Therefore, while these cases established that § 10(b) applies extraterritorially, they did not foreclose the possibility of a more expansive application when the harm shown within this country is less apparent than in *Schoenbaum* and *Travis* or when the activities within this country are less substantial than in *Leasco*.

The *Bersch* and *IIT* opinions represented a clarification by the Second Circuit of the extent to which § 10(b) applies to transnational transactions. These decisions expanded the extraterritorial application of § 10(b) to cases where the harm within this country was less apparent than in *Schoenbaum* and *Travis* and where the domestic activities were less substantial than in *Leasco*. However, the decisions also restricted extraterritorial application by clarifying the requirements necessary for application of the objective and subjective principles.

The first instance of this dual effect concerned the objective territorial principle. The Second Circuit in *Bersch* concluded that Congress intended § 10(b) to protect Americans resident in the United States against fraud in sales of securities abroad only when the fraudulent acts committed abroad "result in injury to purchasers or sellers of those securities in whom the United States has an interest" and "not where acts simply have an adverse affect on the American economy or American investors generally."[67] Since the court assumed reliance by American residents on the allegedly misleading prospectuses mailed into the United States, it reasoned that there was a direct effect on a protected American interest—those American residents who detrimentally relied on the prospectuses.[68] The allegations

Rep. ¶ 93,299 (S.D.N.Y. 1971); Investment Properties Int'l, Ltd. v. I.O.S., Ltd., [1970-1971 Transfer BINDER § CCH FED. SEC. L. REP ¶ 93,011 (S.D.N.Y. 1971), *modified*, 459 F.2d 705 (2d Cir. 1972); Jones, *An Interest Analysis Approach to Extraterritorial Application of Rule 10b-5*, 52 TEX. L. REV. 983, 993-96 (1974).

[64] 405 F.2d at 206.

[65] 473 F.2d at 518-20.

[66] *See* text accompanying note 53 *supra*.

[67] 519 F.2d at 989.

[68] *Id.* at 991-92.

of harm were less apparent than in *Schoenbaum*[69] because the stock involved in *Bersch* was not traded on an American exchange.[70] Moreover, the extent of the harm alleged in *Bersch* was less clear than that in *Travis* where the diminution in value of plaintiff's stock and the decreased dividends were proven.[71] Therefore, the Second Circuit in *Bersch* established that in order to obtain subject matter jurisdiction under the objective territorial principle, a plaintiff within the United States need only show a direct harm to a protected American interest caused by defendant's foreign activities.[72]

However, the Second Circuit stressed that specifity was required in demonstrating a direct harm, and consequently, refused to apply the objective territorial principle to plaintiffs' allegations of general harm to American economic interests or security prices.[73] While the court agreed that the collapse of I.O.S. had an unfortunate domestic effect, it concluded that such an effect was insufficient as a basis for subject matter jurisdiction.[74] The court further clarified the applicability of the objective principle in *IIT*. There the detrimental effect, although direct upon the IIT fund itself, was indirect upon the fundholders of whom an extremely small percentage were Americans to whom the stock was not intended to be sold. Consequently, subject matter jurisdiction did not exist over these indirect allegations of harm under the objective territorial principle.[75]

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[69] The direct harm in *Schoenbaum* was the reduction of equity of the Banff shareholders caused by the increased number of shares on the market after the sale of the Banff treasury stock. 405 F.2d at 208-9. Since the stock was traded on an American exchange, it was clear that American investors were harmed by the decrease in value of the shares they had purchased.

[70] 519 F.2d at 986.

[71] 473 F.2d at 528. The *Bersch* court emphasized that the plaintiffs would have to prove at trial that they were directly harmed by the activities which took place outside of the United States—the mailing from abroad of the misleading prospectuses. 519 F.2d at 990-94.

[72] 519 F.2d at 993. The court cited *Travis* for the proposition that "the absence of certain of the elements which led to finding subject matter jurisdiction in those cases [*Leasco* and *Schoenbaum*] does not necessarily preclude a similar conclusion on the different facts presented here." 519 F.2d at 986.

[73] 519 F.2d at 987-88.

[74] *Id.* Plaintiffs introduced evidence consisting of an economist's testimony that the collapse of I.O.S. had a general adverse effect in the U.S. *See* note 13 *supra*. The testimony contained an opinion that confidence in American underwriters had decreased, that foreign investors had reduced their purchases of securities on United States markets due to this loss of confidence, and that these decreased purchases had an adverse effect on American securities markets.

[75] 519 F.2d at 1016-17. The court found that since a maximum of a .5% interest in the total IIT fund was held by Americans, there was not the "substantial" effect

The synthesis of the *Bersch* and *IIT* opinions illuminates the application of the objective territorial principle. Although the elements of intent and detrimental effect remain intact, the detrimental effect must now be direct upon a protected American interest.[76] Thus, generalized forms of harm are no longer acceptable in a determination of the detrimental effect requirement under the objective principle. This approach is consistent with the rationale used to justify extraterritorial application of the Exchange Act.[77] American investors are protected from extraterritorial frauds, but only upon a significant showing of direct harm to a protected American interest.[78] Therefore, under the objective territorial principle, protection of American interests within this country is assured regardless of the situs of the fraudulent activities when the harm is direct.

The second exemplification of this expansive and yet restrictive effect upon extraterritorial application of § 10(b) regards use of the subjective territorial principle. In *Bersch*, the Second Circuit asserted subject matter jurisdiction over the claims of Americans resident abroad based on what it considered "significant" activities within the United States.[79] The court reasoned that while the actitivities in the

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within this country denoted by the RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 18(b) (ii) (1965). *See* Note 3 *supra*.

[76] The court in both *Bersch* and *IIT* relied on § 18 of the RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES. *See* note 33 *supra*. In *Bersch* there was harm caused to the American plaintiffs which fulfilled the substantial effect and forseeability requirements of § 18(b)(ii). 519 F.2d 991-92. In *IIT* the court made it clear that it would not extend jurisdiction if these requirements were not fulfilled. *See* 519 F.2d at 1017 and note 75 *supra*.

[77] This rationale is that Congress intended to apply the Exchange Act "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." Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969).

[78] 519 F.2d at 989-91. The *Bersch* court stated:

> This means to us that there is subject matter jurisdiction of fraudulent acts relating to securities which are committed abroad only when these result in injury to purchasers or sellers of those securities in whom the United States has an interest, not where acts simply have an adverse affect on the American economy or American investors generally. [footnotes omitted].

Id. at 989. When coupled with the court's requirement of a showing of direct harm to invoke use of the objective principle, *id.* at 991, this statement seems to indicate that a protected American interest is a purchaser or seller of securities directly injured while in the United States as a result of fraudulent activities which occur abroad. *See* note 19 *supra*.

[79] 519 F.2d at 992.

United States were merely preparatory, the sales to Americans abroad in the I.O.B. offering would not have occurred absent significant domestic acts in preparation of the primary offering.[80]

Bersch, therefore, was the first case to uphold subject matter jurisdiction over the claims of Americans when the activities in the United States forming the basis of jurisdiction under the subjective territorial principle were less than essential elements of the fraudulent scheme. *Leasco*, in establishing the applicability of the subjective principle, required significant activities essential to the fraudulent scheme before subject matter jurisdiction would arise.[81] Both *Leasco* and *Travis* involved substantial misrepresentations made within this country directly to the person asserting injury.[82] The *Bersch* court, however, upheld subject matter jurisdiction when the domestic activities merely involved the preparation of the false statements constituting the misrepresentations, which were eventually distributed from abroad.[83]

Conversely, the activities in *Bersch* were insufficient to confer jurisdiction over the claims of foreign plaintiffs.[84] But in *IIT*, under the two theories upon which the court could find jurisdiction given the appropriate facts, "significant" activities would have been sufficient for foreigners' claims if these activities constituted the actual fraudulent acts.[85] The *IIT* holding surpassed *Leasco* and *Travis* because it permitted, for the first time, use of the subjective principle to protect the interests of foreigners resident abroad.[86]

Thus, the *IIT* and *Bersch* opinions have expanded the concept of

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[80] 519 F.2d at 992-93. There would, of course, be no activities within the United States upon which the subjective principle could be applied had the activities in preparation of the prospectuses for the primary offering taken place without the United States.

[81] 468 F.2d at 1334-35.

[82] *See* Travis v. Anthes Imperial, Ltd., 473 F.2d 515, 523-26 (8th Cir. 1973); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1334-35 (2d Cir. 1972).

[83] 519 F.2d at 992-93.

[84] *Id.*

[85] IIT v. Vencap, Ltd., 519 F.2d 1001, 1017-18 (2d Cir. 1975). The test used in *IIT* to assert jurisdiction over the claims of foreigners resident abroad is arguably no different than that applied by the Second Circuit in *Leasco*. The *Leasco* test requires a domestic act which is essential to the furtherance of the fraudulent scheme. 468 F.2d at 1334-35. The *IIT* test requires an actual fraudulent act. 519 F.2d at 1017-18. Since any activity which is essential to a fraud is an "inner or constituent character" of that fraud, it is a part of a fraudulent activity and the tests should be equivalent. *See* WEBSTER'S NEW INTERNATIONAL DICTIONARY 874 (2d ed. 1957).

[86] Such an application, however, is inconsistent with the basis of the subjective principle in International Law. *See generally* Harvard Research in International Law, *Jurisdiction With Respect to Crime*, 29 AM. J. INT'L L. 435, 484-87 (Supp. 1935).

extraterritoriality under the securities acts in two significant ways. First, subject matter jurisdiction under § 10(b) exists over the claims of Americans resident abroad when the domestic activities involved are less than essential to the perpetration of the fraudulent scheme.[87] Second, § 10(b) will be applied under certain circumstances to protect the interests of foreigners when their injuries occur outside the United States.[88]

The restrictive aspect of these two cases is essentially an application of a different standard of analysis to foreigners than to Americans under the subjective territorial principle. Subject matter jurisdiction over claims of foreigners resident abroad requires actual fraudulent acts within this country and not a mere series of acts, however numerous, in preparation of the fraudulent scheme.[89] Therefore, the amount of fraudulent activity on the part of defendants which occurs in the United States is not the important factor. Rather, to invoke subject matter jurisdiction under a § 10(b) claim, a foreigner must show that the fraud which caused him harm emanated from the United States.

Leasco and *Schoenbaum*, in establishing that Congress intended § 10(b) to apply extraterritorially, reasoned that Congress passed the securities acts to protect American investors and American securities markets.[90] In *IIT* the securities were not traded on American markets and the plaintiffs were predominantly foreigners. The Second Circuit, however, held that Congress intended to protect foreigners from the effects of frauds exported from this country.[91] The *Bersch* approach provides protection for Americans resident abroad by requiring a showing of activities in preparation of the fraud which are less than essential to the furtherance of the fraudulent scheme.[92] This expansion of jurisdiction may be justified as necessary to protect an American interest—those Americans harmed by the fraudulent

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[87] *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 992 (2d Cir.), *cert. denied*, 44 U.S.L.W. 3341 (U.S. Dec. 9, 1975) (No. 75-596); text accompanying note 81 *supra*.

[88] *See* IIT v. Vencap, Ltd., 519 F.2d 1001, 1017-18 (2d Cir. 1975); text accompanying note 86 *supra*.

[89] *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 987 (2d Cir.), *cert. denied*, 44 U.S.L.W. 3341 (U.S. Dec. 9, 1975) (No. 75-596); IIT v. Vencap, Ltd., 519 F.2d 1001, 1018 (2d Cir. 1975).

[90] Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1334-36 (2d Cir. 1972); Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir.), *partially rev'd on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906 (1969). *See* text accompanying notes 44, 52-53 *supra*.

[91] 519 F.2d at 1017-18.

[92] 519 F.2d at 992-93.

scheme. Concurrently, the *IIT* court has expanded the concept of a protected American interest beyond that of *Schoenbaum* and *Leasco* in that the protected interest in *IIT* was not an American investor or securities market, but a foreigner harmed by a fraud exported from this country. Although this expansive application of the subjective territorial principle is arguably not justified as necessary to protect an American investor or securities market, it does inhibit the manufacture and exportation of fraudulent schemes from this country.[93]

Thus, the implications of *Bersch* and *IIT* are that Americans will be protected while in the United States through application of the objective territorial principle when there is activity intending to produce and producing harmful effects within this country which are direct and not miniscule. Further, Americans are protected while resident in foreign countries if there is an amount of activity here in connection with the fraudulent scheme which is significant in preparation or furtherance of the actual fraud. Finally, foreigners are protected while resident in their own countries, but only if they are harmed by a fraudulent activity in the United States which is an actual part of the fraud.[92]

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[93] 519 F.2d at 1017.

[94] The holdings as to subject matter jurisdiction in *Bersch* and *IIT* are also applicable to the extension of personal jurisdiction. *Leasco* held that Congress intended § 27 of the Exchange Act to extend personal jurisdiction to the full extent permitted by the due process clause. 468 F.2d at 1339. Thus, personal jurisdiction can be had whenever the defendants satisfy the requirements of "minimum contacts." *See* Hanson v. Denckla, 357 U. S. 235 (1958); McGee v. International Life Ins. Co., 355 U.S. 220 (1957); International Shoe Co. v. Washington, 326 U.S. 310 (1945).

When applying the Exchange Act extraterritorially by use of the subjective territorial principle, there will necessarily be minimum contacts with the United States as a basis for both subject matter and personal jurisdiction. The conduct within the United States which is deemed significant to allow a finding of subject matter jurisdiction would satisfy the minimum contacts test for personal jurisdiction. Similarly, when subject matter jurisdiction is based on use of the objective territorial principle, personal jurisdiction can be found on the same theory. The *Leasco* court set the minimum requirements of extending jurisdiction over the person as those set out in § 18 of the RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES (1965). 468 F.2d at 1341. Thus, it appears that the same conduct which will allow for an extension of subject matter jurisdiction will permit a finding of personal jurisdiction.