

OFFSHORE MUTUAL FUNDS: EXTRATERRITORIAL APPLICATION OF THE SECURITIES EXCHANGE ACT OF 1934

An offshore mutual fund is a mutual fund which (1) is incorporated in a foreign country, (2) does not sell to Americans, and (3) does not aim its sales campaigns primarily at residents of the country in which it is incorporated.¹ Because of their freedom from regulation by the Securities and Exchange Commission (SEC),² and because of favorable tax laws,³ these funds have become an extremely popular vehicle for foreign investment in United States securities.⁴ Although the growth of offshore mutual funds has had a favorable impact on the United States balance of payments,⁵ the proliferation of these funds creates great potential for harm to the American securities markets. According to the SEC, (1) foreign funds may be used to acquire specific United States companies, in contravention of existing laws and national interest;⁶ (2) heavy offshore fund sales of a single United States stock or heavy redemption of United States mutual fund shares could upset market stability and injure the individual security involved;⁷

¹ 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 (generally, but not necessarily, a country offering tax advantages . . .), (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 country in which the fund is legally incorporated. SEC, Institutional Investor Study Report, H.R. Doc. No. 64, 92d Cong., 1st Sess., pt. 3, ch. 7, at 879 n.1 (1971) [hereinafter cited as SEC Institutional Investor Study].

² Id. at 881-82, 949. Under Rule 12g3-2, 17 C.F.R. § 240.12g3-2 (1971), foreign issuers with fewer than 300 holders resident in the United States are exempt from registration under § 12 of the Exchange Act. For this reason the provisions of the Act relating to a fund trading in its own stock are, under the Rule, inapplicable to offshore funds.

³ Id. at 904-12, 949. See also Note, United States Taxation and Regulation of Offshore Mutual Funds, 83 Harv. L. Rev. 404, 404-22 (1969) [hereinafter cited as Note, U.S. Taxation and Regulation of Offshore Mutual Funds].

⁴ See SEC Institutional Investor Study, *supra* note 1, at 879, 920-41, 949.

⁵ Id. at 920, 949; Note, U.S. Taxation and Regulation of Offshore Mutual Funds, *supra* note 3, at 404-06.

⁶ SEC Institutional Investor Study, *supra* note 1, at 945, 951. "For example, one offshore fund was alleged in October, 1970 to hold approximately 28 percent of the stock of a U.S. company subject to the Shipping Act of 1916, which limits foreign ownership in such companies to a maximum of 25 percent." Id. at 951. The potentially harmful impact presented by offshore mutual funds is enhanced by the avoidance of SEC margin and leverage standards. Id. at 945.

⁷ Id. at 945-47, 951. The Study indicates that it is improbable that such sales could have a significant direct effect on general market stability, but that the effect on a given security could be significant. Id. at 947, 951. The improbability of a significant direct impact on general market stability is debatable. See, e.g., Note, Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma, 3 Law & Pol. Int'l Bus. 157, 165 n.38 (1971) [hereinafter cited as Note, Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma]; see also SEC Institutional Investor Study, *supra* note 1, at 946: "There has been at least one occasion in the past when heavy concentrated foreign sales of U.S. securities had a noticeably depressing effect on the NYSE."

(3) the confidence of foreign investors in all offshore funds may be shaken by the demise of some, thus impairing the flow of foreign funds into the United States;⁸ (4) since many offshore funds are viewed by foreigners as American companies, problems with those funds may create an apprehension about investing in registered United States funds;⁹ and (5) foreign regulation of the activities of offshore funds may be applied to all investment companies which are not native to the regulating country, including registered United States funds.¹⁰

It seems clear that some regulation is desirable in order to minimize the harm threatened by offshore funds. Possible methods of control include regulation by the industry itself, by individual foreign nations, by the United States and by international agreement. While any of these methods could insulate the American securities markets from substantial harm, all except United States regulation have inherent problems. For example, self-regulation by the offshore fund industry would probably lack effective enforcement mechanisms;¹¹ foreign regulation could be indiscriminately applied to registered United States funds;¹² and meaningful international regulation may be precluded by diplomatic and international policy considerations.¹³ More importantly, none of these methods is presently available as a means of regulating offshore funds. United States regulation, however, provides the distinct advantage of an already existing, well-developed body of federal securities law to draw upon.

The Securities Exchange Act of 1934 (Exchange Act)¹⁴ is especially well-suited for the regulation of offshore funds. As will be shown in this comment, Section 30(b) of this Act¹⁵ permits *selective* regulation of securities transactions that are predominately foreign, thus making it possible to regulate only those activities harmful to American markets, while insuring the benefits of regulatory freedom for more innocuous activities. Furthermore, Section 10(b) of this Act provides a remedy for fraud in both the new issue and the trading markets, thus governing all activities of the offshore funds.¹⁶

⁸ SEC Institutional Investor Study, *supra* note 1, at 947. In fact, as investors withdraw funds, the outflow of foreign capital injures the balance of payments. *Id.* at 952.

⁹ *Id.* at 947, 949, 952.

¹⁰ *Id.* at 950.

¹¹ One commentator has advocated self-regulation. Siekman, *The Offshore Funds Are in Dangerous Waters*, *Fortune*, Aug. 1970, 118, at 160.

For a description of the compensation and sales techniques of offshore funds, see SEC Institutional Investor Study, *supra* note 1, at 894-901; see generally C. Raw, B. Page, B. G. Hodgson, "Do You Sincerely Want To Be Rich?" (1971).

¹² See text at note 10 *supra*. See generally SEC Institutional Investor Study, *supra* note 1, at 913-20, 950. See Note, *West German Regulation of Foreign Mutual Fund Distributions*, 3 N.Y.U. J. Int'l Law & Pol. 323 (1970), for a discussion of the West German regulatory statute. See also Note, *Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma*, *supra* note 7, at 200-03.

¹³ See, e.g., Siekman, *supra* note 11, at 160.

¹⁴ 15 U.S.C. §§ 78a et seq. (1970).

¹⁵ U.S.C. § 78dd(b) (1970).

¹⁶ For an analysis of the effect of all United States securities laws on the offshore

I. THE EXTRATERRITORIAL APPLICATION OF THE EXCHANGE ACT

The initial inquiry in determining the applicability of the Exchange Act to any transaction, domestic or foreign, is whether the jurisdictional requirements specified in the Act have been met. The three primary jurisdictional bases are (1) use of the mails or other instrumentalities of interstate commerce;¹⁷ (2) the presence of a security registered with the SEC;¹⁸ or (3) the presence of a broker, dealer or member of a national securities exchange.¹⁹ If the applicable basis (or bases) for jurisdiction is present, a court has subject matter jurisdiction over the transaction in question.²⁰ However, notwithstanding satisfaction of the statutory jurisdictional requirements, some transactions are exempted from the requirements of the Exchange Act by the provisions of Section 30(b). The exemption applies 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 this chapter.²¹

The scope of section 30(b), however, is unclear. Since the SEC has not exercised its rule-making power, the task of defining the exemption presently rests with the federal judiciary. The decisions in this area have focused upon the problems of construing the phrases "person insofar as he transacts a business in securities," and "without the jurisdiction of the United States." If the Exchange Act is to be used as a tool for selective regulation of offshore mutual fund activities, the fund must be viewed as a "person" transacting a business in securities. If it is not so viewed, the section 30(b) exemption never applies and statutorily mandated selective regulation is impossible.²² If, however, an offshore fund is viewed as a person transacting a business in securities, fund transactions may or may not be regulated, depending on

mutual fund industry, see Note, *Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma*, supra note 7, at 171-92; see also Note, *U.S. Taxation and Regulation of Offshore Mutual Funds*, supra note 3, at 432-52.

¹⁷ See, e.g., Exchange Act § 10, 15 U.S.C. § 78j (1970). "Incidental" or "indirect" use of the mails or other instrumentalities of interstate commerce is sufficient to confer statutory jurisdiction. See 3 L. Loss, *Securities Regulation* 1519-28 (2d ed. 1961). It is enough to show that another was caused to use the instrumentality, or that it might reasonably have been foreseen that such use would occur. *Id.* at 1524.

¹⁸ See, e.g., Exchange Act § 9(a), 15 U.S.C. § 78i(a) (1970).

¹⁹ See, e.g., Exchange Act § 7(c), 15 U.S.C. § 78g(c) (1970).

²⁰ Problems of enforcement are beyond the scope of this article. See generally 3 L. Loss, *Securities Regulation* 1852-61 (2d ed. 1961). Section 27 of the Act, 15 U.S.C. § 78aa (1970), delineates jurisdiction under the Exchange Act and provides for worldwide service of process in civil actions. See Cary, *Cases and Materials on Corporations* 795-96 (4th ed. unabridged 1969). On the problem of venue, see 3 L. Loss, *Securities Regulation* 2007-15 (2d ed. 1961).

²¹ 15 U.S.C. § 78dd(b) (1970).

²² For discussion of the issue whether isolated transactions come within the exemption, see note 30 infra.

whether the transaction complained of occurred without the jurisdiction of the United States. This, in turn, depends on whether the term "jurisdiction" is defined as *protective* or *territorial* jurisdiction.²³ If the latter term is adopted, only domestic transactions will be regulated. If, however, the former is adopted, nondomestic transactions threatening substantial harm to domestic markets and investors can be regulated. Since the activities of offshore funds do not typically occur within the territory of the United States, but frequently do have the potential for inflicting significant injury upon domestic exchanges and investors, it would seem that effective American regulation presupposes that only those activities without the protective jurisdiction should be exempt from the provisions of the Act.

A. "*Person Insofar as He Transacts a Business in Securities*"

On its face, the statutory language seems clearly to encompass offshore mutual funds. They are "persons" within the statutory definition of section 3(a)(9)²⁴ and they obviously transact business in securities, at least in the generic sense. Nevertheless, the section 3(a)(9) definition does not apply if the context of usage otherwise requires; moreover, no court has been presented squarely with the question of whether mutual funds are persons transacting a business in securities.

The leading decision interpreting the phrase "person insofar as he transacts a business in securities" is *Schoenbaum v. Firstbrook*.²⁵ The Second Circuit in that case stated that the purpose of section 30(b) is to allow persons in the securities business to conduct securities transactions outside the United States without having to comply with the burdensome reporting and regulatory provisions of the Act. The court reasoned that Congress had not intended to exempt *every* transaction outside the United States by *any* person; such a result could have been achieved easily by using the phrase "any transaction in any security."²⁶ Certainly brokers and dealers transact business in securities and come within the scope of the section. However, the court determined that the statutory language was more inclusive since the defined terms "broker" and "dealer" could have been used if the exemption were confined to them.²⁷ The court stated that the reason the drafters used the phrase "person insofar as he transacts a business in securities" in section 30(b) was that "it is a term which would exempt the business transactions not only of brokers and dealers but also of banks."²⁸

It should be noted that the court's language does not specifically

²³ See pp. 1231-49 *infra*.

²⁴ 15 U.S.C. § 78c(a)(9) (1970).

²⁵ 405 F.2d 200 (2d Cir.), *rev'd on rehearing on other grounds*, 405 F.2d 215 (1968) (*en banc*), *cert. denied*, 395 U.S. 906 (1969). The facts of this case are set forth at p. 1238 *infra*.

²⁶ 405 F.2d at 207-08. The court noted that § 30(a) employs this more expansive wording. *Id.* at 208.

²⁷ *Id.* See 15 U.S.C. § 78c(a)(4), (5) (1970), for the definitions of these terms.

²⁸ 405 F.2d at 208.

restrict the term "person" to brokers, dealers and banks; the court's language can also be interpreted to mean that the phrase includes, *at minimum*, these persons. By implication, others may also be persons transacting business in securities within the meaning of section 30(b). This implicit nonexclusive interpretation is supported by the court's recognition that the term "bank" is also defined in the Exchange Act.²⁹ It would thus appear that "person" must include more than brokers, dealers and banks since these terms could have been used if the legislative intent had been to limit the exemption solely to them. This interpretation is substantiated by the court's opinion that the purpose of Section 30(b) is to exempt from the provisions of the Exchange Act only those persons who, because they conduct a business in securities outside the United States, would otherwise be subject to onerous reporting requirements.³⁰

²⁹ Id. See 15 U.S.C. § 78c(a)(6) (1970) for the definition of "bank."

³⁰ For example, offshore mutual funds if not exempt under Rule 12g3-2, could be viewed as being subject to onerous requirements, and statutorily exempt whether or not they are viewed as dealers. See note 2 *supra*.

Another problem arises concerning whether a person engaged in isolated foreign transactions should be viewed as transacting a business in securities. In the memorandum opinion in *Ferraioli v. Cantor*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,615 (S.D.N.Y. Dec. 28, 1965), the court answered this question affirmatively, stating that the intent to exempt those in the securities business must also include the intent to exempt single, isolated transactions:

Surely, if Congress intended to exempt from the Act those persons who are extraterritorially engaged in the securities business, it intended to exempt those who extraterritorially enter into a single, isolated sale of securities.

Id. at 95,311 [footnote omitted].

However, if one accepts the position that the purpose of § 30(b) is to permit persons in the securities business to conduct transactions in securities outside the U.S. without being subject to the burdensome reporting and regulatory provisions of the Exchange Act (see *Schoenbaum v. Firstbrook*, 405 F.2d 200, 207 (2d Cir. 1968)), the less onerous burdens placed upon private investors may indicate that private investors should not be viewed as transacting business in securities within the meaning of § 30(b), as the necessity of exemption from burdensome provisions is less urgent. Cf. Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 Colum. L. Rev. 94, 106-07 (1969) [hereinafter cited as Note, *Extraterritorial Application of the Securities Exchange Act of 1934*]. The possibility that exempted foreign investment businesses are subject to foreign regulation involves questions of foreign relations and supports such an interpretation. The policy considerations which would necessitate exemption of those engaged in the securities business but not those engaging in isolated transactions have been well stated:

Congress could quite easily conclude that another country would resent United States interference concerning the way the investment business is conducted within its borders more than it would resent the application of the American rule to occasional transactions by its nationals in United States securities. This is particularly apparent if one considers the likelihood that a foreign based investment business will be subject to foreign statutory regulation. No country likes its regulatory scheme to be superseded by those of another country and, of course, the existence of foreign regulation lessens the need for interference.

Id. at 106 [footnote omitted]. But see Note, *U.S. Taxation and Regulation of Offshore Mutual Funds*, *supra* note 3, at 448, in which this interpretation is viewed as being anomalous: "the threat that regulation will offend a foreign nation may be greatest precisely when the United States' interest in regulation is most acute."

If the exemption is viewed as applying when required by special circumstances,—i.e., in order to avoid onerous reporting requirements—it is arguable that other circumstances exist which militate against regulation. For example, international policy considerations may obviate the practicability of United States regulation of offshore mutual funds in some instances, and require that these funds be exempted from the provisions of the Act. The “special circumstances” concept could be incorporated into the court’s “burdensome” standard by balancing the regulatory burdens imposed against the resulting benefits. Under such a test, international policy factors might well outweigh the benefits of American regulation in a given circumstance, thus making compliance with the Exchange Act’s provisions counter-productive and “burdensome.”

Nonetheless, *Schoenbaum* has been interpreted by commentators³¹ and subsequent courts³² as limiting the section 30(b) exemption to brokers, dealers and banks. However, even if this limitation is accepted, the exemption may still apply to offshore mutual funds, since they arguably fall within the statutory definition of dealers.³³ As defined by section 3(a)(5), a dealer is

any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.³⁴

Although the SEC has never required investment companies, domestic or offshore, to register as brokers or dealers, an offshore mutual fund can be characterized “as being in the business of buying and selling securities (those they issue and those issued by portfolio companies)

Since the *Schoenbaum* court viewed the § 30(b) exemption as being limited to those in the securities business, it expressly rejected the dictum of *Ferraioli* which would have exempted single, isolated transactions. Nevertheless, the need for regulation of foreign investment businesses is great; exemption, absent meaningful foreign regulation, provides a potentially harmful situation, while exemption of mere private investors does not include the same potential for harm. If the exemption is not viewed as being restricted to brokers, dealers and banks, there seems to be no policy reason not to exempt single, isolated transactions.

³¹ See, e.g., Note, Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma, *supra* note 7, at 189; Note, Extraterritorial Application of the Securities Exchange Act of 1934, *supra* note 30, at 105; Note, U.S. Taxation and Regulation of Offshore Mutual Funds, *supra* note 3, at 446.

³² See, e.g., *Travis v. Anthes Imperial Ltd.*, [Current] CCH Fed. Sec. L. Rep. ¶ 93,303 at 91,679 (E.D. Mo. June 24, 1971).

³³ SEC Institutional Investor Study, *supra* note 1, at 901-02. See also 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, 1038 (1969). But see Note, U.S. Taxation and Regulation of Offshore Mutual Funds, *supra* note 3, at 449 n.137.

³⁴ 15 U.S.C. § 78c(a)(5) (1970).

for its own account."³⁵ While there may be good reason not to define a fund as a dealer in ordinary circumstances,³⁶ the desirability of selectively regulating offshore funds would justify treating these funds as dealers for purposes of the section 30(b) exemption.

Thus it is evident that offshore funds are, by no means, automatically excluded from the section 30(b) exemption. Ultimately, the underlying issue is whether regulation of offshore funds is necessary in order to achieve the fundamental purposes of the Exchange Act. Such a contextual analysis should focus more appropriately on the issue of whether offshore fund activities are within the "protective" jurisdiction of the Exchange Act.³⁷ The issue whether an offshore fund is a person transacting a business in securities should be determined by considering the propriety of regulating these activities in light of international policy considerations. However, the phrase "person insofar as he transacts a business in securities" does not implicate these considerations. More importantly, a decision that mutual funds are not within the phrase would preclude statutorily mandated selective regulation.

B. "*Without the Jurisdiction of the United States*"

Judicial interpretation of section 30(b) has focused primarily on the phrase "without the jurisdiction of the United States."³⁸ Initially, decisions interpreting this phrase addressed the question whether a particular transaction occurred within the territory of the United States.³⁹ However, an emerging, difficult issue is whether the term "jurisdiction" refers only to territorial jurisdiction or whether it also encompasses "protective" concepts of jurisdiction.⁴⁰ An interpretation of section 30(b) which limits the exemption to those persons who transact business "without the *territorial* jurisdiction of the United States" emphasizes the locus of the offense rather than the threat to national interests; it, therefore, leaves unregulated transactions which, while not domestic, could harm substantially American securities markets. On the other hand, exemption only of those persons who transact business "without the *protective* jurisdiction" would permit

³⁵ SEC Institutional Investor Study, *supra* note 1, at 902. Section 3(a)(19) of the Exchange Act, 15 U.S.C. § 78c(a)(19) (1970), adopts the definition of "investment company" in the Investment Company Act of 1940, 15 U.S.C. § 80a-3(a) (1970). Mutual funds fall within this definition. See also Note, Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma, *supra* note 7, at 190.

Dicta in *Roth v. Fund of Funds, Ltd.*, indicates that a mutual fund's trading does not constitute the transaction of business in securities. *Roth v. Fund of Funds, Ltd.*, 405 F.2d 421, 422 (2d Cir. 1968) cert. denied, 394 U.S. 975 (1969). One commentator, although acknowledging that the basis for jurisdiction in *Roth* was territoriality, nevertheless concludes that "*Roth* . . . h[e]ld that a mutual fund investing in securities would not qualify for exemption from the [Exchange] Act under section 30(b), since it was neither a 'broker, dealer, nor bank.'" Note, 10 Colum. J. Transnat'l L. 150, 161 (1971).

³⁶ Thus the SEC has not required registration.

³⁷ See pp. 1249-53 *infra*.

³⁸ See discussion pp. 1232-49 *infra*.

³⁹ See discussion pp. 1232-37 *infra*.

⁴⁰ See discussion pp. 1238-49 *infra*.

the courts to assert protective jurisdiction over predominantly foreign transactions if regulation were required to protect significant national interests. This section of the comment analyses the judicial interpretations of the phrase "without the jurisdiction of the United States" and concludes that the current trend of judicial thinking is that Section 30(b) exempts from the provisions of the Exchange Act those persons who transact business in securities without the protective jurisdiction of the United States.

1. *Territorial Interpretation*

It is a canon of statutory construction that legislation is presumed to apply only territorially, unless a contrary intent is clearly manifest.⁴¹ Prior to the decision of *Kook v. Crang*,⁴² it was believed that Section 30(b) strengthened the presumption against extraterritorial application of the Exchange Act. However, while *Kook* endorsed this interpretation, it also, inadvertently, anticipated its demise.

The plaintiff in *Kook*, an American investor, had placed purchase orders with the defendant, a Canadian brokerage firm maintaining a New York office and registered as a broker-dealer under the Exchange Act. The purchases were "on the margin" orders for shares in certain Canadian corporations made in accordance with the margin requirements of the Toronto Exchange. All orders were placed and executed, payments received and credit extended in Canada. The stock was issued in the name of one of the defendant's employees in trust for plaintiff,⁴³ and was held in Canada as collateral for the credit. Furthermore, all confirmation and margin calls emanated from Canada. However, the transactions did have American contacts; the defendant had made use of United States telephone and mail facilities. When the value of the purchased stock declined sharply, the plaintiff alleged violation of the margin requirements of Section 7(c) of the Exchange Act.⁴⁴

Although the defendant's status as a registered broker-dealer satisfied the statutory requirement for jurisdiction under Section 7(c), the district court ruled that the transactions were specifically exempted from the coverage of the Exchange Act:

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. Congress is primarily concerned with domestic conditions. This construction is reinforced by the Act itself which, in Section

⁴¹ See, e.g., *American Banana Co. v. United Fruit Co.*, 213 U.S. 347, 357 (1909); *Lauritzen v. Larsen*, 345 U.S. 571, 577-79 (1953).

⁴² 182 F. Supp. 388 (S.D.N.Y. 1960) (per Ryan, C. J.).

⁴³ *Id.* at 389. "This trust arrangement was part of a plan of the plaintiff to form a Canadian corporation in hope of effecting a possible tax saving for plaintiff on expected and anticipated profits." *Id.*

⁴⁴ 15 U.S.C. § 78g(c) (1970).

30(b), specifically restricts the Act to the transaction of business within the United States.⁴⁵

The plaintiff contended that the transaction of business had occurred "within" the United States since American mail and telephone facilities had been used. However, the court determined that use of the mails and telephone was insufficient to offset the Canadian character of the transactions:

The question . . . is not whether there are contacts with the United States sufficient to give this Court jurisdiction, no one questions that, but rather whether Congress intended to make the statute applicable to these transactions.⁴⁶

The court determined that it was not the intent of Congress to make the Exchange Act applicable to this Canadian transaction and held "that 'jurisdiction' as used in Section 30(b) contemplates some necessary and substantial act within the United States."⁴⁷ The *Kook* court explicitly stated that section 30(b) reinforced the presumption that legislation is territorial; the court ignored technical statutory jurisdiction and implemented a test which emphasized the locus of the activities. Section 30(b) was thus interpreted to mean that transactions which were without the *territorial* jurisdiction of the United States were exempt from the provisions of the Exchange Act.

The court's opinion that Congress intended the Act to apply only territorially seems inconsistent with the court's position that the SEC could extend the scope of coverage to include extraterritorial transactions, even where there has been no "necessary and substantial act within the United States."⁴⁸ This recognition of the SEC's rule-making power implies acceptance of the argument that the primary intent of Congress in enacting the Exchange Act was to protect the American

⁴⁵ 182 F. Supp. at 390 (citations omitted).

⁴⁶ *Id.*

⁴⁷ *Id.* at 390-91. The court characterized plaintiff's contacts with defendant's New York office, involving weekly communication, as constituting advice given by "an informal adviser . . . who had become personally acquainted with plaintiff." *Id.* at 389. It would have taken little imagination to find this "informal" advice to be both substantial and necessary to plaintiff's dealings with the defendant.

In requiring a "necessary" act, the court clearly did not mean that it was necessary only to show some act done within the United States; nor did the court mean only that the required act be one that necessarily had to be done within the United States. The court indicated that *some act necessary to the transaction in question* must be shown:

In this suit, plaintiff must show some act done within the United States either in furtherance of the direct or indirect extension of credit or in the furtherance of the direct or indirect maintenance of credit. We find none. All contacts with and acts done by the New York Office of defendant had no remote connection with the credit arrangement.

Id. at 391. See also *Travis v. Anthes Imperial Ltd.*, [Current] CCH Fed. Sec. L. Rep. ¶ 93,303, at 91,680-81 (E.D. Mo. June 24, 1971).

⁴⁸ 182 F. Supp. at 391.

securities markets⁴⁰ and that implementation of this primary purpose might require regulation even absent a necessary and substantial act within the United States. In such circumstances, the SEC could contract the scope of the section 30(b) exemption in order to effect the legislative intent. While the court's inconsistency may be attacked as an example of "facile judicial reasoning,"⁵⁰ it nevertheless foreshadowed later judicial interpretations of the legislative intent regarding section 30(b).⁵¹

The next case to consider extraterritorial application of the Exchange Act was *SEC v. Gulf Intercontinental Finance Corp.*⁵² In that case the individual defendants, residing in Florida, controlled five private Florida companies. They organized a Canadian corporation and publicly offered stock by means of extensive advertising in leading daily newspapers published in Canada. The proceeds of the distribution were deposited in Montreal banks and were used to purchase notes executed by the Florida corporations and the individual defendants. In this way the funds were diverted directly and indirectly through salaries and other expenses of the Florida corporations to the individual defendants. Various interstate facilities were used throughout the transaction.

The SEC brought suit for injunctive relief, alleging violations of Section 17(a) of the Securities Act of 1933,⁵³ Section 10(b) of the Exchange Act⁵⁴ and Rule 10b-5 promulgated thereunder.⁵⁵ The appointment of a receiver and an accounting were also requested in order that assets obtained by the sales could be recouped. The defendants contended that the court lacked subject matter jurisdiction since the offer, sales and corporate existence of the offering corporation were all limited to Canadian territory. Citing the *Kook* decision, the defendants argued that Congress had not intended to authorize suits in this situation.

The court held that it possessed subject matter jurisdiction. The statutory basis for jurisdiction under section 10 (b)—*i.e.*, the use of the facilities of interstate commerce—was clearly present. Furthermore, the court noted that the case involved a single scheme to defraud investors spanning both nations, essential parts of which had occurred *within* the United States.⁵⁶ The *offer* of foreign securities in foreign

⁴⁰ Goldman & Magrino, *supra* note 33, at 1028. The purposes of the Act are delineated in § 2, 15 U.S.C. § 78b (1970).

⁵⁰ Goldman & Magrino, *supra* note 33, at 1028.

⁵¹ See pp. 1238-41 *infra*.

⁵² 223 F. Supp. 987 (S.D. Fla. 1963) (per Choate, J.).

⁵³ 15 U.S.C. § 77q(a) (1970) (fraudulent interstate transactions).

⁵⁴ 15 U.S.C. § 78j(b) (1970) (manipulative and deceptive devices).

⁵⁵ 17 C.F.R. § 240.10b-5 (1971).

⁵⁶ 223 F. Supp. at 994-95. The court suggested that it might find a lack of subject matter jurisdiction if it were possible to separate Canadian actions from the rest of the plan. *Id.* at 994. However, this separation was deemed impossible:

The Canadian sales could not have been brought about without the representations to the investors of the underlying securities in the Florida corporations,

newspapers which were sold to Americans *within* the United States was sufficient for subject matter jurisdiction; proof that sales actually resulted or that the alleged misrepresentations had induced sales was not required.⁶⁷

Since the case involved both a fraudulent scheme and offer within the United States, the court found no reason to consider the extent of the Section 30(b) exemption from the Exchange Act. Nonetheless, the court gratuitously discussed the extraterritorial application of the securities laws, observing that these laws do not appear to be limited solely to residents of the United States:

[T]here is nothing within the Acts . . . which would appear to limit the protection offered by Section 17(a) and Section 10(b) and Rule 10b-5 to residents of the United States. It would appear that where the scheme is one which *necessarily* must be accomplished in part by the use of the mails or interstate facilities within the limits of our federal jurisdiction that *even though the offer were made entirely outside the nation* that the remedial protection of these sections may be invoked. Whether the corpus delicti . . . is use of the mails or facilities of interstate commerce or whether it is fraud, it is obvious that the use of interstate facilities either directly or indirectly is the jurisdictional base of a complaint or prosecution under these sections.⁶⁸

Although the use of interstate facilities seems necessary for consummation of the transactions in *Kook* as well as *Gulf*,⁶⁹ in *Kook* the

nor could the monies received from such sales be siphoned off into the hands of the individual conspirators without the individual or corporate activity taking place within this district.

Id. at 995.

The *Gulf* court did not analyze *Kook*, stating merely that *Kook* was "clearly distinguishable." The court continued: "In fact, dictum in *Kook* found at page 391 of 182 F. Supp. would support the conclusion reached in the instant case." 223 F. Supp. at 994 n.9. Presumably, the *Gulf* court was referring to the second passage from *Kook* quoted at note 47 *supra*.

⁶⁷ 223 F. Supp. at 994-95. It must be noted, however, that this offer was not the sole act occurring within the United States in the scheme to defraud.

One commentator has criticized the reliance on this international offering, claiming that the absence of acceptances from the United States indicates that "the offer was not seriously considered by either offerors or offerees to be effective outside [Canada]." Note, 36 U. Colo. L. Rev. 593, 595 n.8 (1964). The same commentator notes that the requirement that the American public be exposed to the offer invites the labelling of an offer as being restricted to non-Americans. Id. at 594-95. This restriction is in fact imposed by offshore mutual funds in order to avoid regulation under the securities laws. See SEC Institutional Investor Study Report, H.R. Doc. No. 64, 92d Cong., 1st Sess. pt. 3, ch. 7, at 882, 902 (1971) [hereinafter cited as SEC Institutional Investor Study].

⁶⁸ 223 F. Supp. at 995 (emphasis added).

⁶⁹ Since *Kook* was an American resident living within the United States, it was inevitable and necessary that the instrumentalities of interstate commerce be used. Furthermore, this residency was known to the Canadian defendant. With little imagination,

transaction was characterized as Canadian, while in *Gulf* the fraud was binational. *Kook* held that Congress did not intend to regulate foreign transactions absent necessary and substantial acts within the United States; the incidental use of the mails was insufficient, in itself, to negate the section 30(b) exemption. *Gulf* found that the use of the facilities of interstate commerce in connection with a transnational scheme to defraud investors justified the regulation of activities which also had significant foreign characteristics. Arguably, the fraudulent acts committed within the United States fulfilled the "necessary and substantial" requirements proposed by *Kook*. However, *Gulf* went further than *Kook* by intimating that the satisfaction of the statutory jurisdictional requirement, in itself, could serve as the jurisdictional basis for the regulation of an otherwise foreign transaction.⁶⁰

Extraterritorial application of the Exchange Act was next considered in *Ferraioli v. Cantor*,⁶¹ a case in which minority shareholders of a United States corporation challenged sale of the controlling interest in the corporation at a premium. The plaintiffs alleged that the defendant, a Canadian corporation, which had owned the controlling interest, had breached its fiduciary duty toward minority shareholders by failing to secure for them an equal opportunity to sell. The plaintiff alleged that this was done by employing manipulative and deceptive devices in violation of Section 10(b) of the Exchange Act and Rule 10b-5. The negotiations and the sale took place in Canada. In a memorandum opinion, the court reaffirmed the applicability of the presumption of territoriality.⁶² Since the plaintiffs had not alleged that any acts occurred within the United States, the court granted the defendant's motion for dismissal, with leave to serve an amended complaint.

The amended complaint alleged that the transfer of power to control the American corporation had occurred within the United States. The specific allegation was that one defendant had instructed its designee officers and directors, serving "within the United States," to resign in order that the purchaser's designees could hold office. The instructions had been transmitted through the facilities of interstate commerce.

The defendants argued that the negotiation and sale, which had

a single, inseparable transaction could have been discovered in *Kook*. However, the American aspects of *Kook* can still be characterized as insignificant.

⁶⁰ This dissimilarity can be explained easily if one views the § 30(b) exemption as being applicable only to those regulations whose jurisdictional basis is the identity of the person involved. *Kook* relied on identity (§ 7(c)) while *Gulf* relied on the use of interstate facilities (§ 10(b)). This explanation is an interpretation of the phrase "person insofar as he transacts a business in securities". The *Gulf* court did not mention this phrase; furthermore, *Kook* was not distinguished specifically on this basis. See discussion pp. 1228-31 *supra*.

⁶¹ 259 F. Supp. 842 (S.D.N.Y. 1966) (per Levett, J.).

⁶² *Ferraioli v. Cantor*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,615 (1965). This decision also extended the § 30(b) exemption to "those who extraterritorially enter into a single, isolated sale of securities." *Id.* at 95,311. See note 30 *supra*.

occurred solely in Canada, were separable from the exercise of control. The court assumed that the Exchange Act applied only to acts committed within the United States⁶³ and found subject matter jurisdiction:

A transfer of control involves more than negotiations and a sale. Necessarily there must be resignations of directors [S]uch resignations were brought about within the United States through use of the mails and other instrumentalities of interstate commerce. That is an United States act [*sic*] which is an inseparable part of the alleged violation ⁶⁴

Like the court in *Gulf*, the *Ferraioli* court strained to find a single, inseparable transaction occurring, in part, within the United States. As a result, the court determined that it was unnecessary to reach the issue of the extraterritorial application of the Exchange Act.⁶⁵

When read together, the *Kook*, *Gulf* and *Ferraioli* decisions reveal a judicial inclination to apply the Exchange Act not only to domestic transactions, but also to transactions predominantly foreign. In *Kook*, the court refused to exercise jurisdiction unless a necessary and substantial act had occurred within the United States, despite the presence of the statutory jurisdictional requirement. Thus although American contacts existed, the court found them unnecessary to the transaction involved and insufficiently substantial to rebut the presumption against extraterritorial application of the Exchange Act. However, in *Gulf* and especially in *Ferraioli*, the courts, having found the required jurisdictional base, also found the transactions to be within the territorial jurisdiction of the United States, on the basis of American acts "which were at most little more substantial than [those] in *Kook*."⁶⁶ Thus the courts in *Gulf* and *Ferraioli* would, in effect, assert jurisdiction if an act necessary to the overall transaction occurred within the country, whether or not the act would actually be considered substantial under the *Kook* decision. While these courts avoided the issue of the extraterritorial application of the Act, and, more specifically, the issue whether the term "jurisdiction" in Section 30(b) refers to protective or territorial jurisdiction, they effectively applied the Exchange Act to transactions occurring within the protective jurisdiction of the United States.

⁶³ *Ferraioli v. Cantor*, 259 F. Supp. 842, 845 (S.D.N.Y. 1966).

⁶⁴ *Id.* at 846.

⁶⁵ 259 F. Supp. at 845 n.4. It has been suggested that the issue of extraterritorial application was not reached because this was not a trial on the merits. See Goldman & Magrino, *supra* note 33 at 1031.

⁶⁶ Note, United States Taxation and Regulation of Offshore Mutual Funds, 83 Harv. L. Rev. 404, 445 (1969) [hereinafter cited as Note, U.S. Taxation and Regulation of Offshore Mutual Funds]. See note 59 *supra*.

2. *Protective Interpretation*

In *Schoenbaum v. Firstbrook*,⁶⁷ the Second Circuit expressly disavowed the presumption that the Exchange Act is applicable only territorially or that the language of Section 30(b) manifests a congressional intent to prevent extraterritorial application of the statute.⁶⁸ The plaintiff, an American shareholder of a Canadian corporation, brought a derivative suit, alleging violations of section 10(b) and Rule 10b-5. Plaintiff alleged that the defendants, including directors of the corporation, had conspired to defraud the corporation; that the defendants had made the corporation sell treasury shares at market price, which the defendants, possessing undisclosed inside information, knew did not represent the true value of the shares.

The only United States contact in *Schoenbaum* was the registration of Canadian corporate stock with a domestic exchange. The transaction had not been consummated on a United States exchange, and all other aspects of the transaction were outside the United States.⁶⁹ Citing *Kook* and *Ferraioli*, the district court found nothing to rebut the presumption of territoriality and stated that section 30(b) reinforced this presumption; therefore, the case was dismissed for lack of jurisdiction.⁷⁰ The Second Circuit disagreed, holding that a federal

⁶⁷ 405 F.2d 200 (2d Cir.) (per Lumbard, C. J.), rev'd on rehearing on other grounds, 405 F.2d 215 (1968) (en banc), cert. denied, 395 U.S. 906 (1969). On rehearing, the court explicitly stated that it did not review the earlier decision on the issue of subject matter jurisdiction and that the earlier decision stands as the holding of the court on that issue. 405 F.2d at 217.

⁶⁸ 405 F.2d at 206.

⁶⁹ These facts appear in the district court opinion, *Schoenbaum v. Firstbrook*, 268 F. Supp. 385, 391, 394 (S.D.N.Y. 1967). However, the requisite use of the mails or facilities of interstate commerce was found. 405 F.2d at 207 n.2.

⁷⁰ 268 F. Supp. at 392. The court strengthened its territorial interpretation by noting that conventional choice of law principles also pointed to the denial of jurisdiction, reasoning that this denial would enforce the reasonable expectations of the parties. *Id.* at 392-93. The court further noted the SEC's power to alter the scope of § 30(b)'s exemption:

If the impact of such foreign transactions is of concern, the S.E.C. has power to make appropriate rules. See section 30(b) of the Exchange Act. The failure of the S.E.C. to do so in an obvious situation is further indication of the lack of interest by the United States in such transactions.

Id. at 393. This statement is reminiscent of the *Kook* court's handling of the SEC's rule-making power; see text at notes 48-51 *supra*. Both viewed the rule-making power as an expression of legislative intent that the SEC can expand the coverage of the Exchange Act in contravention of the presumption of territoriality as reinforced by § 30(b). Neither court looked to the intent of the securities laws and neither viewed § 30(b) in the context of that intent. However, the district court in *Schoenbaum* did mention the "protective principle" of jurisdiction. 268 F. Supp. at 393. The court, however, did not discuss the possibility of interpreting "jurisdiction" in this "protective" manner since there was "no allegation of harm occurring within the United States to support the application of this principle." *Id.*

Throughout this comment *Schoenbaum's* terminology, i.e., the "protective" principle, has been adopted. The term "objective territorial" has also been applied. See, e.g., Note, Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma, 3 Law & Pol. Int'l Bus. 157, 187 (1971). See also Restatement (Second) of the Foreign Relations Law

court has subject matter jurisdiction over transactions occurring outside the United States where the transactions violate the Exchange Act, "at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors."⁷¹

Notably, the court did not expressly base its decision on a finding that registration on a national exchange was a necessary and substantial act. Such a finding would have been required had the court endorsed the *Kook* rationale that the Exchange Act applies only to acts occurring within the territory. Rather, the court quite clearly adopted the protective jurisdiction approach:

We believe that Congress intended the Exchange Act to have extraterritorial application in order 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.⁷²

The court rejected the presumption of territoriality by noting that the purpose of the Exchange Act, as enunciated in Section 2⁷³ is "to regulate the stock exchanges and the relationships of the investing public to corporations which invite public investment by listing on such exchanges."⁷⁴ The court further stated that this protective purpose was compatible with the provisions of section 30(b): "[S]ince Congress found it necessary to draft an exemptive provision for certain foreign transactions . . . the presumption must be that the Act was meant to apply to those foreign transactions not specifically exempted."⁷⁵

The *Schoenbaum* decision may be narrowly interpreted by viewing it as a territorial application of the Exchange Act and assessing its implications for the necessary and substantial test. Thus one commentator has interpreted *Schoenbaum* as completely rejecting the *Kook* requirement that a substantial act must occur within the United States

of the United States § 18(b) (1965). The Restatement requires, inter alia, that the harm be direct and foreseeable in order for an act to come within the objective territorial jurisdiction of a country. Adoption of this test would present semantic difficulties, since the usual American harm caused by distribution of offshore fund shares is indirect. See pp. 1249-53 *infra*. Furthermore, foreseeability was not mentioned in *Schoenbaum*. See Becker, Extraterritorial Dimensions of the Securities Exchange Act, 2 N.Y.U. J. Int'l Law & Pol. 233, 241 (1969).

⁷¹ 405 F.2d at 208. Despite this holding, summary judgment for the defendant was affirmed because of the failure to state a claim under § 10(b) and Rule 10b-5. *Id.* at 210-14. The Second Circuit (en banc), reversed as to all defendants except one, finding a triable claim under § 10(b). *Id.* at 215, 219. See Comment, *Schoenbaum v. Firstbrook*: The "New Fraud" Expands Federal Corporation Law, 55 Va. L. Rev. 1103 (1969).

⁷² 405 F.2d at 206. See note 70 *supra*. Compare 268 F. Supp. at 393 with 405 F.2d at 206.

⁷³ 15 U.S.C. § 78b (1970).

⁷⁴ 405 F.2d at 206.

⁷⁵ *Id.* at 208.

before a court asserts jurisdiction.⁷⁶ This view seems erroneous; the requirement of a substantial act remains in those circumstances where jurisdiction is predicated upon the occurrence of a territorial act.⁷⁷ Furthermore, the *Schoenbaum* holding did not discard the need for a substantial act in all circumstances, only in situations in which the stock is registered on a domestic exchange. Thus *Schoenbaum* arguably held that registration on an American exchange is a "substantial act" within the United States sufficient to warrant exercise of jurisdiction in order to protect American investors when the requisite use of interstate commerce is present.⁷⁸

Another plausible interpretation of *Schoenbaum* is that the court rejected the requirement that the act upon which jurisdiction is based must be necessary to the transaction giving rise to liability. On the facts, registration of foreign stock on a domestic exchange was the basis of jurisdiction; however, registration did not appear necessary to the alleged wrongdoing. To this extent, *Schoenbaum* seems to differ from *Ferraioli*, which deemphasized the "substantiality" requirement and assumed jurisdiction because use of interstate facilities was necessary to complete the transaction.⁷⁹

These narrow interpretations of *Schoenbaum* focus upon its implications for the "necessary and substantial" test. They attempt to bring the decision within the concept of territoriality and to confine extraterritorial application of the Exchange Act to the facts of the case. It is submitted that these interpretations should be rejected because the decision is not based upon a territorial application of the Act;⁸⁰ rather,

⁷⁶ Note, *Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma*, supra note 70 at 183-4. The commentator states that *Schoenbaum* "discarded the earlier requirement of a substantial act within the United States. . . ." While this is true when protective jurisdiction is to be asserted, *Schoenbaum* did not discard the necessity of finding a substantial act within the United States in order to assert territorial jurisdiction. Cf. Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 1 Law & Pol. Int'l Bus. 168, 170-71 (1969).

⁷⁷ See pp. 1242-45 infra.

⁷⁸ This interpretation is supported by the court's discussion of the necessity for protection:

A fraud upon a corporation which has the effect of depriving it of fair compensation for the issuance of its stock would necessarily have the effect of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices for the shares of the domestic stock market. This impairment of the value of American investments by sales by the issuer in a foreign country, allegedly in violation of the Act, has . . . a sufficiently serious effect upon United States commerce to warrant assertion of jurisdiction for the protection of American investors. . . .

405 F.2d at 208-09 (emphasis added).

The textual statement clearly refers to those sections of the Exchange Act requiring use of interstate facilities for jurisdiction, such as § 10(b).

⁷⁹ Of course, registration can be argued to be "necessary" since it engenders a belief that the transactions are regulated.

⁸⁰ But see *Travis v. Anthes Imperial Ltd.*, [Current] CCH Fed. Sec. L. Rep. ¶ 93,303 (E.D. Mo. June 24, 1971):

Schoenbaum also makes it clear that there must be "a necessary and sub-

Schoenbaum stands primarily for the proposition that jurisdiction should be asserted when necessary for protective purposes.⁸¹ As noted previously, the court expressly rejected prior interpretations of Section 30(b) which, focusing upon the "obvious" purpose of the section, concluded that the Exchange Act was applicable only territorially.⁸² Instead, the court took a broader view; it interpreted the section in light of the legislative purpose of Congress in enacting the Act, rather than attempting to discern the intent in including the section within the Act. According to the court, the Section 30(b) exemption was not meant to frustrate the purposes of the Exchange Act, but merely to "[relieve] the Commission of the impossible task of enforcing American securities law upon persons whom it could not subject to the sanctions of the Act for actions upon which it could not bring its investigatory powers to bear."⁸³ If, as seems evident, *Schoenbaum* did adopt a philosophy of protective jurisdiction, the important consideration is whether a *substantial danger* is posed by a particular transaction. Thus the requirement of substantiality for protective jurisdiction should be defined with respect to the significance of the harm threatened and not in relation to the importance of a domestic act in the overall transaction.

The Second Circuit was quickly given the opportunity to clarify the scope of section 30(b) in *Roth v. Fund of Funds, Ltd.*⁸⁴ There, the plaintiff, a stockholder in Dreyfus Corp., brought a stockholder derivative suit to recover short-swing "insider" profits made by the defendant, a Canadian mutual fund, on purchases and sales of Dreyfus common stock, listed on an American exchange. The district court, in a decision antedating *Schoenbaum*, found the place of purchase and sale to be the place of the wrong. Since the wrong occurred within the United States, section 30(b) was ruled inapplicable.⁸⁵ Distinguishing *Kook* as involving transactions effected outside the United States on a

stantial act within the United States" in connection with the alleged violation before an American court may have jurisdiction over foreign transactions. See, also *Kook v. Crang*, 185 [sic] F. Supp. 388 (S.D.N.Y. 1960).

Id. at 91,680.

⁸¹ In *Schoenbaum* "a broadly protective jurisdiction of almost limitless potential was asserted in imperial style." Becker, *supra* note 70, at 241.

⁸² For a discussion and analysis of the meager legislative history of § 30(b), see Goldman & Magrino, *supra* note 33, at 1017-21.

⁸³ 405 F.2d at 207-08. The court stated that the purpose of § 30(b) is twofold: (1) to allow persons in the securities business to conduct transactions in securities outside the United States without complying with the "burdensome" reporting requirements of the Exchange Act and without being subject to its regulatory provisions, except insofar as the Commission finds it necessary and appropriate to regulate such transactions in order to prevent evasion of the Exchange Act; and (2) to keep the SEC out of the business of regulating foreign security exchanges, unless the SEC deems it necessary in order to prevent evasion. Id. at 207.

⁸⁴ 405 F.2d 421 (2d Cir. 1968) cert. denied, 394 U.S. 975 (1969). The decision in *Roth* was handed down six months after the Circuit's first decision in *Schoenbaum* and three weeks prior to the second.

⁸⁵ 279 F. Supp. 935, 936-37 (S.D.N.Y. 1968).

foreign exchange, the Second Circuit affirmed, on the basis that the transaction had an American situs.⁸⁶ Since *Roth* came within the jurisdiction of the United States regardless of whether the "territorial" or "protective" theory was applied, the court avoided discussion of the problem.

In *Finch v. Marathon Securities Corp.*,⁸⁷ however, the court did address the problem, and attempted to interpret the extent of the *Schoenbaum* holding. The plaintiff, a British citizen and resident, had purchased stock not registered or traded in the United States from the defendants, also foreigners, relying on representations which had been made in England. An agreement to purchase the stock had been signed in New York; nevertheless, a substantially identical agreement had been executed by the same parties twenty days later in England. One defendant, a defunct Bermudian closed-end investment company had been registered previously with the SEC. Plaintiff alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

The *Finch* court found *Schoenbaum* dispositive on the issue of subject matter jurisdiction. Acknowledging that *Schoenbaum* subordinated the presumption against extraterritorial application of domestic legislation to the need to protect American investors, the court recited the holding in *Schoenbaum*, which allowed extraterritorial application "at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors."⁸⁸ However, the court interpreted *Schoenbaum* as precluding extraterritorial application when, as in *Finch*,

(1) the substance of the allegedly fraudulent conduct occurred outside the United States; (2) the parties are predominantly foreign; (3) the subject shares are securities in a foreign corporation neither registered nor traded on a national securities exchange; and (4) there is no showing of any domestic injury . . . despite the existence of other less meaningful American-based facts and events.⁸⁹

⁸⁶ Section 30(b) is inapplicable because when the Fund bought and sold the securities in question on the New York Stock Exchange, utilizing New York City stock brokers to execute its orders to buy and sell, and made payment for the purchases through a New York bank, it was not transacting a "business in securities without the jurisdiction of the United States." *Kook v. Crang* . . . dealt with a totally different situation where the transactions were effected outside the United States on the Toronto Stock Exchange.

405 F.2d at 422. See Note, 10 Colum. J. Transnat'l L. 150, 151-52 (1971).

⁸⁷ 316 F. Supp. 1345 (S.D.N.Y. 1970) (per Tenney, J.).

⁸⁸ Id. at 1349, quoting from *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208 (1968).

⁸⁹ 316 F. Supp. at 1349 (emphasis added). These "less meaningful American-based facts and events" were said to "partially bridge the jurisdictional gap." Id. at 1347. They included the original execution in New York; an "offshore" connection with the United States, based upon the predominantly American citizenship of the Bermuda corporate defendant's officers and directors; and the "substantial control" exercised by a United States corporation over the Bermuda corporation. Id.

Thus the decision in *Finch* is compatible with the previously suggested interpretation of *Schoenbaum*.⁹⁰ Before protective jurisdiction will be asserted, an act threatening *substantial* harm to American markets or investors must be present. Although the *Finch* court did not attempt to confine extraterritorial application of the Exchange Act to the narrow situation of *Schoenbaum*,⁹¹ it nevertheless, in the first application of *Schoenbaum*, did not extend its holding. At least in situations where no domestic party; registered security or domestic injury was involved, the *Finch* court ruled that it was not the intent of Congress to make transactions subject to the provisions of the Exchange Act.⁹² In essence, the Court endorsed the philosophy of protective jurisdiction and began to define, albeit by exclusion, the situations under which that jurisdiction should be exercised.

In respect to the territorial aspects of the case the court observed that, despite the presence of some insignificant domestic acts, the substance of the transaction had occurred outside the United States. Therefore, the court ruled that there existed no territorial jurisdiction. The thrust of this observation is that a court does not have territorial jurisdiction unless necessary and substantial aspects of the transaction in question occur within the United States. Thus one of the important generalizations which can be drawn from the *Finch* decision is that the *sine qua non* of jurisdiction, territorial or protective, is a necessary and substantial act. However, in order to resolve the question of territorial jurisdiction, the issue is whether a *substantial act* has occurred *within the United States*; in order to resolve the question of protective jurisdiction, the issue is whether the transaction involves an act threatening *substantial harm* to domestic markets or investors.

This two-part test for determining jurisdiction was clearly articulated in the next case presenting the problem of defining "jurisdiction" under section 30(b)—*Investment Properties International, Ltd. v. I.O.S., Ltd.*⁹³ In that case, the plaintiffs, a Canadian corporation, in

⁹⁰ See pp. 1238-41 *supra*.

⁹¹ [I]t is not suggested that the Act's extraterritorial protection be extended only to frauds involving transactions in securities of publicly held corporations which are traded on a securities market.

316 F. Supp. at 1349. The *Finch* court held that it was "without subject matter jurisdiction." *Id.* at 1349. The court did not find jurisdiction and then decline to exercise it under the doctrine of *forum non conveniens*, a possibility that was suggested by *Schoenbaum*. See *Schoenbaum v. Firstbrook*, 405 F.2d 200, 209 n.5 (2d Cir. 1968).

⁹² It should be noted that *Finch* is the first decision since *Kook* to find a lack of subject matter jurisdiction upon careful consideration of § 30(b), thus delineating at least some circumstances which will not allow application of the Exchange Act. A previous case, however, had found the Exchange Act inapplicable, citing § 30(b) and *Kook*. See *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,535 (S.D.N.Y. Dec. 12, 1969).

⁹³ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,011 (S.D.N.Y. Apr. 21, 1971) (per Frankel, J.).

The court refused a preliminary injunction. The subsequent history of the litigation is outlined in *Investment Properties Int'l, Ltd. v. IOS, Ltd.*, Docket No. 72-1060 (2d Cir. Apr. 21, 1972), and is summarized as follows. The Second Circuit affirmed without an

which defendant owned "virtually all" of the voting common stock, and a group of its subsidiaries alleged multiple claims under section 10(b) and Rule 10b-5. Plaintiffs asserted that a series of intercorporate transactions had been part of a scheme to defraud. The scheme allegedly was intended to impose risks and losses on certain IOS subsidiaries (including the plaintiffs) and their shareholders, reserving profits to IOS and its other subsidiaries.

In determining whether it had jurisdiction, the court applied a two-pronged test: "First, has the allegedly unlawful transaction 'occurred' in the United States? Second, if the transaction has occurred outside the United States does the [Exchange] Act nevertheless reach it?"⁹⁴ In other words, the inquiry is first whether the transaction was "without" the territorial jurisdiction of the United States and, if the answer is affirmative,⁹⁵ second, whether the transaction was nevertheless within the "protective" jurisdiction of the United States. In discussing the second question the court did not rely on section 30(b). Rather, it articulated a test for protective jurisdiction:

[T]he main consideration appears to be: does the transaction have some significant impact on the domestic securities market or on domestic investors, and is extraterritorial application therefore necessary to protect securities trading in the United States and/or American investors? If there is no such domestic impact from a substantially foreign transaction, United States' courts have no reason to become involved, and compelling reason *not* to become involved, in the burdens of enforcement and the delicate problems of foreign relations and international economic policy that extraterritorial application may entail.⁹⁶

opinion. Plaintiffs then sought to depose certain of defendants' officers, with the examination limited to the threshold issues of standing and jurisdiction. The district court vacated plaintiffs' notices of deposition "without prejudice to further discovery if it is determined that this Court has jurisdiction of the subject matter of this action." *Id.* at 2763. The Second Circuit held the vacation to be an abuse of discretion since it "places [the] case in limbo, from which there is no appeal. To move forward at all . . . [plaintiffs] must prove jurisdictional facts at trial; to accomplish that, however, discovery may well be needed." *Id.* at 2765-66. The Second Circuit granted a petition for mandamus and directed the district judge to vacate his vacation. The Second Circuit stated that discovery related to standing and subject matter jurisdiction must be aimed at the production of factual matter other than that which appears in the lower court opinions. *Id.* at 2767. Compare *Fontaine v. SEC*, 259 F. Supp. 880 (D.P.R. 1966) (doctrine of exhaustion of administrative remedies precludes application of the § 30(b) exemption so as to include the SEC right to investigate a registered broker-dealer to determine whether violations have occurred).

⁹⁴ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,011 at 90,734.

⁹⁵ The court found that none of the transactions had occurred in the United States. The court did not view *Schoenbaum* as completely eliminating the need for significant facts in order to assert territorial jurisdiction: "So far as our securities laws are concerned, no significant events . . . are shown to have occurred within the United States." *Id.* at 90,737. Although the plaintiffs had cited American aspects of the scheme, the court did not strain to find a transnational scheme.

⁹⁶ *Id.* at 90,735.

Noting that both parties were foreign corporations,⁹⁷ that none of the securities had been traded on any domestic exchange or over any domestic counter, and that shares had not been sold to citizens or residents of the United States,⁹⁸ the court denied a preliminary injunction. The court ruled that there was lacking a sufficient act within the United States and that there was "no showing of a basis for jurisdiction in concern for American investors."⁹⁹

Although *Investment Properties International*, like *Finch*, did not find subject matter jurisdiction, the court again framed its initial inquiry in terms of the legislative intent to apply the securities laws extraterritorially when necessary to protect American interests. No attempt was made to confine *Schoenbaum* merely to situations involving both registered securities and detriment to the interests of American investors. The existence of a "significant impact on the domestic securities markets or on domestic investors" was deemed sufficient to justify extraterritorial application.¹⁰⁰

⁹⁷ Although some of the parties plaintiff were American corporations, *id.* at 90,726-27, the court stressed that "IPI, the crucial party claiming to be harmed by the alleged frauds, is a foreign corporation. . . ." *Id.* at 90,736. Evidently the indirect harm to the American plaintiffs was viewed as insignificant.

⁹⁸ The court thought it unimportant that officers, directors and employees of IOS and its subsidiaries did own shares despite their American citizenship. *Id.* at 90,736. Furthermore, the court determined that the purchase of shares in the plaintiff corporation by plaintiff's lawyers did not demonstrate a need to protect American investors:

The fact that through a concerted effort private parties can arrange for the arrival of some IPI shares in American hands, in spite of the efforts of IOS and all of its affiliates to prevent this from happening, is scarcely a basis for the jurisdiction plaintiffs invoke.

Id. at 90,736 n.17.

⁹⁹ *Id.* at 90,736. The court also stated: "[P]laintiffs cannot claim that jurisdiction is necessary to effectuate one of the Act's central purposes, 'to regulate the stock exchanges and the relationships of the investing public to corporations which invite investment by listing on such exchanges.'" *Id.* It is submitted that purchases of registered American stocks for the portfolio of an offshore fund could necessitate regulation of the issuance of shares in the funds in order to protect "the relationships of the investing public to corporations which invite investment by listing . . ." See pp. 1249-53 *infra*.

¹⁰⁰ Similarly, in *Manus v. The Bank of Bermuda, Ltd.*, [Current] CCH Fed. Sec. L. Rep. ¶ 93,299 (S.D.N.Y. Dec. 9, 1971), although not reaching the issue, the court noted that subject matter jurisdiction apparently was lacking. The court pointed to the fact that the parties were aliens and that the principal transaction, involving the sale of unregistered common stock of an American corporation, had occurred in England. No allegation or factual determination showed the transaction to be "detrimental to the interests of domestic investors or of the domestic securities market." *Id.* at 91,650.

An SEC examiner has recently considered the scope of regulation permissible under the Exchange Act in IOS, Ltd. (S.A.), SEC Administrative Proceeding File No. 3-2157 (March 14, 1972) as reported in [Current] CCH Fed. Sec. L. Rep. ¶ 78,637. In 1965; respondent IOS, a Panamanian holding company which prior to 1967 was registered as a broker-dealer under the Exchange Act, acquired the assets of a large broker-dealer and placed those assets in a wholly-owned subsidiary, respondent IPC. IPC is presently known as CIP, Inc., and is registered as a broker-dealer. IOS had been subject to prior SEC proceedings. Settlement had prohibited portfolio transactions of IOS and its related foreign funds unless the orders concerning such transactions were placed with an independent, nonaffiliated entity outside the United States or with a United States brokerage

Recently the section 30(b) exemption has been considered outside the Second Circuit. In *Travis v. Anthes Imperial Ltd.*,¹⁰¹ plaintiffs, Missouri citizens, brought a class action alleging violation of section 10(b) and Rule 10b-5. In 1968 the defendant Molson, a Canadian corporation, made a tender offer to acquire the shares of non-United States shareholders of defendant Anthes, also a Canadian corporation. At the time, neither Molson nor Anthes shares were registered with the SEC; since registration is a requisite to a legal exchange offer, the offer was not extended to United States resident shareholders. Plaintiffs, American shareholders of Anthes, claimed that they had been induced to refrain from selling their shares by defendants' representation that, after expiration of the tender offer, the United States resident shareholders of Anthes would be treated on an equivalent basis, net after-taxes, as the non-United States resident shareholders of Anthes.

The alleged misrepresentation in *Travis* involved the use of interstate facilities. However, each use in connection with the misrepresentation had been initiated by the plaintiffs; although the defendants had

firm located, or having branch offices, outside the United States. A partner in a brokerage firm with which IOS had done business was prevailed upon to form another brokerage firm, Arthur Lipper Corporation ("Lipper Corporation"), with offices in London and Geneva. In return for substantial business from IOS, the founder of Lipper Corporation understood that the corporation was required to "give up" 50% of the commissions generated by IOS business to IPC. "A 'give up' is in effect a splitting of the commission received by the executing broker with another broker designated by the customer to receive a certain portion of that commission." [Current] CCH Fed. Sec. L. Rep. ¶ 78,637 at 81,354 n.11. Various over-the-counter transactions were executed by IOS subsidiaries and \$1,275,000 was remitted to IPC by Lipper Corporation. Adequate disclosure of the give-up arrangement was never furnished to the subsidiary offshore funds dealing with Lipper Corporation or to the shareholders of those funds.

The examiner found that the inadequately disclosed arrangements violated Lipper Corporation's obligation to deal fairly with its customers and constituted a fraud in violation of § 10(b), and Rule 10b-5 thereunder, since the commissions charged the funds could have been reduced by 50% in place of the remissions to IPC. *Id.* at 81,354-58. The respondents contended that the Exchange Act did not apply to the relationship between IOS and its related offshore funds. However, the examiner found that respondents' willful aiding and abetting of a registered broker-dealer in its willful violation of § 10(b) and Rule 10b-5 sufficed to bring IOS conduct within SEC jurisdiction under the Exchange Act. *Id.* at 81,360. The examiner noted further that the securities transactions on behalf of the funds were executed on domestic over-the-counter markets. Since the fraudulent scheme necessarily utilized United States over-the-counter markets, significant acts in the United States existed and application of the § 30(b) exemption was thus precluded, *id.* at 81,360-61, and the Exchange Act was applied to measure IOS's fiduciary obligations to its related foreign funds.

In the course of his opinion, the examiner acknowledged *Investment Properties International's* focus on "whether the transactions have 'some significant impact on the domestic securities market or on domestic investors. . .'" *Id.* at 81,360. However, after reciting that case's dual test for subject matter jurisdiction, see *supra* p. 1244, the examiner relied on territorial conceptions, concluding that discussion of protective jurisdiction was inappropriate since the fraudulent overcharges were inextricably tied to transactions on American markets. *Id.* at 81,360-61. The examiner's decision is being appealed. *Wall Street Journal*, March 16, 1972, at 12, col. 3.

¹⁰¹ [Current] CCH Fed. Sec. L. Rep. ¶ 93,303 (E.D. Mo. June 24, 1971) (per Wangelin, J.).

initiated use of interstate facilities, they had not done so in connection with the alleged violation. Although the terms of the exchange had not been agreed upon within the United States, the ultimate exchange of plaintiffs' shares for cash had occurred in St. Louis; however, at the time of the sale, the plaintiffs no longer believed the alleged misrepresentations.

Relying heavily on *Schoenbaum*, the court accepted the position that the Exchange Act was not limited to territorial application. Nevertheless, it dismissed the complaint for want of subject matter jurisdiction.¹⁰² In reaching this result, the *Travis* court examined the extraterritorial scope of the Exchange Act as enunciated in *Schoenbaum*.

According to the court, *Schoenbaum* "set forth the limited situations in which the securities acts have extraterritorial application . . . [F]irst, where a *domestic* purchaser buys *foreign* securities on an *American* exchange, and second, where an improper *foreign* transaction in *American* securities affects the *domestic securities market*."¹⁰³ The court in *Travis* further stated that *Schoenbaum* clearly required "'a necessary and substantial act within the United States' in connection with the alleged violation before an American court may have jurisdiction over foreign transactions."¹⁰⁴ Finding that the defendants had committed no necessary and substantial act within the country, the court concluded that it did not have jurisdiction.

On its facts, the decision in *Travis* is compatible with either a territorial or protective definition of jurisdiction. The only significant domestic acts by defendants were their communications advising the plaintiffs of the true facts and the exchange of plaintiffs' shares for cash. Neither of these acts was connected with the alleged misrepresentation. On the contrary, the former act dispelled the misapprehension so that, at the time of the latter act, the plaintiffs were not being deceived. Thus there existed no necessary and substantial domestic acts, requisite to an assertion of territorial jurisdiction.

Furthermore, there was no threat of substantial harm to domestic markets or investors within the guidelines set forth in *Schoenbaum*. In *Travis*, no foreign securities had been listed on American exchanges. Moreover, while the alleged misrepresentation may have substantially harmed American investors, the harm did not flow from foreign transactions in American securities. Thus, absent a nexus between the foreign transaction and the maintenance of fair and honest securities markets, it was not necessary for the court to exert jurisdiction under the *Schoenbaum* rationale. Since the court in *Travis* restricted protective jurisdiction to those situations specified in *Schoenbaum*, it failed to discuss the implication of *Investment Properties International* that the

¹⁰² The court also stated that it did not have jurisdiction because there was a failure to state a claim under Rule 10b-5; in addition, the court found that venue was improper.

¹⁰³ [Current] CCH Fed. Sec. L. Rep. ¶ 93,303 at 91,679-80.

¹⁰⁴ Id. at 91,680.

protection of American investors, standing alone, may necessitate protective jurisdiction.

The most disturbing aspect of the *Travis* decision is its apparent insistence that, before protective jurisdiction, as defined by *Schoenbaum*, can be asserted, the court must first find a necessary and substantial act *within the United States*. This view follows only if the *Schoenbaum* decision is interpreted to mean that registration of a security on a national exchange is a "necessary and substantial" act. However, it was previously suggested that this extremely narrow reading of *Schoenbaum* should be rejected;¹⁰⁵ it is a reversion to the presumption of a purely territorial application of the Exchange Act. *Schoenbaum* rejected this presumption and endorsed the idea that the Act applies when the requisites of protective jurisdiction are present. While protective jurisdiction probably retains the standard of substantiality, it is suggested that the term "substantial," in this context, refers to the magnitude of harm threatened to domestic markets or investors and not to the significance of a domestic act in relation to the overall transaction.

By way of summary, the courts in the Second Circuit have expressly disavowed the early decisions leaning toward a purely territorial application of the Exchange Act. The earlier section 30(b) cases adopted the presumption that legislation is to apply territorially, unless a contrary intent is clearly manifest. In adopting the territorial concept, *Kook v. Crang* articulated a test for jurisdiction: an act both necessary and substantial in the context of the overall transaction must occur within the United States before there exists territorial jurisdiction. However, the courts, as illustrated by *Ferraioli v. Cantor*, moved away from this position, finding transactions "within" the United States on the basis of acts which were of questionable substantiality: jurisdiction was predicated upon insignificant, but necessary, acts.

In *Schoenbaum v. Firstbrook*, the Second Circuit expressly rejected the presumption of territoriality. Following the spirit of this disavowal, the District Court for the Southern District of New York has not attempted to restrict *Schoenbaum* to its facts. In *Investment Properties International* the protective theory of jurisdiction was affirmed. Under this theory, the issue is whether a transaction is within the territorial or protective jurisdiction of the United States. To determine whether a transaction is within the territorial jurisdiction, the court has revived the requirement enunciated by *Kook* that a necessary and substantial act must occur within the United States. The substantiality standard has also been suggested for the exercise of protective jurisdiction. However, it is submitted that where a court asserts protective jurisdiction, 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. The reason for this interpretation is that protective jurisdiction is con-

¹⁰⁵ See pp. 1239-41 *supra*.

cerned with the impact which foreign activities may have upon domestic markets; unlike territorial jurisdiction, it is not concerned with the relative magnitude of a domestic event.

Outside the Second Circuit, the only decision fully to articulate an opinion on the extraterritorial application of the Exchange Act is the *Travis* decision. There the court concurred with the Second Circuit's philosophy of protective jurisdiction. However, the *Travis* court would require as a prerequisite to assuming protective jurisdiction a necessary and substantial domestic act. It has been noted that this requirement is inconsistent with the spirit of the *Schoenbaum* decision, which first propounded the argument that the Exchange Act should be applied protectively. Since the *Travis* decision is regressive, it should not be followed.

II. APPLICATION TO OFFSHORE FUNDS

Thus far, the discussion has not been directed specifically at offshore mutual funds; it has concerned those persons transacting business in securities without the jurisdiction of the United States. Mutual funds are somewhat unique in that they engage in two distinct types of securities transactions. First, the fund as a dealer engages in transactions in shares of its portfolio companies; second, the fund as an issuer is engaged in the distribution and redemption of its own shares. To determine the extent to which either of these activities can be regulated under the Exchange Act, it may be helpful to reiterate the guidelines for protective jurisdiction propounded by *Schoenbaum*.

Under *Schoenbaum*, the extraterritorial application of the Exchange Act for the purpose of protecting American investors and markets is justified in two situations: (1) where domestic investors have purchased foreign securities on American exchanges and (2) where foreign transactions in American securities threaten substantial harm to domestic markets. An offshore fund's transactions in its own shares, when viewed in isolation, clearly are not within the scope of the guidelines. By definition, the shares of an offshore fund are (1) not American securities, (2) not sold to American investors, and (3) not registered on an American exchange.¹⁰⁰ Thus the contours of protective jurisdiction established by *Schoenbaum* do not encompass transactions by an offshore fund *qua* issuer.

The result may be different when a fund engages in transactions as a dealer. In this situation, the question of subject matter jurisdiction depends on a variety of factors including: (1) whether the securities traded are domestic or foreign; (2) whether the securities are registered with the SEC; (3) whether the securities are listed on a national exchange; (4) the nationality of the other party to the transaction; and (5) the locus of the transaction. If the transaction occurs within the United States, American courts clearly have territorial jurisdiction.

¹⁰⁰ See p. 1225 *supra*.

Where the allegedly unlawful transaction is foreign, *Schoenbaum* would extend protective jurisdiction only when the securities involved are American and the transaction threatens substantial harm to domestic markets.¹⁰⁷ None of the previously discussed decisions address the problem of specifying the foreign transactions threatening substantial harm to domestic markets. However, *Schoenbaum* held that protective jurisdiction exists where a foreign transaction involves *foreign* securities registered on a domestic exchange. If this is so then, *a fortiori*, a court has protective jurisdiction when a foreign transaction involves *domestic* securities registered with a domestic exchange. The import of *Schoenbaum*, it has been suggested, is that a court should assume jurisdiction when there is a significant nexus between the foreign transaction and the maintenance of fair and honest securities markets.¹⁰⁸ This nexus is established when the securities involved are registered on an American exchange or are actively traded on the over-the-counter markets. In these situations, the interest of domestic investors is substantial enough to warrant United States regulation.

Thus it has been concluded that, when viewed in isolation, an offshore mutual fund's activities as an issuer of securities do not confer subject matter jurisdiction on a federal court. On the other hand, when a fund acts as a dealer in securities, courts do have subject matter jurisdiction in some cases. A final and important issue remains in those cases where a fund continuously trades in securities of domestic companies registered on an American exchange: whether offshore mutual funds, trading in domestic portfolio securities, come within the protective jurisdiction of the United States when they commit fraud or other misconduct in connection with transactions in their own securities. In essence, the question is, do a fund's activities as a dealer justify extending jurisdiction over its activities as an issuer? The obvious jurisdictional barrier is that fraud in the issuance of securities is not directly connected with the activities giving rise to protective jurisdiction—the portfolio transactions. This situation is clearly not within the *Schoenbaum* guidelines, yet it is indisputable that the extensive holdings of offshore funds represent the possibility of substantial harm to American securities markets.¹⁰⁹ Arguably, the funds' activities in raising capital are inextricably intertwined with their investments in American securities.

The only case to date dealing with this problem is *SEC v. United Financial Group, Inc.*,¹¹⁰ in which the SEC charged a large offshore complex with fraud and record-keeping violations, requesting a permanent injunction against future violations and the appointment of a receiver. One of the defendants, an American, had dominated and controlled the defendant offshore mutual funds from within the United

¹⁰⁷ See p. 1239 *supra*.

¹⁰⁸ See pp. 1239-41 *supra*; 1253 *infra*.

¹⁰⁹ See pp. 1225-26 *supra*.

¹¹⁰ Civil No. 72-41 (D. Ore., filed Jan. 17, 1972).

States.¹¹¹ These funds were created "to take advantage of technical provisions of [United States] tax laws"; the millions of dollars of foreign capital raised by these offshore funds were reinvested in real estate and securities in the United States.¹¹² Although it was the policy of the funds not to sell to Americans, incidental foreign sales to three Americans did occur,¹¹³ despite precautions taken by the defendants.¹¹⁴

The district court granted the SEC's request for a preliminary injunction and appointed a temporary receiver, *pendente lite*.¹¹⁵ The court's findings emphasized the need to prevent "substantial and irreparable injury" to investors and creditors, both domestic and foreign.¹¹⁶ The injury to domestic investors to which the court referred did not appear to be the injury to the three American purchasers;¹¹⁷ rather, the court seemed concerned about the more general harm to "the ability of American issues of securities to raise capital abroad resulting from defendants' fraudulent operations . . ."¹¹⁸ The court further emphasized the danger to the confidence of foreign investors

¹¹¹ *Id.* Findings of Fact at 2, ¶ 1 (Feb. 16, 1972). UFG is a Delaware corporation. The defendants also include other American and foreign individuals as well as American corporations.

It is not unusual for Americans to control offshore funds. See SEC Institutional Investor Study Report, H.R. Doc. No. 64, 92d Cong., 1st Sess. pt. 3, ch. 7 at 882-84 (1971) [hereinafter cited as SEC Institutional Investor Study]. Cf. note 89 *supra*.

¹¹² Civil No. 72-41 (D. Ore., filed Jan. 17, 1972), Findings of Fact at 4, ¶ 16 (Feb. 16, 1972) [hereinafter cited as Findings of Fact].

¹¹³ Plaintiff's Supplemental Memorandum of Points and Authorities in Support of Motion for Preliminary Injunction and for Appointment of Receiver *Pendente Lite* in SEC v. United Financial Group, Inc. at 15-17 [hereinafter cited as Plaintiff's Supp. Memorandum]. The SEC argued that it was not the policy of the offshore funds to refund money to American investors, but to offer alternative investments. *Id.* at 16. The SEC did not specify the number of American purchasers; the number three appears in a Letter from Garry P. McMurry, defense attorney, Feb. 29, 1972, on file in the Boston College Industrial and Commercial Law Review Office [hereinafter cited as Letter from Garry P. McMurry].

¹¹⁴ These preventive measures were not emphasized by the SEC but are outlined in Defendants' Memorandum on Order to Show Cause in SEC v. United Financial Group, Inc. at 2-3 [hereinafter cited as Defendants' Memorandum].

¹¹⁵ Preliminary Injunction issued Feb. 16, 1972; Order Appointing Receiver *Pendente Lite* issued Feb. 16, 1972; Notice of Appeal filed Feb. 18, 1972.

¹¹⁶ Findings of Fact at 6, ¶ 21 (Feb. 16, 1972). See also *id.* at 4, ¶ 17, stressing the "adverse effect upon American securities, securities markets, investors and creditors . . ." The SEC argued that the prospectuses and other sales literature distributed by the UFG companies had emphasized that investments would be made in securities of United States corporations. The SEC argued that "[t]hese investments have had a substantial effect on the securities of American companies." Plaintiff's Supp. Memorandum, *supra* note 113, at 7. See *id.* at 7-9.

¹¹⁷ Cf. Letter from Garry P. McMurry, *supra* note 113. See also note 98 *supra*. Findings of Fact, *supra* note 112, at 6, ¶ 20, however, reads in part:

Defendants have used the facilities and instrumentalities of interstate commerce to make some sales of securities to citizens and resident [sic] of the United States

¹¹⁸ Findings of Fact, *supra* note 112, at 6, ¶ 21. The SEC argued that, even absent any sales to Americans, the use of the mails and other interstate facilities was sufficient to confer jurisdiction. See Defendants' Memorandum, *supra* note 114, at 12.

in registered United States investment vehicles and reputable offshore funds. The implication was that the investment of foreign funds in American securities confers "protective" jurisdiction to regulate the operations of an offshore mutual fund owned by an American holding company.¹¹⁹ Although the decision is ambiguous, the insubstantial nature of the domestic contacts¹²⁰ compels the conclusion that the court asserted protective jurisdiction. The implications of the decision must thus be measured in the light of *Schoenbaum*.

Under the spirit of *Schoenbaum*, extraterritorial application of the Exchange Act clearly seems permissible when the allegedly fraudulent foreign activities directly related to transactions in American securities present the threat of significant harm to the American securities markets. To decide otherwise would exempt a significant source of potential harm; offshore mutual funds would be allowed to engage in grossly fraudulent distribution of their shares, thus predicated the stability of American portfolio stocks, and perhaps the domestic markets in general, upon the continued viability of unregulated and unreliable offshore mutual funds.

However, the facts of *United Financial Group* are significantly different from those in *Schoenbaum*. *Schoenbaum* involved a threat to American stockholders through fraudulent transactions involving stock registered with the SEC and traded upon an American exchange. The alleged fraud in *United Financial Group* involved stock unregistered and untraded in the United States, and did not involve American investors; that is, the fraud was connected with the fund's activities as an issuer and not with its portfolio transactions. Thus the decision seems to expand significantly the *Schoenbaum* decision. However, it is compatible with the *Schoenbaum* rationale that the Exchange Act should apply extraterritorially when necessary to protect American investors.

Although no direct harm to stock registered and traded within the United States or to American investors is apparent in the sale of shares of offshore mutual funds, a potential indirect harm to American securities and their shareholders is recognizable. This indirect harm would be manifest in the loss of confidence in both American mutual funds and reputable offshore funds; investment in creditable funds could be curtailed to the substantial detriment of portfolio stocks and the market in general. The relatively large financial impact which offshore funds may have on the American market may justify the inference that Congress intended that these funds be regulated in order to pro-

¹¹⁹ For the first time a court of the United States has stated that the investment of foreign funds in the American marketplace creates jurisdiction in the S.E.C. to control the operations of an off-shore mutual fund which is owned by an American holding company with offices in California.

Letter from Garry P. McMurry, *supra* note 113.

¹²⁰ The court does note the American contacts of the defendants and refers to domestic fraudulent operations. See, e.g., Findings of Fact, *supra* note 112 at 6, ¶ 21.

tect the American market.¹²¹ As previously noted, the important consideration in determining whether a case involving a predominantly foreign transaction is properly within the protective jurisdiction of the United States would seem to be whether there exists a substantial connection between the alleged wrong and the necessity of maintaining fair and honest securities markets. Both foreign transactions in American securities and domestic transactions in foreign securities registered on exchanges have this nexus; but surely these transactions are not exhaustive. Fraudulent behavior in connection with the issuance of offshore fund securities may well adversely affect the financial stability of the fund. When, as is often the case, a fund holds a significant amount of domestic securities, traded on domestic exchanges, its financial incompetence portends substantial harm to domestic markets and investors. While the potential for harm is still largely unfulfilled, prospective preventive regulation of the industry may be necessary.

CONCLUSION

Given the lack of presently available alternatives, some form of domestic regulation of offshore mutual funds seems necessary. The Exchange Act appears to be a viable domestic instrument for the needed protection of American securities markets because it contains, in section 30(b), an express provision which exempts certain extraterritorial securities transactions from regulation. Thus, the Exchange Act can provide both the needed regulation and statutory exemption.

The preliminary barrier to application of the exemptive provision of the Exchange Act is in determining whether an offshore mutual fund qualifies as a "person insofar as he transacts a business in securities" within the meaning of section 30(b). If an offshore fund is not included in this phrase, the statutorily mandated exemption is inapplicable; selective exemption based upon a statutory provision would, therefore, be foreclosed. It has been submitted that reasoned judicial evaluation should determine the precise extraterritorial scope of the Exchange Act. This can be done in a more considered manner by focusing on the underlying protective purpose of the Act through interpretation of the phrase "without the jurisdiction of the United States."

The two problems involved in interpreting the phrase "without the jurisdiction of the United States" are: 1) defining the term "jurisdiction," and 2) if a protective interpretation is adopted, determining the scope of protective jurisdiction. The protective theory of jurisdiction focuses upon the harm threatened to American markets or investors. It is difficult to hypothesize circumstances which would *not* affect the domestic market to some degree; for this reason, advocates of a purely territorial interpretation argue that a protective interpretation

¹²¹ Cf. Note, *United States Taxation and Regulation of Offshore Mutual Funds*, 83 Harv. L. Rev. 404, 438-40 (1969).

would render the exemption virtually a meaningless superfluity.¹²² However, the necessity of implementing the primary purpose for enacting the Exchange Act—the protection of the domestic securities market—militates against adoption of this view. The primary protective purpose of the Exchange Act should not be thwarted by a restrictive reading of the word “jurisdiction” in Section 30(b).

Under the protective interpretation, the courts must still ask whether Congress intended to make the statute applicable to a particular transaction.¹²³ If a transaction does not fall *clearly* within the territorial jurisdiction of the United States, the extraterritorial scope of the Exchange Act must be determined through a judicial evaluation of whether the harm threatened to American securities markets or investors requires the imposition of regulatory action. Absent a substantial need for the protection of American interests, the section 30(b) exemption should apply; but it should be limited to those foreign transactions which, while within the technical jurisdiction of the United States under the Exchange Act, are of insignificant impact. The concept of substantiality of harm is a flexible standard which considers actions in the context in which they occur.¹²⁴

The extensive portfolio holdings of offshore mutual funds make these funds a potential source of harm. The difficult problem is specifying those activities of offshore mutual funds which require regulation. Resolution of this problem requires a consideration of both the substantiality of the harm threatened and the likelihood of its occurrence. Such an evaluation should consider the impact of the entire offshore mutual fund industry, rather than the lesser impact of a single offshore mutual fund. The disreputable behavior of one fund may implicate more reputable funds, thus engendering a lack of confidence in the entire industry.

Another primary consideration is the preservation of international harmony. Retaliatory regulation of registered American issuers by foreign governments is a distinct and noxious possibility. However, prudent judicial protective regulation concentrating initially on the

¹²² Note, *Extraterritorial Application of the Securities Exchange Act of 1934*, 69 Colum. L. Rev. 94, 104 (1969).

This protective interpretation would not render the § 30(b) exemption superfluous. The SEC's rule-making power under § 30(b) would, in effect, be a power to override or preclude a judicial finding of insubstantiality of harm if such a finding, in the SEC's view, would prevent the extraterritorial application of a provision of the Exchange Act in order to protect American securities markets.

¹²³ *Kook v. Crang*, 182 F. Supp. 388, 390 (S.D.N.Y. 1960).

¹²⁴ Cf. 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, 1020 (1969). The authors suggest that the legislative history of § 30(b) supports what is actually a protective interpretation. They suggest that SEC rules promulgated under other sections of the Exchange Act may impliedly serve to prevent evasion of the Exchange Act and thus be viewed, effectively, if not formally, as § 30(b) rules. Such an interpretation is close to the focus on the protective purpose of the Exchange Act herein advocated.

most grievous threats—probably section 10(b) violations—should not disrupt international relations. As it becomes clear that the sole reason for extraterritorial application is the prevention of significant harm to American markets,¹²⁵ other nations will be encouraged to develop—as many are already doing—their own regulatory systems, not in retribution, but as a protection for investors.¹²⁶ Thus, the establishment of a de facto minimum standard of international regulation would be encouraged. As meaningful regulation by foreign countries increases, the necessity for protection through American regulation would decrease. The probabilities of substantial harm to American markets would be diminished by foreign regulation and the exemption would find increased application. Alternatively, the doctrine of *forum non conveniens* could be used by the courts to decline the exercise of extraterritorial jurisdiction in those instances where meaningful foreign regulation already existed and in which foreign regulation was more appropriate.

While an extension of American regulation would insure meaningful regulation of offshore fund activities and protect both the American market and foreign investors, it does not placate the fear of capital drainage which exists in many countries; neither does it solve balance of payment considerations.¹²⁷ Both of these factors motivate foreign countries to regulate American issuers and encourage the establishment

¹²⁵ A desirable effect may be increased confidence by foreign investors in the regulated funds. Cf. SEC Institutional Investor Study, *supra* note 111, pt. 1, at XVI.

¹²⁶ For a discussion of securities regulation in the "most important securities market outside the United States," see Knauss, Securities Regulation in the United Kingdom: A Comparison with United States Practice, 5 Vand. J. Transnat'l L. 49 (1971).

¹²⁷ The problem involves bringing offshore funds "onshore" in the regulatory sense, while still providing tax advantages to foreigners. See SEC Institutional Investor Study, *supra* note 111, at 954. The SEC has suggested that one method of solving this problem "would be to establish entities through which nonresident foreign investors could receive the same tax advantages by investing in domestic registered funds as they currently obtain through the purchase of shares in an offshore fund. . . . Alternatively, a separate registered investment company could be created and designed to appeal specifically to foreign investors." *Id.*, pt. 1, at XVI-XVII. The SEC has established an interagency task force to explore the possible solutions. SEC Securities Exchange Act of 1934 Release No. 9285 (Aug. 11, 1971). While these methods would serve to bolster foreign confidence, the present holdings of offshore funds could still have an undesirable impact. The impact could result if investors in offshore funds rushed to reinvest in onshore funds, causing heavy offshore fund sales of a widely held specific portfolio stock. For this reason American securities markets still could face potential harm. Further, since the purpose of this proposal would be merely to neutralize the offshore fund's competitive advantage, the continued potentially harmful involvement of unregulated offshore funds in American securities markets appears to be conceded. However, if such a statutory scheme were adopted, the Exchange Act, and § 30(b) specifically, could be extended as herein advocated in order to fill this regulatory void.

The suggestion of the SEC suffers from a further defect. While the SEC professes to question the justification of those foreign regulations apparently based on protection of foreign capital markets or balance of payments considerations instead of investor protection (SEC Institutional Investor Study, *supra* note 111, at 950), the SEC states that the proposal's "net result would be beneficial both to foreign investor protection and the United States securities market, as well as to the United States balance of payments." *Id.*, pt. 1 at XVI.

of "national funds."¹²⁸ As the home of the most sophisticated securities market, the United States should endorse the view that "[m]ovements of capital between countries should not be restricted unnecessarily."¹²⁹ A free flow of capital would probably lead to substantial investment in American investment companies and American stocks. However, countries which are capital poor might not view this exodus of capital favorably. This problem could be partially alleviated by freeing the sale of shares of foreign investment companies in the United States from present strict restrictions;¹³⁰ provided, of course, that such issuers are meaningfully regulated by the domiciliary nation. Nevertheless, prudent extension of those provisions of the Exchange Act deemed necessary to protect the American market from substantial harm, coupled with a relaxation of the American regulation of foreign issuers already regulated by a foreign nation, would provide the basis for a *de facto* or *de jure* minimum, nondiscriminatory standard of regulation imposed by the major developed nations.¹³¹

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¹²⁸ SEC Institutional Investor Study, *supra* note 111, at 920, 950. See also Note, West German Regulation of Foreign Mutual Funds, 3 N.Y.U. J. Int'l Law & Pol. 323 (1970).

¹²⁹ SEC Institutional Investor Study, *supra* note 111, at 954.

¹³⁰ See Investment Company Act § 7(d), 15 U.S.C. § 80a-7(d) (1970) and 17 C.F.R. § 270.7d-1 (1971). Cf. SEC Institutional Investor Study, *supra* note 111, at 954-55.

¹³¹ See generally, Note, Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma, 3 Law & Pol. Int'l Bus. 157, 203-09 (1971).