



STATE TEACHERS
RETIREMENT SYSTEM
OF OHIO



February 18, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Release No. 34-63174; File No. 4-617; Study on Extraterritorial Private Rights of Action

Dear Ms. Murphy:

The undersigned are five U.S. public pension funds: Ohio Public Employees Retirement System (“OPERS”), State Teachers Retirement System of Ohio (“STRS”), Ohio Police and Fire (“OPF”), School Employees Retirement System of Ohio (“SERS”) and Ohio Highway Patrol Retirement System (“HPRS”) (collectively, the “Ohio Funds”). OPERS manages an investment portfolio valued at \$75.7 billion on behalf of 954,000 members; STRS manages \$64 billion for 470,000 members; OPF manages \$11.9 billion for 54,244 members; SERS manages \$9.8 billion for 192,142 members; and HPRS manages \$730 million for 2,920 members. In the aggregate, the Ohio Funds manage assets of \$162 billion on behalf of more than 1.67 million members.

The Ohio Funds join with many other public pension funds and stakeholders to submit the following comments in response to Release No. 34-63174 of the Securities and Exchange Commission (“SEC” or “the “Commission”), which seeks comments regarding the impact of and changes to the U.S. securities laws that may be required as a result of the decision of the United States Supreme Court in *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010) (“*Morrison*”). We request that the SEC make a finding that Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”), 15 U.S.C. § 78j(b), and the rules and regulations promulgated thereunder, including SEC Rule 10b-5, 17 C.F.R. § 240.10b-5

("Rule 10b-5"), and other provisions of the Exchange Act, should be applicable to all purchases and sales of securities by financial institutions located in the United States and individuals or entities who are resident in the U.S. (collectively "U.S. Investors") and that, accordingly, the Commission recommend to the U.S. Congress that the Exchange Act be so amended.

This would effectively re-establish the long-standing and easy to apply pre-*Morrison* interpretation of the Exchange Act under which U.S. Investors were afforded the protection of the laws of the United States in connection with their purchases and sales of securities. Because all that is being requested is the application of U.S. laws to protect U.S. Investors, no unique international comity or economic cost-benefit concerns apply. If Congress fails to re-establish the pre-*Morrison* protection for U.S. investors, the Ohio Funds, and other institutional investors who purchase substantial amounts of international equities in order to properly diversify their portfolios, will have no practical means to seek recovery for significant losses due to fraud related to securities purchased on non-U.S. exchanges.

I. THE DECISION IN *MORRISON* HAS NEGATIVELY IMPACTED U.S. INVESTORS

The question before the Supreme Court in *Morrison* was whether, under the particular facts before it, foreign investors who purchased securities of a foreign company on a foreign exchange could pursue claims under the anti-fraud provisions of the Exchange Act. The Court noted that unless there is the "affirmative intention of the Congress clearly expressed" to give a statute extraterritorial effect, "we must presume it is **primarily concerned with domestic conditions.**" *Morrison*, 300 S. Ct. at 2877-78 (emphasis added). The Court then examined the language and history of Section 10(b) of the Exchange Act and concluded that it should not be applied extraterritorially. *Id.* at 2881-83. The Court held that "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States." *Id.* at 2888.

Morrison and its recent progeny increasingly are making it clear that the antifraud protections of the Exchange Act will not be extended to those U.S. Investors who purchase securities listed on non-U.S. exchanges, regardless of the extent of fraudulent conduct in which foreign companies engage on our nation's shores, or the effect of such conduct in the United States or on U.S. citizens. This would mean that all of the many companies whose shares are listed on foreign exchanges - including such household names as BP, Toyota, Sony, Hitachi, Samsung, Nokia, DaimlerChrysler, and ING Group - can market those shares to American investors, can obtain a significant portion of their market capitalization from American investors, can file their financial statements with the Commission, *and can even engage in fraudulent conduct on U.S. soil*, yet cannot be held liable under U.S. law to the victims of their fraud. This situation is inconsistent with the law prior to *Morrison* and, for the reasons noted below, should be reversed.

II. AFFORDING U.S. INVESTORS THE PROTECTION OF THE U.S. SECURITIES LAWS FURTHERS THE SEC'S MISSION¹

A. THE SEC'S MISSION OF PROTECTING INVESTORS IS ESSENTIAL TO PROMOTING THE EFFICIENT FUNCTIONING OF CAPITAL MARKETS

The primary purpose of the Exchange Act is protecting the “the interests of investors.” *See Morrison*, 130 S. Ct. at 2894 (“it is the ‘public interest’ and ‘the interests of investors’ that are the objects of the statute’s solicitude”) (Stevens, J., concurring). The SEC specifically recognizes this paramount aspect of its mandate, stating on its website that its mission “is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” This tripartite mission is complementary, *i.e.*, it is recognized that increased investor protection necessarily enhances efficient markets and capital formation. *See* Mary Schapiro, Testimony before the House Financial Services Subcommittee (March 11, 2009) (“we must have a renewed commitment to protecting investors, as it is investors who provide the capital used to fund the productive enterprises that create jobs and wealth. While we have a tripartite mission at the SEC, investor protection is an essential piece from which our other responsibilities flow.”).

The protection of investors provides substantial benefits to society at large by enhancing capital market efficiency. For example, David Ruder, former SEC chairman from 1987 to 1989 wrote a paper in 2005 discussing the interplay of investor protection and capital formation:

The federal securities statutes emphasize the need for corporate and market honesty and integrity as a means of protecting investors. They mandate adequate disclosure of information, prohibit dishonesty and fraud in the sale and purchase of securities, and require brokers, dealers, investment advisers and other market professionals to act in the best interests of investors.

Although the primary objective of requiring honesty is to protect investors, honesty also improves market efficiency. Honest markets will be more liquid, since investors will be more likely to risk their resources in an honest market. Additionally, since in a dishonest market investors will seek higher prices for securities as compensation for the risks of loss due to dishonesty, an honest market will facilitate the transfer of assets at lower prices, thereby lowering the cost of capital.

David Ruder, “Balancing Investor Protection With Capital Formation Needs After the SEC Chamber of Commerce Case,” *Pace Law Review*, pp. 41-42 (2005) (emphasis added).

¹ This addresses the Commission’s request that commenters -- “consider and analyze . . . (3) the economic costs and benefits of extending a private right of action for transnational securities frauds”.

The empirical evidence strongly supports the Commission's position that properly functioning financial markets require the protection of investors' rights. In a study for the World Bank in 2002, former Chairman of the Council of Economic Advisors Glenn Hubbard and others empirically established a strong positive correlation between investor protection and capital formation. The results of the study imply that policies aimed at strengthening investor protection laws and their enforcement will improve capital formation and result in higher economic growth economy-wide. This link was found precisely because higher rates of insider equity ownership are strongly correlated with market inefficiencies. As investor protection is strengthened, firms can increasingly turn to outside investors to meet their capital needs. Conversely, if investor confidence is low due to weak investor protection, firms have a more difficult time raising capital from outsiders, and must increasingly resort to insiders to meet their capital needs, which is highly inefficient. The study concluded:

The weaker is investor protection, the higher is the concentration of inside equity ownership. And second, the higher is the concentration of inside ownership, the higher is the implied cost of capital.

Charles P. Himmelberg, R. Glenn Hubbard and Inessa Love, "Investor Protection, Ownership, and the Cost of Capital," The World Bank Development Research Group, p. 38 (2002).

Thus, there should be no dispute that protecting investors provides critical benefits to the proper and efficient functioning of capital markets and must form an essential component of the securities regulatory regime in the United States. Accordingly, the only relevant question is whether protection of investors requires a private right of action. As shown below, court opinions and economic research strongly support the link between a private right of action, investor protection and the efficient operation of capital markets.

B. THE EXISTENCE OF A PRIVATE RIGHT OF ACTION IS ESSENTIAL TO THE PROTECTION OF INVESTORS' RIGHTS

The Commission has long-recognized the importance of a private right of action as a means of protecting the rights of investors. Giovanni P. Prezioso, General Counsel of the SEC, told the American Bar Association in 2004:

private securities litigation has always formed a major - and essential - component of the enforcement of the federal securities laws. The Commission has long advocated private rights of action precisely because they supplement its own enforcement program in deterring misconduct.

The Supreme Court itself also "has long recognized that meritorious private actions to enforce federal antifraud securities laws are an *essential supplement* to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007); *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (private rights of

action under the securities laws are a “**necessary** supplement to Commission action.”) (emphasis added). The Supreme Court has stated that this is especially true when it comes to actions under Section 10(b): “a private right of action under Section 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure.” *Herman & McLean v. Huddleston*, 459 U.S. 375, 380 (1983). In fact, even when limiting the scope of a private right of action to exclude aiding and abetting liability, the Supreme Court unequivocally recognized that the Congress has ratified and endorsed the existence of a private right of action for the enforcement of the securities laws:

“Congress thus ratified the implied right of action after the Court moved away from a broad willingness to imply private rights of action. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U. S. 353 , and n. 66 (1982); *cf. Borak, supra*, at 433. It is appropriate for us to assume that when §78u-4 was enacted, Congress accepted the §10(b) private cause of action as then defined....”

Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 773 (2008).

Recent research provides significant support for the courts’ longstanding support of a private right of action as an essential component of protecting investors and support the proper functioning of capital markets.² A recent study by academics in Europe provides evidence that individual firms that are the target of enforcement actions can also become more efficient as a result of the action, particularly when the violations are the result of violations of the duty of loyalty by management, such as accounting fraud or insider trading. This result recently was reported by Professor Rob Bauer at the Maastricht University School of Business and Economics in the Netherlands. Rob Bauer and Robin Braun, “Misdeeds Matter: Long-Term Stock Price Performance after the Filing of Class-Action Lawsuits,” *Financial Analysts Journal*, Vol. 66, No. 6, (Nov./Dec. 2010).

Bauer and Braun examined the longstanding assumption that companies facing securities enforcement action, especially private litigation, by definition would experience long-term share price declines, as the truth of past false statements are disclosed, and the public loses confidence in management (and perhaps also in the core business model of the firm). They found, however, at least when the action relates to violations of the duty of loyalty (especially insider trading or accounting fraud), that share prices actually can benefit from an enforcement action:

In the case of insider trading, the filing of the lawsuit and reputational costs discipline the existing managers, or a more efficient and ethical management replaces them. In

² This addresses the Commission’s request that commenters -- “Discuss the cost and benefits of allowing private plaintiffs to pursue claims under the antifraud provisions of the Exchange Act in cases of transnational securities fraud, including the costs and benefits to domestic and international financial systems and securities markets. Identify any studies that have been conducted that purport to show the positive or negative implications that such a private right of action would have.”

the latter case, new managers are aware of the lawsuit that their predecessors faced, and this information deters them from any self-dealing actions. . . .

We further documented shareholder wealth effects for companies that face accounting fraud allegations. . . . [S]ubsequent to the disclosure of fraud (implicitly, the filing of the lawsuit in our case and, eventually, the final verdict), companies typically shed labor and capital to become more productive. . . . Therefore, institutional investors initiating or joining a class action lawsuit can, to some degree, expect substantial reorganizations in the sued company, which can result in medium- to long-term outperformance.

Id. at 90.

Given the complementary role to government enforcement that private litigation has historically played in the Section 10(b) context, to preclude private litigation where government actions are available would lead to a material deficiency in the enforcement of Section 10(b). If suddenly one aspect of Section 10(b) enforcement (protection of U.S. Investors in connection with their non-U.S. securities transactions) is reserved to the SEC, and private actions remain prohibited, this creates an artificial and indefensible inconsistency in the securities laws. Despite the SEC's and the Supreme Court's recognition of the necessary assistance provided by private litigation, an entire class of investors would be carved out of the securities laws and reserved to the SEC. Such a result is contrary to the mission of the SEC and the established record of the benefits of private actions.

III. MORRISON'S PURPORTED "BRIGHT LINE" TRANSACTIONAL TEST FOR DETERMINING THE EXISTENCE OF A PRIVATE RIGHT OF ACTION CREATES A NUMBER OF POTENTIAL ISSUES³

Another important reason to reinstitute the protection of the U.S. securities laws for U.S. Investors is because the current "transaction" test in *Morrison* is unworkable under many circumstances. In *Morrison*, the Supreme Court held that Section 10(b) only reaches the purchase or sale of a security listed on an American stock exchange, or other domestic transactions. *Morrison*, 130 S.Ct. at 2888. However, determining whether a transaction has occurred domestically can prove to be difficult and potentially can result in entirely anomalous results. Thus, reversion to the pre-*Morrison* case law under which U.S. Investors were afforded the protection of the U.S. securities laws is an appropriate mechanism for the Commission and Congress to adopt for private securities litigation.

³ This addresses the Commission request that commenters -- "Address the criteria for determining where a purchase or sale can be said to take place in various transnational securities transactions. Discuss the degree to which investors know, when they place a securities purchase or sale order, whether the order will take place on a foreign stock exchange or a non-exchange trading platform or other alternative trading system outside of the United States."

The *Morrison* Court failed to recognize that, in the modern environment, just because a security is listed on an exchange does not mean the security is traded there. Thus, courts already have begun to reject the listing portion of the *Morrison* test.⁴

The analysis is complicated further by the simple fact that most investors have no idea which exchange their order is directed through, assuming it even occurs on an exchange. Both the European Union⁵ and the United States⁶ have adopted legislation requiring brokers to establish a best execution policy to make sure that orders for securities are executed to the best benefit of the client. In order to achieve “best execution,” in the case of securities that can be purchased in the United States (as an ordinary share or an ADR) or on a foreign exchange, the broker will execute on the exchange that provides the greatest advantage to the client, which could be a U.S. or foreign exchange, depending on conditions. For example, Merrill Lynch (in one of its foreign subsidiaries) in its policy relating to the execution of securities transaction, states that “if the securities are listed on more than one financial instruments exchange (“Multiple Listing”), we will place the order on the exchange which is selected by Quick Corporation as the primary exchange at the time of the execution. (The details of this determination are available upon request from our offices.)”⁷ If purchasers of shares only have a Rule 10b-5 cause of action if the trade occurs on a U.S. exchange, the purchaser has no idea at the time of purchase whether U.S. law will protect them, and investor protection becomes a random event. Such a result cannot possibly further the SEC’s primary mission of investor protection.

This problem is accentuated by the need for U.S. Investors, and particularly pension funds, to diversify their assets, including through investments outside the United States. State and local public employee retirement systems are subject to applicable state and local laws that govern, among other things, investment policy objectives and constraints placed on pension plan fiduciaries. Prudence requires the diversification of assets into different asset

⁴ At least one court recently has held that, despite the clear statement in *Morrison* that listing on a U.S. exchange is sufficient for the U.S. securities laws to apply, in fact that will not make the laws applicable. *In re RBS Securities Litig.*, 09 Civ. 300 (DAB) (S.D.N.Y. Jan. 11, 2001), slip op. at 17-18 (“The idea that a foreign company is subject to U.S. Securities laws everywhere it conducts foreign transactions merely because it has “listed” some securities in the United States is simply contrary to the spirit of *Morrison*”).

⁵ Markets in Financial Instruments Directive (MiFID), “Directive 2004/39/EC”. Official Journal of the European Union. 2004. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:02004L0039-20060428:EN:NOT>.

⁶ FINRA Rule 2320 (“(a)(1) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions.”)

⁷ Bank of Merrill Lynch in Japan – Best Execution policy. 5.2; Information on J.P. Morgan’s Execution Policy for Professional Clients March 2010 (“In the absence of express instructions from you JPMorgan will exercise its own discretion, having regard for the terms of your order in determining the factors that it needs to take into account for the purpose of providing you with Best Execution.”);

classes and in multiple geographic areas. Thus, most state pension plans are required to adopt prudent diversification plans by statute.⁸

To fulfill their statutory mandates, and to act as prudent fiduciaries, virtually all public pension funds adopt investment objectives and policies that diversify globally and provide for a fixed or range of percentage investment in international equities. Further, when buying in specific industry segments, often it is required to buy non-U.S. stocks (for example, an investor seeking to have automotive industry representation simply cannot avoid buying Toyota or Volkswagen and cannot buy into energy without purchasing BP or Royal Dutch Shell). To take two of the largest public pension funds as an example, New York State Common Fund, according to its 2010 annual report, had a target and actual allocation of 16% in international equities, and CALPERS invested 24% in international equities (compared to just 21.1% in domestic equities). See New York State and Local Retirement Systems Comprehensive Annual Financial Report for Fiscal Year Ended March 31, 2010; CALPERS June 30, 2010 Comprehensive Annual Financial Report. This level of international diversification not only makes sense from a prudent investment perspective, but it is in a very real sense required in order to fulfill the legislative mandates designed to protect a state's public employees, as well as taxpayers who ultimately fund these plans. However, given the issues noted above with determining where orders are executed, even those U.S. investors that seek to engage in diversification by purchasing securities from non-U.S. issuers through options on U.S. exchanges may be unable to do so (for example, because there are insufficient ADRs) or at least will be unable to determine whether they have done so in a fashion that, after *Morrison*, permits them to take obtain the protection of the U.S. securities laws.

At its core, Section 10(b) is not about whether the SEC or private investors can sue errant foreign issuers for securities fraud. Such right of action is secondary to the aim of the underlying securities laws, which is truthful disclosures. However, the ability of investors and the SEC to bring actions deters issuers from making false statements to the public, and creates additional incentives for issuers to comply with the disclosures laws. Under the current test articulated in *Morrison*, U.S. investors simply may not know in many cases whether they have a private right of action to seek redress for fraud. Reinstating the

⁸ See e.g., Conn. Gen. Stat. § 45a-541c (2010) (“Diversification. A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.”); Wis. Stat. § 25.15 (2010) (“[T]he standard of responsibility applied to the board when it manages money and property shall be all of the following: ... (b) To diversify investments in order to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so, considering each trusts or funds portfolio as a whole at any point in time.”); Mont. Code Ann. § 17-6-201 (“[P]ublic funds must be administered by the board of investments in accordance with the prudent expert principle, which requires an investment manager to:...(b) diversify the holdings of each fund within the unified investment program to minimize the risk of loss and to maximize the rate of return unless, under the circumstances, it is clearly prudent not to do so”); 840 Code of Mass. Regs. 1.01 (2010) (“A board member shall discharge all of his/her duties...(3) By diversifying the investments of the system so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.”).

longstanding rule that U.S. Investors are subject to the protection of U.S. laws will resolve these ambiguities and further the paramount purpose of protecting investor rights.

In short, the Ohio Funds believe that the *Morrison* decision hurts U.S. Investors in general, and the Ohio Funds and other institutional investors in particular, by removing the only practical means by which such investors can – with respect to investments made on foreign exchanges – (i) discourage fraud in the first place and (ii) recover at least a portion of their losses when such fraud does arise.

We appreciate the opportunity to provide the Commission our views on this critical issue.

Respectfully,

OHIO PUBLIC EMPLOYEES
RETIREMENT SYSTEM

By Julie E. Becker

STATE TEACHERS RETIREMENT
SYSTEM OF OHIO

By William J. Neville

OHIO POLICE AND FIRE PENSION FUND

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OHIO HIGHWAY PATROL
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