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SECURITIES REGULATION—EXTRATERRITORIAL APPLICATION OF SECTION 10(B) AND RULE 10B-5 —RELIEF AVAILABLE FOR FOREIGN INDIVIDUALS WHERE FRAUDULENT ACTS PERPETRATED IN THE UNITED STATES

In *International Investment Trust v. Vencap, Ltd.*,[1] the United States Court of Appeals for the Second Circuit held that federal courts have subject matter jurisdiction over a suit brought by a defrauded foreign individual under federal securities laws where fraudulent acts are perpetrated in the United States.[2]

The case arose out of the activities of Richard Pistell, a United States citizen residing in the Bahamas, who organized a venture capital firm, Vencap, under the laws of the Bahamas. Shortly thereafter, Pistell met with the president of International Capital Investments, Ltd.,[3] the corporation responsible for managing International Investment Trust (I.I.T.).[4] An agreement was reached by which I.I.T. would make a substantial investment in Vencap. Consequently, a memorandum was drafted by I.I.T.'s New York attorneys for the corporation's subscription to a number of shares of Vencap preferred stock.[5] After Vencap obtained I.I.T.'s money, it used a New York office as its base, from which numerous transactions and communications emanated. All the corporation's transactional records were also maintained there. Within the next four months, Pistell caused Vencap to initiate a series of transactions which resulted in funneling substantial amounts of Vencap funds into his own hands. Several months later, after it went into liquidation in Luxembourg, I.I.T. brought this action against Vencap, Pistell, and two corporations in which it held an investment interest, charging fraud, conversion, and corporate waste. The United States District Court for the Southern District of New York[6] concluded that it did have subject matter jurisdiction, and granted a prelimi-

1. 519 F.2d 1001 (2d Cir. 1975).

2. As the court noted, this ruling was limited to the perpetration of fraudulent acts themselves and did not extend to mere preparatory activities or the failure to prevent fraudulent acts where the bulk of the activity was performed in foreign countries. . . . Admittedly the distinction is a fine one. But the position we are taking here itself extends the application of the securities laws to transnational transactions beyond prior decisions and the line has to be drawn somewhere. . . . *Id.* at 1018.

3. International Capital Investments, Ltd. was an English corporation which had overall responsibility for managing various Investors' Overseas Services mutual funds. *Id.* at 1004.

4. I.I.T. was an international investment trust organized under the laws of Luxembourg, and was a division of Investors' Overseas Services mutual funds. *Id.* at 1003.

5. The record was unclear as to whether the specific terms and conditions of the preference stock were formulated and negotiated in New York or in the Bahamas. *Id.* at 1016, n.7.

6. The opinion of the district court is unreported.

nary injunction enjoining the defendants from exercising any control over the assets of I.I.T. or the defendant corporations. Contending that the court lacked subject matter jurisdiction, defendants appealed to the Second Circuit Court of Appeals.[7]

The extent to which the provisions of the Securities Exchange Act of 1934[8] may be applied extraterritorially[9] has only recently become a matter of concern for the federal courts. In *Kook v. Crang*,[10] the first case to consider extraterritorial application of the Exchange Act, the court held that there must be "some necessary and substantial act within the United States" before a federal court may assume subject matter jurisdiction under the Exchange Act.[11] This holding was based primarily on the strong general presumption that regulatory legislation is not to be applied beyond the territorial limits of the United States in the absence of express congressional intent to the contrary.[12] The jurisdictional language of the Exchange Act itself is, unfortunately, unclear and readily susceptible to contradictory judicial interpretations.[13] Consequently, many courts have allowed the

7. The Second Circuit was unable to determine from the record whether the abundant American activity was sufficiently culpable to fall within the anti-fraud provisions of the Securities Exchange Act of 1934. 15 U.S.C.A. §78 *et seq.* (Rev. 1971). For this reason, the court exercised its power under 28 U.S.C.A. §2106 (Rev. 1959) and retained jurisdiction over the appeal pending further findings "as to the wickedness of particular transactions and as to whether they were engineered from the United States." 519 F.2d at 1018.

8. 15 U.S.C.A. §78 *et seq.* (Rev. 1971).

9. As used here, "extraterritorial application" means application of the Act to persons or events linked with other countries as well as with the United States. *See* H. STEINER AND D. VAGTS, TRANSNATIONAL LEGAL PROBLEMS 828 (2d ed. 1968).

10. 182 F. Supp. 388 (S.D.N.Y. 1960). *Kook* involved section 7(c) of the Securities Exchange Act of 1934 dealing with margin requirements for the extension of credit to purchases of securities.

11. This same test was applied six years later in Ferraioli v. Cantor, 259 F. Supp. 842 (S.D.N.Y. 1966).

12. In American Banana Co. v. United Fruit Co., 213 U.S. 347, 29 S. Ct. 511, 53 L.Ed. 826 (1909), the United States Supreme Court first announced that Congress did not intend for a statute to apply to transactions with foreign elements such as citizenship of the parties or locus of the significant events. *See also* Blackmer v. United States, 384 U.S. 421, 52 S.Ct. 252, 76 L.Ed. 375 (1932). However, this extreme position was somewhat mollified in later cases. *See, e.g.*, Foley Bros. v. Filardo, 336 U.S. 281, 69 S.Ct. 575, 93 L.Ed. 680 (1949).

13. Section 30(b) of the Securities Exchange Act of 1934 provides an exemption for anyone "insofar as he transacts a business in securities *without the jurisdiction of the United States*. . . ." 15 U.S. C.A. §78dd(b) (Rev. 1971) (emphasis added). Consequently, the extent to which the Act should be applied extraterritorially is not clearly indicated. The exemption has almost uniformly been interpreted narrowly by the courts, *i.e.*, "without the jurisdiction" has been interpreted in a strict territorial fashion. *See, e.g.*, SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973); Roth v. Fund of Funds, Ltd., 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975, 89 S.Ct. 1469, 23 L.Ed.2d 459 (1969). However, many commentators maintain that the section should be read in flexible terms, taking into account a conflict of laws analysis. *See, e.g.*, Goldman and Magrino, *Some Foreign Aspects of Securities Regulation: Towards a Reevaluation of Section 30(b) of the Securities Exchange Act of 1934*, 55 U. VA. L. REV. 1015 (1969).

presumption against extraterritorial application to erode[14] as international principles of jurisdiction have become more clearly formulated.[15]

In resolving the issue of the spatial reach of federal securities legislation, the courts have placed increasing reliance on the territorial principle of jurisdiction, which has been further refined into the subjective territorial principle[16] and the objective territorial principle.[17] Basically, the subjective territorial principle allows a state to assert jurisdiction over conduct within

14. In Foley Bros., Inc. v. Filardo, 336 U.S. 281, 69 S.Ct. 575, 93 L.Ed. 680 (1949), the United States Supreme Court indicated that the judiciary's most important task in determining whether the overall statutory purposes would be served by assuming jurisdiction, should be to carry out an open and frank consideration of the policies, administrative burdens, and economic problems involved in extraterritorial enforcement. *See also* R. Mizrack, *Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities Exchange Act of 1934*, 30 BUS. LAW. 367 (1975).

15. The five fundamental principles of international jurisdiction, in generally declining order of acceptance and importance are:

> [F]irst, the territorial principle, determining jurisdiction by reference to the place where the offence is committed; second, the nationality principle, determining jurisdiction by reference to the nationality or national character of the person committing the offence; third, the protective principle, determining jurisdiction by reference to the national interest injured by the offence; fourth, the universality principle, determining jurisdiction by reference to the custody of the person committing the offence; and fifth, the passive personality principle, determining jurisdiction by reference to the nationality or national character of the person injured by the offence. *Harvard Research in International Law, Introductory Comment, Jurisdiction With Respect to Crime*, 29 AM. J. INT'L L. 443 (Supp. 1935).

16. The subjective territorial principle of jurisdiction is embodied in the RESTATEMENT OF FOREIGN RELATIONS LAW OF THE UNITED STATES (SECOND) §17 (1965):

> 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.

See also Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972).

17. The objective territorial principle of jurisdiction is expressed in the RESTATEMENT OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES (SECOND) §18 (1965):

> 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.

See, e.g., Strassheim v. Daily, 221 U.S. 280, 31 S.Ct. 558, 55 L.Ed. 735 (1911). *See also* Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PA. L. REV. 1363 (1973).

its territory even though the effects of the conduct are only felt outside the territory. On the other hand, the objective territorial principle allows a state to assert jurisdiction over conduct occurring outside its territory that was both intended to, and did, produce effects within the territory.

The most assertive interpretation of the objective territorial principle in the area of securities regulation was introduced in *Schoenbaum v. Firstbrook*,[18] a landmark decision which began the expansion of the coverage of the Exchange Act to transactions conducted outside the United States. *Schoenbaum* was a derivative action brought by an American shareholder of a Canadian corporation registered on an American exchange. All the fraudulent acts complained of occurred outside the United States. Nevertheless, the Second Circuit upheld subject matter jurisdiction and applied the anti-fraud provisions of section 10(b) of the Securities Exchange Act[19] and rule 10b-5[20] promulgated thereunder. Relying on the objective territorial principle, the court assumed that the fraudulent activity outside the United States had a sufficient detrimental effect upon the interests of American investors to permit the assertion of subject matter jurisdiction.[21]

After *Schoenbaum* it was thought that the Exchange Act would be given

18. 405 F.2d 200 (2d Cir.), *partially rev'd. on rehearing*, 405 F.2d 215 (1968), *cert. denied*, 395 U.S. 906, 89 S.Ct. 1747, 23 L.Ed.2d 219 (1969).

19. Section 10 of the Securities Exchange Act of 1934 reads in part:

> 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. 15 U.S.C.A. §78j(b) (Rev. 1971).

20. 17 C.F.R. §240.10b-5 (1972). This rule was promulgated by the Securities and Exchange Commission pursuant to its authority under the Securities Exchange Act of 1934, and reads as follows:

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

21. The court found that the transaction in Canada could have a "significant impact" on the American securities markets and thought that the illegal Canadian transaction would reduce publicly held equity in the company and could influence the market of the corporation's stock to the detriment of American investors. 405 F.2d at 208.

extraterritorial effect in only two situations: (a) when a domestic purchaser buys foreign securities on an American exchange; and (b) when an improper foreign transaction in American securities affects the domestic securities market.[22] However, in *Leasco Data Processing Equip. Corp. v. Maxwell*,[23] the Second Circuit expanded the *Schoenbaum* limitations and applied rule 10b-5[24] to a situation in which an American investor was injured by fraudulent foreign transactions in securities which were neither registered nor listed on an American exchange. While the *Leasco* court reiterated the *Schoenbaum* concern for protection of American investors, it simultaneously repudiated the objective territorial principle[25] as a basis for jurisdiction.[26] Instead, the court defined its extraterritorial jurisdiction using the subjective territorial principle,[27] which requires that some fraudulent conduct take place within the United States before federal regulatory legislation may be applied.[28] *Leasco* thereby served to limit *Schoenbaum* in part by the "conduct" requirement.[29] At the same time, however, *Leasco* extended *Schoenbaum* so that the anti-fraud provisions of the Exchange Act could be given extraterritorial application even when the transaction involved securities neither registered nor listed on an American exchange.[30]

The Second Circuit's philosophy in both *Leasco* and *Schoenbaum* was that Congress intended for the Exchange Act to protect the interests of American investors. Neither case considered whether federal securities

22. *See* Note, *Securities Law—Extraterritorial Application—The Security Exchange Act of 1934 Applies to Foreign Sales of Foreign Securities to American Investors When Fraudulent Acts Connected With the Sales Take Place Within the United States*, 8 TEX. INT'L L. J. 430 (1973).

23. 468 F.2d 1326.

24. 17 C.F.R. §240.10b-5 (1972).

25. RESTATEMENT OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES (SECOND) §18 (1965).

26. 468 F.2d at 1333.

27. RESTATEMENT OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES (SECOND) §17 (1965).

28. 468 F.2d at 1334.

29. While *Leasco* decidedly set out a requirement of some conduct within the United States, the amount and type of conduct required immediately became the subject of judicial consternation due to the far-reaching dicta in the decision. The court could "see no reason why, for purposes of jurisdiction to impose a rule, making telephone calls and sending mail to the United States should not be deemed to constitute conduct within it." *Id.* at 1335. Did this mean that mere use of the mails or interstate commerce facilities was a sufficient basis for extraterritorial application of the securities laws? *See* Note, *Extra-territorial Application of Section 10(b) and Rule 10b-5*, 34 OHIO ST. L. J. 342 (1973). *See also* Travis v. Anthes Imperial, Ltd., 473 F.2d 515 (8th Cir. 1973), in which the Eighth Circuit upheld subject matter jurisdiction on the basis of the use of interstate commerce facilities. However, the Ninth Circuit in SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973), specifically declined to rule on the questionof whether the mere use of interstate commerce facilities would permit assertion of subject matter jurisdiction.

30. 468 F.2d at 1336.

laws provided relief for a *foreign* investor injured by a transaction in foreign securities not registered on an American exchange; however, this was precisely the issue facing the Second Circuit in *Vencap*.[31]

The district court in *Vencap*[32] had set forth three alternative bases on which subject matter jurisdiction might be founded: first, that one defendant, Pistell, who owned and controlled the other defendants, was a United States citizen;[33] second, that I.I.T. had three hundred fundholders who were United States citizens and residents;[34] and third, that much of the allegedly fraudulent conduct occurred in the United States.[35] The Second Circuit summarily rejected the district court's first two alternatives. The court simply decided that Pistell's United States citizenship alone would not be a sufficient ground on which to impose subject matter jurisdiction.[36] As to the finding that three hundred United States citizens and residents were fundholders of I.I.T., the *Vencap* court placed significant weight on the fact that "the fraud was practiced not on individual Americans who purchased securities but on the trust in which they had invested."[37] This distinction, along with the fact that I.I.T. stock apparently was not intended to be offered to American citizens or residents,[38] constituted, in the Second Circuit's opinion, sufficient reason to decline jurisdiction in the absence of other grounds.

However, turning to the third ground posited by the trial court, the existence of significant fraudulent activity within the United States, the *Vencap* court noted, "[w]e do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners."[39] The *Vencap* court was particularly influenced by a Ninth Circuit case, *SEC v. United Financial Group, Inc.*,[40] which had recently allowed the Securities Exchange Commission to maintain a suit to prevent the concoction in the United States of securities frauds for export. Consequently, the Second Circuit was of the opinion that there would likewise seem to be jurisdiction

31. 519 F.2d at 1001.

32. The opinion of the district court was not reported.

33. 519 F.2d at 1016.

34. The district judge found that approximately three hundred United States citizens and residents who were fundholders of I.I.T. constituted only 0.2% of the total number of fundholders. For the sake of argument, the Second Circuit assumed that these three hundred domestic fundholders represented only about 0.5% of the total investment in I.I.T. *Id.*

35. *Id.* at 1017.

36. According to the court, "[a]lthough the United States has power to prescribe the conduct of its nationals everywhere in the world, . . . Congress does not often do so and courts are forced to interpret the statute at issue in the particular case." *Id.* at 1016.

37. *Id.*

38. *Id.* at 1017.

39. *Id.*

40. 474 F.2d 354 (9th Cir. 1973).

over such a suit by a defrauded foreign individual where fraudulent acts themselves are perpetrated in the United States.[41]

Vencap clearly left the presumption against extraterritorial application of regulatory legislation little, if any, remaining vitality with respect to section 10(b) and rule 10b-5. The Second Circuit seems to have premised its holding solely on its determination that Congress intended to protect the integrity and reputation of the United States in securities dealings around the world.[42] Apparently, the Second Circuit no longer holds to the philosophy that Congress enacted the anti-fraud provisions of the Securities Exchange Act primarily to protect American investors. Instead, the court has broadly interpreted the Exchange Act as providing protection for any investor injured in securities transactions anywhere in the world when the requisite fraudulent activity has taken place within the territorial boundaries of the United States. However, the Second Circuit was somewhat misleading in citing *United Financial* to support its conclusion that some significant U.S. activity alone would be sufficient for assertion of jurisdiction. In *United Financial*, the Ninth Circuit flatly stated that "focus should be upon appellants' activities within the United States *and the impact of these activities upon American investors.*"[43] Obviously, it would have been a simple matter for the *Vencap* court to have concluded that the significant activity within the United States, coupled with the detrimental impact upon three hundred American investors, brought *Vencap* directly in line with *United Financial*. Nevertheless, the Second Circuit ignored the detrimental impact upon American investors altogether, wholly reinterpreting congressional intent in order to further expand application of the Securities Exchange Act to transnational transactions.

While this altruistic move by the Second Circuit will likely be met with commendation by some, it is perplexing that such a decision has come at a time when the workload of the federal court system is, we are told, overpowering.[44] Depending upon how inclusive the definition of "fraudulent acts" will become, the Second Circuit may have let itself in for more than it bargained for.

At least one other potential drawback remains: the decision may also create international ill will. Effectuation of American securities policies may well serve to frustrate securities laws of other countries; yet the court neglected to even mention the transnational consequences of its decision.

41. 519 F.2d at 1018. *See also* note 2, *supra*.

42. In support of this proposition, the court stated: "This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States." *Id.* at 1017.

43. 474 F.2d at 356 (emphasis added).

44. *See* Chanin, *A Survey of the Writing and Publication of Opinions in Federal and State Appellate Courts*, 67 LAW LIB. J. 362 (1974).

The realization that Vencap could be saddled with conflicting duties and liabilities, to the extent that Bahamian law might differ from American securities law, strikes a conscientious chord of unfairness.[45] The solution to such situations likely will come in the form of multilateral treaties between nations. Meanwhile, the better approach may be that jurisdiction should be declined when the transaction involved has little or no impact upon American investors.[46]

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45. For a superficial exposure to the conflicts of laws problems inherent in transnational regulation of economic activity, see N. LEECH, *et al.*, THE INTERNATIONAL LEGAL SYSTEM 480 (2d ed. 1973).

46. One commentator has suggested five factors that should first be considered before applying regulatory legislation extraterritorially: (1) the importance to the forum state of a particular regulatory policy; (2) the policy and law of other jurisdictions; (3) the relative importance to other jurisdictions of the regulatory scheme; (4) the degree to which parts of transactions are related to various jurisdictions; and (5) the weights to be given these factors. Trautman, *The Role of Conflicts Thinking in Defining the International Reach of American Regulatory Legislation*, 22 OHIO ST. L. J. 586, 611 (1961).