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Abstract

This Note examines the extent to which the corporate mismanagement sphere of Rule 10b-5 may be applied extraterritorially to the internal regulation of offshore investment funds. Part I analyzes the policies behind the assertion of subject matter jurisdiction under international law and illustrates that the jurisdictional policies prescribed by international law do not support such an expansionist view of the Securities Exchange Act of 193415 ('34 Act). Part II focuses on the Congressional intent behind the '34 Act and addresses the issue whether the '34 Act was to have extraterritorial application and to be a vehicle for the regulation of offshore investment funds. Part III discusses and analyzes the application of Rule 10b-5 to the regulation of offshore investment funds and examines cases involving extraterritorial application of Rule 10b-5.

OFFSHORE FUNDS AND RULE 10b-5: AN INTERNATIONAL LAW APPROACH TO EXTRATERRITORIAL JURISDICTION UNDER THE SECURITIES EXCHANGE ACT OF 1934

INTRODUCTION

As foreign investment in United States securities rose from $25.6 billion in 1971[1] to $74 billion in 1981,[2] offshore investment funds[3] provided a large number of foreign investors with a vehicle for diversified portfolio investment in United States securities.[4] Offshore funds proved a particularly popular vehicle for foreign investment in United States securities for two reasons. They enjoy freedom from Securities and Exchange Commission[5] (SEC or Commission) regulation,[6] and

1. U.S. DEP'T OF COM., SURVEY OF CURRENT BUSINESS 21 (Aug. 1973).

2. U.S. DEP'T OF COM., SURVEY OF CURRENT BUSINESS 56 (Aug. 1981).

3. "An offshore fund is defined as a mutual fund, hedge fund, leverage fund, investment company or combination thereof that (a) is incorporated in a foreign country . . . (b) does all or most or a principal part of its selling to persons who are not U.S. citizens or residents, and (c) whose principal sales efforts are not aimed primarily at residents of [the incorporating nation]." SECURITIES AND EXCHANGE COMMISSION, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 64, Part 3, 92d Cong., 1st Sess. 879 n.1 (1971) [hereinafter cited as SEC INSTITUTIONAL INVESTOR STUDY]. For a general discussion of offshore funds, see 4 T. FRANKEL, THE REGULATION OF MONEY MANAGERS 329-33 (1980); *see also* PRACTICING LAW INSTITUTE, INVESTMENT PARTNERSHIPS AND OFFSHORE FUNDS (1969) (discussing generally offshore investment funds).

4. *See* SEC INSTITUTIONAL INVESTOR STUDY, *supra* note 3, at 879, 920-41, 949; Hart, *Use of Tax Treaties and Offshore Investment Vehicles for Foreign Investors* in 6 N.Y.U. INT'L INST. ON TAX AND BUS. PLAN., FOREIGN INVESTMENT IN THE UNITED STATES AND THE EUROPEAN COMMUNITY 125, 148-49 (N. Liakas ed. 1978).

5. The Securities and Exchange Commission (SEC or Commission) is a federal agency created by Congress through the Securities Exchange Act of 1934, 15 U.S.C. § 78d (1982 & Supp. 1985) ('34 Act). The Commission administers the Securities Act of 1933, *id.* §§ 77a, s, t, u, the '34 Act, *id.* § 78d, and various other acts, all of which are listed in 17 C.F.R. § 200.2 (1984).

As an administrative agency, the Commission promulgates rules to implement the acts which it administers. Congress specifically gave the Commission power to promulgate rules under § 10(b), 15 U.S.C. § 78j (1982 & Supp. 1985), by providing that "it shall be unlawful . . . [to engage in specific conduct] . . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate . . . ." *Id.* § 78j(b). Furthermore, the '34 Act gives the Commission broad powers to promulgate rules as are necessary to carry out the provisions of the Act. *See id.* § 78w(a). A "rule" has been defined as "the product . . . of the administrative process that resembles a legislature's enactment of a statute." K. DAVIS, ADMINISTRATIVE LAW TEXT § 5.01, at 123 (3d ed. 1972). The Administrative Procedure Act, 5

they receive favorable tax advantages by incorporating in hospitable tax forums such as the Bahamas, Bermuda, Luxembourg, and the Netherlands Antilles.[7] Although a burgeoning business in offshore funds exposes the United States securities markets to some potential harm,[8] the real potential for abuse lies in the internal corporate and financial structure of the offshore investment fund itself. It is this aspect of offshore funds that is considered beyond the regulation of the United States.[9]

U.S.C. § 500 (1982 & Supp. 1985), distinguishes between substantive or legislative rules and interpretative rules. *Id.* § 553. It has been suggested that a substantive rule is one "issued by an agency pursuant to statutory authority and which implement[s] the statute, as for example, the proxy rules issued by the Securities and Exchange Commission." K. DAVIS, *supra*, § 5.03 at 126 (citing 1947 ATTORNEY GENERAL'S MANUAL ON THE APA at 30). Rule 10b-5 fits this definition. 17 C.F.R. § 240.10b-5 (1984).

6. SEC INSTITUTIONAL INVESTOR STUDY, *supra* note 3, at 881-82, 949; Pursuant to Rule 12g3-2, 17 C.F.R. § 240.12g3-2 (1984), any foreign private issuers with fewer than 300 holders resident in the United States are exempt from registration under § 12(g) of the '34 Act. Therefore, the provisions of the '34 Act relating to a fund trading in its own stock are, under the rule, inapplicable to offshore funds. 17 C.F.R. § 240.12g3-2. The rule provides that "(a) securities of any class issued by any foreign private issuer shall be exempt from section 12(g) of the Act if the class has fewer than 300 holders resident in the United States." *Id.* § 240.12g3-2(a).

7. *See* SEC INSTITUTIONAL INVESTOR STUDY, *supra* note 3, at 904-912, 949; 4 T. FRANKEL, *supra* note 3, at 329-33; Hart, *supra* note 4, at 147. It is pointed out that:

> Offshore funds offer what American investment companies cannot offer: investment in United States securities without the liability for United States estate tax. . . . Because these funds are not regulated or taxed, their managers have more flexibility to adopt effective investment policies. The foreign investor pays no tax in his own country on dividends and interest credited to his participations in the fund until he sells his participations; neither does the foreign investor pay United States tax on his income.

T. FRANKEL, *supra* note 3, at 329-30; Note, *United States Taxation and Regulation of Offshore Mutual Funds*, 83 HARV. L. REV. 404, 404-22 (1969). For a current discussion of the possible erosion of these tax advantages, see also PRACTICING LAW INSTITUTE, FOREIGN TAX PLANNING 1983 at 189-285 (discussing the elements involved in the taxation of offshore investment companies).

8. SEC INSTITUTIONAL INVESTOR STUDY, *supra* note 3, at 945-47, 951. The SEC noted that potential abuses might include: 1) foreign funds being used to acquire specific United States companies in violation of United States laws and national interests; 2) large sales in an offshore fund of a United States security could have some effect on market stability and prove harmful to the individual security in question; and 3) foreign investor confidence in offshore funds might be impaired, thus creating apprehension in foreigners. *Id.*; *see also* Note, *Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma*, 3 LAW & POL'Y INT'L BUS. 157, 165 n.38 (1971).

9. The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (1982 & Supp. 1985), and the Investment Advisers Act of 1940, *id.* §§ 80b-1 to -21, regulate only those companies that register under them, *id.* §§ 80a-7, -8, or use the instrumentalities of interstate commerce to sell securities. *Id.* §§ 80b-4, -6; *see id.* § 80a-7(d). A foreign investment company is not entitled to register of right, but § 7(d) of the In-

In recent years, however, United States courts have tried to extend Rule 10b-5[10] extraterritorially in order to exercise subject matter jurisdiction in actions involving offshore investment funds.[11]

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vestment Company Act (ICA) authorizes the SEC, upon application by a foreign investment company, to issue an order permitting such company to register if enforcement of the provisions of the ICA against such company is feasible and the interests of United States investors are protected. *Id.* § 80a-7(d).

10. 17 C.F.R. § 240.10b-5 (1984) (promulgated under the '34 Act, § 10(b), 15 U.S.C. § 78j (1982 & Supp. 1985)). The rule 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,
>
> (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.

Id.

11. Although the cases listed below do not all involve offshore investment funds per se, they deal with extraterritorial extensions of Rule 10b-5 to situations involving foreign investment vehicles similar to offshore funds. These cases point out that United States interests predominate in decisions to exercise or decline jurisdiction. The courts make little mention of the broader interests of the international community. *See, e.g.*, Grunenthal GmbH v. Hotz, 712 F.2d 421, 423-26 (9th Cir. 1983); IIT v. Cornfeld, 619 F.2d 909, 919-21 (2d Cir. 1980); Fidenas A.G. v. Compagnie Int'l, 606 F.2d 5, 8-10 (2d Cir. 1979); Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc., 592 F.2d 409, 414-17 (8th Cir. 1979); United States v. Cook, 573 F.2d 281, 283-84 (5th Cir. 1978); SEC v. Kasser, 548 F.2d 109, 111-16 (3d Cir.), *cert. denied*, 431 U.S. 938 (1977); Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 985-87 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); IIT v. Vencap, 519 F.2d 1001, 1004-12 (2d Cir. 1975); SEC v. United Financial Group, Inc., 474 F.2d 354, 356-58 (9th Cir. 1973); Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1330-39 (2d Cir. 1972); Schoenbaum v. Firstbrook, 405 F.2d 215, 206-08 (2d Cir.), *rev'd with respect to holding on merits*, 405 F.2d 215, 216-23 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); Roth v. Fund of Funds, Ltd., 405 F.2d 421, 422-23 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969). The Supreme Court expressed a similar opinion in a related context in the Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 9 (1971). The Court stated:

> The expansion of American business and industry will hardly be encouraged if . . . we insist on a parochial concept that all disputes must be resolved under our laws and in our courts. . . . We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts.

Id.; *see also* Loomis & Grant, *The U.S. Securities and Exchange Commission, Financial Institutions Outside the U.S. and Extraterritorial Application of the U.S. Securities Laws*, 1 J. COMP. CORP. L. & SEC. REG. 3, 24 n.1 (1978). The issue that needs to be addressed here is whether United State's courts have applied securities laws and regulations that have

Although Rule 10b-5 is usually thought of as a device to protect investors by proscribing nondisclosure of material information or distribution of materially misleading information,[12] it also operates to protect the corporation in its securities dealings.[13] This range of activities is normally labeled "internal corporate mismanagement."[14]

This Note examines the extent to which the corporate mis-

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effectively controlled domestic transactions too rigidly in an international context. Former SEC Commissioner Barbara Thomas admits that this is a real concern and acknowledges that "there will be much greater need in this decade, and beyond, to recognize the interests of other nations, and to factor notions of comity and foreign sovereignty into the governance of transactions that traverse national borders." Thomas, *Extraterritoriality in an Era of Internationalization of the Securities Markets: The Need to Revisit Domestic Policies*, 35 RUTGERS L. REV. 453, 454 (1983); *see also* Thomas, *Internationalization of the World's Capital Markets—Can the SEC Help Shape the Future?*, in PRIVATE INVESTORS ABROAD—PROBLEMS AND SOLUTIONS IN INTERNATIONAL BUSINESS IN 1982 at 83-97; *Comments Sought on Multinational Securities Offerings*, SEC Today, (Mar. 1, 1985) (reporting that the SEC is soliciting comments on two approaches designed to harmonize disclosure and distribution practices for multinational offerings. The SEC is also soliciting public comments on a series of specific questions dealing with these approaches and the SEC's role in facilitating multinational offerings).

Issues dealing with transnational securities fraud have been analyzed in a number of legal publications. *See, e.g.*, Beard, *International Securities Regulation-Absorption of the Shock*, 10 INT'L LAW. 635 (1976); Goldman & Magrino, *Some Foreign Aspects of Securities Regulation: Towards a Reevaluation of Section 30(b) of the Securities Exchange Act of 1934*, 55 VA. L. REV. 1015 (1969); Johnson, *Application of Federal Securities Law to International Securities Transactions*, in 1980 FORDHAM CORPORATE LAW INSTITUTE, FINANCING IN THE INTERNATIONAL CAPITAL MARKETS 57 (B. Hawk ed.); Karmel, *The Extraterritorial Application of the Federal Securities Code*, 7 CONN. L. REV. 669 (1975); Mizrack, *Recent Developments in the Extraterritorial Application of Section 10(b) of the Securities Exchange Act of 1934*, 30 BUS. LAW. 367 (1975); Norton, *Extraterritorial Jurisdiction of U.S. Antitrust and Securities Laws*, 28 INT'L & COMP. L.Q. 575 (1979); Thomas, *supra*, at 454; Note, *Offshore Mutual Funds: Extraterritorial Application of the Securities Exchange Act of 1934*, 13 B.C. INDUS. & COM. L. REV. 1225 (1972); Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 COLUM. L. REV. 94 (1969); Note, *The Extraterritorial Application of the Antifraud Provisions of the Securities Acts*, 11 CORNELL INT'L L.J. 137 (1978); Note, *Regulation of Offshore Investment Companies Through Extraterritorial Application of Rule 10b-5*, 1982 DUKE L.J. 167; Note, *American Adjudication of Transnational Securities Fraud*, 89 HARV. L. REV. 553 (1976); Note, *The International Character of Securities Credit: A Regulatory Problem*, 2 LAW & POL'Y INT'L BUS. 147, 155-64 (1970); Comment, *Securities Law—Subject Matter Jurisdiction in Transnational Securities Fraud—Bersch v. Drexel Firestone, Inc.—IIT v. Vencap, Ltd.*, 9 N.Y.U.J. INT'L L. & POL'Y 113 (1976); Note, *Extra Territorial Application of Section 10(b) and Rule 10b-5*, 34 OHIO ST. L.J. 342 (1973); Note, *Extraterritorial Application of United States Laws: A Conflict of Laws Approach*, 28 STAN. L. REV. 1005 (1976); Comment, *The Transnational Reach of Rule 10b-5*, 121 U. PA. L. REV. 1363 (1973); Note, *Extraterritorial Application of the Federal Securities Code: An Examination of the Role of International Law in American Courts*, 11 VAND. J. TRANSNAT'L L. 711 (1978).

12. *See infra* notes 148-67 and accompanying text.

13. *See infra* notes 118-33 and accompanying text.

14. *See infra* notes 118-20 and accompanying text.

management sphere of Rule 10b-5 may be applied extraterritorially to the internal regulation of offshore investment funds. Part I analyzes the policies behind the assertion of subject matter jurisdiction under international law and illustrates that the jurisdictional policies prescribed by international law do not support such an expansionist view of the Securities Exchange Act of 1934[15] ('34 Act). Part II focuses on the Congressional intent behind the '34 Act and addresses the issue whether the '34 Act was to have extraterritorial application and to be a vehicle for the regulation of offshore investment funds. Part III discusses and analyzes the application of Rule 10b-5 to the regulation of offshore investment funds and examines cases involving extraterritorial application of Rule 10b-5.

I. *INTERNATIONAL LAW PRINCIPLES AND EXTRATERRITORIAL APPLICATION OF RULE 10b-5*

A. *Doctrine of Jurisdiction Under International Law*

International law has yet to define all forms of jurisdiction that may be exercised by "international legal persons and states."[16] It has arrived, however, at a definition of the juris-

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15. 15 U.S.C. § 78a-kk (1982 & Supp. 1985).

16. L. HENKIN, R. PUGH, O. SCHACHTER & H. SMIT, CASES AND MATERIALS ON INTERNATIONAL LAW 168, 421 (2d ed. 1980) [hereinafter cited as L. HENKIN]. The term international legal person is defined by Henkin as follows:

> A subject of international law is considered to be an entity capable of possessing international rights and duties and endowed with the capacity to take certain types of action on the international plane. The terms "international legal person" or "legal personality" are commonly used in referring to such entities. Questions of whether an entity is an international legal person arise in various contexts. Most commonly, they have related to the capacity to make treaties and agreements under internatonal law, the capacity to make claims for breaches of international law, and the enjoyment of privileges and immunities from national jurisdiction. The question of international legal personality may also arise in regard to membership or participation in international bodies.
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> States are, of course, the principal examples of international persons. The attributes of statehood, as developed in customary law, provided the criteria for determining the "personality" of other entities. Indeed, under the traditional view only fully sovereign states could be persons in international law. The realities were more complex and many different kinds of entities have been considered as capable of having international rights and duties and the capacity to act on the international plane.
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> . . . .
>
> The widening of the concept of international legal personality beyond

diction of states.[17] Under international law, jurisdiction refers to a state's right to exercise certain powers to regulate matters not exclusively of domestic concern.[18] This "exercise of power" in an international context is entirely distinct from the existence of internal power, constitutional capacity, or sovereignty.[19] The fact that a state has power under municipal law

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the state is one of the more significant features of contemporary international law.

Id. at 168.

17. *See* 1 H. LAUTERPACHT, INTERNATIONAL LAW 279 (1970). Lauterpacht describes the difference between states and individuals under international law by stating that international law is a law of states exclusively. *Id.* Lauterpacht writes that individuals are only the objects of international law and as such international law does not impose duties upon them; neither does it grant to them directly any rights. *Id.* Lauterpacht argues that "such internationally relevant rights as they possess are granted by municipal law in accordance with international law. It is obviously a theory which sees in the sovereign State the ultimate unit and maker of international law, with all the consequences attaching thereto." *Id.*; *see* Mann, *The Doctrine of Jurisdiction in International Law*, in I RECUEIL DES COURS, ACADÉMIE DE DROIT INTERNATIONAL 9, 9-15 (1964). "The problem of international jurisdiction relates to the activities of a *State*, though it can arise in the case of an international organisation which, by the treaty creating it, usually is empowered to act within a limited sphere and which, by exceeding it, would be acting ultra vires." *Id.* at 9. International jurisdiction has been described as one of the fundamental functions of public international law. *Id.* at 15. In other words, "the function of regulating and delimiting the respective competences of States, 'de conférer, de repartir et de réglementer des compétences.' The same idea is expressed, when in German reference is made to the 'Geltungsbereich' of laws, or the 'Gesetzgebungsgewalt' of States." *Id.* at 15 (footnote omitted).

The Convention on Rights and Duties of States, Dec. 26, 1933, 49 Stat. 3097, T.S. No. 881, 165 L.N.T.S. 19, has defined a state in the following manner: "The State as a person of international law should possess the following qualifications: (a) a permanent population; (b) a defined territory; (c) government; and (d) capacity to enter into relations with the other States. *Id.* art. 1. The RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 4 (1965) [hereinafter cited as the SECOND RESTATEMENT] has also defined "state." Section 4 provides: "Except as otherwise indicated, 'state,' . . . means an entity that has a defined territory and population under the control of a government and that engages in foreign relations." *Id.*

18. Mann, *supra* note 17, at 9.

19. *Id.* at 9-17. "There is, of course, no doubt that, as a matter of international law, a State is free to legislate in whatever manner and for whatever purpose it chooses. But like all other attributes of sovereignty this liberty is subject to the overriding question of entitlement." *Id.* at 9. But the mere fact that a state has the power under municipal law to do a particular act does not imply that international law will recognize the same. *Id.* "The existence of the State's right to exercise jurisdiction is exclusively determined by *public international law*." *Id.* at 10-11. In circumstances involving international jurisdiction, international law limits jurisdiction which would have been granted to the state alone. *Id.* at 9-22. " '[J]urisdiction which, in principle, belongs solely to the State, is limited by the rule of international law.' No theory of sovereignty can displace them. . . . Were this not so, it would be possible, in the

to do a particular act does not imply that it has this power under international law.[20]

Under international law, the jurisdiction of a state depends upon its interests in exercising jurisdiction when viewed in light of the competing interests of other states.[21] These competing interests, which determine who will exercise jurisdiction, balance the transaction or event in question, and the person to be affected, with the state's interests.[22]

The international law criteria for determining jurisdiction of a state are: territory, nationality, and the protection of certain state and universal interests.[23] Whatever happens within a

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name of sovereignty, to impose measures which are outside the State's jurisdiction. This would be an intolerable result." *Id.* at 17 (footnotes omitted).

20. *Id.* The main difference between international law and municipal law lies in the fact that they regulate different subject matter. International law is the law between sovereign states while municipal law applies within a state and controls the relations of its citizens with each other and with the executive. I. BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 33-34 (3d ed. 1979). For a discussion of the relation between international law and municipal law, see L. HENKIN, *supra* note 16, at 114-167. Henkin states this distinction as follows:

> There have developed two principal "schools" or approaches seeking to explain in terms of traditional legal analysis the relation of international law to municipal law: the dualist (or pluralist) and the monist. There are several versions of both approaches, but in simplest terms the dualists regard international law and municipal law as entirely separate legal systems which operate on different levels. They hold that international law can be applied by municipal courts only when it has been "transformed" or "incorporated" into municipal law, and emphasize the international legal personality of states rather than individuals or other entities. The monists, on the other hand, regard international law and municipal law as parts of a single legal system, and find it easier to maintain that individuals have international legal personality. In a prevalent version of monism, municipal law is seen as ultimately deriving its validity from international law, which stands "higher" in the hierarchy of legal norms.

Id. at 118 n.3.

21. L. HENKIN, *supra* note 16, at 421. This approach, which advocates the balancing of states' interests prior to their exercise of jurisdiction in transnational cases, is a particularly important part of the RESTATEMENT (REVISED) OF FOREIGN RELATIONS LAW OF THE UNITED STATES (Tent. Draft No. 2, 1981) [hereinafter cited as the DRAFT RESTATEMENT]; *see id.* §§ 402-403; *see also* Reese, *Limitations on Extraterritorial Application of Law*, 4 DALHOUSIE L.J. 589 (1978) (discussing limitations on extraterritorial application of law imposed by public international law).

22. L. HENKIN, *supra* note 16, at 421. These relative state interests as advocated by international law have been codified in the SECOND RESTATEMENT, *supra* note 17, § 40; *see infra* notes 96-101 and accompanying text.

23. L. HENKIN, *supra* note 14, at 421-22. The international law criteria of territory, nationality, and protection of certain state and universal interests—the criteria

state's territory is of fundamental concern to that state.[24] Therefore, a state's jurisdiction over events or individuals within its territory is absolute.[25] A state also has a major interest in exercising jurisdiction over its own nationals.[26] There-

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evaluated when determining jurisdiction—are reflected in the SECOND RESTATEMENT, *supra* note 17, § 10. Section 10 provides:

> The jurisdiction of a state is founded on the following bases:
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> (a) territory, . . .
>
> (b) nationality, . . .
>
> (c) protection of certain state interests not covered under (a) and (b), . . . and
>
> (d) protection of certain universal interests . . . .

Given the fact that each state is part of the world community, rules defining its jurisdiction must take due account of the needs of that community and, specifically, of the need not to encroach unnecessarily on the interests of other members. This has been a significant consideration in delimiting in different fashion the extraterritorial reach of the various kinds of jurisdiction. *Id.*

24. L. HENKIN, *supra* note 16, at 421.

25. The Schooner Exchange v. M'Faddon, 11 U.S. (7 Cranch) 116, 136 (1812). In the classic expression of this principle, Chief Justice Marshall stated:

> The jurisdiction of the nation within its own territory is necessarily exclusive and absolute. It is susceptible of no limitation not imposed by itself. Any restriction upon it, deriving validity from an external source, would imply a diminution of its sovereignty to the extent of the restriction, and an investment of that sovereignty to the same extent in that power which could impose such restriction. All exceptions, therefore, to the full and complete power of a nation within its own territories, must be traced up to the consent of the nation itself.

Id. at 135. Later Justice Story writing for the Court in The Apollon, 22 U.S. (9 Wheat.) 362, 370 (1824), said: "The laws of no nation can justly extend beyond its own territories, except so far as regards its own citizens. They can have no force to control the sovereignty or rights of any other nation, within its own jurisdiction." *Id.* Territoriality remains the cardinal principle of jurisdiction in international law and has been adopted by the United States in cases involving extraterritorial reach of domestic statutes. D. GRIEG, INTERNATIONAL LAW 164 (1970); *see supra* note 11 (listing such cases). For a brief history of the territorial character of legislation, see Mann, *supra* note 17, at 24-28.

26. 48 C.J.S. *International Law* § 27 (1981). Jurisdiction over nationals in an international context is described in the following manner:

> Generally, nationals abroad are subject to the laws of their government wherever they may be, and, under some circumstances, 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. . . . A state or nation is not debarred by any rule of international law governing the conduct of its own citizens upon the high seas or even in foreign countries when the rights of other nations or their nationals are not infringed, and, thus, a sovereignty has power to make laws regulating the conduct of its subjects while beyond the limits of its territorial jurisdiction, and, while such laws have no extraterritorial effect and hence cannot be enforced while the subject remains abroad, they may be enforced on his return to its jurisdiction.

fore, international law does not bar a state from governing the conduct of its nationals in foreign countries or on the high seas.[27] Finally, a state's interest in protecting itself against actions executed outside its territory that threaten its existence and against certain universally condemned activities are also weighed to determine international jurisdiction.[28]

Traditionally three types of jurisdiction are distinguished: executive, judicial, and legislative.[29] Although municipal law defines these types of jurisdiction on several levels,[30] international law provides yet another basis of definition. Interna-

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Id.

Common law countries have traditionally declined jurisdiction based on nationality or on any principle other than territoriality. Akehurst, *Jurisdiction in International Law*, 1972-1973 BRIT. Y.B. INT'L L. 145, 157-58, 163. "The territorial principle is very deep-rooted in English-speaking countries, because originally the members of the jury were supposed to decide cases on the basis of their own knowledge of the facts, which meant that they could only try crimes committed in the place where they lived. . . ." *Id.* at 163.

27. Mann, *supra* note 17, at 50; *see* I. BROWNLIE, *supra* note 20, at 303. Brownlie describes the nationality principle as an aspect of sovereignty that may be used as a basis for jurisdiction over extraterritorial acts. *Id.*

28. Akehurst, *supra* note 26, at 157-66. Beginning in the nineteenth century continental countries began to claim jurisdiction over acts committed by aliens abroad which threatened the State. *Id.* This principle is well-established although the range of acts covered by it is the subject of controversy. The Harvard Research Draft Convention on Jurisdiction with Respect to Crime, articles 7 and 8 included the following acts under this rubric: "crimes against the security, territorial integrity or political independence of the State, and the counterfeiting of the seals, currency, instruments of credit, stamps, passports or public documents issued by the State." *Id.* at 158.

The universality principle of jurisdiction has been asserted against pirates for centuries. *Id.* at 160. It proposes that states work together to punish acts that are considered crimes in the state where they were committed and in the state claiming jurisdiction. *Id.* at 160-66.

29. L. HENKIN, *supra* note 16, at 420-23; Akehurst, *supra* note 24, at 145, 212.

30. L. HENKIN, *supra* note 16, at 420. Henkin points out that under municipal law the legislative, judicial, or enforcement powers of particular institutions are defined on more than one level. For instance, the legislative, judicial, and enforcement powers of the federal branches of government are defined in the constitution, which sets limits on federal and state governments' legislative, judicial, and enforcement jurisdiction. *Id.*; *see, e.g.*, U.S. CONST. art. X. Yet, under municipal law's conflict of law rules these same three areas of jurisdiction are defined and limited in ways that may vary from those prescribed by constitutional law. Thus, Henkin notes that

> a court in the United States may deny recognition to a foreign judgment or refuse to apply a foreign law, because, under its conflicts rules, the foreign court or legislature sought to extend its jurisdiction too far; and it may do so, even if recognition of what the foreign institution did would not run afoul of constitutional limitations.

L. HENKIN, *supra* note 16, at 420.

tional law sets limits that states may not exceed in the exercise of these three types of jurisdiction.[31]

1. Executive Jurisdiction

Executive jurisdiction is the power of one state to perform acts in the territory of another state.[32] As a general rule, a state may not exercise its executive or enforcement jurisdiction in the territory of another state without the permission or consent of that other state.[33] Not every act by one state in the territory of another, however, violates international law.[34] An act by one state violates international law only when the act amounts to a "usurpation of the sovereign powers" of the local state.[35] Acts by one state in the territory of another may usurp the sovereign powers of the other state either because of the nature of the acts involved or the purpose for which the act is performed.[36]

International law condemns an act by one state in the territory of another when that act, *by its nature*, could only be performed by the officials of the local state and not by private individuals.[37] For example, because taxes may be collected only by public officials and not by private individuals, the officials of one state may not collect taxes in another state's territory.[38]

An act by one state in the territory of another may amount

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31. L. HENKIN, *supra* note 16, at 420. Henkin points out that while these three types of jurisdiction have already been defined on "several levels under municipal law, international law provides still a different level. It defines the limits states and other international legal persons may not exceed in exercising jurisdiction. . . . But, within the international system, rules of international law operate directly on the subjects of international law whose powers they delimit." *Id.*

32. *Id.* at 423; Akehurst, *supra* note 26, at 145. The SECOND RESTATEMENT, *supra* note 17, § 6, deals with both judicial jurisdiction and executive jurisdiction under the term "enforcement jurisdiction." Enforcement jurisdiction is defined as "the capacity of a state under international law to enforce a rule of law, whether its capacity be exercised by the judicial or the executive branch . . . or by some other branch of government." *Id.*

33. L. HENKIN, *supra* note 16, at 423.

34. Akehurst, *supra* note 26, at 145-46. For example, every representative of a state who signs a contract in another state is not acting in derogation of international law. *Id.* In addition, some breaches of local law do not necessarily violate international law. *Id.* Spying in peacetime, for example, is by no means contrary to international law, although it will probably be contrary to a state's local law. *See id.*

35. *Id.* at 146.

36. *Id.*

37. *Id.*

38. *Id.*

to a usurpation of the latter state's sovereign power because of the act's purpose.[39] For example, a state may not normally enter the territory of another state for the purpose of enforcing its sovereign taxing powers in that territory.[40] Entry is a usurpation of the local state's sovereign powers, and this is contrary to international law.

2. Judicial Jurisdiction

Judicial jurisdiction is defined as the power of a state's courts to try cases involving a foreign element.[41] No issue of international law arises when an act occurs within a state involving only persons who are nationals, domiciliaries, or residents of that state. The problem of international judicial jurisdiction surfaces only when there is some genuine foreign element, as when a state's court tries to reach either persons of foreign nationality or events that happen abroad.[42]

The territorial principle furnishes a basis for the state's exercise of judicial jurisdiction over foreign persons or transactions within the territory in question.[43] The territorial principle holds that a state has the power to control conduct occurring within its borders.[44] The principle is frequently invoked to obtain jurisdiction in criminal actions.[45] This can be problematic because quite often a crime is committed partly in one country and partly in another, as in the textbook case involving a gun being fired across a frontier.[46] In this instance, the state must prove that a "constituent element" of the offense took place in its territory[47] because, pursuant to the international

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39. *Id.* at 147.

40. *Id.*

41. L. HENKIN, *supra* note 16, at 422; Akehurst, *supra* note 26, at 145.

42. Mann, *supra* note 17, at 14.

43. L. HENKIN, *supra* note 16, at 422.

44. Akehurst, *supra* note 26, at 152.

45. *Id.* This is true "even in continental countries, which also rely on the nationality principle to a far greater extent than common law countries, prosecutions based on the territorial principle far outnumber prosecutions based on the nationality principle." *Id.*

46. *Id.*

47. *Id.* at 152-53. This is the viewpoint adopted in the Case of the S.S. "Lotus" (Fr. v. Turk.), 1927 P.C.I.J., ser. A, No. 10, at 5 (Judgment of Sept. 7). In this case, a French steamship, the *Lotus*, collided on the high seas with a Turkish vessel. The latter sank and eight Turkish crew members lost their lives. *Id.* at 12-13. When the *Lotus* reached Constantinople, one of her French officers was arrested, prosecuted for manslaughter and eventually convicted in accordance with Turkish law which pro-

law principle of territoriality, a state should only be able to claim judicial jurisdiction if an offense takes place totally or partially in its territory.[48] At times this rule has been stretched considerably in order to claim judicial jurisdiction over offenses committed abroad that merely produce effects within the territory of judicial jurisdiction.[49]

A state also has the right to base judicial jurisdiction on crimes committed by its nationals abroad.[50] Acknowledging a genuine link between nationality and the state, an individual is considered to have the nationality that a state confers upon

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vided for the application of Turkish criminal law where a foreigner committed an offense against a Turkish subject outside Turkey. *Id.* The court found in favor of Turkey by invoking a fictitious locality of the offense: the French vessel's act could be said to have had its "effect" on what may be deemed to be Turkish territory. *Id.* at 23. With respect to the general question of territoriality of jurisdiction the majority said:

> It does not, however, follow that international law prohibits a State from exercising jurisdiction in its own territory, in respect of any case which relates to acts which have taken place abroad, and in which it cannot rely on some permissive rule of international law. Such a view would only be tenable if international law contained a general prohibition to States to extend the application of their laws and the jurisdiction of their courts to persons, property and acts outside their territory, and if, as an exception to this general prohibition, it allowed States to do so in certain specific cases. But this is certainly not the case under international law as it stands at present. *Far from laying down a general prohibition to the effect that States may not extend the application of their laws and the jurisdiction of their courts to persons, property and acts outside their territory, it leaves them in this respect a wide measure of discretion which is only limited in certain cases by prohibitive rules; as regards other cases, every State remains free to adopt the principles which it regards as best and most suitable.*
>
> This discretion left to States by international law explains the great variety of rules which they have been able to adopt without objections or complaints on the part of other States . . . .
>
> In these circumstances, all that can be required of a State is that it should not overstep the limits which international law places upon its jurisdiction; within these limits, its title to exercise jurisdiction rests in its sovereignty.

Id. at 19 (emphasis added).

48. Akehurst, *supra* note 26, at 152-53.

49. *Id.* at 153. "Some States . . . claim jurisdiction over offences committed abroad which merely produce effects on their territory, even though those effects were not a constituent element of the crime." *Id.*

The English Perjury Act, 1911, 1 & 2 Geo. 5, ch. 6. illustrates this approach. The Act provides that perjury by a person testifying before British authorities in foreign countries for the purposes of juridical proceedings in England shall be treated as if the perjury was committed in England. *Id.* § 1(5). "[O]n similar facts, courts in Argentina and the United States have openly based jurisdiction on the doctrine of effects. Other (non-perjury) cases in the United States and Switzerland also talk in terms of effects." Akehurst, *supra* note 26, at 153-54.

50. *Id.* at 156.

him.[51] Thus, a state has judicial jurisdiction to prevent its nationals from evading its laws by going abroad to commit acts proscribed within its own borders.[52]

International law also recognizes a protective principle of judicial jurisdiction over acts committed by aliens abroad that threaten the state.[53] This principle includes a range of acts that threaten the security, integrity, and political freedom of a state.[54]

3. Legislative Jurisdiction

Legislative jurisdiction is the power of a state to apply its laws to cases involving a foreign element.[55] Legislative jurisdiction tries to determine whether and under what circumstances a state has a right of regulation.[56] International law does not limit the scope of a state's legislative jurisdiction in civil matters,[57] but limits are imposed on a state's criminal legislative jurisdiction by requiring a proper jurisdictional basis.[58] Once a proper basis for the exercise of jurisdiction is found, a state's legislative reach extends beyond its boundaries into the territory of another state.[59]

Some international legal authorities suggest that international law should oppose extraterritorial legislation.[60] The ter-

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51. *See generally id.* at 156-57.

52. *Id.*

53. *Id.* at 157-59.

54. *Id.*

55. *Id.* at 145. For a thorough analysis of legislative jurisdiction, see Mann, *supra* note 17, at 23-51; Reese, *Legislative Jurisdiction*, 78 COLUM. L. REV. 1587 (1978).

56. Mann, *supra* note 17, at 13. Mann points out that: "Jurisdiction is concerned with the State's right of *regulation* or, in the incomparably pithy language of Mr. Justice Holmes, with the right 'to apply the law to the acts of men.' " *Id.* (quoting Wedding v. Meyler, 192 U.S. 573, 584 (1904)).

57. L. HENKIN, *supra* note 16, at 422.

58. *Id.*

59. *Id.*

60. Akehurst, *supra* note 26, at 181. The problem has been explained as follows:

> It has sometimes been suggested that *all* extraterritorial legislation is contrary to international law. In this connection a tag from Justinian's *Digest* is often quoted: *extra territorium ius dicenti impune non paretur*. What this tag means is that a man can disobey a judge with impunity outside the territory over which the judge has jurisdiction. This is not the same as saying that the judge (or the legislator) breaks international law if he asserts extraterritorial jurisdiction; ineffectiveness is not the same as illegality. . . . The view that extraterritorial legislation is *invariably* contrary to international law was rejected by the Permanent Court of International Justice in the *Lotus* case.

ritorial principle of legislation indicates that a state's legislation cannot regulate foreign citizens in a foreign country.[61] When such conduct injures the legislating state or its nationals, however, the state may impose liability in certain instances.[62] Thus, extraterritorial legislation is not always contrary to international law.[63] In fact, the Permanent Court of International Justice[64] in *The Case of the S.S. "Lotus"*[65] rejected the notion that extraterritorial legislation is invariably opposed to international law.[66] The court concluded that no rule of international law prohibits a state in which the effects of an offense take place from regarding the offense as having been committed in its territory and from prosecuting the delinquent accordingly.[67] Overwhelming state practice suggests that there are "no rules of international law limiting the legislative jurisdiction of States in questions of what might be loosely described as 'private law' (i.e. those areas of municipal law which are not concerned with crimes, the functioning of public bodies or the sovereign rights of the State)."[68] Although this assertion is quite broad, there are certain limits to extraterritorial legislative jurisdiction advocated by international law. For example, a state should not apply its law unless a close connection exists between the state and the person, thing, or event to which the law is to be applied.[69] A state's interest in the subject matter of

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Id. at 181-82.

61. Mann, *supra* note 17, at 47. International law implies what one may call, a requirement of noninterference in the affairs of foreign states. *Id.* In addition, this noninterference requirement "renders unlawful such legislation as would have the effect of regulating the conduct of foreigners in foreign countries. It is not normally lawful for legislation to operate 'as applying to foreigners in respect of acts done by them outside the dominions of the sovereign power enacting.'" *Id.*

62. Akehurst, *supra* note 26, at 179-81.

63. *Id.*

64. L. HENKIN, *supra* note 16, at 7, 33.

65. (Fr. v. Turk.), 1927 P.C.I.J., ser. A, No. 10 (Judgment of Sept. 7).

66. *Id.* at 20. In the *Case of the S.S. "Lotus"* the issue decided was whether Turkey had acted in conflict with the principles of international law by instituting joint criminal proceedings in pursuance of Turkish law against a French officer, following the collision on the high seas of the French steamer *Lotus* and the Turkish steamer, *Boz-Kourt*. *Id.* at 18; *see supra* note 47.

67. 1927 P.C.I.J., ser. A, No. 10, at 31.

68. Akehurst, *supra* note 26, at 187.

69. *See* Mann, *supra* note 15, at 46. Mann, a proponent of this viewpoint states that:

> [N]ot every close contact will be legally acceptable. The question whether the contact is sufficiently close, though a question of degree, is answered,

its legislation and whether this interest outweighs the concerns of other states are factors deserving careful consideration within an international context.[70] International law will usually allow a state to apply its own rule of law provided that the underlying policy of the rule would be served by its application.[71]

4. Comity

The doctrine of comity,[72] although not considered public international law,[73] emphasizes many values recognized as significant by the international legal community. Among these values are the use of local restraint and the limited application of sovereign powers to extraterritorial events and persons.[74]

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not by the idiosyncracies or the discretion of States or judges, but by the objective standards of international law. All circumstances will have to be taken into account, including, particularly, those to which the territorial doctrine attaches significance. These are in no sense to be discarded, but their presence is not invariably necessary or sufficient to support international jurisdiction . . . . In the final analysis, however, the question will be whether international law . . . sanctions the exercise of jurisdiction, special regard being had to the practice of States and the general principles of law recognized by civilized nations.

Id. at 46-47.

70. *Id.* at 48-51; *see also* DRAFT RESTATEMENT, *supra* note 21, § 403(c) (stating factors to be considered in limiting international jurisdiction).

71. Reese, *supra* note 55, 1608.

72. Akehurst, *supra* note 26, at 214-16. "Comity" was a term first used by the Netherlands writers on private international law in the seventeenth century. They used it to mean courtesy. *Id.* at 214. In most instances comity has been treated as something different from international law. *Id.* at 215. Thus, the extradition of criminals, in the absence of treaty is a matter of comity, not of right; exclusion of foreign vessels from a port would be a breach of comity, but not of international law. *Id.* Although comity is regarded as something more than courtesy, it is definitely not synonymous with duty imposed by international law. *Id.* at 215-16.

73. *Id.* at 236. The United States Court of Appeals for the Ninth Circuit, in Timberlane Lumber Co. v. Bank of America, 549 F.2d 597 (9th Cir. 1976), adopted a comity analysis to the issue of whether United States law should be extraterritorially applied. *Id.* at 601-14. A similar comity analysis has also been proposed in the American Law Institute's DRAFT RESTATEMENT, *supra* note 21, § 403. Both analyses balance the relevant interests of the United States and the foreign nation to determine whether United States law should be applied. *See Timberlane*, 549 F.2d at 611-14; DRAFT RESTATEMENT, *supra* note 21, § 403.

74. Akehurst, *supra* note 26, at 214-15; *see* I. BROWNLIE, *supra* note 20, at 31. Brownlie notes that:

International comity, *comitas gentium*, is a species of accommodation not unrelated to morality but to be distinguished from it nevertheless. Neighbourliness, mutual respect, and the friendly waiver of technicalities are involved, and the practice is exemplified by the exemption of diplomatic envoys from customs duties. Oppenheim writes of the 'rules of politeness, convenience

The value of comity should not be underestimated in assessing international jurisdiction. Comity stresses the notion of reciprocal tolerance in international affairs.[75] It requires that the legal rights of other states and the decisions of courts of other countries be respected as a matter of policy, not as a matter of law.[76] The international law goals of stability and order are reinforced by this doctrine's emphasis on the principle of self restraint, a principle that facilitates accommodation rather than confrontation.[77] Comity imposes a figurative injunction upon states to act reasonably. With this in mind, a great deal of emphasis is placed on balancing the relative interests of the states before asserting jurisdiction. This balancing of interests approach was incorporated by section 403 of the Restatement (Revised) of the Foreign Relations Law of the United States (Draft Restatement)[78] and to a lesser extent by section 40 of the Restatement (Second) of Foreign Relations Law of the United States (Second Restatement).[79]

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and goodwill observed by States in their mutual intercourse without being legally bound by them.' Particular rules of comity, maintained over a long period, may develop into rules of customary law. Apart from the meaning just explained, the term "comity" is used in four other ways: (1) as a synonym for international law; (2) as equivalent to private international law (conflict of laws); (3) as a policy basis for, and source of, particular rules of conflict of laws; and (4) as the reason for and source of a rule of international law.

Id. (footnotes omitted).

75. 1 H. LAUTERPACHT, *supra* note 17, at 44-46.

76. Maier, *Extraterritorial Jurisdiction at a Crossroads: An Intersection Between Public and Private International Law*, 76 AM. J. INT'L L. 280, 296 (1982).

77. *See* Akehurst, *supra* note 26, at 216.

78. DRAFT RESTATEMENT, *supra* note 21, § 403.

79. SECOND RESTATEMENT, *supra* note 17, § 40; *see* Houck, *The New A.L.I. Restatement of the Foreign Relations Law of the United States—Problems for Practitioners*, in PRIVATE INVESTORS ABROAD—PROBLEMS AND SOLUTIONS IN INTERNATIONAL BUSINESS IN 1983, 37 (1983). The Second Restatement has been described as "a treatise of very great significance. U.S. courts quote it on matters of international law as if it were the Bible . . . . The lack of a large body of case law in the international field . . . gives this Restatement disproportionately greater influence." *Id.* at 39. With respect to § 40 of the Second Restatement, one authority writes that "the courts, after determining jurisdiction exists under the territorial or nationality principles, have resolved concurrent jurisdiction by exercising 'voluntary restraint' when the regulatory interests of foreign nations having contact with the transaction or occurrence are great or when those of the United States are minimal." Maier, *supra* note 76, at 295-96.

B. *Restatement (Second) of Foreign Relations Law of the United States*

The Second Restatement distinguishes between two types of jurisdiction that may be exercised by a state: jurisdiction to prescribe and jurisdiction to enforce.[80] Jurisdiction to prescribe is the "capacity of a state under international law to make a rule of law."[81] Jurisdiction to enforce is the "capacity of a state under international law to enforce a rule of law" by the act of any branch of government.[82] To enforce any legal rule, both jurisdiction to prescribe and jurisdiction to enforce must be present.[83] It is contrary to international law either to prescribe or enforce a rule without adequate jurisdiction.[84]

Consistent with the principles of public international law,[85] the jurisdictional rules set forth in the Second Restatement are based primarily on nationality and territoriality.[86] Concerning nationality, section 30 of the Second Restatement acknowledges that a state always has jurisdiction to regulate the conduct of its own nationals wherever that conduct may occur.[87] A state does not have jurisdiction over the conduct of an alien outside its territory, however, merely on the ground that the conduct affects one of its nationals.[88] Two distinct doctrines are subsumed under the rubric of territoriality:[89] the subjective territorial principle, or "conduct" doctrine, and the objective territorial principle, or "effects" doctrine.[90]

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80. SECOND RESTATEMENT, *supra* note 17, §§ 6-7.
81. *Id.* § 6.
82. *Id.*
83. *See id.* § 7.
84. *Id.* § 8.
85. I. BROWNLIE, *supra* note 20, at 15-20, 300-03.
86. SECOND RESTATEMENT, *supra* note 17, §§ 17-18.
87. *Id.* § 30.
88. *Id.* §§ 17-18.
89. The doctrine of territoriality holds that a state has the power to control conduct occurring within its borders. A state has jurisdiction over persons, things, and events within its territory. D. GRIEG, *supra* note 25, at 164. The classic formulation of the territoriality principle which holds that a state may regard an offense as having been committed in its national territory "if one of the constituent elements of the offence, and more specially its effects, have taken place there," comes from the *"Lotus"* Case. 1927 P.C.I.J., ser. A, No. 10, at 23.
90. Harvard Research in International Law, *Jurisdiction with Respect to Crime*, 29 AM. J. INT'L L. 435, 484, 487-88 (1935); *see also*, Jennings, *Extraterritorial Jurisdiction and the United States Antitrust Laws*, 1957 BRIT. Y.B. INT'L L. 145, 159 (commenting on the conduct and effects test in an antitrust context).

Under the conduct doctrine, a state has subject matter jurisdiction in civil cases over anything located in its territory or over the conduct of any person, including an alien, that occurs within the state's territory.[91] There are problems, however, with the Second Restatement's adoption of this doctrine. The term "conduct" as used in section 17(a) of the Second Restatement is so broad that it covers all territorial conduct.[92] It defines extraterritorial jurisdiction expansively without including workable limitations into the term "conduct."[93] Without any further qualification of the term, a minimal degree of domestic conduct could serve as a basis for subject matter jurisdiction under section 17.

Under the effects doctrine, conduct abroad that produces a substantial, direct, and foreseeable effect within the state is considered within the subject matter jurisdiction of the state.[94] The extraterritorial conduct and its effect must be constituent elements of the proscribed activity.[95] The only connection with a territory required by section 18 of the Second Restatement is the presence of an effect, injury, or constituent element of the offense.[96] Conduct within the territory per se is not re-

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91. SECOND RESTATEMENT, *supra* note 17, § 17. Section 17 provides that:

> 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.

Id. (emphasis added).

92. *See id.* § 17(a).

93. *See id.*

94. *Id.* § 18. Section 18 provides that: 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.

Id.

95. *Id.* "Constituent element" as used in § 18 implies an assertion of jurisdiction based on "attendant consequences or repercussions" resulting from the offense. *Id.* Note that "effects" in § 18 is not confined to constituent elements of the offense. *See id.*

96. *Id.*

quired.[97] Consequently, the effects doctrine should be used with caution lest liability be imposed for every impact within the borders of a state.

Where states have concurrent jurisdiction to prescribe and enforce rules of law for the same parties or the same facts, section 40 of the Second Restatement[98] creates legal limitations upon a state's exercise of enforcement jurisdiction.[99] Under section 40, a rule of reason approach is advocated to decide whether preexisting jurisdiction should be exercised.[100] "Reasonableness" is determined by the forum's evaluation of the states' relative interests and the fairness of enforcing the rules in question.[101] The factors of international comity and fairness

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97. *Id.*

98. *Id.* § 40. Section 40 provides that:

> Where two states have jurisdiction to prescribe and enforce rules of law and the rules they may prescribe require inconsistent conduct upon the part of a person, each state is required by international law to consider, in good faith, moderating the exercise of its enforcement jurisdiction, in the light of such factors as
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> (a) vital national interest of each of the states,
>
> (b) the extent and the nature of the hardship that inconsistent enforcement actions would impose upon the person,
>
> (c) the extent to which the required conduct is to take place in the territory of the other state,
>
> (d) the nationality of the person, and
>
> (e) the extent to which enforcement by action of either state can reasonably be expected to achieve compliance with the rule prescribed by that state.

Id.

99. *Id.*

100. *See id.* The term "rule of reason" is applied here by analogy to the term of art used in antitrust analysis. P. AREEDA, ANTITRUST ANALYSIS §§ 146, 203, 301 (1981). The rule of reason, which prohibited unreasonable conduct and unreasonable restraints of trade was first articulated in Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911). Chief Justice White stated "the dread of enhancement of prices . . . which . . . would flow from undue limitation on competitive conditions caused by contracts or other acts . . . led, as a matter of public policy, to the prohibition or treating as illegal all contracts or acts which were unreasonably restrictive of competitive conditions." *Id.* at 58. Applying a "standard of reason" to determine whether an agreement is prohibited as a restraint of trade depends upon a number of factors including the purpose of the arrangement, the character of the parties and the effect of their actions. P. AREEDA, *supra*, § 203. These balancing factors in antitrust law, are mirrored in § 40 of the Second Restatement. Section 40 tries to determine by a "rule of reason" whether jurisdiction should be exercised. SECOND RESTATEMENT, *supra* note 17, § 40. Reasonableness in the § 40 context is determined by the forum's perception of the competing state's interest and fairness to the parties. *See id.*

101. Maier, *supra* note 76, at 293-95, n.67.

advocated in section 40 provide additional guidance to decisionmakers in resolving problems of extraterritoriality. The Draft Restatement also advocates this qualitative evaluation of interests between regulating states and the parties or events to be regulated.

C. *Restatement (Revised) of the Foreign Relations Law of the United States*

The importance of the Draft Restatement,[102] which includes a section entitled "Jurisdiction over Securities Transactions,"[103] lies in its more equitable approach toward determining international jurisdiction.[104] This approach supplements the territoriality and nationality tests of the Second Restatement with a balancing test that evaluates "all relevant factors."[105] These balancing factors help determine which state has greater interest in deciding a matter. Among the considerations taken into account are whether the parties had legitimate expectations that certain results would flow from their conduct and whether the jurisdictional rules invoked sufficiently notified the states of the obligations that a prescribing state would enforce to vindicate its interests.[106] Far from emphasizing narrowly nationalistic interests, these factors underscore the international law goals of stability, order, and pre-

102. DRAFT RESTATEMENT, *supra* note 21; Houck, *supra* note 79, at 47. "The Draft Restatement describes a system for reducing collisons between legal systems by reference to various balancing factors that help to determine which state has greater interest in regulating the matter, and [it] give[s] considerable weight to the reasonable expectation of the parties which the law would govern." *Id.* This balancing of the interests of the parties is applied by analogy to the principles of conflicts of law. *Id.* "It is an attempt to apply in the public law area the principles of conflicts of laws that have long been applied in the public law area." *Id.*

103. DRAFT RESTATEMENT, *supra* note 21, § 416.

104. *Id.* § 403. The equity in the Draft Restatement's approach lies in the balancing of the relevant interests of the United States and the foreign nation concerned to determine whether the United States should assert jurisdiction. *Id.*; *see* Maier, *supra* note 76, at 300. The Draft Restatement "seeks to build on the instinctive recognition in these cases of a relationship between international law and wise national politics by creating a coherent format for inquiry into jurisdictional problems so as to reflect accurately the process by which the exercise of national power is legitimatized in the international community." *Id.* For this reason, "whether jurisdiction exists *ab initio* is not determined by mechanical analysis of factual contacts but by judicial evaluation of the propriety of the exercise of power." *Id.*

105. DRAFT RESTATEMENT, *supra* note 21, § 403 (2).

106. *Id.* § 403(2)(d), (f)-(h).

dictability.[107]

The Draft Restatement applies these same balancing factors to jurisdiction in securities transactions.[108] Section 416 would permit the United States to prescribe its securities laws over any transaction carried out on a United States securities market.[109] But, jurisdiction to prescribe depends upon reasonableness evaluated in light of the section 403 balancing factors where:

> (a) securities of the same issuer are traded on a securities market in the United States; or
> (b) representations are made or negotiations are conducted in the United States in regard to the transactions; or
> (c) the party subject to the regulation is a United States national or resident, or the persons sought to be protected are residents of the United States . . . .[110]

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107. For a summary of the goals of international law as perceived by the United States, see Lauritzen v. Larsen, 345 U.S. 571 (1953). The Court emphasized the functional role of judicial decision making in the international system. International law "aims at stability and order through usages which considerations of comity, reciprocity and long-range interest have devleoped to define the domain which each nation will claim as its own." *Id.* at 582.

108. DRAFT RESTATEMENT, *supra* note 21, § 416. Section 416 provides that the following factors should be taken into account in securities cases by incorporating § 403(2):

> (a) the extent to which the activity (i) takes place within the regulating state, or (ii) has substantial, direct, and foreseeable effect upon or in the regulating state;
> (b) the links, such as nationality, residence, or economic activity, between the regulating state and the persons principally responsible for the activity to be regulated, or between that state and those whom the law or regulation is designed to protect;
> (c) the character of the activity to be regulated, the importance of regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted;
> (d) the existence of justified expectations that might be protected or hurt by the regulation in question;
> (e) the importance of regulation to the international political, legal or economic system;
> (f) the extent to which such regulation is consistent with the traditions of the international system;
> (g) the extent to which another state may have an interest in regulating the activity;
> (h) the likelihood of conflict with regulation by other states.

Id. § 403(2).

109. *Id.* § 416.

110. *Id.*

Therefore, the factors for determining "reasonableness" in a securities context include: the interests of a foreign state in asserting jurisdiction; the expectations of the parties involved that their conduct would be subject to the securities regulations of the United States; and, the interests of the state in regulating the conduct or effects of a fraudulent securities scheme.[111]

The Draft Restatement limits the broad extraterritorial application of the federal securities laws by rejecting the minimal conduct approach, which recognizes a minimal degree of domestic conduct as a sufficient basis for exercise of subject matter jurisdiction.[112] The fact that the Draft Restatement rejects this approach implies an unreasonable assertion of United States jurisdiction.[113] Under the Draft Restatement, "conduct" would be only one factor among many to be evaluated in assessing jurisdiction.[114] In keeping with the purpose of this section of the Draft Restatement, which is to define the securities laws within the "limits of international law,"[115] the minimal conduct approach would be rejected as a basis for asserting jurisdiction in extraterritorial securities cases.

The impact of the Draft Restatement on the effects test is more difficult to assess. For jurisdiction to be predicated on a domestic effect of extraterritorial conduct, the Second Restatement required that the effect be a direct and foreseeable result of the conduct outside the territory and that the effect within the territory be substantial.[116] Similarly, the Draft Restatement, when listing relevant factors to consider in determining whether jurisdiction is reasonable under section 403(2), states that an effect must be direct, foreseeable, and substantial.[117] The difficulty in applying this test under both Restatements lies in the fact that the term effects could be either broadly or narrowly construed depending upon the meaning attributed to

111. *Id.* §§ 403, 416.

112. *See id.* The list of balancing factors set forth in § 403(2) of the Draft Restatement forces states to decide the question of extraterritorial application of United States laws by considering relevant comity counsiderations as opposed to a mere mechanical test of minimal conduct. *Id.* § 403(2).

113. *See id.*

114. *Id.* § 416 n.3.

115. *Id.* § 416 n.6.

116. SECOND RESTATEMENT, *supra* note 17, § 18.

117. DRAFT RESTATEMENT, *supra* note 21, § 403(2)(a).

the qualifying adjectives. Unless the meaning of direct, foreseeable, and substantial is more clearly defined in light of the interests of other nations as well as the demands of international order, the effects test runs the risk of being too relative and amorphous to be useful.

II. *EXTRATERRITORIAL APPLICATION OF RULE 10b-5 TO OFFSHORE INVESTMENT FUNDS*

In recent years, United States courts have extended the extraterritorial reach of the corporate mismanagement application of Rule 10b-5[118] to the internal regulation[119] of offshore investment funds.[120] This extension of Rule 10b-5 not only vi-

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118. 17 C.F.R. § 240.10-b (1984); *see supra* note 10 (for the text of Rule 10b-5).

119. *See* 15 U.S.C. § 80a-1, -64; *id.* § 80b-1, -21. Internal regulation refers to the management of the corporate structure of the investment company. It includes the management of routine activities of the investment company by its fiduciaries. Regulation also includes control over inter alia: breaches of fiduciary duty; affiliations of directors; changes in investment policy; and, changes in board of directors. *Id.*

120. *See, e.g.*, IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); SEC v. Kasser, 548 F.2d 109 (3d Cir. 1977); IIT v. Vencap, 519 F.2d 1001 (2d Cir. 1975); Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); Roth v. Fund of Funds, Ltd., 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969); *see also* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 925-46 (1983). The situations involving corporate mismanagement applications of Rule 10b-5 typically involve activities where the controlling shareholders of a corporation induce the corporation to enter into a securities transaction from which they personally benefit. This may occur, for example, when: 1) they issue themselves stock for an inadequate price; 2) approve a merger from which they stand to personally benefit; or 3) consolidate their control through a redemption of securities by the corporation. In these situations, there are two corporate interests neither of which are served by the controlling directors or dominant shareholders: i) the interest the corporation has in obtaining reliable information in making its trading decisions; and ii) the interest of the corporation in being able to trust its directors with the management of its securities dealings. *See generally id.; infra* notes 168-297 and accompanying text.

There is a line of cases originating with Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), *rev'd with respect to holding on merits*, 405 F.2d 215 (2d Cir. 1968)(en banc), *cert. denied*, 395 U.S. 906 (1969), which underscores this latter class of interests in the Rule 10b-5 mismanagement context. In spite of the fact that the court in *Schoenbaum* could not point to a specific act of actual deception, it found that once a minority shareholder had controlling influence over the board's decision-making powers, the fraud requirement would be met. *See id.* This test has been referred to as "new fraud" given the novel approach to liability: liability is found for a pure breach of fiduciary obligation. *See* Sherrad, *Federal Judicial & Regulatory Response to Santa Fe Industries, Inc. v. Green*, 35 WASH. & LEE L. REV. 695, 698 n.19 (1978); Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103, 1103-04 (1969). Courts later interpreted *Schoenbaum* as holding that in a corporate mismanagement context, no deception need be shown. In Marshel v. AFW

olates principles of international law[121] but its application in

Fabric Corp., 533 F.2d 1277 (2d Cir. 1976), the court allowed a cause of action based upon a breach of fiduciary duty despite a finding of prior full and fair disclosure. *Id.*

The use of the "controlling influence" or "new fraud" test has been extremely limited. *See* Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972). In Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 473-74 (1977), the Court limited this application of the Rule by requiring that liability under Rule 10b-5 be based on deception and not on breach of fiduciary duty alone. *Id.* at 473-74. The Court first took issue with the Second Circuit's interpretation of Rule 10b-5. It reasoned that the statutory language of § 10(b) controlled the regulatory language of Rule 10b-5. Since "fraud" does not appear in § 10(b), the Court called it a gloss on the language of the statute and held that since § 10(b) gave no indication that Congress meant to prohibit any conduct not involving manipulation or deception, a pure equitable fraud case was not within the scope of § 10(b). *Id.* at 473. The plaintiff would have to either show manipulation or deception in order to come within the scope of Rule 10b-5. *Id.* The Court stated that while a need for a federal fiduciary standard might exist, a judicial extension of Rule 10b-5 is an improper servant for this cause. *Id.* at 479-80. Although the Court, through *Santa Fe*, has virtually dealt a death blow to the notion that a corporate mismanagement suit may be brought under Rule 10b-5 without an allegation of manipulation or deception, several lower court decisions led by Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978), have narrowly construed *Santa Fe*. They hold that, with a proper allegation of deception, *Santa Fe* will not bar a corporate mismanagement action. *See* Healey v. Catalyst Recovery, 616 F.2d 641 (3d Cir. 1980); Alabama Farm Bureau Mutual Casualty Co., Inc. v. Fidelity Life Insurance Co., 606 F.2d 602 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980).

Ironically, judicial application of Rule 10b-5 to offshore funds occurs at a time when the Supreme Court has been trying to reduce the scope of this Rule. For example, in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Supreme Court held that proof of an actual purchase or sale of securities, rather than a lost opportunity to purchase, is necessary to recover for a violation of Rule 10b-5. *Id.* at 754-55. In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court held that scienter, not mere negligence, is necessary to establish a Rule 10b-5 violation. *Id.* at 201. And, in Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), the Court held that mere unfairness or breach of fiduciary duty, unsupported by allegations of deception or manipulation, is not actionable under Rule 10b-5. *Id.* at 477-80; *see also* Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977) (discussing the status of Rule 10b-5 after *Schoenbaum*).

121. Akehurst, *supra* note 26 at 214-17. Legislation is presumed to apply territorially unless a contrary Congressional intent is indicated. In a case where Congress expressly provides that a statute applies to conduct outside the United States, a court, according to *Leasco*, 468 F.2d 1326 (2d Cir. 1972), "would be bound to follow the Congressional direction unless this would violate the due process requirement of the Fifth Amendment." *Id.* at 1334. *But see* SECOND RESTATEMENT, *supra* note 17, § 7(1) ("[a] state having jurisdiction to prescribe a rule of law does not necessarily have jurisdiction to enforce it in all cases"); *id.* § 30(2) ("[a] State does not have jurisdiction to prescribe a rule of law attaching legal consequences to conduct of an alien outside its territory merely on the gound that the conduct affects one of its nationals"). The Second Restatement represents an awareness that when one nation begins to extend its laws beyond its own boundaries, two principles of international law come into conflict: i) that every state is sovereign and as such has exclusive control over acts occurring within its territory; and, ii) a state may impose penalties on

this area ignores the basic purpose for which section 10(b)[122] and Rule 10b-5 were enacted. These regulations were enacted to insure and protect the integrity of the marketplace and to minimize market risk to potential investors by requiring full disclosure.[123] While minority shareholders in offshore funds deserve protection against inequitable treatment by their officers and directors,[124] overly broad constructions of Rule 10b-5 resulting in extraterritorial extension of United States jurisdiction are an improper way to remedy the corporate wrongs of offshore investment companies.[125]

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persons who owe no allegiance to the state when their acts have detrimental effects within the state. Underhill v. Hernandez, 168 U.S. 250, 252 (1897); United States v. Aluminum Company of America, 148 F.2d 416, 443 (2d Cir. 1945). It seems proper to limit the scope of the '34 Act to situations involving sufficient domestic acts. *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 985 (2d Cir. 1975) ("[w]hen . . . a court is confronted with transactions that on any view are predominantly foreign, it must seek to determine whether Congress would have wished the precious resources of United States courts and law enforcement agencies to be devoted to them rather than leave the problem to foreign countries").

122. Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1982 & Supp. 1985). The statute states:

> 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 . . . 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.

Id.

123. *See infra* notes 148-67 and accompanying text.

124. A fiduciary relationship exists between the officers and directors of the fund and its shareholders. W. CARY & M. EISENBERG, CORPORATIONS 563-76 (5th ed. 1980). A fiduciary relationship creates a duty to act primarily for the benefit of another in matters connected with a client's undertaking. 15 U.S.C. § 80a-35(a) (1982 & Supp. 1985). *See generally* RESTATEMENT (SECOND) OF AGENCY § 13, comment a (1958); Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181, 192, 196 (1966). The cornerstone of a fiduciary's duty is the obligation to act for the client's benefit and to treat that client fairly. These standards are based on reasonable assumptions that reasonable persons would not entrust their property to fiduciaries unless their fiduciaries would act in conformity with certain standards. Fiduciaries are therefore expected to act for their client's benefit. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 187-188 (1963); RESTATEMENT (SECOND) OF AGENCY § 390 (1958).

125. *Cf.* 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 2.2(410), 2.2(420) (1981); *Conference on the Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967); *infra* notes 148-67 and accompanying text. The Supreme Court has remarked upon the paucity of legislative history on § 10(b) in

Courts have tried to identify the scope of liability under the broadly stated prohibitions of section 10(b) and Rule 10b-5.[126] Liability is contingent upon proof that a person used a manipulative or deceptive device involving a material misrepresentation or material omission in connection with the purchase or sale of a security.[127] In making or facilitating the transaction, the person must have acted with scienter beyond mere negligence.[128] The plaintiff must show reliance on a material deception or that a loss was at least causally related to the deception.[129] Liability under Rule 10b-5 can result either from an affirmative misrepresentation or from the witholding of information material to a decision whether to buy or sell a security.[130] In the case of offshore funds, Rule 10b-5 violations usually derive from abuse of control[131] and consist of either: 1) the defendant fund's knowing misrepresentation or omis-

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Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). "Neither the intended scope of § 10 (b) nor the reasons for the change in its operative language are revealed explicitly in the legislative history of the '34 Act, which deals primarily with other aspects of the legislation." *Id.* at 202.

126. 3 L. Loss, *supra* note 120, at 820-944; *see* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Superintendent of Ins. of New York v. Bankers Life and Casualty Co., 404 U.S. 6 (1971); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). On the elements needed to invoke Rule 10b-5 in a civil action, see J.V. Patrick, *Litigation Under SEC Rule 10b-5* (ALI/ABA Publication 1975).

127. 17 C.F.R. § 240.10b-5 (1984); *see* United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-31 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952).

128. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

129. Shores v. Sklar, 647 F.2d 462, 468-69 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970).

130. Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978), *cert. denied*, 439 U.S. 1039 (1978); Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951).

131. It was precisely these "control" relationships which engendered the abuses against which the ICA was targeted. Investment Company Act, §§ 10a-b, 15 U.S.C. §§ 80a-10(a)-(b) (1982 & Supp. 1985); *id.* § 17, 15 U.S.C. § 80a-17. The relationship between the fund's directors, adviser, and shareholders is a "control" relationship. It is the fund directors and advisers who really run the investment companies. In order to effectively stay the abuses of control, the ICA limits insiders' participation in the management of investment companies and drastically reduces their ability to deal with the companies. *Id.* § 80a-17(e); *see* 2 T. FRANKEL, *supra* note 3, at 585-603.

"Control" is defined in the ICA and the IAA, 15 U.S.C. §§ 80a-2(9), 80b-2(17) (1982 & Supp. 1985), in almost identical terms. The ICA defines "control" as follows:

"Control" means the power to exercise controlling influence over the man-

sion of material facts to fund shareholders regarding investment decisions; or 2) the defendant fund's arrival at an investment decision based on prospective benefit to the directors or fund managers rather than benefit to the shareholders.[132] Either type of investment decision involves improper action by the directors or fund managers and results in economic loss to shareholders.[133]

In the Rule 10b-5 corporate mismanagement cases dealing with offshore funds, the complaint is typically that an insider or controlling shareholder has caused the fund to execute a transaction that results in economic injury to the independent shareholder.[134] Courts began to apply Rule 10b-5 to the corporate mismanagement of offshore funds because the statutes that ordinarily cover abuses in investment companies, the Investment Company Act of 1940[135] (ICA) and the Investment Advisers Act of 1940[136] (IAA) (collectively, Investment Acts), are not applicable to offshore funds.[137]

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agement or policies of a company, unless such power is solely the result of an official position with such company.

Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company. Any person who does not so own more than 25 per centum of the voting securities of any company shall be presumed not to control such company. A natural person shall be presumed not to be a control person within the meaning of this subchapter. Any such presumption may be rebutted by evidence, but except as hereinafter provided, shall continue until a determination to the contrary made by the Commission by order either on its own motion or on application by an interested person.

15 U.S.C. § 80a-2(9) (1982 & Supp. 1985); *see also*, Note, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 736, 799 (1969) (discussing management control of the investment company).

132. 15 U.S.C. § 80a-1(b); *id.* §§ 80a-17(a)-(j); *see* 2 T. FRANKEL *supra* note 3, at 5-85; Note, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 L.Q. REV. 472, 476 (1968).

133. Since a Rule 10b-5 action requires a causal connection between the deceptive misrepresentation or omission of material facts and the injury, the typical case involves a plaintiff making an investment decision that leads to his loss. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238 (2d Cir. 1974); SEC v. Texas Gulf Sulphur, 401 F.2d 833, 845-50 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Klamberg v. Roth, 473 F. Supp. 544, 550 (S.D.N.Y. 1979); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

134. 2 A. BROMBERG & L. LOWENFELS, *supra* note 125, §§ 4.7(b-41), 4.7 (000)(1); L. Loss, *supra* note 120, at 926-28.

135. 15 U.S.C. §§ 80a-1 to -64 (1982 & Supp. 1985).

136. *Id.* §§ 80b-1 to -21.

137. The Investment Company Act of 1940 and the Investment Advisers Act of

Congress enacted the ICA and the IAA to curb the scores of abuses inherent in the structure of investment companies[138] and in the relationship between the investment company, its

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1940 regulate only those companies that register under them or use the instrumentalities of interstate commerce to sell securities. *Id.* §§ 80a-7, -8, 80b-4, -6.; *see also* SEC. EXCHANGE COMM'N, THE ORIGIN, SCOPE, AND CONDUCT OF THE INDUSTRY, NATURE, AND CLASSIFICATION OF INVESTMENT TRUSTS AND INVESTMENT COMPANY MOVEMENT IN THE UNITED STATES, H.R. DOC. No. 707, 75th Cong., 3d Sess. (1940). *See generally* 1-4 T. FRANKEL, *supra* note 3 (discussing abuses in investment companies).

Many provisions of the Investment Acts are intended to prevent or inhibit outright fraud. For example, § 17, the ICA's conflict of interest provision, contains important antifraud protections. The SEC is authorized to adopt rules to prevent fraudulent and deceptive practices in connection with the purchase or sale of securities held or intended to be acquired by an investment company. 15 U.S.C. § 80a-37, -38. In addition, § 10 of the ICA places strict limitations on the composition of the board of a registered investment company by requiring that no less than 40% of most boards consist of persons who are not officers, directors, employees, or other "interested persons" of the investment company, its adviser, or its principal underwriter. *Id.* § 80a-10. These restrictions help ensure that someone in a position of power will serve as a "watchdog" on behalf of the shareholders, especially in situations involving possible conflicts of interest. *See id.* Similarly, § 206 of the IAA governs fraud in the offering and rendering of investment advice. Under § 206 of the IAA, advisers have a fiduciary duty toward their present and prospective clients to disclose all material facts in connection with the offer of their services. *Id.* § 80b-6, -3; *see* 2 T. FRANKEL, *supra* note 3, at 348-52. "The language of the section [206] is similar to the language of Rule 10b-5 under the 1934 Act . . . . However, section 206 deals with duties of fiduciaries, whereas Rule 10b-5 deals with sale and purchase of securities. Fraud by unfair dealings may therefore be within the section." *Id.* at 352.

Furthermore the ICA contains two sections enacted to deal with investment abuse: § 37 makes it unlawful to embezzle and commit larceny of investment company funds; and § 36 authorizes the SEC to bring an action for injunctive relief on the ground that the adviser, directors, and others have committed gross misconduct and gross abuse of trust. 15 U.S.C. §§ 80a-35, -36.

138. 15 U.S.C. §§ 80a-1(b)(1)-(8), 80b-7, -11; *see* 1 T. FRANKEL, *supra* note 3, at 30-33. "Temptations of the 1930s appeared in other forms in the 1960s. For example, there were attempts to form investment companies to invest in other investment companies, arrangements that offer doubtful advantages to investors but may double managers' fees. . . . The Hearings which preceded the 1940 Act revealed many of these abuses." *Id.* at 30. The shareholders of the investment companies are the risktakers in the mutual scheme. Regulation of investment companies strengthens the shareholders' control over the companies' management and investment policies. The ICA does this by converting pools of liquid assets into enterprises managed for the benefit of their shareholders.

> The Act regulates the safekeeping of investment company assets, makes larceny of assets a federal offense, prohibits or limits self-dealing between investment companies and their affiliates, regulates the capital structure of investment companies, and strengthens the control of investment companies' shareholders over the management and over their companies' investment policies.

Id.

adviser, officers, and directors.[139] These abuses include: self-dealing, overreaching, and fraud.[140]

Both domestic and offshore investment companies offer a "special temptation to looters" because of their large pools of liquid assets.[141] The temptation exists to use these funds not only for the benefit of investors but also for the benefit of managers and directors.[142] Many investment company transactions reflect the conflicting interests between investment adviser, investment company, director, and shareholder transactions characterized by the absence of arm's length dealing and by opportunities for overreaching.[143]

There are express statutory sections in the Investment Acts that exclude foreign investment companies and foreign investment advisers from the reach of both the ICA and the IAA.[144] A foreign investment company or adviser must register under the Investment Acts or use the instrumentalities of interstate commerce in order to be regulated by them.[145] Thus, the abuses covered by the Acts do not extend to offshore funds. Consequently, United States courts have tried in recent

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139. 1 T. FRANKEL, *supra* note 3, at 30-33.

140. 15 U.S.C. §§ 80a-7, -10, -15; *see* 2 T. FRANKEL, *supra* note 3, at 470; Note, *supra* note 131, at 789, 802.

141. 1 T. FRANKEL, *supra* note 3, at 29.

142. The Findings and Declaration of Policy in the Investment Company Act of 1940, 15 U.S.C. § 80a-1(b) illustrates that curbing such abuse is the primary intent of the statute.

> [I]t is declared that the national public interest and the interest of investors are adversely affected . . .
>
> (2) when investment companies are organized, operated, managed, or their portfolio securities are selected in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

Id.

143. 2 T. FRANKEL, *supra* note 3, at 371-643. "In 1940, Congress found that the persons who managed investment companies had conflicting interests with the companies' interest and their shareholders, and that shareholders did not have sufficient rights to elect the managements of their choice or to control them." *Id.* at 1; *see* 15 U.S.C. §§ 80a-1(b)(2), (b)(3), (b)(6); Kapp, *Role of Investment Company Directors*, in PRACTICING LAW INSTITUTE, INVESTMENT COMPANIES: AN INDUSTRY IN TRANSITION 1983, at 439-52.

144. 15 U.S.C. §§ 80a-7, -8, 80b-4 (1982 & Supp. 1985).

145. *Id.*

years to extend Rule 10b-5[146] extraterritorially in order to exercise subject matter jurisdiction in actions involving offshore investment funds.[147]

III. *LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934*

United States courts have found little guidance in either the language or the legislative history of the '34 Act to help them deal with securities cases involving primarily foreign action with a United States nexus.[148] The legislative history merely indicates that section 10(b) was primarily intended as an antifraud catchall.[149] Among the Act's purposes is the prevention of inequitable practices on securities exchanges and markets operating in interstate and foreign commerce.[150] In

146. See *supra* note 11 for a listing of cases reflecting this intent.

147. See *supra* note 120 for a listing of cases specifically involving offshore investment funds.

148. *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 993 (2d Cir. 1975), *cert. denied*, 423 U.S. 1018 (1975). The Second Circuit in *Bersch* stated it was impossible to accurately discern Congressional intent with regard to the extraterritorial scope of Rule 10b-5. In House Report No. 1383, the purpose of the '34 Act was described as an effort to protect the investing public by providing them with more adequate public information. The House Report reads:

> No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys and sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. . . . The disclosure of information materially important to investors may not instantaneously be reflected in the market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. . . .
>
> The reporting provisions of the proposed legislation are a very modest begining to afford that long denied aid to the exchanges in the way of securing proper information for the investor . . . . Making these facts generally available will be of material benefit and guidance to business as a whole.

H.R. REP. No. 1383, 73rd Cong., 2d Sess. 11-13 (1934); *see Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce*, 73rd Cong., 2d Sess. 115 (1934) [hereinafter cited as *Exchange Hearing*].

149. *Exchange Hearing*, *supra* note 148, at 115.

150. 15 U.S.C. § 78e, j; *see also* United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd.*, 445 U.S. 22 (1980) ("[a] major purpose of the [securities law is] to 'protect the integrity of the marketplace in which securities are traded' "). "The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should

keeping with the spirit and the scope of this legislation, section 10 extends its proscriptions to fraudulent activity conducted by "any person" employing, even indirectly, "any means or instrumentality of interstate commerce or of the mails."[151] In this context, "interstate commerce" has been broadly defined in section 3(a)(17) to include "trade, commerce, transportation, or communication . . . between any foreign country and any State."[152] The main jurisdictional bases set forth in the '34 Act are: (i) use of the mails; (2) use of any instrumentality of interstate commerce, e.g. the telephone, and, (3) use of a national exchange.[153] In order to confer statutory jurisdiction, it is sufficient to show that someone was caused to use an instrumentality of interstate commerce[154] or that it might have been reasonably foreseen that this would happen.[155] Although both section 10(b) and Rule 10b-5 contain similar language prohibiting fraudulent schemes that make use of the instrumentalities of interstate commerce, neither provision delineates the jurisdictional scope of the '34 Act. In addition, the legislative history does not reveal congressional intent regarding the extraterritorial application of section 10(b) and Rule 10b-5.[156]

In section 30 of the Exchange Act, Congress dealt with applications of the '34 Act in an international context.[157] Notwithstanding satisfaction of the jurisdictional requirements of section 10(b) and Rule 10b-5, some transactions are ex-

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be subject to identical market risks." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851-52 (2d Cir. 1968).

151. 15 U.S.C. § 78b (1982 & Supp. 1985). The scope of the Securities Exchange Bill of 1934, as reported in the House Report No. 1383, dated April 27, 1934, includes abuses such as,

> inadequate corporate reporting which keeps in ignorance of necessary factors for intelligent judgment . . . a public continually solicited to buy such securities by the sheer advertising value of listing. They include exploitation of that ignorance by self-perpetuating managements in possession of inside information. Speculation, manipulation, faulty credit control, investors' ignorance, and disregard of trust relationships by those whom the law should disregard as fiduciaries, are all a single seamless web.

H.R. Rep. No. 1383, *supra* note 148, 5-6.

152. 15 U.S.C. § 78c(a)(17).

153. *Id.* § 78e, f, j.

154. Bersch v. Drexel Firestone, Inc. 519 F.2d 974, 989 (2d Cir. 1975), *cert. denied*, 423 U.S. 1018 (1975).

155. Ferraioli v. Cantor, 259 F. Supp. 842, 845 (S.D.N.Y. 1966); SEC v. Gulf Intercontinental Finance Corp., 223 F. Supp. 987, 994-95 (S.D. Fla. 1963).

156. *Exchange Hearings*, *supra* note 148, at 115.

157. 15 U.S.C. § 78dd(a)-(b).

empted from the requirements of the '34 Act. Section 30 exempts "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."[158] Clearly, Congress intended section 30 to have extraterritorial application only in cases where the protection of domestic markets was at issue.[159]

Determining whether offshore funds fall within the section 30 exemption depends upon the meaning assigned to the phrase "without the jurisdiction of the United States."[160] The term jurisdiction could refer to either protective or territorial jurisdiction.[161] If jurisdiction refers to territorial jurisdiction, then transactions occurring outside the confines of the United States will be exempt under section 30.[162] If it refers to protective jurisdiction, then transactions of a predominantly foreign nature that effect national interests would not be exempt from United States jurisdiction.[163]

The issue of subject matter jurisdiction and offshore funds arises primarily in connection with the securities held by these funds in their portfolios.[164] To the extent that their portfolios consist of either United States securities or securities listed on United States exchanges, portfolio transactions in these securities may be deemed transactions occurring in the United States.[165] Whether this provides a sufficient contact with the

158. *Id.* § 78dd(a) (emphasis added).

159. *Hearings Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6569, 6578-79 (1934).

160. 15 U.S.C. § 78(dd)(b); Note, *Offshore Mutual Funds: Extraterritorial Application of the Securities Exchange Act of 1934*, 113 B.C. INDUS. & COMM. L. REV. 1225, 1226 (1972).

161. Note, *supra* note 160, at 1231-49.

162. *See* 15 U.S.C. § 78(dd)(b); Note, *supra* note 160, at 1231-49; *supra* text accompanying note 158 (for the text of § 30 of the '34 Act).

163. Note, *supra* note 160, at 1231-49. In order to determine if a transaction is within the protective jurisdiction of the United States, "the question of whether an act is substantial should be answered by reference to its potential for harm rather than by reference to the significance of the act in the overall transaction." *Id.* at 1248.

164. *Id.* at 1249.

165. *Id.* at 1249-51. The question posed by this Note is whether an offshore fund's activities as a dealer trading in securities of domestic companies on United States exchanges, justify extending protective jurisdiction where they commit fraud. *Id.* at 1250.

United States to assert subject matter jurisdiction is a matter that has been hotly debated in United States courts.[166] It is within this context that United States case law treats subject matter jurisdiction and the extraterritorial application of Rule 10b-5.[167]

IV. *CASE LAW ANALYSIS*

United States courts dealing with the application of Rule 10b-5 to transnational transactions have decided these cases by relying primarily on the conducts and effects tests set forth in sections 17 and 18 of the Second Restatement.[168] Both tests result in a rigid determination of jurisdiction that ignores the propriety of exercising jurisdictional power in an international context.[169] The conduct test allows for the assertion of extraterritorial jurisdiction where only a minimal degree of conduct occurs in the United States.[170] The justification for applying this test to cases in which only a small amount of conduct occurs in the United States rests on the territorial principle of international law.[171] However, this test fails to define the scope of conduct that comes within the jurisdictional reach of courts, thereby allowing a broad range of acts to fall under the rubric of minimal conduct. The effects test has an even greater sweep than the conduct test. If extraterritorial jurisdiction is to be measured by the effects of improper foreign transactions on United States securities or United States securities markets, the results could be devastating because an infinite number of securities transactions come within the ambit of this test. Analysis of the case law on this topic assists in determining whether the extension of extraterritorial jurisdiction via Rule 10b-5 actions in fact regulates offshore investment companies under the guise of protecting United States investors and the United States securities markets.

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166. *See supra* note 11.

167. *See infra* notes 168-297 and accompanying text.

168. *See infra* notes 172-297 and accompanying text (discussing the Restatement tests).

169. *See infra* notes 172-297 and accompanying text.

170. *See infra* notes 172-252 and accompanying text.

171. *See supra* note 89 and accompanying text.

A. *Conduct Test*

Legislation is presumed to apply territorially unless a contrary intent is clearly indicated.[172] In 1960, the District Court for the Southern District of New York decided in *Kook v. Crang*,[173] that a United States court may assert subject matter jurisdiction extraterritorially only where the illegal act occurs within the United States.[174] *Kook* involved a United States resident who bought stock of a Canadian corporation on the Toronto Exchange from a Canadian broker.[175] The court held that the transaction was a Canadian transaction "without the jurisdiction of the United States."[176] The court also held the transaction exempt under section 30(b) of the '34 Act,[177] notwithstanding the use made of the mails and telephones between the United States and Canada or the fact that the Canadian brokerage house had a New York office with which the plaintiff made contact.[178] It was alleged that the New York office of the Canadian brokerage house neither bought nor sold securities for individual customers but was opened to deal directly with institutions and with members of the New York Stock Exchange.[179] As such, this conduct was not sufficient to bring the transaction within the legislative jurisdiction of the '34 Act.[180]

The *Kook* court did not grapple with the issue of whether United States conduct was sufficient to give the court jurisdiction. Rather, the main issue addressed was whether Congress intended the '34 Act to be applicable to extraterritorial transactions.[181] The court explicitly stated that section 30(b) sup-

172. Mann, *supra* note 17, at 63. "It is a matter of universal experience that in fact States do not ordinarily attempt to legislate in respect of matters outside their jurisdiction. As a rule they legislate solely for the purpose of regulating their own affairs . . . ." *Id.*.

173. Kook v. Crang, 182 F. Supp. 388, 390 (S.D.N.Y. 1960).

174. *Id.* at 388-90.

175. *Id.* at 389.

176. *Id.* at 391.

177. 15 U.S.C. § 78(dd)(b).

178. *Kook*, 182 F. Supp. at 389.

179. *Id.*

180. *Id.* at 390-91. "Certainly, the mere presence of defendants as a broker or dealer under Section 15 could not, without more, make its foreign transactions subject to the Act." *Id.* at 391.

181. *Id.* at 390.

ports the presumption that legislation is territorial.[182] In arriving at this conclusion, the court applied a test that emphasized the locus of the activities. "[J]urisdiction," the court held, "as used in Section 30(b) contemplates some necessary and substantial act within the United States . . . . Certainly, the mere presence of defendant as a broker or dealer under Section 15 would not, without more, make its foreign transactions subject to the Act."[183] The United States conduct in *Kook* was not sufficiently substantial to rebut the presumption against extraterritorial application of the '34 Act. In subsequent cases, however, courts applied the '34 Act to foreign transactions based on United States conduct that was not significantly more substantial than that in *Kook*.[184]

Later cases have held that conduct within the United States is a ground for applying Rule 10b-5 in transnational securities transactions.[185] Courts, however, have not regarded the mere existence of some United States conduct as calling for automatic extraterritorial application of the rule.[186] Unfortunately, *Kook* did not delimit the conduct sufficient to give United States courts jurisdiction.[187] Thus, courts have expanded the scope of behavior that falls under the rubric of conduct which is sufficient for extraterritorial jurisdiction.

In 1972, the Second Circuit in *Leasco Data Processing Equipment Corp. v. Maxwell*,[188] found that a United States corporation was defrauded by foreign defendants who had made material misrepresentations in the United States regarding their company's securities.[189] Some material misrepresentations were also made in England where the actual securities transaction

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182. *Id.* "It is a canon of construction that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States. . . . This construction is reinforced by the Act itself which, in Section 30(b), specifically restricts the Act to the transaction of business within the United States." *Id.*

183. *Id.* at 390-91.

184. *See infra* notes 185-252 and accompanying text.

185. *See, e.g.*, SEC v. United Financial Group, Inc., 474 F.2d 354, 356-57 (9th Cir. 1973); Travis v. Anthes Imperial Ltd., 473 F.2d 515, 524, 526 (8th Cir. 1973); Ferraioli v. Cantor, 259 F. Supp. 842, 846 (S.D.N.Y. 1966); SEC v. Gulf International Fin. Corp., 223 F. Supp. 987, 995 (S.D. Fla. 1963).

186. *See infra* notes 188-297 and accompanying text.

187. *See Kook*, 182 F. Supp. 388.

188. 468 F.2d 1326, 1327 (2d Cir. 1972).

189. *Id.* at 1336.

occurred.[190] The heart of the *Leasco* complaint was that defendants conspired to cause Leasco to buy stock of Pergamon Press, Ltd., a British corporation controlled by Robert Maxwell, a British citizen, at prices in excess of its true value.[191] The first contact occurred in 1969 when Maxwell came to Great Neck, New York, where Leasco then had its principal office.[192] There he proposed to Saul Steinberg, then Leasco's Chairman, that Pergamon and Leasco engage in a joint venture in Europe.[193] Within this time period, Maxwell made false representations to Steinberg and gave Steinberg the most recent Pergamon annual report which contained materially false and misleading statements about Pergamon's business affairs.[194] Noting that material misrepresentations occurred in the United States, the court held that "if Congress had thought about the point, it would . . . have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him to purchase foreign securities abroad."[195]

Leasco developed a test applicable to an extraterritorial transaction in foreign securities traded exclusively in foreign markets. The Second Circuit specifically declined to rely on the effects test of jurisdiction, but instead chose to underscore the conduct aspect of territoriality.[196] The court found defendant's use of the mails and phones to be sufficient domestic conduct to warrant assertion of extraterritorial jurisdiction for violations of Rule 10b-5.[197] Regardless of whether the inducements were triggered by a phone call from London to New York or by a conversation that took place exclusively in England, the court held that the conduct within the United States was an essential link in luring Leasco into making the open market purchases.[198]

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190. *Id.* at 1334.
191. *Id.* at 1330.
192. *Id.*
193. *Id.*
194. *Id.* at 1330-31.
195. *Id.* at 1337.
196. *Id.* at 1334. "When no fraud has been practiced in this country and the purchase or sale has not been made here, we would be hard pressed to find justification for going beyond *Schoenbaum*." *Id.*
197. *Id.*
198. *Id.* at 1335. "[I]f defendants' fraudulent acts in the United States significantly whetted Leasco's interest in acquiring Pergamon shares, it would be immate-

Leasco stretches the territoriality principle beyond the dictates of international law, which provides that rules relating to jurisdiction ought to put citizens of other countries on notice concerning the conduct within the United States that will subject them to liability under United States law.[199] When, as in *Leasco*, a minor degree of territorial conduct is responsible for serious legal consequences, this strict conduct test is likely to cause more international conflicts than it resolves.[200]

Leasco held that the language of section 10(b) is much too inconclusive to lead anyone to believe that Congress meant to impose rules throughout the world in every instance where an American bought or sold a security.[201] Although the Court's opinion ironically appears to advocate narrowing extraterritorial application of Rule 10b-5, *Leasco* expanded the basis for Rule 10b-5 liability by formulating a rule predicated on minimal conduct within the United States.[202] Although *Leasco* involved only domestic plaintiffs, in 1975 the Second Circuit, in *Bersch v. Drexel Firestone, Inc.*,[203] affirmed Rule 10b-5 liability predicated on conduct in the United States where the plaintiff class included both United States citizens and foreigners.[204]

Bersch was a class action on behalf of thousands of residents of Canada, Australia, England, France, Germany, Asia, Africa, and South America.[205] The securities in question were the common stock of defendant I.O.S., Ltd.[206] I.O.S. was an international sales and financial organization engaged primarily in selling and managing mutual funds and complementary

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rial, from the standpoint of foreign relations law, that the damage resulted, not from the contract . . . procured in this country, but from interrelated action which he induced in England . . . ." *Id.*

199. *See supra* notes 99-117 and accompanying text.

200. Maier, *supra* note 76, 317. "Unilateral attempts to balance national interests in transnational cases can result, at best, in a pale reflection of the true weight and complexity of the competing interests involved." *Id.*

201. *Leasco*, 468 F.2d at 1334-35.

202. *Id.* In *Leasco* minimum domestic conduct such as the signing of a contract in the United States is construed as significant. "Conduct within the territory alone would seem sufficient from the standpoint of jurisdiction to prescribe a rule . . . . And that contract, signed in the United States was an essential link in reducing *Leasco* to make open-market purchases . . . ." *Id.* at 1335.

203. 519 F.2d 974 (2d Cir. 1975), *cert. denied*, 423 U.S. 1018 (1975).

204. *Id.* at 977-78.

205. *Id.*

206. *Id.* at 978.

financial services.[207] It was organized under the laws of Canada and had its main office in Geneva, Switzerland.[208] Bersch charged, inter alia, that: 1) the underwriters impliedly represented to the public that I.O.S. was a suitable company for public ownership when in fact the underwriters should have known that it was not; and, 2) the prospectuses failed to reveal illegal activities by I.O.S. and its officers that had seriously damaged the company.[209]

Judge Friendly, writing for the court, concluded that the federal securities laws did apply to sales of securities to United States residents in the United States whether or not acts of material importance occurred in this country.[210] This holding effectively overruled the restrictive application of extraterritorial jurisdiction.[211] In addition, *Bersch* held that the securities laws applied to United States residents abroad, but only if conduct of material importance in the United States significantly contributed to plaintiff's losses.[212] However, the Second Circuit limited its exercise of jurisdiction by holding that the federal securities laws did not apply to losses from sales of securities to foreign citizens outside the United States where conduct in the United States did not directly cause the losses.[213] Foreign purchasers were dismissed from the plaintiff class.[214]

The plaintiffs in *Bersch*, which included both United States citizens and foreigners, alleged that with the assistance of United States accountants and underwriters, I.O.S. planned the offering and drafted part of the prospectus within the United States.[215] The court held that in determining whether the activities that occurred within the United States were sufficient to support subject matter jurisdiction, the answer varied depending upon whether the plaintiffs were foreign or United

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207. *Id.*

208. *Id.*

209. *Id.* at 978-81.

210. *Id.* at 974. "[T]he federal securities laws did apply to sales of securities to American residents in the United States whether or not acts of material importance occurred in this country." *Id.*

211. 182 F. Supp. at 388-90; *see supra* notes 172-84 and accompanying text.

212. *Bersch*, 519 F.2d at 974.

213. *Id.* "The Court of Appeals . . . held that . . . the federal securities laws did not apply to losses from sales of securities to foreigners outside the United States where acts in United States did not directly cause such losses." *Id.*

214. *Id.*

215. *Id.* at 987.

States citizens.[216] In addition, the mere fact that activities had occurred in the United States was not sufficient in itself to confer subject matter jurisdiction if the activities performed in the United States were "merely preparatory" to the actual fraud.[217]

Bersch rejected plaintiffs' argument that jurisdiction could be based on the adverse economic impact on domestic securities markets resulting from the collapse of I.O.S.[218] The court concluded that subject matter jurisdiction lies only when fraud results in injury to purchasers or sellers of those securities in which the United States has an interest.[219] Subject matter jurisdiction does not lie where acts simply have an adverse effect on the United States economy or on United States investors generally.[220]

Bersch set forth a comprehensive test for the application of the antifraud provisions of the '34 Act to extraterritorial transactions in foreign securities. The antifraud provisions:

(1) Apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country; and
(2) Apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but
(3) Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) directly caused such losses.[221]

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216. *Id.* at 992-93. "Whether Congress intended that such persons should be entitled to obtain damages for violation of the securities laws is a different and closer question . . . . We think the answer would be in the negative if none of the defendants engaged in significant activities within the United States, as defendants . . . ." *Id.*

217. *Id.* "While merely preparatory activities in the United States are not enough to trigger application of the securities laws for injury to foreigners located abroad, they are sufficient when the injury is to Americans so resident." *Id.*

218. *Id.* at 987-88.

219. *Id.* at 989. "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 effect on the American economy or American investors generally." *Id.*

220. *Id.*

221. *Id.* at 993.

In determining whether subject matter jurisdiction lies under the *Bersch* conduct test, courts evaluate the nationality of the plaintiff and the type of conduct taking place in the United States.[222] *Bersch* attempted to redefine the application of Rule 10b-5 in terms of citizenship, residence, and conduct by balancing concepts of territorial conduct and economic impact or effect. The most important advance made in *Bersch* was the court's rejection of a general effects test, one that would have caused nearly every large security transaction to be subsumed under the Act.[223]

In 1980, the Second Circuit in *IIT v. Cornfeld*,[224] extended Rule 10b-5 extraterritorially and asserted subject matter jurisdiction over foreign shareholders of a foreign investment company, while declining subject matter jurisdiction based on generalized effects on the United States economy.[225] IIT was an international investment trust, run like an open-ended mutual fund.[226] It provided foreign fundholders with an investment vehicle through which they could participate in a portfolio of securities chosen by its investment adviser, IIT Management Co.[227] IIT brought a derivative action in the United States against its investment adviser, IIT Management Co., alleging that IIT Management Co. had violated Rule 10b-5.[228] In the late 1960's, at the height of its prosperity, IIT held assets worth U.S.$375 million, about forty percent of which were United States securities.[229] The issue in *Cornfeld* was whether United States courts had subject matter jurisdiction over a foreign investment adviser's scheme to defraud a foreign investment company.[230] Although this would have been a proper

222. *Id.* at 991-93.

223. *Id.* at 988. "[W]e conclude that the generalized effects described by Professor Mendelson would not be sufficient to confer subject matter jurisdiction over a damage suit by a foreigner under the anti-fraud provisions of the securities laws." *Id.*

224. 619 F.2d 909 (2d Cir. 1980).

225. *Id.* at 917.

226. *Id.* at 909-13. An "open-end company" is defined as a company, "which is offering for sale or has outstanding any redeemable security of which it is the issuer." 15 U.S.C. § 80a-5(a)(1) (1982 & Supp. 1985). The issuer has the obligation to pay shareholders a proportionate share of the net assets of the fund which the shares tendered for redemption represent. *See* 17 C.F.R. § 270.22c-1 (1984); *see also* Note, *supra* note 131, at 742-43 (defining open-end mutual fund).

227. *Cornfeld*, 619 F.2d at 913.

228. *Id.* at 912-14.

229. *Id.* at 913.

230. *Id.* at 912-16.

subject for review under both the ICA and the IAA, this abuse was left unregulated because the Investment Acts do not apply to foreign investment companies.[231] Consequently, the court asserted jurisdiction by a more circuitous means.

The court held that there was subject matter jurisdiction through an extraterritorial application of Rule 10b-5.[232] This determination was made by viewing the transaction as not entirely foreign and by straining to emphasize the domestic activities of the United States-based King companies, who were not parties to the action.[233] The issuer's United States nationality and the consummation of the fraudulent transactions in the United States were factors that strongly guided the Second Circuit toward applying the antifraud provisions of the '34 Act[234] and reversing the district court's dismissal for lack of subject matter jurisdiction. The district court had viewed the transaction as one having "its genesis abroad . . . with a group of foreign managers of a foreign investment trust violating what would appear to be their fiduciary duties to their fundholders."[235] The district court believed that the foreign managers were merely enlisting United States aiders and abettors.[236]

Cornfeld is a case where neither the alleged wrong nor its substantial constituent elements occurred in the United States, nor were they initiated here. The Second Circuit increased the '34 Act's jurisdictional scope by subjecting to Rule 10b-5 liability foreign investment advisers that breach their fiduciary duty to their clients.[237] However, the extraterritorial application of Rule 10b-5 to the fiduciary activities of foreign investment funds (or, as in this case, investment trusts) is contrary to the

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231. *See* 15 U.S.C. §§ 80a-7, -8, 80b-4, -6.

232. *Cornfeld*, 619 F.2d at 917-18.

233. *Id.* at 914.

234. *Id.* at 909. Judge Friendly stated that "the American nationality of the issuer and the consummation of the transactions in the United States were factors pointing strongly toward applying the antifraud provisions of the United States securities laws." *Id.*

235. IIT v. Cornfeld, 462 F. Supp. 209, 225 (S.D.N.Y. 1978).

236. *Id.*

237. IIT v. Cornfeld, 619 F.2d at 917-18. "IIT and its liquidators are complaining of deception practices on IIT by both the King complex, . . . and Management, whose acts were mainly outside [the United States] . . . . The ability of such a victim to maintain such an action was decided in *Goldberg*, we see no reason to depart from that decision . . . ." *Id.* at 918.

Congressional intent limiting such regulation to domestic investment companies by the IAA.[238]

To use Rule 10b-5 in *Cornfeld*, the Second Circuit characterized the breach of fiduciary duty of the foreign investment adviser as a material fact.[239] Failure to disclose a material fact to a corporation's disinterested directors[240] or its investors qualifies as one of the deceptive acts prohibited by Rule 10b-5.[241] The effect of using an expanded scope of the Rule in this case permits United States courts to regulate the internal affairs of foreign investment companies.[242] Under its corporate mismanagement application, Rule 10b-5 subjects to scrutiny and liability the questionable activities of an investment adviser in connection with its duty toward the investment company that it advises.

From the Second Circuit's assertion of subject matter jurisdiction based on the tenuous link between IIT Management Co. and the King Corp.'s United States activities, it is just a short step to the Eighth Circuit's holding in *Continental Grain v. Pacific Oilseeds, Inc.*[243] *Continental Grain* opened the courts to foreign plaintiffs "where at least *some activity* designed to further a fraudulent scheme occurs within [the United States]."[244]

Plaintiff in *Continental Grain* was an Australian subsidiary of a United States corporation.[245] Continental purchased the common stock of another Australian subsidiary to obtain "seedstock," a product that was produced under a licensing

238. *Compare* H.R. REP. No. 1383, *supra* note 148, at 11-13 *with* 17 C.F.R. § 240.10b-5 (1984).

239. *Cornfeld*, 619 F.2d at 917-19; *see* Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641, 645 (3d Cir. 1980); Kidwell v. Meikle, 597 F.2d 1273, 1291-92 (9th Cir. 1979); Wright v. Heizer Corp., 560 F.2d 236, 250 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978); Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

240. *See* 15 U.S.C. § 80a-10 (the ICA requires a certain percentage of the board of directors to be independent, namely not "interested persons" as defined in § 2(a)(19), 15 U.S.C. § 80a-2(a)(19)).

241. 17 C.F.R. § 240.10b-5 (1984).; *see supra* note 226 and accompanying text.

242. The extended scope of Rule 10b-5 effectively regulates the fiduciary activities of directors and investment advisers of offshore companies. *See generally Cornfeld*, 619 F.2d 909.

243. 592 F.2d 409 (8th Cir. 1979).

244. *Id.* at 415 (quoting SEC v. Kasser, 548 F.2d 109, 114 (3d Cir. 1977)(emphasis added).

245. *Id.* at 411.

agreement with a United States corporation.[246] The acquiring company was not told that the selling company's primary asset, the licensing agreement, could be reclaimed by the licensor upon the expiration of the licensing agreement.[247] The Eighth Circuit held that defendant's conduct was sufficient to provide jurisdiction even though the ultimate effect of its conduct was felt mainly in Australia.[248] The fraudulent scheme of material nondisclosure was devised and completed in the United States and only then "exported to Australia."[249]

Continental Grain involved a securities transaction spanning two continents where the sole victim was a foreign corporation.[250] The securities in question were not traded on any United States exchange, nor did they have any measurable effect on domestic markets.[251] Relying on *Bersch* and *Leasco*, *Continental Grain* held that letters and telephone calls that originated in the United States and were necessary to further the fraud constituted domestic conduct "sufficiently" significant to establish extraterritorial jurisdiction.[252] Despite the court's finding that domestic conduct was significant, the facts point to the conclusion that a minimal amount of conduct is a sufficient basis for subject matter jurisdiction in the Eighth Circuit.

B. *Effects Test*

Courts have held that in terms of the Second Restatement, a finding that a United States effect was direct, substantial, and foreseeable supports extraterritorial jurisdiction under Rule 10b-5.[253] The cases on point, however, do not clearly define

246. *Id.*

247. *Id.*

248. *Id.* at 421. "The present case, however, involves a substantially foreign transaction, [with] little if any domestic impact, and domestic conduct which consisted for the most part of use of the mail and telephone." *Id.* The court did not explain how the fraud could be completed in the United States when all the negotiations and the closing were carried out in Australia.

249. *Id.* at 409.

250. *Id.* at 415.

251. *Id.*

252. *Id.* at 409. "Conduct alleged to establish a Rule 10b-5 violation, i.e., a scheme of fraudulent nondisclosure devised in the United States by use of the mail and other instrumentalities of interstate commerce, was conduct significant enough to establish subject-matter jurisdiction." *Id.*

253. See *supra* note 11 and accompanying text for a listing of such cases.

the limits of the effects test.[254]

Schoenbaum v. Firstbrook[255] laid the foundation for the effects test when it stated that "Congress intended the Exchange Act to have extraterritorial application in order . . . to protect the domestic securities market from the effects of improper foreign transactions in American securities."[256] The plaintiff in *Schoenbaum* alleged that an issue of stock in Canada to insiders of a Canadian company at an unfairly low price adversely affected the value and price of the company's shares listed on the American Stock Exchange, some of which were held by resident United States citizens, including the plaintiff.[257] Although the foreign defendant's fraud was perpetrated on a Canadian company and the foreign defendant never entered the United States in connection with the fraud, the Second Circuit found that because the company's stock was registered and traded on the American Stock Exchange, an adverse effect on the equity of United States shareholders was sufficient to support jurisdiction.[258]

The problems with the *Schoenbaum* decision are easily recognizable. First, although section 18(b) of the Second Restatement limits the effects doctrine to "substantial and foreseeable" effects of conduct in the United States,[259] the plaintiffs in *Schoenbaum* exceed these limits by neither claiming nor proving dilution in the value of their stock as a basis for jurisdiction.[260] The plaintiffs brought a derivative suit on behalf of the Canadian company to recover losses caused by the sale of treasury stock at what they considered an unfairly low price.[261] Since most publicly owned companies are likely to have United States shareholders,[262] an expansive interpretation of

254. *See infra* notes 255-297 and accompanying text.

255. 405 F.2d 200 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

256. *Id.* at 206.

257. *Id.* at 204.

258. *Id.* at 206.

259. SECOND RESTATEMENT, *supra* note 17, § 18(b).

260. *Schoenbaum*, 405 F.2d at 204-08.

261. *Id.* at 200-04.

262. NEW YORK STOCK EXCHANGE FACT BOOK OF 1984, at 4, 54 (1984) (statistical portrait of the Exchange Community in 1983). At year-end 1983, shares listed on the New York Stock Exchange (NYSE) totaled 45.1 billion with a record 42.36 million United States shareholders. *Id.* An additional 133 million individuals owned stock directly through such assets as pension plans, mutual savings bank accounts and life insurance policies. *Id.* at 57. Major institutional investors held approximately 35.4%

Schoenbaum would bring securities transactions throughout the world within the ambit of Rule 10b-5. This decision does not clearly define the limits of the effects test. The omission gives other courts the option of extending Rule 10b-5 jurisdiction to an unacceptably wide scope.[263] It leaves open the question whether the "direct and foreseeable" conduct requirement in the Second Restatement may be waived in all circumstances or only in situations where stock is registered on a domestic exchange.[264]

An even more disturbing aspect of *Schoenbaum* is its holding regarding federal standards of conduct in Rule 10b-5 corporate mismanagement cases.[265] In the line of cases representing the corporate mismanagement aspect of Rule 10b-5 actions, *Schoenbaum* sets a "new fraud" standard,[266] which bases liability on a finding of controlling influence to induce an injurious securities transaction in cases that involve a failure to disclose.[267] If plaintiffs demonstrate that: 1) the defendants had exerted controlling influence over the corporation in inducing the transaction, and 2) the transaction was unfair to the corporation, this would be sufficient to prove that defendant's conduct was either an, "act, practice, or course of business which operates . . . as a fraud" within the meaning of Rule 10b-5.[268] As an entirely independent basis for liability, the Court also held that the directors had deceived the plaintiff company's shareholders.[269] The implications of this new fraud standard for extraterritorial jurisdiction in 10b-5 actions are significant.

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of all NYSE stock. For a comparison of the lesser activity engaged in on foreign exchanges, see *id.* at 68.

263. *See supra* text accompanying notes 147-66.

264. *Schoenbaum*, 405 F.2d at 206-08.

265. *Id.* at 219-20. The plaintiffs in *Schoenbaum* alleged that Aquitaine exercised a "controlling influence" over the decision to issue stock. *Id.* at 219. The court held that if Aquitaine had exercised such control, it would be a violation of Rule 10b-5(3), because the transaction would operate as a fraud. *Id.* at 219-20; *see supra* note 120 and accompanying text.

266. *See*, Comment, *Schoenbaum v. Firstbrook: The "New Fraud" Expands Federal Corporation Law*, 55 VA. L. REV. 1103, 1108 n.33 (1969).

267. *Schoenbaum*, 405 F.2d at 219-20. "In the present case it is alleged that Aquitaine exercised a controlling influence over the issuance to it of treasury stock of Banff for a wholly inadequate consideration." *Id.* at 219.

268. *Id.* 219-20.

269. *Id.* If it is established that the transaction took place as alleged it constituted a violation of Rule 10b-5, subdivision (3) because Aquitaine engaged in an "act, practice or course of business which operates or would operate as a fraud or deceit

Although deception need not be shown to invoke this standard, a showing of controlling influence by offshore fund directors or advisers exerted in connection with a transaction that is unfair to the corporation would be a sufficient basis for jurisdiction.[270] This standard would make virtually all control persons in an offshore fund context suspect and amenable to Rule 10b-5 liability.[271]

Schoenbaum was immediately seen as the advent of a new federal standard to regulate the behavior of corporate insiders in handling their corporate securities transactions.[272] Since 1969, when *Schoenbaum* was handed down, many decisions including *Popkin v. Bishop*,[273] *Santa Fe v. Green*,[274] and *Goldberg v. Meridor*[275] have limited and qualified its holding concerning corporate mismanagement standards under Rule 10b-5.[276] Nevertheless, after *Schoenbaum*, the use of controlling influence to destroy arm's length business dealings between the corporation and its directors continues to be open to Rule 10b-5 liability.[277] Therefore, it remains an important unsettled issue whether a federal interest exists in applying the Rule extraterritorially to maintain a climate of fair dealing by preventing the kinds of fraud and manipulation to which a corporation is uniquely susceptible in an international context.[278]

In 1975, the Second Circuit in *IIT v. Vencap*,[279] limited the extraterritorial application of the conduct and effects test.[280] Decided on the same day as *Bersch*, *Vencap* involved the liquidators of IIT, an investment trust organized in Luxembourg

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. . . . Moreover, Aquitaine and the directors of Banff were guilty of deceiving the stockholders of Banff (other than Aquitaine)." *Id.*

270. *Id.*

271. The "controlling influence" test set forth in *Schoenbaum* has a very broad sweep. Since deception need not be proven, the controlling influence test creates pure liability for a breach of fiduciary obligations under Rule 10b-5. *Id.*

272. Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 HARV. L. REV. 1007, 1033 (1973).

273. 464 F.2d 714 (2d Cir. 1972).

274. 430 U.S. 462 (1977).

275. 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

276. *Santa Fe*, 430 U.S. at 474-76; *Goldberg*, 567 F.2d at 217-21; *Popkin*, 464 F.2d at 718-21; *see* Note, *Securities Regulation - Liability for Corporate Mismanagement Under Rule 10b-5 After Santa Fe v. Green*, 27 WAYNE L. REV. 269 (1980).

277. Note, *supra* note 276, at 279.

278. *Id.*

279. 519 F.2d 1001 (2d Cir. 1975).

280. *Id.* at 1012-16.

which sued Vencap, a Bahamian venture capital firm[281] in which IIT had become a preferred shareholder.[282] The purchase and sale was negotiated in the Bahamas, and the agreement was drafted in New York by United States lawyers for IIT and Vencap.[283] Once IIT's money was invested and the agreements concluded, Richard Pistell, a United States citizen who was chairman and president of Vencap, caused the company to enter into business deals that led to the conversion of substantial amounts of Vencap's assets to Pistell's personal use.[284] In effect, IIT hired Pistell as a money manager who would receive, in addition to liberal compensation, two-thirds of the profit after six percent interest, the latter payable to preferred shareholders only if earned.[285] Although Pistell represented that Vencap would be operated solely as a bona fide venture capital enterprise, it was in fact to be used, in substantial part, for Pistell's private use.[286] Plaintiffs tried to argue that since there were United States fundholders of IIT, Pistell's foreign activities could have had a significant United States effect.[287] Judge Friendly admitted that this would be a possible argument if there were complicity by IIT's management in the fraud.[288] This theory was nevertheless rejected since less than one percent of IIT fundholders were United States citizens living in the United States, and because IIT had not intended to offer its shares to United States residents or citizens.[289]

The Second Restatement's requirement that the effect

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281. Venture capital is defined as being "[c]apital to provide for start-up situations ("seed capital") and for the existing high-risk small businesses suffering from capital deficiencies but having high profit potential as of high technology." G. MUNN, ENCYCLOPEDIA OF BANKING AND FINANCE (8th ed. 1983).

282. *Vencap*, 519 F.2d at 1003-07.

283. *Id.* at 1004-06

284. *Id.* at 1013.

285. *Id.* at 1012.

286. *Id.* at 1013.

287. *Id.* at 1016.

288. *Id.* at 1016-17. "Even on some of the theories listed above which assume complicity by IIT's management, the action would be a derivative one on IIT's behalf. The American residence or citizenship of certain fundholders would thus become important only on a theory akin to that of piercing the corporate veil." *Id.*

289. *Id.* Although IIT's prospectus stated that shares were neither offered for sale nor sold to United States citizens or United States residents, the Judge found that "approximately 300 United States citizens and residents are fundholders in IIT." *Id.*

within the United States be substantial[290] clearly could not be satisfied.[291] The only United States activity during this period was the drafting of the agreement formalizing a deal worked out in the Bahamas.[292] The court held that these activities were merely preparatory in the *Bersch* sense and could not alone support a Rule 10b-5 suit.[293] The court did find a basis, however, for asserting subject matter jurisdiction in the fraudulent transactions, in which Pistell was engaged from the offices of his New York lawyers.[294] Judge Friendly indicated that fraudulent acts for purposes of subject matter jurisdiction are those that are elements of a substantive Rule 10b-5 violation.[295] The court viewed Pistell's New York activities as misrepresentations evidencing either Pistell's fraudulent intention or as acts that consummated the fraud.[296] Thus, where the United States is used as a base for manufacturing fraudulent security devices for export, the court of appeals found jurisdiction to exist.[297]

C. *Analysis*

Although section 30(b) of the '34 Act expressly exempts transactions conducted "without the jurisdiction of the United States," courts have recognized the need to apply Rule 10b-5 extraterritorially in order to: 1) protect domestic investors

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290. *See* SECOND RESTATEMENT, *supra* note 17, § 18.

291. *Vencap*, 519 F.2d at 1018.

292. *Id.*

293. *Id.* "Our ruling on this basis of jurisdiction is limited to the perpetration of fraudulent acts themselves and does not extend to mere preparatory activities or the failure to prevent fraudulent acts where the bulk of the activity was performed in foreign countries, such as in *Bersch*." *Id.*

294. *Id.*

295. *Id.* Acts initiating, directing, and consummating the mailing of literally hundreds of pieces of mail to and from Vencap's 99 Park Avenue office, where all transaction records were maintained, could "be regarded substantively as the acts that consummated the fraud." *Id.*

296. *Id.* at 1017-18.

297. *Id.* at 1017.

> We 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. 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. By the same token it is hard to believe Congress meant to prohibit the SEC from policing similar activities within this country.

Id.

who have purchased foreign securities on domestic exchanges; and 2) protect the domestic securities markets from the effects of improper foreign transactions in United States securities.[298] Guided by the principles embodied in sections 17 and 18 of the Second Restatement,[299] courts initially applied the strict territoriality principle and required that the illegal act occur within the United States.[300] Gradually, the court's focus shifted away from a strict conduct test to an analysis of effects. Under this test, the illegal act did not have to occur in the United States as long as conduct abroad produced domestic harm[301] and defendant accomplished other related acts within the United States that significantly affected domestic markets.[302] The extent of the domestic harm and the degree of additional related conduct needed to invoke the statute has been hotly debated and litigated.[303]

What emerges from this background is a series of cases struggling to define the '34 Act's extraterritorial reach. Judicial interpretations of Rule 10b-5 have led to its extraterritorial application to offshore funds based primarily on broad constructions of the Second Restatement's conduct and effects test.[304]

Ironically, the use of the Second Restatement to justify the extraterritorial application of Rule 10b-5 to situations involving corporate mismanagement and breach of fiduciary duty occurs at a time when the Supreme Court has repeatedly attempted to limit the application of the Rule in domestic corporate mismanagement situations.[305] The corporate

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298. *See supra* notes 127-67 and accompanying text.

299. SECOND RESTATEMENT, *supra* note 117, §§ 17-18.

300. Kook v. Crang, 182 F. Supp. 388 (S.D.N.Y. 1960).

301. Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1341 (2d Cir. 1972).

302. Travis v. Anthes Imperial Ltd., 473 F.2d 515, 524 (8th Cir. 1973); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir.), *rev'd with respect to holding on merits*, 405 F.2d 215 (2d Cir. 1968), (en banc), *cert. denied*, 395 U.S. 906 (1969).

303. Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 987-90 (2d Cir. 1973), *cert. denied*, 423 U.S. 1018 (1975).

304. *See supra* notes 79-297 and accompanying text.

305. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 471-74 (1977); IIT v. Cornfeld, 619 F.2d 909, 922-23 (2d Cir. 1980); Healey v. Catalyst Recovery, Inc., 616 F.2d 641, 647 (3d Cir. 1980); Alabama Farm Bureau Mut. Cas. Co. v. American Fidelity Life Ins. Co., 606 F.2d 602, 614 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980); Goldberg v. Meridor, 567 F.2d 209, 210-16 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069

mismanagement aspect of Rule 10b-5 effectively regulates offshore investment funds by subjecting business and investment decisions of directors and advisers of these funds to a "mythical American fiduciary" standard.[306] This far exceeds the legislative intent of section 10(b).[307] Nothing in the legislative history of section 10(b) expresses Congressional intent to regulate transactions that constitute no more than internal corporate mismanagement.[308] In addition, this application of United States securities laws to offshore funds is far from consistent with international law.[309] Under international law, a state should not without good reason apply its law in disregard of the substantial interests of another state.[310] In the cases dealing with the extraterritorial application of Rule 10b-5, there has been a paucity of information relating to the concerns of offshore funds. The broad extraterritorial application of Rule 10b-5 is little more than a minimum conduct approach, that is, a rigid approach to jurisdiction that often upsets the justified expectations of the foreign parties and thereby ignores the demands of international law.[311]

What is needed in determining international jurisdiction in securities cases is an approach similar to that proposed in sections 413 and 416 of the Draft Restatement,[312] or an approach that calls for weighing the relative state interests with special sensitivity to the "reasonableness" of enforcing the

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(1978); *see* Note, *Causation in Rule 10b-5 Actions for Corporate Mismanagement*, 48 U. CHI. L. REV. 936 (1981).

306. *See* 17 C.F.R. 240.10b-5 (1984). The argument can be made that Rule 10b-5 is operating in corporate mismanagement cases as a substitute for a nonexistent federal fiduciary standard and not as a disclosure statute. It has been suggested that a federal fiduciary standard should be incorporated as part of the securities laws of the United States and that the increasing number of mismanagement cases heard under the guise of nondisclosure suggests a need for such a standard. Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976).

307. *See supra* notes 118-67 and accompanying text.

308. *See* H.R. REP. No. 1383, *supra* note 148, at 5-13; *Exchange Hearings*, *supra* note 148, at 115.

309. *See supra* notes 16-117 and accompanying text.

310. *See supra* notes 55-101 and accompanying text.

311. Mann, *supra* note 17, at 46-48; *see* I. BROWNLIE, *supra* note 20, at 31; Maier, *supra* note 76, at 293-95 n.67.

312. DRAFT RESTATEMENT, *supra* note 21, §§ 413, 416; *see supra* notes 102-17 and accompanying text.

rules in question. As the mobility of the world's capital markets increases, the political importance of avoiding international confrontation in an increasingly interdependent international environment cannot be overemphasized.[313] United States courts need to focus on a jurisdictional test that will facilitate transnational commercial interaction.[314] Considerations of international comity and reciprocity, as characterized by judicial restraint in exercising jurisdiction, should be the rule.[315] Absent guidance from legislative history on the topic of extraterritorial jurisdiction and Rule 10b-5, courts should look to the general principles of international law to guide the prudent exercise of national power in the international community.[316]

CONCLUSION

By asserting jurisdiction extraterritorially to offshore funds in corporate mismanagement situations, the courts in effect use Rule 10b-5 to regulate the internal affairs of offshore investment funds. This internal regulation is an impermissible intrusion which is not substantiated by the legislative history of the '34 Act and which violates the principles of comity and reciprocity of international law.

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313. Thomas, *Internationalization of the World's Capital Markets-Can the SEC Help Shape the Future*, *supra* note 11, at 83-85.

314. Thomas, *Extraterritoriality in an Era of Internationalization of the Securities Markets: The Need to Revisit Domestic Policies*, *supra* note 11, at 454.

315. Maier, *supra* note 76, at 306-11; Mann, *supra* note 17, at 36-51; *see* Akehurst, *supra* note 26, at 212-40.

316. Maier, *supra* note 76, at 319. "Any judicial decision that fails to consider the needs of the international system in light of shared community values must necessarily fall short of achieving an effective coordination of national laws and concurrent national claims to jurisdictional power." *Id.*