The Recent Securities Law Litigation in the US Supreme Court*

Sebastian Okinczyc**

Abstract

The purpose of this case-law study is to introduce the reader to some of the most significant recent developments in US Supreme Court litigation related to securities law in the context of the recent credit crisis. Using critical legal analysis, with the help of scholarly writings, the following US Supreme Court cases will be examined one-by-one in turn:

- Morrison et al. v. National Australia Bank Ltd et al. (Morrison);
- Merck & Co., Inc., et. al. v. Reynolds et. al. (Merck);

A deep and thorough analysis of the cases allows one to draw a general conclusion as to the ideas usually present in the securities’ law cases brought before the US Supreme Court. The ever present and evident concept uniting the three cases is that of information asymmetry as identified and analysed by George Akerlof. The article concludes with a general discussion of information asymmetry being an ever-present issue in securities litigation in front of the US Supreme Court.

---

* This article is largely based on a paper written to fulfill the coursework requirement of the author’s International Corporate Governance: Managing Global Risks, Ethics and Cultures module, University of Westminster, from where he graduated in the LLM Corporate Finance Law (with Distinction) in November 2011.

**LLM, Vilnius University, Lithuania; LLM, University of Westminster, UK. Associate, bnt attorneys-at-law, Vilnius, Lithuania; Visiting fellow in Theory of Law, KazimierasSimonavicius University, Vilnius, Lithuania; email: sokinczyc@yahoo.com, sebastian.okinczyc@bnt.eu.

The author would like to thank Prof. Joseph Tanega and RezarteVukatana for their constructive and supportive comments, special thanks to Prof. Gerard H. Kelly, CandemirBaltali and PravinJeyaraj for their helpful insights and assistance.
# Table of Contents

II  INTRODUCTION .................................................................................................................. 52

III  MORRISON ET AL. V. NATIONAL AUSTRALIA BANK LTD ET AL. .......................... 53  
   FACTS SUMMARY ................................................................................................................. 53  
   JUDGMENT OF THE COURT ................................................................................................. 54  
   MORRISON OVERTURNED BY DODD-FRANK? ................................................................. 58

IV  MERCK & CO., INC., ET. AL. V. REYNOLDS ET. AL. ................................................. 59  
   FACTS SUMMARY ................................................................................................................. 59  
   JUDGMENT OF THE COURT ................................................................................................. 61  
   IMPLICATIONS OF THE JUDGMENT .................................................................................... 62

V  SECURITIES AND EXCHANGE COMMISSION V. EDWARDS ....................................... 63  
   FACTS SUMMARY ................................................................................................................. 63  
   JUDGMENT OF THE COURT ................................................................................................. 64

VI  CRITICAL ANALYSIS ......................................................................................................... 65  
   EVIDENCE OF THE INFORMATION ASYMMETRY THEORY IN THE ANALYSED CASES ...... 66  
   ARE SECURITIES – LEMONS IN THE US SUPREME COURT? ............................................ 68  
   INFORMATION ASYMMETRY IN SECURITIES’ LAW CASES IN THE US SUPREME COURT .... 68

VII CONCLUSION ..................................................................................................................... 69

VIII BIBLIOGRAPHY .................................................................................................................. 69
I INTRODUCTION

Financial engineers build dreams. When those dreams turn out to be nightmares, other people pay for it.
Andrew Sheng

No other nation ever constituted so powerful a judiciary as the Americans.
Alexis de Tocqueville

In the aftermath of the credit crisis, largely caused by the failures within the financial system, the numerous legal disputes arising therefrom will sooner or later land in courts. Therefore, eventually, the number of US Supreme Court cases relating to securities law is likely to increase, regardless of the fact that many major securities law cases are settled outside of court. The figures show the obvious – expert knowledge leads to a greater chance of success in the Supreme Court. Consequently, there is a growing demand for lawyers specializing in US Supreme Court litigation. Therefore, the relevance of the topic is of no dispute.

This article will examine three landmark cases in reverse chronological order and how the judgments depend on the information asymmetry between the parties to the cases. One feels that a brief justification as to the reasons for selecting the particular cases is necessary. Firstly, the Morrison et al. v. National Australia Bank Ltd et al. (Morrison) case has been chosen as the most recent case relating to securities law in the US Supreme Court. It is also relevant if we observe any impact coming from the recent regulatory changes – the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) as commentators/analysts claim it might

---

1Chief advisor to China Banking Regulatory Commission, Board Member of the Qatar Financial Centre Regulatory Authority, adjunct Professor at the Graduate School of Economics and Management, Tsinghua University, Beijing and the University of Malaya, Kuala Lumpur.

This particular quote has been taken from an interview with Andrew Sheng in Charles Ferguson’s 2010 award-winning documentary on the financial crisis ‘The Inside Job’.


be overturning the decision of the court. Secondly, the *Merck & Co., Inc., et. al. v. Reynolds et. al.* (*Merck*) case has been selected because of how great an impact it might have on the market – the possible claimants are given time to make up their minds and file a suit only if the situation in the market does not satisfy them. Finally, the *SEC v. Edwards* case has been chosen *inter alia* in order to note the role of the United States Securities and Exchange Commission (SEC) in securities’ litigation.

Afterwards, a brief discussion on what might link these three cases would follow. It will concentrate on the information asymmetry problem and its relation to investor protection in light of the three cases. Sparing the reader an exhaustive explanation of the theory itself already here, a brief and simplified outline of what information asymmetry is will be provided in the relevant part of the paper below. Also, a role of US Supreme Court in investor protection will be emphasized. The article will show that the notion of information asymmetry is ever-present in securities litigation before the US Supreme Court.

II MORRISON ET AL. V. NATIONAL AUSTRALIA BANK LTD ET AL.

*Morrison* was decided on June 24, 2010 by a unanimous 8-0 vote. It involved an issue of securities fraud, but the most important question in the case deals with the jurisdiction of the court. The decision of the Supreme Court is regarded as ground breaking as it rejected a number of years of federal jurisprudence involving extraterritorial application of US securities fraud legislation. In most general terms the *Morrison* decision limits claims that can be made in the US against companies not listed on a US stock exchange.

**Facts summary**

In 1998, National Australia Bank (NAB) – the respondent in the case – a big foreign bank whose shares were traded on securities exchanges in Australia, London, Tokyo and New Zealand, but not on any exchange in US, acquired the shares of HomeSide Lending, a company headquartered

---


in Florida involved in the business of servicing mortgages. In 2001, National Australia Bank was forced to write down the value of HomeSide’s assets, causing NAB’s share prices to fall. Australian citizens, having purchased NAB’s shares before the write-downs, brought a class action against respondents – NAB, HomeSide, and officers of both companies – in the US and Australia in a securities class action in the Federal District Court for violation of §§10(b) and 20(a) of the Securities and Exchange Act of 1934 and SEC Rule 10b–5. The claimants held that HomeSide and its officers were involved in manipulating financial models to make the company’s mortgage-servicing rights appear more valuable than they actually were. They also claimed that NAB and its chief executive officer were fully aware of this situation. The line of defence chosen by respondents was to claim lack of subject matter jurisdiction under the relevant provisions of the Federal Rule of Civil Procedure. The District Court found no jurisdiction because the US domestic acts were, at most, a link in a securities fraud that took place abroad. The Second Circuit affirmed the judgment of the District Court.

Judgment of the court

The US Supreme Court in its opinion written by Justice Scalia affirmed the position of the Second Circuit court. The Supreme Court’s opinion relied on the ‘longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.’ This principle is based on the understanding that US Congress passes legislation with respect to domestic matters, not foreign ones. The Supreme Court

15For a matter of additional clarity, a word on US court system is necessary. District courts are courts of first instance, Circuit courts – appellate courts and Supreme Court is the highest court.
Court relied also on its 1991 decision in *EEOC v. Arabian American Oil Co. (Aramco)*¹⁹, where extraterritorial application of Title VII of the Civil Rights Act of 1964 had been rejected on such grounds.²⁰

The Supreme Court’s opinion seems to have put an end to the so-called “foreign-cubed” cases— that is, claims brought in US courts under US securities laws by foreign claimants who acquired their shares in foreign companies on foreign stock exchanges. Indeed, the opinion came as a great disappointment to the potential foreign claimants who bought their shares on foreign exchanges to seek protection under the US securities laws in the US courts.²¹

In other words, the decision made it more difficult to bring a successful action under US securities laws in connection with purchases of securities made outside the US. One source of uncertainty about the effect of the decision relates to whether it will ultimately be reversed by legislation. The Dodd-Frank Act includes provisions that open the door to potentially expanding the extraterritorial reach of US securities class action litigation, which would restore certain investors’ ability to bring claims that may seem to have been excluded by the Morrison decision.²²

A look at recent filings against foreign companies highlights some characteristics of the kind of cases the Morrison decision may affect looking forward. From January 1, 2007 through June 30, 2010, there were 98 federal securities class actions filed against companies with their headquarters outside the US, about 13% of the total filings during this period. In more than half of these cases, investors who purchased or sold securities on a foreign (non-US) market were explicitly or implicitly included in the class definition set out in the complaint. The Morrison decision may limit such investors’ ability to bring a claim under US securities laws.²³ One might

---


See also
wish to venture here as far as claiming whole class action is struck out, where the class includes investors who bought securities on foreign exchanges. However, to be definitely sure that in fact is the case, an additional analysis that is beyond this paper would be necessary also in relation to examining the effect of the Dodd-Frank Act on the Morrison decision.

The critique delivered by Justice Scalia in the judgment can be easily applied to many of the previous authorities on extraterritoriality in other securities law precedents. Ever since deciding the Blue Chip Stamps v. Manor Drug Stores case, the Supreme Court has been consistent in limiting the scope of Section 10(b) and rejecting expansive interpretation of the provision supported by private plaintiffs as well as the SEC. While it is unlikely to ever reverse its decision to imply a private cause of action pursuant to Section 10(b), the Morrison decision continues the Court’s conservative approach to extra-territorial liability under Section 10(b) and confirms the Court’s intentions for it to remain within the current limits.

The Court discarded the “conduct” test (an analysis whether there was sufficient conduct in the US to support the application of the US securities law to a foreign company) and stated that the securities law rather required a "transaction" test, and effectively held that the US securities law does not apply to transactions that take place outside of the US.

The decision was an outright loss for the SEC. In the amicus brief submitted by the solicitor general, SEC argued in favour of the “conduct” test. The SEC argued that Section 10(b) applied to this conduct and, therefore, the SEC had the right to investigate and bring enforcement

---

26 ‘Supreme Court Protects Foreign Issuers from Securities Class Actions’ (Securities Litigation Alert; Akin Gump Strauss Hauer& Feld LLP, 28 June 2010) <http://www.akingump.com/files/Publication/e3168ce9-ba3a-4710-a83b-0213d3583700/Presentation/PublicationAttachment/39c8eae5-6ee6-4341-b7e6-fd52a3f84355/100628_Supreme_Court_Protects_Foreign_Issuers_from_Securities_Class_Actions.pdf> accessed 11 December 2010, p. 2
28 Amicus brief is an opinion submitted to the court by a volunteer, not a party to a case, to offer information to assist a court in deciding a matter before it. The decision on whether to admit the brief lies at the discretion of the court.
proceedings even if foreign investors might not be able to recover the losses they suffer as a result of this fraud. The Court unconditionally rejected this argument, as there was no support to it either in the statute or in precedent. Although it is likely that other rules of the Securities Exchange Act could apply to such fraudulent activities in which respect SEC may still have jurisdiction, at least to some extent, the inapplicability of Section 10(b), the principal antifraud provision of the Act, is a considerable loss to the SEC with regard to international fraud.30

The beneficiaries of the case are the foreign issuers, especially those who have recently faced securities litigation in the United States and/or suffered adverse verdicts, such as Vivendi Universal S.A.31, Fairfax Financial Holdings Limited32, Fortis N.V.33, Royal Dutch/Shell Transportation34, Bayer AG35, and Siemens AG.36 37

30‘Supreme Court Protects Foreign Issuers from Securities Class Actions’ (Securities Litigation Alert; Akin Gump Strauss Hauer & Feld LLP, 28 June 2010) <http://www.akingump.com/files/Publication/e3168ce9-ba3a-4710-a83b-0213d3583700/Presentation/PublicationAttachment/39c8eae5-6ee6-4341-b7e6-fd52a3f84355/100628_Supreme_Court_Protects_Foreign_Issuers_from_Securities_Class_Actions.pdf> accessed 11 December 2010, p. 2
35In re Bayer AG Securities Litigation, No. 03-1546 (S.D.N.Y.)
RiskMetrics Group as well as Kevin M. LaCroix — both prominent commentators of securities laws developments in the US, are concerned that the opinion of the court could lead foreign companies to decide not to list their shares on US exchanges, or to delist their shares, as a way to avoid the burden and expense of US-based litigation exposure. Finally, considering how significant a percentage of overall US-based securities class action filings the lawsuits against foreign companies have recently become, the reduction in these filings could mean a substantial decline in the total number of securities class action filings.

*Morrison overturned by Dodd-Frank?*  

Advisen, another prominent commentator of securities law developments in the US, suggests that certain provisions in the Dodd-Frank act were drafted in reaction to the Supreme Court decision. Title 9 of the Act is devoted to investor protection. It addresses, among other things, how to...
things, several key issues with respect to securities class actions.\textsuperscript{41} The Dodd-Frank Act provides federal court jurisdiction in certain actions brought by the SEC relating to fraud sections of the Securities Acts of both, 1933 and 1934, but also the Investment Companies Act 1940.\textsuperscript{42} The alleged fraud may involve conduct within the US that forms “significant steps” in a violation, even if the transaction itself occurred outside the US and involves only foreign traders.\textsuperscript{43}

The limitation on US securities fraud laws to domestic exchanges could mean as much as a 10% reduction in cases filed in US annually in addition to a reduction in size of numerous US class actions. Furthermore, collective remedies in various jurisdictions remain complicated and in certain cases, non-existent. However, RiskMetrics Group believes that such a scenario could very likely be only a short-term result. They believe there exists a high possibility that, considering the worldwide economic downturn, the claimants will more actively and effectively pursue a uniform collective action regulation within the EU and comparable remedies in other jurisdictions. Nevertheless, the Dodd-Frank Act gave a significant blow to the Morrison decision. The SEC’s authority to pursue market fraud all over the world on behalf of US investors is now uncontested. In addition, the possibility of civil penalties against aides and abettors under a much less stringent burden of proof will mean more significant and further reaching SEC enforcement actions on behalf of the aggrieved investors.\textsuperscript{44}

### III MERCK & CO., INC., ET. AL. V. REYNOLDS ET. AL.

**Facts summary**

In early November 2003, investors filed a securities fraud action under Section 10(b) of the Securities Exchange Act of 1934, claiming that Merck & Co. ‘knowingly misrepresented’ and therefore misled investors as to the hazardous side effects associated with its drug Vioxx. The statute of limitations regarding the securities fraud complaints provides, that it is made in time if filed not later than ‘2 years after the discovery of the facts constituting the violation’ or 5 years


\textsuperscript{42}Dodd-Frank Wall Street Reform and Consumer Protection Act.H. R. 4173, especially Title IX – Investor Protections and Improvements to the Regulation of Securities, Subtitle B—Increasing Regulatory Enforcement and Remedies. For example, Section 929P(b) authorizes an action brought by the SEC based on a statutorily defined conduct and effects test. Section 929Y directs the Commission to study whether private rights of action should be allowed on the same basis as authorized for the Commission in 929P(b).


after such violation has occurred. The claim was initially dismissed by the District Court as untimely because the plaintiffs should have been aware of the possibility of Merck’s misrepresentations before November 2001, over 2 years before filing the lawsuit, and they did not initiate a ‘diligent investigation’ at the time. There was a study conducted in March 2000 that compared Vioxx with the painkiller naproxen that had shown adverse cardiovascular results for Vioxx, which, according to Merck, were due to the so-called ‘naproxen hypothesis’. Secondly, FDA issued a warning letter that was released to the public in September 2001 indicating that Merck’s advertising campaign of Vioxx was ‘false, lacking in fair balance, or otherwise misleading’ with regards to the cardiovascular results. Thirdly, a number of pleadings filed in relation to products liability in September and October 2001 alleged that Merck had concealed the data they possessed about Vioxx and downplayed its risks on purpose. On appeal the Third Circuit reversed the decision by holding that the events prior to November 2001 did not suggest that Merck acted with scienter, being an element of Section 10(b) violation, and consequently the statute of limitation period did not begin to run.

45 U.S. Code Title 28 - Judiciary and Judicial Procedure, 28 U. S. C. §1658(b) provides “a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c (a)(47)), may be brought not later than the earlier of— 2 years after the discovery of the facts constituting the violation; or 5 years after such violation.”

46 The naproxen hypothesis implied that the results of the study were caused by the absence of a benefit conferred by naproxen rather than a harm caused by Vioxx. Merck & Co. v. Reynolds, No. 08-905, p. 7

47 FDA – Food and Drug Administration, an authority of the USA Department of Health and Human Services, responsible for protecting and promoting public health by regulation and supervision of food safety, tabacco, drugs, etc.

48 FDA warning letter – a correspondence open to the public, that notifies the industry of violations that FDA has discovered during inspection.

49Scienter – legal term that referring to intent or knowledge of wrongdoing.

50 In the United States, in order to prevail in a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934, a plaintiff must prove that the defendant acted with scienter. The meaning of scienter under this law has been highly controversial since the enactment of the Private Securities Litigation Reform Act of 1995. In 2007, the United States Supreme Court issued a decision in which it clarified what was to be understood as a "strong inference". In Tellabs, Inc. v. Makor Issues & Rights, LTD (21 June 2007), by an 8-1 ruling, the Court defined the standard that the plaintiff should meet in order to proceed with a securities fraud litigation: a complaint must show "cogent and compelling evidence" of scienter.


51Merck & Co. v. Reynolds, No. 08-905, p. 23
Judgment of the court

The Supreme Court’s unanimous 9-0 decision settled a dispute the circuit courts could not agree upon – as to the application of the statute of limitations for claims under Section 10(b) of the Securities Exchange Act of 1934. As lawyers at Milbank, Tweed, Hadley & McCloy indicate, one possible effect of this decision is to force defendants arguing for dismissal of Section 10(b) claims to choose either claiming that a plaintiff has not adequately pleaded scienter or arguing that the claims are untimely.52

In its judgment the Supreme Court expressly rejected decisions from several circuits53 that had regarded the two-year limitations period (‘after the discovery of the facts constituting the violation’) as beginning to run on the day when the plaintiff received ‘storm warnings’, sufficient to put one on ‘inquiry notice’54 to investigate whether he had been defrauded. According to the Supreme Court’s reasoning, material to the running of the statute of limitations is the ‘discovery of the facts’ and not the inquiry notices or storm warnings that may have taken place prior to the actual discovery and could have led to the discovery. The Supreme Court implicitly rejected Merck’s argument that, at least in situations where the plaintiff made no effort to investigate his claim, the limitations period should start to run from the point of inquiry notice. Another argument rejected by the Supreme Court was that of inquiry notice as the preferable triggering event because courts would find it complicated to decide ‘when a hypothetical reasonably diligent plaintiff would have discovered the necessary facts’, additionally noting that at least five circuit courts have already applied the approach without material difficulties.55

53 I.e. Franze v. Equitable Assurance, 296 F.3d 1250 (11th Cir. 2002); Theoharous v. Fong, 256 F.3d 1219 (11th Cir 2001); Fujisawa Pharmaceutical Co. v. Kapoor, 115 F.3d 1332 (7th Cir. 1997); Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc., 120 F.3d 893 (8th Cir. 1997); Dodds v. Cigna Securities, Inc., 12 F.3d 346 (2d Cir. 1993), all cited in Merck.
54 Merck & Co. v. Reynolds, No. 08-905,
See also Sheppard Mullin, ‘United States Supreme Court Clarifies Statute Of Limitations For Private Securities Actions’ (Corporate And Securities Law Blog, 7 May 2010)
Justice Scalia in his opinion concurring in part and concurring in the judgement, whereby Justice Thomas joined him, expressed a point worth of additional mentioning. He argued that, regardless of the contrary views of the parties and the Solicitor General, the actual wording of Section 1658(b)(1) permitted only a single reason for the limitations period – actual discovery of the facts constituting the violation. By comparing the above mentioned provision with the limitations period included in Section 13 of the Securities Act of 1933, explicitly referring to both actual discovery as well as to when the discovery should have been made by the exercise of reasonable diligence, Justice Scalia found no reason to read Section’s 1658(b)(1) reference to ‘discovery’ as including both alternatives and raised objections with the other members of the court that the broader understanding had been uniformly adopted by the circuit courts regarding limitations provisions of the Securities Exchange Act that similarly referred only to ‘discovery’.56

Implications of the judgment

Following the US Supreme Court’s clarification in this case as to the effect of the ‘inquiry notice’ and ‘storm warnings’ on the beginning of the limitations period, defendants in securities fraud cases have a high threshold to achieve in order to indicate plaintiffs failure to bring their claims within the two-year period set in Section 1658(b). Defendants are now obliged to show that the plaintiffs actually discovered or a reasonably acting plaintiff should have discovered the facts constituting the actual violation, including scienter. Pleading the application of scienter will require more than simply alleging facts that might show a materially false, misleading statement or omission.57

Shortly after the decision was announced, Washington Legal Foundation, a public interest law and policy centre, who filed an amicus brief in the Merck case, expressed its disappointment with the ruling. According to the Foundation’s Chief Counsel Richard Samp, it invites manipulation by investors. Instead of encouraging investors to sue promptly, the judgment provides them with the option to delay the lawsuit and take notice of the events happening in the market. One can be safe to state, that if during the delay, there is a rise in stock prices, the investor is delighted about his profits, but if the price drops, he is able to sue and recover his


damages. Consequently investors are granted an opportunity to manipulate federal securities law to minimize their market risk.58

The fact that there have since been relatively few new filings reflecting the potential longer limitations period so far does not indicate that there is no possibility for a rise in belated filings. The challenge this presents for both directors and officers insurance underwriters as well as companies is that it is more difficult now to be certain when a company which has adverse developments in the past may be ‘out of the woods’ with regards to the possible securities lawsuits.59

IV SECURITIES AND EXCHANGE COMMISSION V. EDWARDS

Facts summary

Charles Edwards established a company that sold pay telephones and then leased them back from the buyers for a fixed monthly fee. When Mr. Edwards filed for bankruptcy, the SEC sued him for selling securities without proper registration and disclosure, as it considered the telephones to be investments and therefore securities, violating the registration and anti-fraud provisions of the federal securities laws.

In a preliminary injunction, the federal district court froze Edwards’ assets. This decision was overruled by the 11th Circuit Court of Appeals for lack of jurisdiction. In the court’s reasoning, the SEC failed to show that the selling of the telephones could be qualified as an ‘investment contract’ under federal securities laws. While defining the ‘investment contract’, the court used the Supreme Court’s ruling in SEC v Howey60 from 1946, indicating that a financial interest is an ‘investment contract’ if it involves the following three conditions: firstly, it is an investment of money; secondly, it is invested in a common enterprise, and finally, that the investment is made with the expectation of profits to be derived solely from the efforts of others. According to the 11th Circuit’s ruling, SEC could not have argued that the final third test’s part was met, because the acquirers received a fixed fee indicated in the contract rather than a variable fee the amount of which is dependent on Edwards’ success.61


See also
Judgment of the court

In a unanimous 9-0 judgment delivered by Justice O’Connor in January 2004, the US Supreme Court held that an investment scheme with a fixed rate of return, can be an ‘investment contract’ and therefore, a security subject to federal securities law. The test applied by the court in this case was ‘whether the scheme involves an investment of money in a common enterprise with profits to come solely from the effort of others’. Because the test does not include a distinction between promises of fixed and variable returns, the scheme at issue in this case, can be defined as an ‘investment contract’.62

For a number of years, securities law has long covered a wide list of investment schemes similar to the pay telephones scheme of this case. One may argue that securities law should not be involved when only a sophisticated case of consumer fraud is at issue, but this has long ago been rejected.63

In general, the Supreme Court simply applied the conventional investment contract analysis to the facts of the case. The Court did not even hold that the investment scheme in the case was actually a security, it merely stated that the lower court made a mistake and should have applied the traditional analysis. As no cases were overruled, there is an opinion expressed that no extensive implications should be drawn.64

Nevertheless, the judgment voices alternative insights from both business and theory perspectives that are worth mentioning. Preventing fraud is at the core of federal securities regulation. However, the investment contract analysis ignores promoter’s material motivations


as to the legitimacy of the transaction. Consequently as federal securities law is applied, one might argue it eventually raises questions as to the principles of federalism.  

The Court’s support for a flexible and broad definition of securities and, therefore, covering more investors with the SEC protection may reflect that many new traders are entering the securities market. A lot of them are inexperienced, looking for additional retirement income when social security looks to be less secure. The general idea of protecting vulnerable investors from dishonest traders brings to mind the US Congress’ initial intention in the 1930s in creating the Securities Laws. It may seem that history is repeating itself by reference to the American experience from the early 1900s, where the securities fraud was a serious issue in light of the unregulated market and at a time where the states responded with ‘blue sky’ laws.  

V CRITICAL ANALYSIS

This section will concentrate on the critical analysis of the US Supreme Court judgements that were presented in the previous sections, with regards to the US Supreme Court’s participation in investor/consumer protection, its attempts to impose the duty of honesty and various other notions that could all be in general encompassed by a broad understanding of the information asymmetry theory. As well explained by George Akerlof, this theory deals with decisions in transactions where one party (the seller) has better information than the other (the buyer). Before we engage into identifying traces of information asymmetry in the cases analysed above, a few further words on the very theory would be of use. As already indicated above, information asymmetry covers various issues involved in the situations where one party to a deal has more (or better) information than the other. This creates an imbalance of powers that may lead to a market failure. Examples of this problem are adverse selection, moral hazard and others. One has to resist the temptation of venturing further into theoretical discussions of the matter here and such a naïve and simplified outline must suffice, since, firstly, the theory itself is not the topic of this paper, secondly, much has already been said in this area, and, finally, the reader is

66Blue sky law – state law in the US regulating the offering and sale of securities to protect the public from fraud.
69 Please see, for example, sources mentioned in the footnote above.
yet to be convinced information asymmetry is indeed present at all in the three cases analysed above.70

Evidence of the information asymmetry theory in the analysed cases

In order to clarify, where, in each of the three cases, the ideas of information asymmetry theory are present, a brief additional explanation is provided:

- Morrison – the Securities Exchange Act71 does not provide a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign stock exchanges. However, the relevant provisions of the Dodd-Frank Act72 at least partly reversing the judgment (some authors suggest - drafted in reaction to the judgment73) concentrate on investor protection (Title IX Subtitle B of the act) whereby federal courts are given jurisdiction in certain actions brought by the SEC relating to fraud sections of the Securities Acts of 193374 and 193475, as well as the Investment Companies Act of 194076. As the relevant provisions of the Dodd-Frank Act put it, the alleged fraud can involve conduct within the US that constitutes “significant steps” in a violation, even if the securities transaction occurred outside of the US and involves only foreign investors. Federal court jurisdiction is also established if the alleged

70 Should the reader wish to learn more about the information asymmetry theory, it should go without saying, such endeavor should start with familiarizing oneself with the Akerlof’s initial paper as cited above.
73 For example:
    or
    Mark A. Berube, ‘Fraud international’ (The Deal Magazine, 1 October 2010) <http://www.thedeal.com/newsweekly/community/soapbox-1/fraud-international.php#bottom> accessed 12 December 2010,
    To name but a few.
fraudulent conduct occurred outside of the US but has a foreseeable substantial effect within the US.

In other words, and considering the lack of efficient collective remedies in other jurisdictions - the SEC is granted the power to pursue market fraud worldwide on behalf of disappointed US investors (buyers)\textsuperscript{77}, which consequently means higher level of protection for the investors, and attempt to impose the duty of honesty on the sellers.

- Merck case – the statute of limitations begins to run once the plaintiff actually discovered or a reasonably diligent plaintiff would have discovered the facts constituting the violation – whichever comes first. Supreme Court noted that "inquiry notice" is only useful to the extent it describes the circumstances when a reasonably diligent plaintiff would have begun to investigate.

In terms of information asymmetry, the judgement provides the investors (buyers) time to think about the situation in the market and no need to sue promptly.

- SEC v. Edwards - an investment scheme promising a fixed rate of return can be an "investment contract" and thus a "security" subject to federal securities law. The test the Court used for determining whether a scheme is an "investment contract" is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." Because the test does not distinguish between promises of fixed returns and promises of variable returns, the scheme at issue here can be defined as an "investment contract."

Court decision (year 2003) in SEC. v. Edwards on covering more investors (buyers) with SEC protection reflected that there were more than ever new investors in the market and the aim of protecting new investors is similar to the one around the enactment of the Securities Acts back in 1930s on imposing the duty of honesty on the sellers.

Are securities – lemons in the US Supreme Court?\textsuperscript{78}

The notion of information asymmetry is not new at all in the judgments of the US Supreme Court. For example, evidences of these ideas can be found in cases involving the professional conduct of lawyers, the Kodak case of competition in the aftermarket, to name but a few, all of them later analyzed by academics in scholarly writings\textsuperscript{79}.

Information asymmetry in securities’ law cases in the US Supreme Court

Concentrating on the securities law, it has to be mentioned that the US Supreme Court made its first attempt to solve information asymmetry problem by imposing the duty of honesty in this sphere as early as 1909, when in Strong v. Rapide case it decided that firms must either disclose inside information or abstain from using it in trade\textsuperscript{80}. One cannot refrain from noticing here that the case had been decided over 20 years before the Securities’ Acts\textsuperscript{81} were enacted.

This and a number of other US Supreme Court cases relating to securities law\textsuperscript{82}, also the ones involving insider trading, all evoke in one or another way the ideas of information asymmetry


\textsuperscript{79} For lawyers - Are Lawyers – Lemons? see
For Kodak Case see

\textsuperscript{80} Strong v. Repide, 213 U.S. 419 (1909).


\textsuperscript{82} For example, Dirks v. SEC, 463 U.S. 646, 658 n.16 (1983); Chiarella v. United States, 445 U.S. 222, 231-32 (1980) (rejecting notion that federal securities laws were intended to provide equal access to all information), also Lowe v. SEC 472 U.S. 181 (1985), See

theory and attempts to solve the problem, though without using this explicit terminology. Consequently, it is definitely safe to say that in the US Supreme Court case-law, relating to securities law, one will most probably find traces of Akrelof’s ideas in each of them, it just depends on how deep one may sometimes have to look for them.

Furthermore, it is worth noting, as illustrated above, that it has taken the US Supreme Court 100 years of attempting to solve information asymmetry problems in securities law already, and one must be a true optimist to claim that the final solution has been found. The problem one notices in this situation is that US Supreme Court addresses the issue with a step-by-step approach and is therefore reluctant to show any bit of judicial radicalism in solving information asymmetry problems, which may be reasonably explained by its unwillingness to commit to a high level of judicial activism in securities law.

VI CONCLUSION

As a first part of the conclusion, let us have a final quick run through the judgments. In the *Morrison* case the Court held the Securities Exchange Act not to provide a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with securities traded on foreign stock exchanges. In the *Merck* case it was held the statute of limitations starts to run once the plaintiff actually discovers or a reasonably diligent plaintiff should discover the facts constituting the violation – whichever comes first. Finally, in the SEC v.*Edwards* the Court held that even a fixed-rate return investment scheme could be an "investment contract" and thus a "security" subject to federal securities law.

As an outcome, this paper provides a deep analysis of three recent US Supreme Court cases relating to securities law, supported by their facts as well as legal implications and evidence as to the presence of the information asymmetry problem in each of them and attempts of the US Supreme Court to solve it. It is apparent that the Court has spent over 100 years already looking for the solution to this problem in the particular area of securities law and, as there is no indications of a rise in the level of judicial activism in the area of clarifying information asymmetry, the only thing one can be certain of is that the story is not over yet. Finally, the present analysis, of almost randomly selected recent securities law cases, allows one to venture as far as saying that it’s more probable than not, any securities law case in front of the US Supreme Court involves a certain degree of reference to the information asymmetry theory.

VII BIBLIOGRAPHY

Legislation

- Securities Act of 1933, 15 U.S.C. § 77a
Case-law

- In re Bayer AG Securities Litigation, No. 03-1546 (S.D.N.Y.)
- Copeland v. Fortis, et al., 08 Civ. 09060 (S.D.N.Y.)
- Merck & Co. v. Reynolds, No. 08-905
- Parks v. Fairfax Financial Holdings, Ltd., et al., 06 Civ. 2820 (S.D.N.Y.)
- In re Royal Dutch/Shell Transport Securities Litigation, No. 04-374 (D.N.J.)
- Smith v. United States, 507 U.S. 197, 204 n.5 (1993)
- U.S. v. Siemens Aktiengesellschaft, No. 08-367 (D.D.C. Filed Dec. 15, 2008);
- In re Vivendi Universal, S.A. Sec. Litigation, 02 Civ. 5571 (RJH/HBP)(S.D.N.Y.)

Consultative documents


Books

- de Tocqueville, Alexis, Democracy in America (George Lawrence tr, J.P. Mayer ed, Garden City, N.Y.: Doubleday 1969)
Journals, Newspapers and Online resources
