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The Extraterritorial Reach of the Federal Securities Code: An Analysis of Section 1905

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TABLE OF CONTENTS

I. INTRODUCTION 495
II. THE CODE'S APPROACH TO EXTRATERRITORIALITY 499
A. *General Structure* 499
B. *Section 30(b) of the Securities Exchange Act* 500
C. *Sources of Section 1905* 501
III. ANALYSIS OF SECTION 1905 505
A. *Section 1905(a)(1)* 505
B. *Sections 1905(a)(2) and 1905(b)(1)* 511
C. *Section 1905(b)(2)* 512
D. *Section 1905(b)(3)* 518
E. *Section 1905(c)* 519
IV. CONCLUSION 522
APPENDIX 523

I. INTRODUCTION

Section 1905 of the proposed Federal Securities Code[1] sets forth the applicability of the Code to transnational securities transactions. The drafters could have stated in each provision of the Code whether and to what extent it was to apply extraterritorially. Instead, they placed in one section a set of general principles that cuts across all other sections of the Code and indicates which sections are to have extraterritorial application. The result is a descriptive guide that relies on a classification of transactions rather than a section-by-section enumeration.

A single provision containing general principles that govern extraterritorial application should meet at least three criteria. First,

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1. ALI FED. SEC. CODE § 1905 (Proposed Official Draft, 1978) [hereinafter cited as 1978 Draft]. The complete text of § 1905 is set forth in the Appendix to this Article.

it should be consistent with principles of international law governing the ability of a state to prescribe rules of law affecting conduct over which another state might have an equal or stronger jurisdictional claim. Second, it should be drafted with sufficient precision to serve as a practical guide for lawyers and businessmen whose activities will be governed by the Code. Third, it should properly balance competing public policy interests of the United States.

The need to satisfy the first criterion is manifest: Congress normally will not seek to intrude unduly into the affairs of other nations.[2] The drafters of section 1905 ensured that the Code would meet this criterion by stating expressly in each paragraph delineating the Code's extraterritorial scope that it is not to extend beyond "the limits of international law."

The second criterion—clear, unambiguous draftsmanship—must be satisfied so that reasonable predictions can be made about whether a proposed or continuing course of conduct will in the future be deemed subject to one or more of the Code's provisions. Such certainty is particularly important in the securities industry for several reasons. First, many securities transactions are inherently complex and require detailed advance planning. Second, because securities are intangible assets that are difficult to value, the ordinary investor relies to a large extent on the advice of a securities professional. This reliance is possible only if the investor has confidence in the professional's integrity. If a securities firm is to maintain its reputation for honesty and fair dealing, it cannot afford an allegation of even an inadvertent violation of the securities laws. Third, the potential financial liabilities in private damage actions based upon securities law violations are so large that no financial institution, issuer, or other person involved in securities transactions can afford unnecessary exposure to the risk of an adverse judgment.[3]

In general, section 1905 effects a vast improvement over existing law in terms of the certainty it affords, but, as will be demonstrated below, the language of several of its provisions could be clearer.[4] Maximum certainty could have been attained by delimiting the Code's scope, either narrowly or broadly, with extreme precision. Instead, the approach taken in section 1905 is to sacrifice

2. *See* text accompanying note 111 *infra*. But if a statute does expressly extend extraterritorially, the courts of the United States are bound only by the Constitution and not by international law. United States v. Aluminum Co. of America, 148 F.2d 416, 443 (2d Cir. 1945).

3. *See, e.g.*, Piper v. Chris-Craft Indus., 430 U.S. 1 (1977) (the Supreme Court reversed a damage award of $36 million in favor of Chris-Craft on the ground that an unsuccessful tender offeror does not have standing to sue under § 14(e) of the Securities Exchange Act).

4. *See* text accompanying notes 62 & 76 *infra*.

potential clarity for the assertion of as much extraterritorial jurisdiction as possible without transgressing the boundaries of international law. The section is precise in some areas but ambiguous in others; several provisions are quite broad in scope, although, as noted above, all are circumscribed by the vague perimeter of international law. This approach leaves to the courts the task of determining what the ambiguous provisions were intended to mean and when international law requires that the far-reaching provisions be cut off.

The third criterion—correct balancing of public policy objectives—must be satisfied so that the interests of the United States in protecting investors within its territory[5] and preventing the use of its territory as a base from which to "export fraud"[6] are not pursued singlemindedly to the detriment of its interest in maintaining free and open access to investment capital in the world's developed capital markets.[7] The latter interest, recognized even by the Securities and Exchange Commission (Commission or SEC),[8] must be supported if United States issuers are to have an opportunity to attract foreign investment, which lowers their cost of capital,[9] and if United States investors are to be able to diversify their holdings and to hedge their risks by placing a portion of their funds in overseas investments. Other important interests that should be weighed are the United States' relations with other nations and the ability of its financial institutions to compete abroad effectively. Although it is understandable that a securities code should emphasize protection of investors,[10] the broader interests of the United States as an international financial center must be borne in mind. As discussed below, in several areas the Code seems to place excessive emphasis on investor protection to the exclusion of other policy objectives.[11]

It has been suggested that another criterion by which to judge

5. By contrast, a state does not have jurisdiction to prescribe rules of law governing conduct affecting aliens outside its territory merely on the ground that the conduct affects one of its nationals. RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 30(2) (1965) [hereinafter cited as RESTATEMENT].

6. *See* text accompanying note 81 *infra*.

7. U.S. DEP'T OF THE TREASURY, PUBLIC POLICY FOR AMERICAN CAPITAL MARKETS 18 (1974).

8. SEC Securities Exchange Act Release No. 14128 § II(A) (Nov. 2, 1977), *reprinted in* [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,361.

9. U.S. DEP'T OF THE TREASURY, *supra* note 7, at 18.

10. The preamble to the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1976) [hereinafter referred to as 1934 Act], sets forth the Act's purposes as follows: "To provide for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."

11. *See* text accompanying notes 61-62 & 70-74 *infra*.

section 1905 would be whether the Code follows faithfully the holdings of decided cases in the area of extraterritorial application of the securities laws.[12] This is not a useful standard for several reasons. First, the decided cases consist largely of efforts by the courts to divine, in the absence of clear guidance from the language of the securities laws[13] or their legislative history, whether Congress considered the extraterritorial effect of these laws and what scope it intended or would have intended them to have had it done so.[14] Accordingly, the cases are comprised chiefly of judicial attempts to construe the provisions of existing statutes that the Code would supersede. In drafting a new code, however, Congress should disregard past judicial attempts at construction and decide *ab initio* the proper scope of the Code's provisions on the basis of correct public policy, subject to the limits of international law. Congress could thereby provide clear guidance as to how it intends the Code to be construed. Thus, existing precedents are useful only to the extent that they discuss the limits international law places upon a state's ability to apply its statutes extraterritorially.[15]

Second, in determining the extraterritorial scope of existing securities laws, the courts in many cases have been faced with plaintiffs who have suffered substantial losses as a result of egregious frauds.[16] Consequently, the courts have strained their interpretations to reach a result that punishes malefactors and compensates victims. Yet, they have been obliged to square their interpolations of congressional intent with principles of international law. Rather than producing a coherent statement of the extraterritorial application of the securities laws, this process has yielded some confusing,

12. Karmel, *The Extraterritorial Application of the Federal Securities Code*, 7 CONN. L. REV. 669 (1975).

13. Section 30(b) of the 1934 Act, 15 U.S.C. § 78dd(b) (1976), addresses the question of extraterritorial application, but it has been criticized as being too ambiguous to serve as a useful guide. *See* text accompanying notes 22-29 *infra*.

14. *E.g.*, Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 985 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975).

15. As discussed in the text accompanying notes 34-49 *infra*, the courts have been reluctant to assert jurisdiction to the limits allowable under international law. This reluctance need not affect Congress, since international law does not impose any limit on the power of Congress to enact laws. In *Leasco Data Processing Equip. Corp. v. Maxwell*, the court said:

> [I]f Congress has expressly prescribed a rule with respect to conduct outside the United States, even one going beyond the scope recognized by foreign relations law, a United States court would be bound to follow the Congressional direction unless this would violate the due process clause of the Fifth Amendment.

468 F.2d 1326, 1334 (2d Cir. 1972).

16. *See, e.g.*, ITT v. Vencap, Ltd., 519 F.2d 1001, 1017 (2d Cir. 1975); Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975).

far-reaching, and often inconsistent principles.[17] For the foregoing reasons, substantial reliance on existing case law would appear misplaced. Unfortunately, the Reporter's Comments on section 1905's predecessor, section 1604, suggest that in its preparation considerable weight was given to the decided cases on extraterritoriality.[18]

This Article will not analyze the existing cases, except to the extent they offer instruction as to the effect of applicable international law. Instead, it will examine the drafters' approach to extraterritoriality and then judge whether section 1905 affords reasonable predictability as to the Code's coverage of transactions with foreign elements and whether it strikes an appropriate balance among the competing goals of United States public policy respecting regulation of transnational securities transactions.

II. THE CODE'S APPROACH TO EXTRATERRITORIALITY

A. *General Structure*

Section 1905 delineates the Code's extraterritorial scope and thus gives the federal courts a basis for exercising subject matter jurisdiction over transactions falling within its intended coverage. Three provisions of section 1905—paragraphs (a), (b), and (c)—define this coverage.[19] Paragraph (a) states the circumstances

17. The following two statements from *Bersch* exemplify this point. First, the court states "[w]hile *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." 519 F.2d at 992 (emphasis added). On the next page, however, the court concludes that the antifraud provisions of the federal securities laws "[a]pply 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 . . . ." *Id.* at 993 (emphasis added). Assigning the emphasized terms their customary meaning, it is difficult to understand how "merely preparatory" activities can equal acts of "material importance."

18. *See generally* ALI FED. SEC. CODE § 1604, Reporter's Comments, at 165 (Tent. Draft No. 3, 1974) [hereinafter cited as TD-3]. In addition, the Reporter made the following observation with respect to § 1905:

> This section codifies a good deal of the law on extraterritorial application of the SEC legislation, which has produced a considerable number of precedents in recent years, and sets the tone for further elucidation by rule. The approach is to make the substantive coverage of the Code quite broad *prima facie*, though always "within the limits of international law," and to rely on a revised and more specific rulemaking authority to tailor that expression of *power* (in the international law sense) to the appropriate *policy* considerations in the myriad contexts of the Code.

1978 Draft, *supra* note 1, Reporter's Introduction, at lxix.

19. Paragraph (d) codifies section 103(a) of the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, tit. I, 91 Stat. 1494 (codified at 15 U.S.C. §§ 78dd-1, 78dd-2, 78m(b), 78ff (Supp. 1977)). Paragraph (e) deals with personal jurisdiction. Paragraph (f) contains a very technical provision concerning the nonapplicability of certain sections of the Code to actions in foreign courts, and paragraph (g) is the cross-reference paragraph. None of these paragraphs is discussed further herein.

in which the Code is intended to apply. Paragraph (b) specifies when the Code will not apply, but it does not "exempt" transactions; instead, it "excludes" them. Those transactions set forth in paragraph (b), therefore, are not carved out of paragraph (a); they constitute distinct categories of conduct to which the Code is expressly inapplicable. This is more than a semantic point—it means that the rule of construction providing that exemptions, particularly exemptions from remedial statutes, are to be narrowly construed does not apply to section 1905(b).[20]

Paragraph (c) empowers the Commission, by rule, to contract the coverage of paragraph (a), expand the coverage of paragraph (b), or determine whether the Code shall apply in any set of circumstances not covered by either (a) or (b). Paragraph (c) also directs the SEC to draft exemptive rules delineating the extent to which the registration provisions of the Code[21] will apply to nonresident issuers.

B. Section 30(b) of the Securities Exchange Act

One of the few provisions of the existing securities laws expressly recognizing that the securities business exists outside as well as within the United States is section 30(b) of the Securities Exchange Act (the Act).[22] This section provides that:

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

This language has been construed as an attempt to relieve foreign persons in the securities business from reporting and registration under the Act.[23]

The Commission has never adopted rules under section 30(b). According to Philip A. Loomis, Jr., the longest sitting of the SEC Commissioners and a longtime staff member as well, the principal reason is that the courts have construed the exemption narrowly, making such rules unnecessary.[24] An additional reason is that any rules under section 30(b) might involve the SEC in seeking to regu-

20. Woods v. Oak Park Chateau Corp., 179 F.2d 611 (7th Cir. 1950).

21. 1978 Draft, *supra* note 1, § 402.

22. 1934 Act § 30(b), 15 U.S.C. § 78dd(b) (1976).

23. Schoenbaum v. Firstbrook, 405 F.2d 200, 207 (2d Cir. 1968), *cert. denied sub nom.*, Manley v. Schoenbaum, 395 U.S. 906 (1969).

24. Loomis & Grant, *Extraterritorial Application of U.S. Securities Laws*, 1 J. COMP. CORP. LAW & SEC. REG. 3, 16 (1978).

late foreign broker-dealers abroad or, by implication, might broaden the exemption.[25]

Although this provision has been at the heart of a number of cases concerned with the extraterritorial application of the securities laws, its terms have raised questions as to its meaning.[26] One dispute over its interpretation is whether the words, "the jurisdiction of the United States," refer to territorial or judicial jurisdiction.[27] Another is whether an isolated sale of securities constitutes "[transaction of] a business in securities."[28] Because of problems of this nature, the Code's drafters have abandoned the language of section 30(b).[29]

C. *Sources of Section 1905*

The drafters of the Code were well aware of the relevant rules of international law.[30] The principles of international law applicable to questions of transnational jurisdiction are articulated in sections 17 and 18 of the *Restatement of Foreign Relations Law of the United States*[31] *(Restatement)* and are reflected in clauses (A) and (D) of section (a)(1) of the Code. Section 17, which is said to embody the "subjective" principle of transnational jurisdiction, 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.[32]

Under this provision, a state's jurisdiction over conduct within its territory exists without regard to the locus of the conduct's effects or the nationality of the actor or the victim.

Section 18 of the *Restatement* embodies the "objective" principle. Pursuant to this principle:

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25. *Id.*

26. *See, e.g.*, SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973); Roth v. Fund of Funds, Ltd., 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969); Schoenbaum v. Firstbrook, 405 F.2d 200, 207 (2d Cir. 1968), *cert. denied sub nom.*, Manley v. Schoenbaum, 395 U.S. 906 (1969).

27. 474 F.2d at 357-58.

28. 405 F.2d at 207.

29. TD-3, *supra* note 18, § 1604, Reporter's Comments, at 161.

30. *Id.* at 161-62.

31. RESTATEMENT, *supra* note 5, §§ 17-18.

32. Although there is no "or" between clauses (a) and (b), the illustrations offered in the *Restatement* treat them as if written disjunctively. Judge Friendly observed this inconsistency in *Leasco*. 468 F.2d at 1334.

> 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 laws of states that have reasonably developed legal systems, or
> (b) . . . (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.[33]

This principle permits jurisdiction to attach where the effects of conduct are felt, irrespective of the locus of the conduct.

Notwithstanding the subjective principle of section 17, in securities law cases the courts have expressed unwillingness to extend conduct-based jurisdiction to the limits permitted by international law.[34] This reluctance has persisted, even in the face of SEC arguments that the slightest use of the jurisdictional means[35] in connection with actionable conduct provides a sufficient basis for subject matter jurisdiction, regardless whether the principal elements of the transaction occurred abroad.[36] The courts' reluctance to extend jurisdiction to the limits of international law has been based upon the absence of clear extraterritorial intent in the statutes under which virtually all the cases have been brought[37] and the rule of construction holding that statutes are presumed not to apply extraterritorially unless a contrary intention is expressed.[38] Thus, the courts have examined a number of factors in deciding whether jurisdiction was intended to be asserted, including the nature of the acts in question, the extent to which they occurred in the United States, the residence and nationality of the victims, and whether the plaintiff was the SEC or a private party.[39]

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33. RESTATEMENT, *supra* note 5, § 18.

34. *Id.*; *see* Travis v. Anthes Imperial, Ltd., 473 F.2d 515 (8th Cir. 1973). *See also* Loomis & Grant, *supra* note 24, at 8.

35. *See, e.g.*, 1934 Act § 10, 15 U.S.C. § 78j (1976) (prohibiting "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 a national securities exchange" to employ a manipulative or deceptive device in connection with a purchase or sale of securities).

36. *See* SEC v. United Financial Group, Inc., 474 F.2d 354, 357 (9th Cir. 1973); Brief for SEC as Amicus Curiae at 13, Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968).

37. The Securities Act of 1933, 15 U.S.C. § 77a (1976) [hereinafter referred to as 1933 Act], is silent as to its extraterritorial effect. With regard to the limited extraterritorial language of the Securities Exchange Act of 1934, see note 13 *supra*.

38. Foley Bros. v. Filardo, 336 U.S. 281, 285 (1949); Blackmer v. United States, 284 U.S. 421, 437 (1932).

39. ITT v. Vencap, Ltd., 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).

Section 18 of the *Restatement* focuses exclusively on the locus of the effects of the conduct and ignores the situs of the conduct itself. The case that carried this principle to its furthest extreme was *Schoenbaum v. Firstbrook,*[40] in which the Second Circuit found that Congress intended the antifraud provisions of the securities laws to be given extraterritorial effect:

> to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities. In our view, neither the usual presumption against extraterritorial application of legislation nor the specific language of Section 30(b) show Congressional intent to preclude application of the Exchange Act to transactions regarding stocks traded in the United States which are effected outside the United States, when extraterritorial application of the Act is necessary to protect American investors.[41]

The court did find, however, that some conduct associated with the transaction in question occurred in New York.[42] Thus, the decision in the case can be interpreted as resting on conduct as well as effects. Moreover, in *Leasco Data Processing Equipment Corp. v. Maxwell,*[43] in which conduct within the United States had fraudulently induced an American corporation to purchase foreign securities abroad, the court questioned whether, if the alleged misconduct had occurred solely in England, the adverse impact upon the plaintiff and its American shareholders would support jurisdiction.[44] Judge Friendly, writing for the Second Circuit, took the position that "[w]hen 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.*"[45] While *Schoenbaum* has been said to support jurisdiction based on effects alone,[46] at least one commentator has taken the view that all the cases have involved conduct as well as effects.[47] Moreover, from a practical viewpoint, when conduct occurs in one state and produces an effect in another, the principles set forth in sections 17 and 18 may afford both states jurisdiction to prescribe rules of law attaching consequences to the conduct;[48] this overlapping jurisdiction can

40. 405 F.2d 200 (2d Cir. 1968), *cert. denied sub nom.*, Manley v. Schoenbaum, 395 U.S. 906 (1969).

41. *Id.* at 206.

42. *Id.* at 210.

43. 468 F.2d 1326 (2d Cir. 1972).

44. *Id.* at 1334.

45. *Id.*

46. *See* Loomis & Grant, *supra* note 24, at 11.

47. Karmel, *supra* note 12, at 678.

48. RESTATEMENT, *supra* note 5, § 17(a), Comment b, § 18, Comment d.

produce a conflict of laws.[49]

The foregoing discussion illustrates several reasons why existing case law, another important source of the Code's extraterritorial provision, is not an important criterion by which to judge section 1905. There are numerous decided cases on the extraterritorial application of the securities laws,[50] and the SEC has played a role in shaping the outcome of many of them, either as a party or through an amicus brief.[51] It is not essential for present purposes, however, to analyze the faithfulness with which section 1905 traces the contours of these cases. Although the Code was intended to codify existing law, the Reporter has made it abundantly clear that the drafters did not feel bound by existing law if reform seemed desirable and practicable,[52] and the Code is filled with examples of such departures.[53] In addition, since many of the cases have involved rather serious allegations of fraud, often of dramatic proportions,[54] most of them are ill-suited to the broader task of determining whether specific regulatory provisions of the Code should apply to essentially nonfraudulent transnational securities transactions. Finally, as noted above, the courts in previous cases have analyzed the facts before them chiefly to discern not whether international law would support the exercise of subject matter jurisdiction but whether Congress intended such an application of the Act—a question of considerable irrelevance in preparing a statute that will speak directly to that issue.

An additional source of the Code's provisions apparently is SEC administrative practice.[55] Apart from its enforcement efforts, the Commission's policy concerning extraterritoriality has been reasonably well articulated. For example, an entire body of "lore" governing offshore offerings by United States issuers has been developed by means of releases and no-action letters issued by the SEC staff

49. *Id.* §§ 37-40 (discussion of the resolution of the resulting conflicts). For a discussion of potential conflicts, see text accompanying notes 70-75 *infra.*

50. A number of articles have analyzed these cases. *See, e.g.,* Karmel, *supra* note 12; Loomis & Grant, *supra* note 24; Sandberg, *The Extraterritorial Reach of American Economic Regulation: The Case of Securities Law,* 17 HARV. INT'L L.J. 315 (1976).

51. *See, e.g.,* Brief for SEC as Amicus Curiae, Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968).

52. *See, e.g.,* 1978 Draft, *supra* note 1, Reporter's Introduction, at xv.

53. *See, e.g.,* Bialkin, *The Issuer Registration and Distribution Provisions of the Proposed Federal Securities Code,* 30 VAND. L. REV. 327 (1977).

54. *See, e.g.,* ITT v. Vencap, Ltd., 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).

55. TD-3, *supra* note 18, § 1604, Reporter's Note (9).

in response to specific factual situations.[56] The drafters of the Code apparently have not ignored this material.[57]

III. Analysis of Section 1905

A. *Section 1905(a)(1)*

Section 1905(a)(1) provides that "[w]ithin the limits of international law, this Code . . . applies with respect to" the types of conduct that are specified in clauses (A) through (D).[58] Each of these clauses will be examined in turn.

Clause (A) is keyed to the same four basic types of conduct with which the antifraud provisions of Code section 1602(a) are concerned: (1) purchases and sales, offers to buy or sell, and inducements not to buy or sell; (2) proxy solicitations; (3) tender offers and related recommendations; and (4) investment advisory activity (but in each instance only when such conduct occurs within the United States, even though it may have been initiated abroad). Clause (A) means that whatever consequences the Code may prescribe for conduct that occurs wholly within the United States likewise will attach to such conduct when initiated outside the United States, irrespective of whether the conduct has any significant effect in the United States or elsewhere. Clause (A) thus expresses the subjective territoriality principle embodied in section 17 of the *Restatement.* Under clause (A), if a Belgian company were to offer securities in the United States, or if a German company were to invite tenders by United States residents of securities of a Dutch issuer, or even if a Swiss investment adviser were to recommend to a United States resident a French security traded only abroad, the Code would apply.

One issue raised by clause (A) is the type of contact necessary for a transaction to occur "within the United States." Suppose a German corporation were to sell its securities in London to the United Kingdom subsidiary of a United States-registered broker-dealer acting for the account of a customer—a United Kingdom subject normally resident in London but who confirmed the transaction by telephone from Florida. It is not clear whether under clause (A) the telephone call would constitute conduct "within the United States;"[59] however, the Reporter's Notes to Tentative Draft No. 3

56. *See, e.g.*, SEC Securities Act Release No. 4708 (July 9, 1964), *reprinted in* 1 Fed. Sec. L. Rep. (CCH) § 1361.

57. *See, e.g.*, 1978 Draft, *supra* note 1, § 1905(b)(2)-(3).

58. For the text of § 1905(a)(1), see Appendix.

59. Section 1905(b)(2) provides that such a transaction would not in itself require the United Kingdom subsidiary to register as a broker under § 702 of the 1978 Draft of the Code.

suggest it would.[60]

Regardless of what the phrase "within the United States" means, if clause (A) is read literally, even a single, isolated act within the territory of the United States would trigger the applicability of the Code. For example, if two Japanese businessmen meet in New York, agree upon a sale of Sony common stock to be delivered in Japan, and fly back to Tokyo on the next plane, under the terms of clause (A) the Code would apply to that sale. At least one court, however, has questioned whether such an exercise of subject matter jurisdiction is permissible under international law when no effect of the conduct is felt in the United States.[61]

To permit the assertion of jurisdiction on the basis of such de minimus contacts with the United States could produce undesirable consequences. For example, if international businessmen know that any discussion in the United States of a proposed sale or purchase of securities, even when no American is involved as a principal, may subject that transaction to the full range of United States securities regulation, they may shun this Nation as a place to negotiate, plan, or arrange business transactions. The ultimate result might be to diminish the role of the United States as a world financial center and to reduce the worldwide demand for its banking, insurance, legal, accounting, and other ancillary services. The Code's drafters may be aware of this problem and perhaps are relying on the SEC to promulgate rules narrowing the scope of clause (A) pursuant to section 1905(c)(1)(A) to prevent such a result.[62] An alternative approach would be to require here, as in clause (D), that the act's constituent elements occur at least to a substantial extent in the United States, so that truly minimal contacts would not trigger subject matter jurisdiction.

Apart from the issue of correct policy suggested by clause (A)'s apparent de minimus contacts standard, the clause also raises an interpretive problem in cases in which a single, covered act within the territory is part of a large, essentially foreign, transaction. It is

60. TD-3, *supra* note 18, § 1604, Comment 3(b). The comment, which refers specifically to clause (A)'s predecessor, states that "[p]resumably everybody would agree that the making of an offer from another country into the United States by mail or telephone is subject to Sec. Act §§ 5 and 17(a) even though neither the seller nor an agent of the seller sets foot in the United States." Apparently, the Reporter believes clause (A) is analogous and that use of the mails or the telephone would trigger its applicability. Perhaps a court faced with clause (A) would disagree, however, and construe the phrase "within the United States" as a territorial concept, as the defendants argued § 30(b)'s language, "the jurisdiction of the United States," was a territorial reference in SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973). The Reporter's notes, however, are to be part of the Code's legislative history.

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

62. *See* note 18 *supra.*

unclear, for instance, whether, if the sale of Sony stock in the previous example were part of a public stock offering in Japan by a Japanese seller, the Code would apply to the entire transaction. To hold that it would is to arrive at an unsupportable result in terms of both law and policy, since the sales effected in Japan would constitute neither conduct nor effect in the United States. Undoubtedly, the correct interpretation is that the Code would not apply to such sales, and that only the sale within the United States is covered; however, this point should be clarified.

Clause (B) provides that the Code is applicable to "a nonresident of the United States that has a status described in section 1902(b), to the extent that the Code attaches consequences to such a status." Section 1902(b) covers issuers registered under the Code and other registered persons (including brokers, dealers, and investment advisers), insiders with respect to a registrant, persons who make tender offers, United States banks, and certain other types of persons.[63] As an illustration, a Dutch broker who registers as such under the Code thereby would become subject to all provisions of the Code governing registered brokers, at least in so far as his resident United States customers are concerned. Clause (B) does not specify the extent to which those provisions apply to his dealings with his Dutch customers, although it is possible to read section 1902(b), which applies "without regard to use of the mails or Federal commerce," as making those provisions applicable. As discussed below,[64] however, section 1905(b)(2) would seem to exclude him from the registration requirements of the Code to the extent that he does business with customers outside the United States and, in all likelihood, from its provisions governing registered brokers as well.

Clause (B), then, is aimed chiefly at those nonresidents whose activities in the United States are deemed sufficient to require that they register or otherwise submit themselves to the jurisdiction of the United States for purposes of its securities laws. It is difficult to fault the proposition that registered nonresidents should receive

63. Section 1902(b) provides as follows:

Status of actor or issuer. This Code applies without regard to use of the mails or Federal commerce in connection with a particular act or omission if the actor, the person required to act, or the issuer of a security involved in the act or omission is (1) a registrant, (2) any other person registered under this Code, (3) a person within section 605 or 606 so far as those sections are concerned, (4) a participant in a registered clearing agency, (5) a bank, (6) a mutual service company, or (7) an associate, or person acting on behalf, of any such person.

1978 Draft, *supra* note 1, at 707.

64. The exclusion of foreign residents from the broker-dealer registration requirements of the Code is treated below in the discussion of § 1905(b)(2) and (3) in the text accompanying notes 83-122 *infra*.

the same treatment as registered residents, provided they have not unfairly been obliged to register in the first instance.[65]

Clause (C) merits little discussion. It is a criminal provision bringing within the Code's scope any "attempt, solicitation, or conspiracy outside the United States [to violate the] Code within the United States." Certainly a state is justified in seeking to use its police power to deter criminal activities directed within its borders from abroad.[66]

Perhaps the most troublesome provision in this portion of the Code is clause (D). This clause brings within the Code's coverage

> any other prohibited, required, or actionable conduct (i) whose constituent elements occur to a substantial (but not necessarily predominant) extent within the United States or (ii) some or all of whose constituent elements occur outside the United States but cause a substantial effect within it (of a type that this Code is designed to prevent) as a direct and reasonably foreseeable result of the conduct.

By its express terms, clause (D) is a residual clause for all types of regulated conduct not covered elsewhere in section 1905(a). It reaches any *other* conduct that is "prohibited, required, or actionable." If it is read broadly, however, as the Reporter's Notes suggest it should be,[67] clause (D) ignores the more carefully drawn provisions of the preceding three clauses of section 1905(a)(1). Instead, it purports to reach any type of regulated conduct those clauses might fail to include, provided only that its lower threshold of contacts with the United States is satisfied. Because of the sweeping implications of this clause, the latter point merits further analysis.

In so far as the type of conduct covered by clause (D) is concerned, the phrase in clause (D), "any other prohibited, required, or actionable conduct," must refer to all conduct that is not covered by clauses (A) through (C) of section 1905(a)(1) (for example, conduct not covered because the act specifically described in clause (A) does not occur within the United States, as clause (A) would require), and not just conduct that is not specifically described in

65. *See* text accompanying note 83 *infra*.

66. *See, e.g.*, Criminal Code Reform Act of 1977, S. 1437, 95th Cong., 1st Sess., § 1126 (1977); H.R. 6869, 95th Cong., 1st Sess., § 1126 (1977).

67. Note (2) following § 1905(c) reads as follows:

> § 1905(a)(1)(D): A new comment to Clause (D) will state that the "constituent elements" phrase is not limited to acts essential to the establishment of the "prohibited, required, or actionable conduct." Thus, Clause (i) is broad enough, in the context of [the antifraud provision of the Code relating to purchases and sales], to cover (within the limitations of that clause) a sale consummated in England pursuant to negotiations in both England and the United States even though the only misrepresentations occurred in the negotiations abroad.

1978 Draft, *supra* note 1.

clauses (A) through (C) of section 1905 (that is, conduct other than sales, purchases, proxy solicitations, and the like). Reporter's Note (2) seems to confirm this interpretation, since it contemplates that clause (D) would apply to a sale, notwithstanding that sales are expressly covered by clause (A).

Turning to the locus of the conduct, subclause (i) of clause (D) refers to conduct whose constituent elements occur to a substantial extent within the United States. By implication, then, under clause (D) the regulated act itself—a sale, for example—may occur abroad. Under clause (A), however, the regulated act apparently must occur within the United States for subject matter jurisdiction to exist. Since types of conduct specified in clause (A) are among those most closely regulated by the Code,[68] it is curious that the Code sets a less stringent standard of contact with the United States for the more generalized conduct that is the subject of clause (D). One might have expected the latter, more broadly based, provision to employ a stricter test as to the proportion of the regulated act that must occur within the United States.

Assuming the foregoing interpretation of clause (D) is correct, the courts will have to decide what comprises the constituent elements of a particular regulated act.[69] Thus, clause (D) does little to advance the goal of greater predictability of the Code's extraterritorial impact. Moreover, in cutting so wide a swath, clause (D) raises serious questions of policy, similar to but even more grave than those noted in the discussion of clause (A) above.[70]

Subclause (ii) of clause (D) presents further problems. That subclause resembles closely the jurisdictional standard of section 18 of the *Restatement* with respect to the domestic effects of conduct abroad; however, it omits the third condition of section 18: that the regulation or proscription not be inconsistent with generally recognized principles of justice in states that have reasonably developed legal systems. Of course, this condition is implicit, since section 1905(a)(1) is, as noted above, by its terms circumscribed by the limits of international law. Nonetheless, since the other elements of section 18—that the effects of the conduct be substantial, direct, and foreseeable—are specifically mentioned, the exclusion of this condition is curious.

68. *See id.* § 1602(a).

69. The Reporter's Note quoted in note 67 *supra* indicates that the term "constituent elements" is intended to have quite a broad scope. It is unclear, however, whether acts that are, in the words of Judge Friendly in *Bersch,* "merely preparatory" would rise to the level of constituent elements. *See* note 17 *supra.*

70. *See* text accompanying notes 58-62 *supra.*

This observation also suggests a more fundamental problem concerning the breadth of subclause (ii). Whether or not the prohibition of fraud is consistent with principles of justice generally recognized by states with developed legal systems, the concept of fraud, as applied in the context of securities transactions in the United States, probably extends further than it does in most other jurisdictions. The principal element of fraudulent conduct, as it has come to be understood in this context, is the failure by either party to the transaction to make full disclosure of all material facts.[71]

Numerous countries with developed legal systems have consciously rejected full disclosure as an element of their regulation of corporate and financial activity.[72] For example, French regulators have played down implementation of an elaborate system of corporate disclosure in an attempt to encourage issuers to enter the developing French capital market.[73] A Swiss author has suggested that Europeans have not accepted full disclosure as a substantial aid to making investment decisions.[74] Even less in the way of disclosure is required in developing nations such as Brazil, Pakistan, Korea, and the Philippines, which, though they may not be full-scale industrial powers, certainly have reasonably developed legal systems.

In light of this discrepancy in philosophy, an attempt under clause (D) to apply the Code's antifraud provisions to a transaction occurring in a nation that has rejected the concept of full disclosure could be found by a court to go beyond the limits of international law: such an application of the Code would violate the third condition of *Restatement* section 18, notwithstanding substantial, direct, and foreseeable effects within the United States. Admittedly, the test under section 18 is whether the rule of law is inconsistent with generally recognized principles of justice, not those of a particular state. But even if a court were unable to assess what such generally recognized principles would provide, and if it were to face a conflict as a result of a contrary policy in the state with conduct-based jurisdiction, then the predominant interest of that state might well

71. Santa Fe Indus. v. Green, 430 U.S. 462, 473-74, 477 (1977).

72. Widmer, *The U.S. Securities Laws—Banking Law of the World? (A Reply to Messrs. Loomis and Grant)*, 1 J. COMP. CORP. L. & SEC. REG. 39 (1978).

73. *See* Sandberg, *supra* note 50, at 327-28.

74. According to Peter Widmer, a member of the Zurich Bar:

> To Europeans, the basic burden of judging an investment is on the investor; Europeans do not believe that full disclosure greatly helps him in making his decision. They rather place emphasis on the functioning of competition in the capital markets, on professional control by banks and investment advisers and, finally, on the general criminal provisions of the European criminal codes prohibiting fraud in the form of "obtaining monies through willfully false pretenses" with the intent to damage the investor.

Widmer, *supra* note 72, at 39-40.

prevail, without regard to generally recognized principles.[75] Further, apart from whether clause (D) would raise problems under international law, assertion of jurisdiction over foreign entities carries obvious potential for disrupting our relations with the nations in which the entity is domiciled.[76] The above catalogue of interpretive, legal, and policy issues that might flow from adoption of clause (D) suggests that this provision may be inconsistent with the statement of objectives laid down for section 1905 in the Introduction to this Article. Serious consideration should be given to its deletion.

B. Sections 1905(a)(2) and 1905(b)(1)

Sections 1905(a)(2) and 1905(b)(1) treat the four basic acts specified in clause (A) from the opposite perspective—when the act is initiated within the United States but occurs abroad.[77] Reading these two provisions together produces the following result: when the conduct is thus "exported," the four basic acts are not covered by the Code, except that the antifraud provisions of part XVI are applicable. As an illustration, a distribution of securities of a United States issuer effected abroad would remain free from the Code's distribution rules but would be subject to the antifraud rules.

For purposes of sections 1905(a)(2) and 1905(b)(1), it is irrelevant whether persons affected by the specified acts are United States citizens, so long as they are abroad when the acts occur. This treatment, which minimizes the importance of the nationality of the victim of an act, is consistent with international law[78] but is not recognized by existing SEC administrative practice. For example, the Commission's staff traditionally has required that offshore offerings be restricted to foreign nationals as a condition of the SEC's not taking action in cases in which the issuer does not plan to register the offering.[79] Accordingly, if the Code were adopted, it would be possible to modify the typical restriction in an agreement among underwriters that requires members of the underwriting syndicate to agree to limit their sales to noncitizens, as well as nonresidents, of the United States.[80]

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75. RESTATEMENT, *supra* note 5, § 40. For a conflict of laws analysis of subject matter jurisdiction, see Sandberg, *supra* note 50, at 329.

76. *See* text accompanying note 112 *infra*.

77. For the texts of §§ 1905(a)(2) and 1905(b)(1), see Appendix.

78. *See* note 5 *supra*.

79. SEC Securities Act Release No. 4708 (July 9, 1964), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 1363.

80. A typical provision is the following:

> We represent that we have not offered or sold, and agree that, except in transactions with Underwriters with your prior consent and transactions through you with dealers as

In general, these two provisions appear to embody the view, recognized by the courts under existing securities law, that the United States has a legitimate interest in preventing its territory from being used as a base for exporting fraudulent securities schemes.[81] Although this proposition has been energetically litigated, the United States' interest in asserting its jurisdiction in this manner is manifest. Frauds perpetrated on foreigners abroad can discourage foreign investment in the United States if the frauds are publicly associated with United States persons or entities so as to cast doubt upon the fairness of our markets and our ability to police them, or upon the soundness of our financial institutions. On the other hand, to avoid undue interference with commerce in foreign countries, the Code's extraterritorial reach probably should be limited to those situations in which the "exported" conduct in question rises to the level of fraud, and it should not attempt to regulate conduct generally, for example, by requiring registration of offshore securities distributions. Given the Code's attempt to narrow the range of undesirable conduct that comes under the fraud rubric,[82] the approach taken by sections 1905(a)(2) and 1905(b)(1) properly balances the relevant policy objectives.

C. *Section 1905(b)(2)*

Section 1905(b)(2) excludes from the registration provisions of section 702 brokers, dealers, municipal brokers, municipal dealers, and investment advisers, provided they are not United States residents and to the extent that they do business (a) with persons situ-

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provided in Section 3, we will not, directly or indirectly, offer, sell or deliver, any Notes acquired by us pursuant to the Purchase Agreement or this Agreement or allotted by you to us as contemplated hereby in the United States or to any U.S. person or to others for offering, resale or delivery, directly or indirectly, in the United States or to any U.S. person.

. . . .

As used in this paragraph "United States" means the United States of America, its territories and possessions and all areas subject to its jurisdiction and "U.S. person" means any national or citizen of or person resident or normally resident in the United States, including any corporation or other entity organized under the laws of the United States or any political subdivision thereof.

I C Industries Finance Corporation N.V., Agreement Among Underwriters, at 2, April 13, 1978. The underwriters also agree to deliver to each person to whom they sell securities a confirmation stating that the purchaser, by accepting the securities, agrees to similar restrictions with respect to any resales made within a specified period (90 days is not uncommon) from the date the distribution is completed.

81. ITT v. Vencap, Ltd., 519 F.2d 1001, 1017 (2d Cir. 1975).

82. Section 916 of the Code provides that "[a] violation of part IX is not of itself a violation of part XVI." Thus, for example, failure to obtain prompt execution of a customer's order, as prohibited by section 913(a), would not necessarily be deemed fraudulent conduct.

ated outside the United States, or (b) with existing clients who are not United States citizens and are present only temporarily in the United States.[83] Under subclause (A) of section 1905(b)(2), as in the case of section 1905(b)(1), it is not required that the customers or clients be noncitizens of the United States so long as they are present abroad.

This provision may have been intended to resolve a longstanding problem faced under present law by foreign subsidiaries of United States broker-dealers. Given the uncertainty surrounding section 30(b) of the Securities Exchange Act,[84] it is unclear which provisions of the Act are applicable to these foreign firms, even when they deal exclusively with foreign customers. It is normally thought that section 30(b) should be construed to mean that the broker-dealer registration requirements of section 15(a) of the Act[85] do not apply to these foreign subsidiaries.[86] While the Commission has conceded this interpretation in an amicus brief, it has argued that most of the other provisions of the Act are applicable, including section 10(b) and section 15(c),[87] which prohibits manipulative, deceptive, or other fraudulent devices or contrivances in the over-the-counter market.[88]

Principles of fair competition dictate that these firms and their foreign competitors, many of which are foreign banks acting in a brokerage capacity, should stand in the same position with respect to the federal securities laws. As a practical matter, however, only foreign firms controlled by United States broker-dealers, with their parents within easy reach of the SEC's grasp, have demonstrated any serious concern for provisions of the United States securities laws. An objective of the Code should be to ensure that such United States-controlled firms can conduct their overseas activities with confidence that they will not be at a competitive disadvantage with respect to their foreign competitors because of unequal regulatory

83. For the text of section 1905(b)(2), see Appendix.

84. 1934 Act § 30(b), 15 U.S.C. § 78dd(b) (1976).

85. 1934 Act § 15(a), 15 U.S.C. § 78o(a) (1976).

86. Schoenbaum v. Firstbrook, 405 F.2d 200, 207 (2d Cir. 1968), *cert. denied sub nom.*, Manley v. Schoenbaum, 395 U.S. 906 (1969).

87. 1934 Act § 15(c), 15 U.S.C. § 78o(c) (1976).

88. Brief for SEC as Amicus Curiae at 24, Schoenbaum v. Firstbrook, 405 F.2d 200, 207 (2d Cir. 1968). In an injunctive action settled by consent, the Commission charged a broker-dealer incorporated under Hong Kong law and operating in Thailand with violations of §§ 15(a) (broker-dealer registration), 17(a) (books and records), and 10(b) (antifraud) of the Securities Exchange Act. SEC v. Siamerican Securities, Ltd., Civ. No. 75-0947 (D.D.C. 1975). Although the Commission alleged a violation of § 15(a), the defendant's customers were primarily United States citizens residing in Southeast Asia, and most of the transactions effected were in securities traded in United States markets.

treatment. But this objective has not been attained in the present draft of the Code because section 1905(b)(2) excludes nonresident entities only from the registration provisions of section 702; the section is silent as to the antifraud provisions of part XVI and the market regulation provisions of part IX.

The language of section 1905(a)(2), however, might be construed to apply part XVI to the foreign firm's conduct abroad. If a foreign firm is a subsidiary of a registered United States broker-dealer, or is under common control with such an entity, it may be deemed to operate under the direction of a United States person, and its activities may be deemed to be "initiated within the United States" within the meaning of section 1905(a)(2).[89] An argument also might be made that subclause (i) of clause (D) would apply to these foreign subsidiaries, again assuming that direction of the subsidiary's business from the United States could be demonstrated and that such direction amounted to a "constituent element" of the subsidiary's business activities. If clause (D) applied in this manner, then, in addition to part XVI, all the market regulation provisions of part IX, which by their terms apply to brokers, dealers, and investment advisers regardless of their registered status, could be held to apply to the foreign entity. This would include provisions governing affiliated trading,[90] marketmaking and segregation of functions,[91] confirmations,[92] hypothecation and lending,[93] short sales,[94] options,[95] trading practices,[96] and the various provisions regulating investment advisers.[97]

Application of either part IX or part XVI to foreign entities controlled by United States corporations raises the question of the jurisdiction of the United States under international law to prescribe rules of law governing foreign subsidiaries of United States corporations. According to the *Restatement of Foreign Relations Law of the United States,* the United States has the power to prescribe rules governing the conduct of its nationals everywhere in the world;[98] however, it does not have jurisdiction to prescribe rules

89. Whether such an assertion of extraterritorial jurisdiction would be consistent with international law is discussed in the text accompanying notes 98-114 *infra.*

90. 1978 Draft, *supra* note 1, § 906(b).

91. *Id.* § 907.

92. *Id.* § 909.

93. *Id.* § 910.

94. *Id.* § 911.

95. *Id.* § 912.

96. *Id.* § 913.

97. *Id.* §§ 914, 915, 919.

98. RESTATEMENT, *supra* note 5, § 30(1)(a).

attaching legal consequences to the conduct of aliens outside its territory merely on the ground that such conduct affects one of its nationals.[99] For the United States to apply one of its statutes to a foreign subsidiary, then, another basis of jurisdiction must be found. The obvious nexus is control by a United States entity, but whether control provides an adequate basis is not an easy issue to resolve. Congress has faced this problem before in regulating the conduct of multinational corporations. Three federal statutes illustrate how it has dealt with the issue of its jurisdiction over foreign subsidiaries of United States corporations.

The Trading with the Enemy Act (TEA),[100] originally enacted in 1917, was amended in 1933 to extend the President's power to regulate trade between residents of foreign countries and "any person . . . subject to the jurisdiction of the United States."[101] Regulations promulgated under the TEA by the Office of Foreign Assets Control of the Treasury Department define persons "subject to the jurisdiction of the United States" as:

> (1) Any person, wheresoever located, who is a citizen or resident of the United States;
> (2) Any person actually within the United States;
> (3) Any corporation organized under the laws of the United States or of any state, territory, possession, or district of the United States; and
> (4) *Any partnership, association, corporation, or other organization, wheresoever, organized or doing business, which is owned, or controlled by persons specified in paragraphs (a) (1), (2), or (3) of this section.*[102]

Although no prosecutions have ever been brought under the TEA, at least one attempt by the Treasury Department to regulate the sales of a foreign subsidiary of a United States corporation provoked serious opposition from a foreign country.[103] The TEA, as applied to United States-controlled subsidiaries trading with Cuba, also has been a subject of continuing controversy with foreign governments, particularly Canada.[104] Nonetheless, Congress has taken no steps to amend the TEA.

The administrative experience of the Treasury Department under the TEA, however, may have been reflected in the approach Congress took to the problem of controlled foreign entities in the Foreign Corrupt Practices Act of 1977 (FCPA).[105] Among other

99. *Id.* § 30(2).
100. 50 U.S.C. app. §§ 1-44 (1970).
101. *Id.* § 5(b)(1)(B).
102. 31 C.F.R. § 500.329 (1977) (emphasis added).
103. Judgment of Cours d'appel, Paris, [1965] J.C.P. II, Nos. 14, 174 (litigation involving Freuhauf Corporation).
104. *See* text accompanying note 112 *infra.*
105. 15 U.S.C. § 78q, 78dd-1, 78dd-2, 78ff (Supp. I 1978).

things, the FCPA makes it unlawful for a "domestic concern" to make payments to any foreign official or politician if the payment is made "corruptly." An earlier version of the FCPA would have included within the definition of "domestic concern" any legal entity "owned or controlled by individuals who are citizens or nationals of the United States."[106] The final version, however, limited the definition of "domestic concern" to United States citizens or residents, including corporations organized or having their principal place of business in the United States; domestically owned or controlled foreign entities were excluded.[107] The conference report stated that "the conferees recognized the inherent jurisdictional, enforcement, and diplomatic difficulties raised by the inclusion of foreign subsidiaries of U.S. companies in the direct prohibitions of the bill."[108]

The question of extending a statute extraterritorially to reach subsidiaries of United States corporations also arose in connection with the Export Administration Amendments of 1977 (EAA).[109] The EAA amended the Export Administration Act of 1969 to put teeth into the United States' policy of discouraging compliance with foreign boycotts of countries friendly to the United States. It applies to "any United States person, with respect to his activities in the interstate or foreign commerce of the United States."[110] A "United States person" is defined to include "any United States resident or national . . . , any domestic concern . . . and any foreign subsidiary or affiliate . . . of any domestic concern which is controlled in fact by such domestic concern, as determined under regulations of the President."[111] A Senate report on an earlier version of the EAA contains language indicating a congressional belief that application of a statute to foreign entities is justified so long as there is a connection with United States commerce:

> By limiting the reach of the law to activities of U.S. persons in the interstate or foreign commerce of the United States, S.69 would avoid unwarranted intrusions into the affairs of foreign countries not participating in a foreign boycott. A subsidiary of a U.S. company in Canada, for example, is, from the Canadian and every legal point of view, a Canadian citizen. U.S. restrictions on that company's ability to trade or do business with the Middle East would

106. H.R. 3815, 95th Cong., 1st Sess. (1977).

107. 15 U.S.C. § 78dd-2(d)(1) (Supp. I 1978).

108. H.R. REP. No. 831, 95th Cong., 1st Sess. 14 (1977).

109. 50 U.S.C.A. app. § 2403-1a (West Supp. 1978).

110. *Id.* § 2403-1a(a)(1). The Department of Commerce has promulgated regulations specifying when the activities of a person are in United States commerce. 15 C.F.R. § 369.1(d) (1978).

111. 50 U.S.C.A. app. § 2410(2) (West Supp. 1978).

> be deeply resented, as were recently ended U.S. efforts to prohibit Canadian subsidiaries of U.S. firms from trading with Cuba.
>
> Such restrictions can be justified where U.S. commerce is involved, for example where a U.S. company's Canadian subsidiary purchases goods or services from the United States in connection with its Middle East trade. There a direct U.S. interest is involved. But otherwise the interest is tangential and attempts to pursue it in such circumstances unnecessarily intrude upon the sovereignty of others.
>
> Equally relevant are the serious obstacles to enforcement of U.S. law against foreign companies not engaged in U.S. commerce. The fact that they may happen to be subsidiaries of U.S. concerns does not resolve the problem. It is difficult, if not impossible, in most instances to secure the requisite jurisdiction over a foreign company with no connection with U.S. commerce. Where the U.S. parent commands the illegal action, the parent itself would be liable, and no unusual jurisdictional problems are presented. But where the subsidiary acts on its own and the transaction has no connection with U.S. commerce, the jurisdictional hurdles may be insuperable. Hence, S.69 goes as far as it is realistically possible to go by limiting its reach to transactions which involve U.S. commerce.[112]

Thus, in enacting the EAA, Congress considered the jurisdictional problem but felt that the extension of the statutory prohibitions to controlled foreign companies was supportable because of the Act's limitation to activities in United States commerce.

Since no judicial decision has tested any of the above statutory provisions, it is impossible to predict how the courts would apply international law to them.[113] One can observe, however, that in the case of the FCPA and the EAA, in the enactment of which Congress considered and discussed the extraterritorial effect of its legislation, the furthest it was willing to go was in the EAA, in which it prescribed rules governing the conduct of United States-controlled or affiliated entities only when those entities were engaged in United States commerce. Congress apparently intended to require at least some meaningful connection with United States business activities as a condition of asserting jurisdiction, even in a case in which the thrust of its legislative initiative was specifically concerned with transnational activity.

Of course, the question of jurisdiction over a foreign entity is distinct from the question whether Congress desires to regulate that entity. As indicated by the Senate report quoted above, Congress may choose to avoid the jurisdictional question by regulating the United States parent in those cases in which the parent is found to have directed a foreign entity to violate the law in question.[114] To

112. S. REP. No. 104, 95th Cong., 1st Sess. 26-27 (1977).

113. An action has been filed challenging the constitutionality of the Export Administration Amendments of 1977, but plaintiff is a domestic manufacturer and exporter of goods to certain Arab countries. Trane Co. v. Kreps, No. 78-6413 (W.D. Wis., filed Sept. 1978).

114. *See* text accompanying note 112 *supra.*

avoid future disputes over whether Congress sought to pursue this course in the Code, section 1905(b)(2) should be drafted to leave no doubt as to whether controlled foreign firms must comply with parts IX and XVI. If they must, their parents may be in violation of the Code for directing the foreign firms to carry out activities that these provisions forbid.

If neither section 1905(a)(2) nor clause (D) is construed to extend the antifraud and market regulation provisions of the Code to foreign subsidiaries of United States broker-dealers, the area would be left open to SEC rulemaking pursuant to section 1905(c)(1)(C), as discussed below.[115] The Commission, however, is admonished by the preamble to its grant of authority in section 1905(c) to use its rulemaking authority "in the light of the significance or effects within the United States of particular acts or conduct."[116] This restriction probably would preclude the promulgation of rules extending either the antifraud or market regulation provisions to the overseas activities of foreign broker-dealers, despite their United States parentage. In any event, there is no reason for the Code to leave unresolved the question of its applicability to overseas subsidiaries of United States brokers; it should clarify the matter absolutely, preferably by excluding the persons described in section 1905(b)(2) from all the provisions of the Code.

D. Section 1905(b)(3)

Section 1905(b)(3)[117] speaks to participation by nonresident brokers and dealers in offshore distributions and limited offerings.[118] It provides that participants in these offerings need not be registered under section 702 so long as their activity is limited to purchasing securities for sale abroad and to participating in underwriting group activities performed by a registered broker or dealer. This approach is consistent with the SEC's existing administrative position,[119] except that, as elsewhere in section 1905(b), there is no requirement that the purchasers in the distribution or offering be noncitizens of the United States.[120] Again, the Commission has rulemaking authority under section 1905(c)(1)(B) to alter or condition this exclusion.

115. The Commission's rulemaking authority is discussed in the text accompanying note 123 *infra*.

116. For the full text of § 1905(c), see Appendix.

117. For the full text of § 1905(b)(3), see Appendix.

118. A limited offering is the Code's term for a private placement. 1978 Draft, *supra* note 1, § 242(b).

119. SEC Securities Act Release No. 4708 (July 9, 1964), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶¶ 1361-63.

120. *See* text accompanying note 79 *supra*.

Typically, the problem faced by counsel to underwriters of offshore offerings is not broker-dealer registration but the question of when an offshore distribution has "come to rest" so that resales in the United States of the distributed securities can occur without the need to prepare and file an "offering statement."[121] The Code seemingly resolves this problem by its silence. Under section 1905(b)(1) an offer or sale of securities that occurs abroad is excluded from the Code, provided there is no fraudulent activity, and it appears that this exclusion is not affected by subsequent resales in the United States of the securities sold abroad. Therefore, the reseller need only bring his transaction outside the definition of a "distribution," for which section 502 requires an offering statement; for example, he may be able to avail himself of the exclusion provided for "trading transactions"[122] under section 242(c) of the Code.

E. Section 1905(c)

Section 1905(c)(1) gives the Commission rulemaking authority, within the limits of international law and clause (D), in three areas: (1) it can contract the coverage of the Code with respect to the subject matter of section 1905(a); (2) it can expand the coverage of the Code with respect to the subject matter of section 1905(b); and (3) it can expand or contract the coverage of the Code with respect to any other subject matter.[123] Additionally, as noted above,[124] the Commission is required to use its rulemaking authority "in the light of the significance or effects within the United States of particular acts or conduct." This clause instructs the Commission not to press its rulemaking authority to the limits of international law to govern conduct that has no substantial impact in the United States.

Section 1905(c) raises several problems. The first is the proper construction of the reference in the preamble to clause (D). Since the SEC's authority already is circumscribed by the limits of international law, the reference would have meaning only if clause (D) imposed an additional limitation. As noted above,[125] it appears that the terms of clause (D) are at least as broad as international law; thus, it is unclear what additional limitation the drafters intended. Perhaps this unnecessary reference could be eliminated.

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121. An offering statement is the Code counterpart of a registration statement under the Securities Act of 1933. *See* 1978 Draft, *supra* note 1, § 502.

122. A trading transaction is the Code's term for a broker's transaction under § 4(4) of the 1933 Act. *See* 1978 Draft, *supra* note 1, § 242(c).

123. For the full text of § 1905(c), see Appendix.

124. *See* text accompanying note 116 *supra.*

125. *See* text accompanying notes 67-75 *supra.*

Another question concerns clause (2) of section 1905(c). Under that clause, the Commission is obliged to prescribe the extent to which the registration provisions of section 402 apply with respect to nonresident issuers. The Code obviously intends the Commission to draft exemptive rules for foreign issuers comparable to those presently in effect under section 12(g) of the Act.[126] Interestingly, this provision does not mention sections 14 and 16 of the Act,[127] although by SEC rule foreign issuers are exempt from these sections,[128] which regulate proxy solicitations and insider trading. It has long been recognized that to subject foreign issuers to these sections would be tantamount to imposing upon them our own notions of corporate governance,[129] a step that even the SEC thus far has been reluctant to take. Because of the dismay with which other nations doubtless would view an attempt by the United States to affect the conduct of corporations domiciled within their borders, Congress ought to give serious consideration to writing these exemptions into the Code rather than leaving their scope to the Commission's discretion.

An additional problem raised by section 1905(c) concerns its scope. It has been criticized by at least one author as relegating to the Commission an excessive amount of rulemaking authority.[130] Implicit in this criticism is the fear that the Commission might ignore all United States policy obligations other than investor protection and either wield its rulemaking authority to expand its jurisdiction to the maximum extent permitted by international law, or fail to reduce its jurisdiction in appropriate circumstances. It also has been asserted that this fear assumes that in exercising its rulemaking authority the Commission cannot be relied on to give due regard to broader considerations, such as foreign and monetary policy.[131] These broader considerations might include the effect of the United States' assertion of extraterritorial jurisdiction upon its relations with other nations, its international payments, the ability of United States-owned financial institutions to compete abroad, and the risk of retaliatory action by foreign governments against United States financial institutions. Before accepting the validity of this criticism, however, a closer look at the Commission's authority

126. 1934 Act § 12g, 15 U.S.C. § 781(g) (1976).

127. 1934 Act §§ 14, 16, 15 U.S.C. §§ 78n, 78p (1976).

128. 17 C.F.R. § 240.3a12-3 (1978).

129. SEC Securities Exchange Act Release No. 7746 (Nov. 16, 1965), *reprinted in* [1964-1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,301. *See also* Karmel, *supra* note 12, at 674 n.18.

130. Karmel, *supra* note 12, at 701-04.

131. *Id.* at 703.

under section 1905(c) is warranted.

The only area in which section 1905(c)(1) permits the SEC to expand the Code's coverage is with respect to the subject matter of section 1905(b) and any other subject matter not covered by section 1905(a). It is true that the Commission, by indiscriminate exercise of its rulemaking power, could narrow the carefully crafted exclusions of section 1905(b), subject to the limitations described above. There is good reason to doubt, however, that this result would ensue. As noted above, most of the exclusions afforded by that section are consistent with existing administrative practice as it has been developed by, or with the active participation of, the Commission and its staff. Although the Code effects a minor relaxation of existing practice, in so far as it excludes sales abroad to United States citizens, in large measure it merely excludes activity that the Commission has shown little inclination to regulate, at least in the absence of fraud. To the extent fraud exists, section 1905 (a)(2) may make part XVI applicable in any event. Moreover, any proposed contraction of the exclusions of section 1905(b) would have to go through the normal rulemaking process, providing ample opportunity for contrary points of view to be heard.

The Commission also has authority under section 1905(c) to expand (as well as contract) the Code's coverage in any area not dealt with by section 1905(a) or (b). The precise scope of this authority is difficult to discern because of the uncertainty regarding the scope of clause (D).[132] With or without clause (D), however, section 1905(a) is an expansive provision. Clause (A) of that section covers many of the basic types of conduct regulated by the Code,[133] and, as previously noted, a single act within the United States may trigger clause (A)'s applicability.[134] Thus, the ground left untouched by section 1905(a) may well prove to be relatively narrow, leaving the Commission few new fields to plow.

The other concern expressed about the Commission's rulemaking authority is that, judging by the Commission's failure to adopt rules under section 30(b),[135] it is hopeless to rely on the Commission to contract the scope of the Code delineated in section 1905(a). This criticism is based on the assumption that the scope of that provision is too broad. Indeed, according to the Reporter, the goal of section 1905 was to make the coverage of the Code quite broad and to rely

132. *See* text accompanying notes 67-75 *supra.*

133. *See* text accompanying note 58 *supra.*

134. *See* text accompanying note 60 *supra.*

135. *See* Karmel, *supra* note 12, at 701; TD-3, *supra* note 18, § 1604, Reporter's Comments, at 164.

on Commission rulemaking to tailor that broad grant of legislative power "to the appropriate policy considerations in the myriad contexts that could result in litigation."[136] While it is difficult to disagree with those who suggest that the Commission is unlikely to use often or aggressively its rulemaking power to reduce the scope of section 1905(a), this should be a cause for concern only if certain other problems with the Code are not resolved by Congress. The most desirable way to solve these problems is for Congress to narrow the scope of clause (A) by including a greater contacts requirement and to eliminate clause (D), as suggested above.[137] If this is done, there will be no need to depend unduly upon the Commission to reduce the scope of section 1905(a).

IV. CONCLUSION

Although section 1905 might profit from some fine tuning, it is a vast improvement over the present confusing state of the law. If the Code is adopted, this section will make much simpler the life of those who must advise foreign entities, or domestic entities engaging in transnational business dealings, as to the laws that govern their conduct. Nevertheless, several drafting and substantive problems remain. These relate primarily to clauses (A) and (D) of section 1905(a) and paragraph (2) of section 1905(b).[138] It is hoped that these problems will receive adequate attention when Congress considers the Code and that Congress, rather than relying upon the Commission and the courts to shape the ultimate contours of section 1905, instead will engage in its own weighing of the various policy objectives that are relevant to the United States' regulation of transnational securities transactions.

136. *See* TD-3, *supra* note 18, § 1604, Reporter's Comments, at 165.

137. The suggested changes in these portions of the Code are discussed in the text accompanying notes 62 (§ 1905(a)(1)(A)) & 76 (§ 1905(a)(1)(D)) *supra*.

138. The suggested change in § 1905(b)(2) is discussed in the text accompanying note 116 *supra*.

APPENDIX

Sec. 1905. [*Relation to other countries.*] (a) [*Application extraterritorially.*] (1) Within the limits of international law, this Code (as defined in section 225) applies with respect to

(A) (i) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security, (ii) a proxy solicitation or other circularization of security holders, (iii) a tender offer or a recommendation to security holders in favor of or opposition to a tender offer, or (iv) any activity as an investment adviser that occurs (in each case) within the United States although it is initiated outside the United States;

(B) a nonresident of the United States that has a status described in section 1902(b), to the extent that the Code attaches consequences to such a status;

(C) an attempt, solicitation, or conspiracy outside the United States to commit a violation of this Code within the United States (except that section 1905(a)(1)(C) applies only for purposes of section 1821); and

(D) any other prohibited, required, or actionable conduct (i) whose constituent elements occur to a substantial (but not necessarily predominant) extent within the United States or (ii) some or all of whose constituent elements occur outside the United States but cause a substantial effect within it (of a type that this Code is designed to prevent) as a direct and reasonably foreseeable result of the conduct.

(2) Within the limits of international law, part XVI, together with those sections in part XVII that create liability for conduct in violation of part XVI, applies with respect to an act specified in section 1905(a)(1)(A) that is initiated within the United States although it occurs outside the United States.

(b) [*Nonapplication extraterritorially.*] (1) Except as provided in section 1905(a)(2), this Code (as defined in section 225) does not apply with respect to an act specified in section 1905(a)(1)(A) that occurs outside the United States although it is initiated within the United States.

(2) Section 702 does not apply with respect to a broker, dealer, municipal broker, municipal dealer, or investment adviser, not a resident of the United States, insofar as he does business with (A) a person outside the United States or (B) a non-national of the United States who is present as a nonresident within the United States and was previously a customer or client.

(3) Section 702 does not apply with respect to a broker or

dealer, not a resident of the United States, insofar as he participates in a distribution or a limited offering if his only connection with the United States as a broker or dealer, so far as the distribution or limited offering is concerned, consists of (A) taking down securities for sale outside the United States and (B) participating solely through his group membership in group activities of a principal underwriter who is a registered broker or dealer.

(c) [*Rulemaking authority.*] Within the limits of international law and section 1905(a)(1)(D), and in the light of the significance or effects within the United States of particular acts or conduct, the Commission, by rule,

(1) may provide (A) that this Code does not apply with respect to the subject matter of section 1905(a), (B) that it does apply with respect to the subject matter of section 1905(b), and (C) that it does or does not apply with respect to any other subject matters; and

(2) shall prescribe the extent to which section 402 applies with respect to an issuer that is not a resident of the United States.

(d) [*Foreign corrupt practices by registrants.*] (1) It is unlawful for a registrant, or an officer, director, employee, agent, or stockholder acting on its behalf, corruptly to pay or give or offer or promise to pay or give (or to authorize the payment or gift or the promise of a payment or gift of) any money or anything of value to a foreign official, foreign political party, or candidate for foreign political office (or to any other person if the first person knows or reasonably should know that some or all of the money or thing of value will be paid, given, offered, or promised, directly or indirectly, to any such official, party, or candidate) for purposes of

(A) influencing any of his or its acts or decisions in an official capacity, including a decision to fail to perform an official function, or

(B) inducing the use of his or its influence with a foreign government or a department, agency, or instrumentality thereof to affect or influence any of its decisions, in order to assist the registrant in obtaining or retaining business for or with, or directing business to, any person.

(2) For purposes of section 1905(d)(1), "foreign official" means an officer or employee of, or a person acting in an official capacity for or on behalf of, a foreign government, a department, agency, or instrumentality thereof, or a foreign political party;

but the term does not include such an employee whose duties are essentially clerical or ministerial.

(e) [*Jurisdiction.*] (1) A nonresident of the United States in any of the following categories (other than a foreign government with sovereign immunity) shall file with the Commission an irrevocable consent and submission to jurisdiction in any action or proceeding against him (or his personal representative if he is a natural person) created by or based on a violation of this Code (as defined in section 225) and brought, whether in a Federal or State court or before the Commission, after the filing of the consent; such a consent has the same force and validity as an express consent and submission to jurisdiction in connection with a particular action or proceeding; it shall be filed in whatever form the Commission prescribes by rule; and the same instrument shall appoint whatever official (or his successor in office) the Commission so designates to be an attorney to receive notice of process, pleadings, or other papers:

(A) A prospective registrant, or any other person that is an applicant for registration under this Code, shall file such a consent before the registration statement or application for registration becomes effective.

(B) A person who is to be one of the officers of a prospective registrant specified in section 1704(b)(2), or a director or officer of a person (other than a prospective registrant) who is an applicant for registration under this Code, shall file such a consent before the registration statement or application for registration becomes effective.

(C) A person who becomes such an officer of a registrant, a director or officer of a person (other than a registrant) who is registered under this Code, or a participant in a registered clearing agency shall file such a consent, retroactive to the date of his becoming such an officer, director, or participant, within whatever period the Commission specifies by rule.

(D) In the case of an offering or distribution statement a secondary distributor or underwriter who is not a resident of the United States, and in the case of an offering statement an expert whose consent is filed under section 2003(e) and who is not a resident of the United States (whether or not in either case the issuer is a resident), shall file such a consent before the offering statement becomes effective or when the distribution statement is filed.

(2) A rule under section 303 or 514 may require the filing of

consents similar to those required by section 1905 (e)(1).

(3) When any person, whether or not he is a resident of the United States or has filed a consent under section 1905(e)(1), engages in conduct to which this Code applies as a result of section 1905(a) or (c), the Federal and State courts and the Commission have jurisdiction with respect to an action or proceeding against him (or his representative if he is a natural person) that (A) is created by or based on a violation of this Code (as defined in section 225) and (B) arises from that conduct or a resultant effect within the meaning of section 1905(a)(1)(D). See also section 1822(h).

(4) Jurisdiction may not be exercised under section 1905(e)(1) to (3) inclusive unless the plaintiff (which includes the Commission in an administrative proceeding instituted by it)

(A) leaves a copy of the process in the office of any designated attorney,

(B) sends a copy, by any form of mail or other communication that requires a return receipt, to the defendant or respondent at his last address on file (or a later address if supplied by a designated attorney), or, in the absence of such an address, sends him a copy by such mail or other communication at his last known address (if any) or takes other steps reasonably calculated to give notice (except that the plaintiff in any event need take only whatever steps are reasonably calculated to give notice if the country to which a copy would be mailed does not permit notice by mail or other communication), and

(C) files in the action or proceeding an affidavit of compliance with section 1905(e)(4) on or before the return date of the process, if any, or within whatever further time the court (or the Commission in an administrative proceeding) allows.

(5) Section 1905(e) does not limit or affect any other basis of jurisdiction authorized by law.

(f) [*Actions in foreign courts.*] (1) Nothing in section 1711 applies to an action in a foreign court, or is intended to affect the decision of a foreign court whether to entertain an action to which that section applies.

(2) Nothing in section 1822(a) affects the jurisdiction of a foreign court.

(g) [*Cross-references.*] See also sections 918(d), 1202(b)(2), 1402(c), 1505(g)(3), 1511(b)(1), 2004(b)(3)(E), and 2004(e).