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<u>Study on Extraterritorial Private Rights of Action</u>

Dear Ms Murphy

Introduction and Summary

This letter constitutes the response of the Government of the United Kingdom to the Commission's Request for Comments in connection with the study on extraterritorial private rights of action mandated by section 929Y of the Dodd-Frank Act.

The UK Government is grateful for the opportunity to comment on this subject. It greatly values the co-operation with the Commission and the United States in the area of securities regulation and enforcement which the United Kingdom and its authorities have enjoyed for many years.

In summary, the UK Government does not consider that the scope of section 10(b) of the Exchange Act and Rule 10b-5 (the "antifraud provisions of the Exchange Act") should be extended to private rights of action. Such an extension does not appear to be necessary to protect United States interests and, as explained in this letter, has the potential to conflict with the interests of the United Kingdom and other jurisdictions. Following the US Supreme Court's decision in *Morrison*[1] and the enactment of section 929P of the Dodd-Frank Act, this potential conflict has been removed. Current US law in this area is sufficiently clear and provides adequate protection to investors.

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[1] *Morrison* v *National Australia Bank*, 130 S.Ct.2869 (2010).

Concerns Presented by Extraterritorial Private Rights of Action under the Antifraud Provisions of the Exchange Act

The UK Government has already stated its position on many of the issues relating to extraterritorial private rights of action under the antifraud provisions of the Exchange Act in its *amicus* brief submitted to the US Supreme Court in *Morrison* (the "UK Brief")[2]. For ease of reference, a copy of the UK Brief accompanies this letter.

Prior to the *Morrison* decision, the extraterritorial application of the antifraud provisions of the Exchange Act that resulted from the "conduct" and "effects" tests applied by most US federal courts of appeals:

- produced potential conflicts with the UK's regulatory policies regarding disclosures by UK listed corporations;
- made the application of US securities law unpredictable for UK listed corporations; and
- imposed unnecessary costs and risks on equity investment in UK listed corporations.

Conflicts with the UK's Regulatory Policies Regarding Disclosures by UK Listed Corporations

The United Kingdom has a comprehensive system of securities regulation and long-established private law remedies[3]. The United Kingdom has made numerous important policy choices regarding securities regulation and litigation practices and procedures, reflecting a balancing of interests and policies that sometimes differs from the balances that have been struck in the United States.

The UK Brief describes some of the ways in which the approaches adopted by the United States and the United Kingdom in the area of securities regulation and private law remedies differ.[4] Differences include:

- the relative emphasis on continuous disclosure of price-sensitive developments versus periodic disclosure;
- the ways in which safe harbours operate and their availability;

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[2] Brief of the United Kingdom of Great Britain and Northern Ireland as *amicus curiae* in support of the Respondents (Feb. 25, 2010).

[3] UK Brief, pages 5 to 13.

[4] UK Brief, pages 15 to 21.

- the extent to which a claimant must show reliance on a statement, or whether this requirement is displaced by the "fraud-on-the-market" doctrine;
- the availability of class actions; and
- the extent to which the losing side is required to pay the winning side's costs in litigation.

One of the critical policy decisions that all jurisdictions face is how to encourage regular and open reporting by listed corporations, particularly in the area of forward-looking statements, without exposing those corporations and their shareholders to opportunistic litigation. The totality of the policy choices made by a particular jurisdiction in the areas highlighted above and in other key areas will influence the approach that listed corporations in that jurisdiction take to the disclosure of information to their investors. If the risk of opportunistic litigation is high, corporations may resort to bland and defensive reporting behind a barrier of risk factors. This may defeat the policy objective of ensuring that a listed corporation provides clear and straightforward disclosure to its investors to enable them to make an informed assessment of the corporation's position and prospects.

The balance that is carefully struck in one jurisdiction may be upset by the extraterritorial availability of remedies in another jurisdiction. In this way, a jurisdiction's ability to set regulatory policies for its listed corporations may be defeated and the principle of comity called into question[5]. By way of illustration, the United Kingdom has provided a statutory remedy to investors in relation to untrue or misleading disclosures (or dishonest delays in disclosure) by UK listed corporations to the market. It has chosen, after extensive recent consultation and consideration, to impose a requirement that reliance must be shown by the claimant and to provide a safe harbour so that only disclosures made (or not made) with the knowledge, recklessness or dishonesty of a person discharging management responsibilities within the corporation attract liability[6]. If extraterritorial claims under the antifraud provisions of the Exchange Act were permitted, the United Kingdom's policy would be undermined because of the different legal standards applied to such claims and the different litigation system in the United States. For example, the "fraud-on-the-market"

[5] See *Predictability and Comity: Toward Common Principles of Extraterritorial Jurisdiction*, 98 Harv. L. Rev 1310 (Apr. 1985), pages 1322-1323.

[6] Financial Services and Market Act 2000, section 90A and Schedule 10A; *Davies Review of Issuer Liability*, Professor Paul Davies Q.C. (H.M. Treasury, 2007).

doctrine in the United States would obviate the need to show reliance and the safe harbour requiring the connivance of a person discharging management responsibilities within the corporation would not be available in the United States[7].

Unpredictability in the Application of US Securities Law for UK Listed Corporations

Prior to *Morrison,* the standards applied by the federal courts to extraterritorial claims under the antifraud provisions of the Exchange Act changed over time and required an intensive, fact-sensitive, case-by-case approach. The case law of the courts of appeals in different circuits also differed. These factors contributed to a high degree of unpredictability for UK listed corporations in the extent to which the antifraud provisions of the Exchange Act would be applied to their communications, even where those communications were made outside the United States to non-US investors.

The evolution of the "conduct" and "effects" tests developed by the federal courts was discussed in the brief for the Respondents in *Morrison*[8]. That discussion demonstrates how an apparently clear concept, such as that formulated by the Second Circuit in *Bersch*[9], can degenerate into an unpredictable collection of incompatible decisions and theories, as the plaintiff bar persuades courts in different circuits to become involved in a variety of disputes between non-US parties[10].

Any test that looks to issues requiring judgment, such as whether conduct contributing to the fraud has taken place in the United States, whether that conduct is substantial or merely preparatory, or whether significant effects have been felt in the United States, will suffer from the same problems that existed prior to *Morrison*. Federal courts will have to become involved in highly factual investigations in each case in order to determine whether, on the specific facts of that particular case, one or more (blurred) lines have been crossed. The parties will have to produce detailed factual evidence merely at the jurisdiction stage. The outcome of the jurisdictional hearing will be unpredictable and subjective. Even if a non-US

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[7] The safe harbour provisions contained in section 27A of the US Securities Act of 1933, as amended and section 21E of the US Securities Exchange Act of 1934 provide analogous protections, but they are limited in application to forward-looking statements made by US reporting issuers.

[8] *Morrison,* US Supreme Court, Brief for Respondents, pages 4-7.

[9] *Bersch v. Drexel Firestone, Inc.*, 519 F2d. 974 (2d Cir. 1975).

[10] See also Joseph N. Sacca, *Restricting the extraterritorial application of anti-fraud provisions of the US securities laws,* 8 JIBL 484 (Sept. 1, 2010); and Stephen J. Choi and Linda J. Silberman, *The Continuing Evolution of Securities Class Actions Symposium: Transnational Litigation and Global Securities Class Action Lawsuits,* 2009 Wis. L. Rev. 465 (2009).

defendant is successful in establishing that the US courts do not have jurisdiction to hear the claim, the cost to it of this process, including producing the factual evidence required, will be very substantial and irrecoverable.

By contrast, the bright-line "transactional" test in *Morrison* provides both corporations listed outside the United States and their investors with clarity and predictability as to the application of the antifraud provisions of the Exchange Act. The antifraud provisions of the Exchange Act will only be available to a plaintiff in connection with clearly defined transactions, i.e. the sale or purchase by him of a security listed on an American stock exchange and the purchase or sale of any other security in the United States. The federal courts have already demonstrated that they are able to apply this transactional test (and, where necessary, clarify it) without any great difficulty[11]. This transactional test is not vulnerable to the varied and gradually changing *ad hoc* analysis that bedevilled the "conduct" and "effects" test and that would apply equally to other tests focussing on the materiality of conduct in the United States or on other facts-and-circumstances standards. As a result, under current law a non-US corporation is able to assess its risk exposure and plan its business strategy accordingly. If it wishes to avoid exposure to private securities litigation in the US courts, it will not list its securities on a US exchange or market them in the US. Thus the *Morrison* test is conducive to predictability and certainty.

Unnecessary Costs and Risks of Equity Investment in UK Listed Corporations

The extraterritorial availability of private law remedies under the antifraud provisions of the Exchange Act has the potential to damage the interests of both the United Kingdom and the United States.

For the United Kingdom, class actions in the United States based on the extraterritorial application of the antifraud provisions of the Exchange Act can impose unnecessary costs and risks on equity investment in UK listed corporations. If the provisions apply extraterritorially, such corporations are unable to determine by their own choices (such as

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[11] *Cornwell v. Credit Suisse Grp.*, No. 08-CV-3758, 2010 WL 3069597 (SDNY July 27, 2010); *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, No. 08-CV-1958, 2010 WL 3860397 (SDNY Oct. 4, 2010; *In re Société Générale Sec. Litig.*, No. 08-CV-2495, 2010 WL 3910286 (SDNY Sept. 29, 2010); *In re Alstom SA Sec. Litig.*, No. 03-CV-6595, 2010 WL 3718863 (SDNY Sept. 14, 2010); *Stackhouse v. Toyota Motor Co.*, No. 10-CV-0922, 2010 WL 3377409 (C.D. Cal. July 16, 2010); *In re Banco Santander Securities-Optimal Litig.*, No. 09-MD-02073, 2010 WL 3036990 (S.D. Fla. July 30, 2010); *Quail Cruises Ship Management Ltd. V. Agencia de Viagens CVC Tur Limitada*, No. 09-CV-23248, 2010 WL 311998 (S.D. Fla. Aug. 6, 2010); and *In re Royal Bank of Scotland Group PLC Sec. Litig.*,, 09-CV-300, 2011 US Dist Lexis 3974 (SDNY Jan. 11, 2011).

choices as to where to offer and list their securities) whether they will become subject to class actions in the United States.

US class actions in this area present even the innocent non-US defendant with particular difficulties, including: the prospect of substantial irrecoverable legal costs; the expenditure of significant management time and corporate resources in discovery exercises and depositions; and the difficulty and cost of explaining foreign (and often different) disclosure obligations and legal frameworks to a US court. Plaintiff attorneys may seek to exploit these difficulties. Thus, to an even greater extent than with US corporations, class actions may be brought against a foreign listed corporation in situations where the claim is weak but plaintiff attorneys believe that they will be able to exploit the relatively favourable US class action and litigation system with a view to constituting an extended class of claimants that will persuade an innocent defendant to settle and yield a large success fee.

The wider the jurisdictional rules applicable to private rights of action, the greater is this risk. The test set out in section 929P of the Dodd-Frank Act, if applied to private rights of action, would be very wide. As illustrated by the many cases brought against non-US corporations under the pre-*Morrison* rules, it would greatly increase the exposure of non-US corporations to these risks and costs.

Likewise, the less clear the jurisdictional rules, the greater is this risk: the more subjective and imprecise the rules, the more willing plaintiff attorneys will be to bring weak claims in the hope that they will be able to persuade the US courts to take jurisdiction.

For the United States, the adoption of wide or unclear jurisdictional rules for private securities actions would utilise the resources of the federal courts in cases in which the United States courts have little or no policy reason to become involved. In addition, such rules would be likely to cause foreign listed corporations to take a defensive approach to US securities law risks by reducing their contact with the United States. Foreign corporations might seek to exclude US investors from their normal investor communication programmes and from participating in transactions such as rights offerings or mergers. Ultimately, if the presence of business operations and financial reporting functions within the United States is considered determinative of their exposure to US class actions in this area (as was argued by petitioners in *Morrison*), foreign corporations may choose not to invest in the United States.

The issues presented by the US litigation environment for foreign direct investment in the United States are recognised in the study recently published by the Department of Commerce of the United States[12].

Assessment of the Current US Legal Position

Following the *Morrison* case and the enactment of section 929P of the Dodd-Frank Act, the current legal position on this point of the antifraud provisions of the Exchange Act appears to the UK Government to strike a reasonable balance between avoiding conflict with the interests of other jurisdictions and providing the US authorities with the necessary powers to pursue cross-border securities fraud.

The UK Government welcomes the enactment of section 929P of the Dodd-Frank Act, which ensures that the Commission and the United States are able to pursue violations of the antifraud provisions of the Exchange Act in the US district courts. Within the framework of their existing co-operation with the Commission, the UK authorities will continue to support enforcement action by the Commission wherever appropriate.

The Commission and the United States may be expected to show restraint in cases where it is more appropriate that the authorities of another nation should take the lead in pursuing the perpetrators of securities fraud, and to work in cooperation with the foreign authorities where that is the appropriate course. By contrast, experience prior to *Morrison* showed that the plaintiff bar in the US cannot be expected to show comparable restraint in its pursuit of extraterritorial *private* rights of action. In particular, where UK listed companies are involved, the US class action system provides incentives to plaintiff firms to pursue class actions in respect of the antifraud provisions of the Exchange Act in the US courts, even where there may be powerful arguments that the case should instead be heard in the UK courts. In addition to incentives that are the mirror image of the factors that may lead an innocent foreign corporation to settle a claim, as listed above, a powerful incentive to plaintiff attorneys to bring a class action in the United States is provided by the payment to plaintiff attorneys of a relatively high percentage of the entire amount resulting from any settlement or recovery.

Therefore, the holding in *Morrison* that the antifraud provisions of the Exchange Act will only be available to a plaintiff in connection with purchase or sale by him of a security listed on an American stock exchange and the purchase or sale of any other security in the United

[12] Department of Commerce of the United States, *The US Litigation Environment and Foreign Direct Investment: Supporting US Competitiveness by Reducing Legal Costs and Uncertainty* (Oct. 2008).

States avoids any conflict with the interests of the United Kingdom in the area of private rights of action under the antifraud provisions of the Exchange Act.

The United Kingdom does not consider that the decision of the US Supreme Court in *Morrison* requires further legislative clarification. In response to the Commission's request for comments relating to the issue of where the purchase or sale of a security takes place, the United Kingdom would note that the US federal courts have continued to apply and clarify this test in a range of decisions since *Morrison* and will no doubt continue to do so without any need for legislative guidance.[13]

Availability of UK remedies

As stated above and as detailed in the UK Brief, the United Kingdom has a comprehensive system of securities regulation and long-established private law remedies.

The Financial Services Authority is an independent statutory authority responsible for the regulation of financial services and markets in the United Kingdom, and related enforcement activities. The enforcement powers of the Financial Services Authority include the powers to: impose penalties for a breach of its listing rules, disclosure rules, prospectus rules or transparency rules;[14] impose penalties for market abuse;[15] bring criminal proceedings for specified misleading statements and practices;[16] fine or censure authorised firms;[17] apply for an injunction where there is reasonable likelihood of contravention, or continuing contravention, of the Financial Services and Markets Act 2000; [18] and order restitution where any such provision has been contravened.[19] The UK Government has announced proposals to further enhance the protection of consumers and the supervision of markets by transferring these functions from the Financial Services Authority to a new Consumer Protection and Markets Authority. This new authority will be established as the single

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13 See footnote 11, *supra*.

14 Financial Services and Markets Act 2000, section 91.

15 Financial Services and Markets Act 2000, Part VIII.

16 Financial Services and Markets Act 2000, section 397.

17 Financial Services and Markets Act 2000, Part XIV.

18 Financial Services and Markets Act 2000, sections 380-381.

19 Financial Services and Markets Act 2000, sections 382-384.

integrated conduct regulator, taking a tougher, more proactive and more focused approach to regulating conduct in financial services and markets[20].

The private law remedies available to investors were described in the UK Brief[21]. They include statutory compensation rights of investors in respect of untrue or misleading statements in prospectuses issued by UK listed corporations and in respect of untrue or misleading statements issued (or omitted to be issued) by UK listed corporations in the course of discharging their continuous disclosure obligations. These statutory compensation rights are mandatory provisions of law in the United Kingdom and will be available to US or other investors bringing claims in the UK courts regardless of the application of conflicts of law rules[22].

A US investor purchasing securities of a UK listed corporation is therefore adequately protected both by the UK regulatory system and the actions of its authorities and by the private rights of action under the laws of the jurisdictions within the United Kingdom.

Position of the UK Government

In the light of the foregoing, the UK Government does not consider that any change to US law in this area is necessary and is concerned that changes to the present position may have the potential to conflict with the interests of the United Kingdom while bringing little or no benefit to United States interests.

Yours sincerely,

Jonathan Taylor
Managing Director Financial Services and Stability
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[20] See Chapter 4, *A new approach to financial regulation: judgment, focus and stability*, HM Treasury, July 2010.

[21] UK Brief, pages 8 and 9.

[22] Under Article 16 of the Rome II Regulation of the European Union (864/2007(EC)), which governs conflicts of laws applicable to non-contractual obligations, the Regulation does not restrict the application of the provisions of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the non-contractual obligation. 506863632