07-0583-cv

United States Court of Appeals

for the

Second Circuit

ROBERT MORRISON, individually and on behalf of all others similarly situated,
RUSSELL LESLIE OWEN, BRIAN SILVERLOCK
and GERALDINE SILVERLOCK,

Plaintiffs-Appellants,

MARIA KENNEDY, HARVARD B. KOLM and NORMAN HAUGE,

Plaintiffs,

– v. –

NATIONAL AUSTRALIA BANK LTD., HOMESIDE LENDING INC.,
FRANK CICUTTO, HUGH HARRIS, KEVIN RACE and W. BLAKE WILSON,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF AND SPECIAL APPENDIX FOR PLAINTIFFS-APPELLANTS

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PRELIMINARY STATEMENT

This appeal is from a final judgment of the United States District Court for the Southern District of New York (Honorable Barbara S. Jones, U.S.D.J.), entered on January 16, 2007 (SPA. 24)[1], and the Order, entered on October 26, 2006 (SPA. 1), dismissing the Consolidated Class Action Complaint.

JURISDICTIONAL STATEMENT

Plaintiffs-Appellants allege in the Complaint that the district court has subject matter jurisdiction over this action pursuant to Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa, and 28 U.S.C. §§ 1331 and 1337.

The Court has jurisdiction over this appeal pursuant to 28 U.S.C. § 1291 in that a final judgment disposing of all claims with respect to all remaining parties was entered in the United States District Court for the Southern District of New York on January 16, 2007 and the Notice of Appeal was timely filed with the district court clerk on February 13, 2007 pursuant to Fed. R. Civ. P. 3-4.

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[1] Numerical references in parenthesis in the form "(A.__)" refer to pages of the Joint Appendix filed in this matter. Numerical references in parenthesis in the form "(SPA. __)" refer to pages of the Special Appendix filed in this matter.

STATEMENT OF THE ISSUES PRESENTED

1. Whether the district court has subject matter jurisdiction over the federal securities claims brought by Australian shareholders of an Australia-based corporate parent where such claims arose from a massive accounting fraud perpetrated in Florida by Florida residents who were officers of a Florida-based subsidiary of that Australian corporate parent?

2. Whether the district court has subject matter jurisdiction over the federal securities claims brought by Australian shareholders against those defendants who resided in Florida and who conceived and executed the securities fraud in Florida?

STATEMENT OF THE CASE

This is an action brought by Plaintiffs-Appellants Russell Leslie Owen ("Owen") and Brian and Geraldine Silverlock (the "Silverlocks"), residents of Australia (the "Foreign Plaintiffs"), and Robert Morrison ("Morrison"), a resident of the United States (collectively, "Plaintiffs"), against defendants National Australia Bank ("NAB"), Frank Cicutti ("Cicutti"), an officer of NAB, HomeSide Lending, Inc. ("HomeSide"), a Florida-based subsidiary of NAB, and Hugh Harris ("Harris"), Kevin Race

("Race") and W. Blake Wilson ("Wilson"), officers of HomeSide, arising from accounting fraud at HomeSide.

HomeSide was at one time the sixth largest mortgage servicer in the United States, and at all relevant times was NAB's principal subsidiary in the United States. Plaintiffs allege that defendants violated the federal securities laws by intentionally overvaluing HomeSide's portfolio with the selection of unduly aggressive mortgage prepayment speeds, in violation of Generally Accepted Accounting Principles ("GAAP"), which defendants knew were incorrect and which were chosen solely in order to achieve over-inflated earnings targets. When the accounting fraud was uncovered and disclosed, NAB announced two massive writedowns totaling well over A$3 billion.[2]

The original Complaint was filed on August 28, 2003. (A. 13) By Stipulation and Order entered on December 3, 2003, Morrison, Owen and the Silverlocks were appointed lead plaintiffs. (A. 61) The Consolidated Class Action Complaint ("Complaint") was filed on January 30, 2004. (A. 70)

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[2] The symbol "A" denotes Australian dollars. As of April 30, 2007, one Australian dollar was worth approximately US$0.83.

Defendants filed their motions to dismiss on March 11, 2004. (A. 120) Plaintiffs, in opposition to the motions, submitted the Certification of Bela Borg Brenner (A. 1425) and the Affidavit of Robert W. Berliner, CPA. (A. 1418) Brenner, an expert in the mortgage-backed securities industry, analyzed HomeSide's internal prepayment speeds and rates that counsel obtained from a confidential witness, and concluded, among other things, that:

> (c) The process by which NAB chose its prepayment speeds to value its mortgage portfolio was an extreme departure from industry standards, could not have happened by chance or even gross sloppiness and was pervasive in the period reviewed. In my opinion given the pervasiveness and the size of the differences from the Bloomberg published rate and other reported sources, I infer that this conduct constituted a conscious effort to misrepresent the value of the [Mortgage Servicing Rights].

(A. 1425-26)

Berliner, a certified public accountant and certified fraud examiner, analyzed HomeSide's actions, all of which occurred in Florida, and explained how those actions violated GAAP, and how HomeSide's resulting financials, which were reported by its parent NAB, were false and misleading. (A. 1418-21)

Notwithstanding uncontroverted proof of the perpetration of the fraud in Florida, documented and corroborated by the internal records of HomeSide provided to counsel by confidential witnesses, the district court, in an Opinion entered on October 26, 2004: (a) dismissed the securities claims of Morrison, the United States domestic lead plaintiff, finding that Morrison did not suffer any losses; and (b) dismissed the securities claims of Owen and the Silverlocks, on the grounds that the district court did not have subject matter jurisdiction over the Foreign Plaintiffs' claims. (SPA. 5-20)[3]

The district court entered final judgment on January 16, 2007. (SPA. 22-23) This appeal followed.

STATEMENT OF FACTS[4]

The Defendants

Headquartered in Melbourne, Australia, NAB is organized under the laws of Australia and is that country's largest bank. (A. 72) NAB's ordinary shares trade on the Australian securities exchanges, and its

[3] The district court permitted plaintiffs to file an amended complaint on behalf of domestic purchasers of NAB securities only. Plaintiffs subsequently dismissed that amended complaint (A. 1450) pursuant to a Stipulation and Order entered on January 11, 2007 (A. 1503), in order to pursue this appeal.

[4] Since the district court dismissed the claims of the Foreign Plaintiffs pursuant to Fed. R. Civ. P. 12(b)(6), this Court "must take all facts alleged in the complaint as true and draw all reasonable inferences in favor of plaintiff." Raila v. United States, 355 F.3d 118, 119 (2d Cir. 2004).

American Depositary Receipts ("ADRs")[5] trade on the New York Stock Exchange. (Id.) Cicutti was NAB's Managing Director and Chief Executive Officer. (A. 73)

At all relevant times, HomeSide was a wholly-owned subsidiary of NAB, located in Jacksonville, Florida. (Id.)[6] HomeSide was a mortgage service provider, meaning it serviced mortgages in return for a fee. (A. 73) Harris, Race and Wilson served as HomeSide's Chief Executive Officer, Chief Operating Officer, and Chief Financial Officer, respectively, from April 1999 until each man "resigned" on September 4, 2001. (A. 73-74)

HomeSide's Key Role In NAB's Global Expansion And Revenue Diversification

NAB aspired to become a global financial institution. (A. 79) In order to achieve this goal, NAB was compelled to look outside its domestic market for its primary areas of growth, as Australia has a population of approximately 20 million people. (A. 79)

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[5] An "ADR" is a negotiable certificate issued by a U.S. depositary bank that represents a specified number of shares of a foreign security that have been deposited with a foreign branch or agent of the depositary. ADRs are registered with the Securities and Exchange Commission ("SEC") and are governed by the provisions of the federal securities laws. (A. 75) In particular, NAB was required to file with the SEC Forms 6 and 20, which are nearly analogous to Forms 10-Q and 10K filed with the SEC by U.S. corporations.

[6] After the stunning revelation in September 2001 of the A$3.05 billion writedown that NAB was forced to book, NAB sold HomeSide to Washington Mutual, Inc. (A. 73)

In its 1999 Annual Report for the fiscal year ending September 30, 1999, NAB highlighted its moves to expand globally:

> The geographic diversity of [NAB's] operations does more than reduce the risk of being dependent on one market. Our international operations create economies of scale and a customer base that, in aggregate, are well above the ability of any one bank to achieve in a market the size of Australia.

(A. 79) The report went on to state that:

> in 1999, half of the Group's profit came from our international operations. The key international regions, Europe, New Zealand and the United States all increased their profit contribution. The benefits of recent international acquisitions, such as the United States based HomeSide International, Inc., a mortgage origination and service operation, go beyond the addition of revenues and profits in the near term. These businesses fit within [NAB's] overall growth strategy and provide key benefits in sustaining shareholder value.

(A. 79)

By the year 2000, NAB Chairman Mark Rayner boasted that more than 45 percent of NAB's assets and revenues were outside Australia and, that based on profitability, NAB was one of the 25 largest banks in the world. (A. 80) He reinforced NAB's growth philosophy when he stated on December 14, 2000 at NAB's annual general meeting that, "The bottom line is that only companies of adequate size will attract core capital of the major long term investors. So growth is important." (A. 80)

Another important element of NAB's strategy had been the company's efforts to reduce its dependency on interest income. This reduction, the 1999 Annual Report stated, was the result of NAB's efforts to increase its involvement in businesses, such as HomeSide, that have substantial fee income potential. Indeed, in 1999, NAB earned nearly 43 percent of its income from non-interest sources such as "fees from mortgage servicing in the United States, treasury income and fees from the marketing of a variety of innovative financial services products." (A. 79)

Cicutti later boasted that, in the year 2000, more than 50 percent of NAB's revenues came from non-interest sources, compared to 35 percent five years earlier, and that 40 percent of these non-interest income sources did not exist five years ago. According to Cicutti, this represented a "marked transformation of NAB." (A. 80)

NAB could hardly hope to realize its ambition to be an international financial services company without an active and expanding presence in the United States. Thus, HomeSide was critical to NAB's presence in the United States, or at least the perception of that commitment, particularly after NAB announced the sale of its other significant U.S. business,

Michigan National Corporation, for approximately A$5.3 billion in November 2000. (A. 80-81)

Thus, HomeSide was critical to NAB for several reasons. First, it bolstered NAB's United States presence, particularly after the sale of Michigan National Corporation. Second, it was an important step in NAB's international growth strategy. Third, and perhaps most important, it appeared, at least initially, to strongly support Cicutti's boast of the growth of non-interest sources of income for NAB. (A. 81)

HomeSide's Business And NAB's Reaping Of Fraudulent Profits From 1999 To 2001

NAB acquired HomeSide on February 11, 1998, for $1.22 billion. (A. 81) As a mortgage service provider, HomeSide serviced mortgages in return for a fee. (A. 81) Those fees represented a source of future income for HomeSide (and NAB), the present value of which was calculated by HomeSide, in Florida, using valuation models. NAB then booked the resulting value on its balance sheet as an asset, known as Mortgage Servicing Rights ("MSR"), and amortized the value over the MSR's expected life. (A. 82)

The basic way for a mortgage service provider like HomeSide to increase its profitability is to increase its originations, i.e., the number of

loans it services, and hope that interest rates remain at such levels that the mortgages are not repaid. (A. 82) Accordingly, NAB, anxious to portray itself as a growing and integrated international financial company, drastically increased HomeSide's mortgage servicing portfolio by acquiring portfolios from other mortgage servicing companies. (A. 82, 85) As a result of NAB's strategy of growing HomeSide by acquisitions, by March 2000, HomeSide's mortgage servicing portfolio had grown to approximately $188 billion, making HomeSide the sixth largest mortgage servicer in the United States. (A. 82)

Not long after NAB acquired HomeSide, Race was publicly touting the strength of HomeSide's business, despite the challenging environment faced by the mortgage industry as a whole in 1999 resulting from declining interest rates and the resulting prepayment of existing mortgages leaving fewer "assets" or mortgages to "service." The American Banker quoted Race as saying that HomeSide was "insulated from a downturn because it does not have retail branches and gets most of its mortgages from brokers, correspondents, and banks that agree to sell HomeSide all their loans." (A. 84-85)

Race's optimism appeared to be well-founded, for on July 22, 1999, NAB reported that HomeSide had contributed A$37 million to NAB's profit for the period ending June 30, 1999. The press release also stated, in relevant part:

> Mr. Cicutti said the pleasing features of the latest results included the strong growth in lending and the continued increase in non interest income.
>
> Mr. Cicutti also noted the progress of the Group's global wholesale financial services business and the rapid development of its product specialists such as HomeSide and other financial services.
>
> "Looking ahead, we will continue to focus on diversification of our business and the capturing of the benefits of our global structure."

(A. 86)

On November 4, 1999, NAB announced record operating profits of A$2.82 billion for the fiscal year 1999, an increase of 12.3 percent over the prior year's results. In HomeSide's first year, it earned A$313 million in mortgage servicing fees, and contributed A$153 million to NAB's net profits. (A. 86-87) In touting NAB's success -- *particularly with regard to HomeSide* -- Cicutti stated:

> We made considerable progress with a number of key strategic initiatives such as the implementation of our global business model, the integration of HomeSide and the acceleration of our

> e-commerce program . . . [E]ach of these individual successes are indicative of the confidence with which the Group has pursued its Australian and global ambitions.

(A. 87)

HomeSide's solid contributions to NAB continued into the year 2000. In a May 4, 2000 press release, NAB announced record half-year results, which included an after-tax operating profit of A$1.57 billion, a full 13.2 percent higher than the same period the prior year. (A. 88) Other operating income, which included HomeSide's mortgage servicing fees, was A$2.47 billion – an increase of 9.8 percent. Earnings from NAB's international operations had increased 16.6 percent, representing nearly 50 percent of NAB's after-tax profit. Specifically, profits from the United States had increased to A$265 million, which included "a solid contribution from Michigan National Corporation, higher profits from HomeSide and interest income attributable to the issue of National Income Securities in June 1999."[7] (A. 88)

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[7] Riding the wave of HomeSide's successes and contributions to NAB's rising earnings and increasing stock price, NAB issued over $1 billion in National Income Securities on June 29, 1999. (A. 86) NAB would later do the same in early 2001, when it issued over $1.1 billion in mortgage-backed securities, a move aimed at diversifying NAB's funding sources and increasing its available capital. (A. 92)

On July 27, 2000, an NAB press release announced that for the quarter ending June 30, 2000, NAB posted an after-tax profit of A$829 million – an increase of 18.9 percent over the prior year. In commenting on NAB's performance, Cicutti stated that the result was solid, given that it was achieved against a backdrop of increasingly difficult conditions for HomeSide in the United States, meaning that interest rates were declining, thus raising the risk that mortgages would be repaid. (A. 89-90)

Similarly, on November 2, 2000, NAB announced "record" profits of A$3.37 billion for its fiscal year ending September 30, 2000, of which 47.3 percent was generated from outside Australia. In its press release, NAB highlighted the facts that non-interest income from mortgage activities and other fee-generating business rose 43 percent from 1999, and that "HomeSide continued to expand its operations in the United States . . . ." (A. 90-91)

According to NAB's 2000 Form 20-F filed with the SEC at the end of 2000, HomeSide contributed to NAB after-tax profits of A$141 million, and A$535 million to NAB's operating income. HomeSide's contribution was said to have been generated by its mortgage servicing fees, which had increased 71.5 percent because of "an increase in the servicing portfolio due

to higher volumes from strategic alliances entered into during 1999," notwithstanding falling interest rates. (A. 91)

Although falling interest rates and other factors in 2001 made the environment increasingly difficult for companies in the mortgage industry, the supposed good news at NAB and HomeSide continued. On May 10, 2001, NAB announced that for the six months ending March 31, 2001, NAB had a "strong" 28.7 percent increase in net after-tax profit to A$4.02 billion. (A. 93) With respect to HomeSide, the press release also reported, in relevant part:

> HomeSide's contribution fell to $71 million after tax from $84 million; however this represents an improvement on the September 2000 half contribution of $48 million. The improvement is due to a 9.7% increase in profit from the US operations, which reflects *the recent recovery of production volumes in the US due to falling mortgage interest rates*, the development of the Australian business, and the impact of the weaker Australian dollar. . .

(A. 93) (emphasis added). NAB was suggesting that it and HomeSide were weathering the storm of lower interest rates and that "new" mortgages originated at these lower rates outweighed the "disappearance" of existing mortgages at higher interest rates that were being paid off.

On June 4, 2001, the Australian Financial Review published an article that quoted Andrew Linklater, an NAB executive, as saying: "NAB's

HomeSide-branded mortgages, which were sold via mortgage brokers, had delivered 100 per cent growth per annum over the past two years." (A. 93)

The Fraud Unravels: The First Writedown

After nearly three full years of NAB's rosy predictions and waving the HomeSide flag, NAB announced on July 5, 2001 that it would write-down A$568 million on HomeSide's balance sheet value of HomeSide's mortgage servicing rights assets. (A. 94) The writedown represented nearly 10 percent of the then-current book value of HomeSide's mortgage servicing rights assets. (A. 94) In reaction to news, NAB's ordinary shares fell A$1.80, or more than 5 percent. (A. 94)

Despite the writedown, Cicutti, in a press release NAB issued that same day, sounded a decidedly reassuring tone: "Our underlying business is strong and performing well." He added that the writedown "reflects the fact that we are a prudent bank with a disciplined approach for managing risk. That is why we have responded decisively and expeditiously to deal with this." (A. 94) The clear message to investors and the public: problem solved.

The Restatement

But the problem was far from solved. Just *two weeks* after these confident reassurances, NAB announced on Monday, September 3, 2001, that it would incur a A$3.05 *billion* writedown of the carrying value of HomeSide's operations - all related directly or indirectly to the value of the MSR assets and business of HomeSide. (A. 95)

Cicutti announced that NAB was forced to take the writedown because during its review of HomeSide's market sales value, NAB "discovered" that the carrying value of HomeSide's MSR far exceeded its actual value, and the MSR – HomeSide's most significant asset – was "impaired." (A. 95) See SFAS No. 144 (impairment defined as "the condition that exists when the carrying amount of a long-lived asset . . . exceeds its fair value").

In the wake of the announcement, on September 3, 2001, NAB's ordinary shares on the Sydney Stock Exchange fell A$4.30 to A$28.90. When trading resumed in the United States after the Labor Day holiday, NAB's ADRs fell US$10.24 to US$78.24. (A. 96) NAB, in its Amended Form 10-Q filed with the SEC on December 6, 2001, detailed the process of correcting errors in its previously issued financial statements related to

HomeSide. The restatement consisted of the following items: A$755 million from the incorrect "interest rate assumptions" used in HomeSide's mortgage servicing rights assets; A$1.43 billion from other changed assumptions in the evaluation of the mortgage servicing rights; and A$858 million from a writedown of goodwill related to HomeSide. (A. 95-96) In essence, NAB acknowledged that its investment, and the overall investment of NAB shareholders, in HomeSide was substantially reduced by the accounting fraud.

NAB, In Assigning One Of Its Senior Officers To HomeSide, Was Fully Aware Of The Accounting Fraud

NAB, when it acquired HomeSide in February 1998, installed one of its Australian officers and/or employees, Dave Thompson, at HomeSide. Thompson, who relocated to Florida from Australia, continued in this position at HomeSide during the relevant time period and acted as the interface between HomeSide and NAB. Thompson's position at HomeSide provided him with full access to and knowledge of the accounting fraud at HomeSide. Thus, Thompson, who had virtually daily contact with NAB, constitutes another link by which NAB was apprised of, monitored and controlled the business operations at HomeSide, and permitted the fraudulent activity to continue. (A. 1484)

The "Resignations" Of HomeSide's Senior Officers

In addition to the fallout from the restatement, there were other casualties from the public disclosure of the fraud. On September 4, 2001, Harris, Race and Wilson abruptly "resigned" from their posts at HomeSide. (A. 96) In addition, during the weekend prior to the disclosure of the writedown, Mark Rayner had formally resigned as Chairman of NAB, having stepped aside purportedly because of a potential conflict of interest in another manner. (A. 96) Chris Matton, the head of group capital and balance sheet management at NAB, when asked to comment on the writedown, reportedly stated that he would take his knowledge with him "to the grave." (A. 96)

The writedown and its aftermath were disastrous to NAB. Charles Allen, who was appointed Chairman of NAB at an emergency Board meeting on Sunday, September 2, 2001, rightly described the writedown as "a disaster for the organization," adding that "no other [NAB] chief executive has stood before you to announce a provision of this size." (A. 97)

NAB's Spin – "Inadvertent Errors" –
And The Wachtell Investigation

Not surprisingly, NAB took great pains to portray the writedown and restatement as the product of simple error. For example, in its Form 6-K for the year 2001, NAB stated that the problem at HomeSide was "discovered" to be an "incorrect interest assumption":

> In September, an incorrect interest rate assumption in the MSR valuation model was discovered, which had caused the model to understate HomeSide's sensitivity to interest rate movements, and overstate the value of its servicing rights, leaving the Group underhedged.

(A. 97)

Despite NAB's and HomeSide's public assurances that the massive writedown and restatement were merely the product of mistake, the NAB Board of Directors quickly hired Wachtell, Lipton, Rosen & Katz to conduct a worldwide investigation into the events leading to the writedowns.[8]

(A. 100)

NAB's Prior Warnings

Soon after the September 2001 restatement, news began emerging that NAB had received ample and early warnings about the problems at

[8] Wachtell, with the assistance of Promontory Financial Group, provided NAB's Board with a report (the "Wachtell Report") in early 2002. A summary of the Wachtell Report was later sent to all NAB shareholders. (A. 100)

HomeSide. For example, according to a September 8, 2001 Australian Financial Review article, not only did "some of the blame . . . lie with Cicutti and his team," but NAB officials had been warned about HomeSide's accounting problems. (A. 98-99)

The article also recounted that, according to one former executive, "A lot of people were very concerned and came to me and I asked them to look into it, *but it was ignored*." Id. (emphasis added) The article continued:

> Deep in the bowels of HomeSide's Jacksonville, Florida headquarters, another time bomb was ticking away.
>
> In the northern autumn of 1999, HomeSide's computers were overhauled. As part of the change, a computer model that worked out the fees the business could expect was replaced. The model was vital to working out how much the HomeSide business was worth. It did this by estimating future interest rates and how quickly clients would pay off their home loans. It used a gross interest rate figure.
>
> The new model used a net interest figure. *HomeSide executives made a very simple and stupid mistake: they accidentally plugged the gross interest figure into the new model. The blunder – which was uncovered only during the past week – meant that since 1999, HomeSide's future revenue had been grossly over-estimated.*
>
> * * *
>
> The question remains: How did the bank which had first expanded overseas in 1987 suddenly find itself in so much difficulty?

> The answer, according to the former NAB executives, is that HomeSide had *too much independence*. *There was not enough hands-on control from Melbourne*.

(A. 98-99) (emphases added)

Similarly, an article in Bulletin, in commenting on the Wachtell Report, wrote in relevant part that:

> the snippets [of the Wachtell Report] that NAB . . . did share with the bank's owners show *just how lax the NAB's internal risk controls had become between 1999 and 2001*.
>
> * * *
>
> *NAB's senior management had been warned about the financial risks entailed in managing HomeSide's $US 180 bn ($355 bn) mortgage portfolio but a lack of follow-up and implementation left the bank exposed to huge losses in the event of unforeseen and large moves in interest rates.* It's probably safe to assume the Wachtell Lipton report did not use the term "asleep at the wheel" but in my opinion that is the report's central conclusion.

(A. 100) (emphases added)

The Truth Emerges Concerning The Accounting Fraud

The problems at HomeSide were not caused by inadvertent errors or mere mistakes. The real reason for the writedown and restatement was fraud. Several employees and top executives at HomeSide had been cooking HomeSide's books since at least April 1999. (A. 101) Based, in part, on the investigation of counsel and analysis of HomeSide's internal data, as reflected in the pleadings, HomeSide executives Harris, Race and Wilson,

along with HomeSide employees Jay B. Busker and Azad Rafat, had been deliberately overvaluing HomeSide's mortgage portfolio – in a declining interest rate environment where customers were refinancing to pay off mortgages that were being serviced by HomeSide – by hundreds of millions of dollars. (A. 101) These HomeSide employees had been doing so by modifying the various assumptions in the computer data HomeSide used to produce the MSR valuations. (Id.)

The Impact Of Declining Interest Rates

As noted, early repayments on mortgages affect the value of MSR because they shorten the life over which the mortgage service provider receives fees on the loans it services. To analyze the effect of early repayment, its likelihood and the impact upon MSR, HomeSide utilized certain software systems to value its mortgage servicing rights for its balance sheet pursuant to GAAP. (A. 82) The software used market-based assumptions that HomeSide downloaded each month, including mortgage prepayment speeds (commonly referred to as "PSA" rates), discount assumptions and cost assumptions. These assumptions were then "plugged" into HomeSide's valuation model. (A. 101-02) In addition, HomeSide, like all mortgage servicers, hedged against the risk of early repayment. (A. 82)

To achieve the valuation numbers that met its earnings targets, HomeSide then ran its models for each "tranche"[9] of mortgages using assumptions that deviated significantly from the market-based data it had downloaded. (A. 102) In short, HomeSide knowingly manipulated the prepayment and discount rate assumptions in a declining interest rate environment to lengthen the average life and duration of its mortgage portfolio, thereby keeping alive the income stream derived from servicing those mortgages, many of which were being paid off because of lower interest rates. (A. 102)[10] HomeSide thereby artificially created the appearance that the income stream was still alive.

Applying the Bloomberg PSA rates to models that value a mortgage portfolio is an accepted industry standard. (A. 103) However, the process by which HomeSide selected the various PSA rates to value HomeSide's mortgage portfolio was not reasonable and not consistent with industry

[9] A tranche is a group of mortgages with the same maturity, interest rate and risk characteristics. For example, one tranche might comprise 15-year Ginnie Mae mortgages, another, 30-year Ginnie Mae mortgages. (A. 102)

[10] Put another way, as interest rates go down, mortgage holders prepay and refinance their mortgages to take advantage of the lower rates. The "rate" of these prepayments is reflected in the PSA speed. The higher the PSA, the faster the level of prepayment. As mortgages are prepaid, the MSR "asset" disappears because a prepaid mortgage no longer exists to be "serviced"; the result is that there is no future earnings stream attributable to those servicing rights. In sum, the rate of prepayment, as embodied in the PSA rate, affects the current value of the MSR asset, as well as the company's future earnings. (A. 102)

standards. (A. 103-04) Indeed, HomeSide tested various PSA rates that were significantly slower – meaning the "life" of the mortgages would be longer and the mortgage servicing rights would be extended – than the Bloomberg medians until its internal models produced a dollar value that satisfied the company's bidding – i.e., *meeting its expected earnings targets*. (A. 101-02)

In some instances, HomeSide hand-picked PSA rates that were up to *379 percent slower* than the Bloomberg median rate. (A. 103, 106) For example, in January 2000, HomeSide chose a PSA rate for certain newly-originated 30-year mortgages which was *85 percent slower* than the Bloomberg median PSA. (A. 104) Similarly, in January 2000, HomeSide selected PSA rates for its various Ginnie Mae mortgages which were 30 to 379 percent slower than the Bloomberg median rate. Meanwhile, the PSA rate HomeSide used for certain moderately-seasoned Ginnie Mae 30-year mortgages was up to 112 percent slower than the Bloomberg median rates. (A. 106) This conduct constituted a conscious effort to misrepresent the value of the portfolios and the service fees that the portfolios would generate overtime. (A. 1425-26)

Defendants' Accounting Fraud Violated GAAP

Indeed, the process by which defendants chose the prepayment speeds to value the mortgage portfolio was an extreme departure from industry standards and violated GAAP; it could not have happened by chance or even gross sloppiness; and, it was pervasive in the Class Period. Given the pervasiveness and the size of the differences from the Bloomberg published rate and other reported sources, this conduct -- all of which occurred in Florida -- constituted a deliberate effort to misrepresent the value of the MSRs. (A. 1418-20)

HomeSide Employees Notified NAB Of The Fraud

It goes without saying that, because HomeSide's top executives and certain other employees were the individuals who had been cooking the company's books in Florida, HomeSide had actual knowledge of the fraud. (A. 101) Yet NAB was not just reckless when it chose to ignore the many warning signs of accounting, hedging and internal control problems at HomeSide, as described above. Indeed, perhaps the most significant "warning" that NAB officials received was more than simply a warning – in July 2000, *HomeSide employees specifically notified NAB that HomeSide was engaged in accounting fraud.*

In July 2000, several HomeSide employees blew the whistle on the fraud that they witnessed taking place at HomeSide's offices in Florida. (A. 107) The employees sent a letter to Cicutti, members of NAB's risk management group in Melbourne, and KPMG, the bank's outside auditor. (Id.) The letter did not simply say that there was "fraud" taking place at HomeSide; rather, the letter detailed the *specific processes* Harris, Race and Wilson and others were using to manipulate the prepayment and discount rate assumptions HomeSide used to value its MSR, the business's most significant asset. (Id.) In addition, the whistle-blowing employees directed Cicutti, NAB's risk management team, and KPMG to *specific electronic files* that contained data which confirmed and documented the fraudulent scheme. (Id.) *Thus, for more than 13 months prior to NAB's disclosure that it would write off A$3.5 billion due to problems at HomeSide, NAB and Cicutti had direct knowledge of the fraud that was used to make HomeSide's and NAB's financial situations appear significantly better than they actually were*. (A. 108)

SUMMARY OF THE ARGUMENT

This Court's de novo review of the district court's ruling on subject matter jurisdiction, S.E.C. v. Berger, 322 F.3d 187, 191 (2d Cir. 2003), is

particularly crucial here since the district court, in addressing defendants' motions to dismiss for lack of subject matter jurisdiction, acknowledged that "the instant case presents a close call . . . ." (SPA. 18) While the district court held that it "is ultimately left with the impression that the Lead Foreign Plaintiffs have not met their burden of demonstrating that Congress intended to extend the reach of its laws to the predominantly foreign securities transactions at issue here" (SPA. 18-19), the district court's ruling ignored that the entire accounting fraud at issue occurred in the United States. If affirmed, the district court's decision would overrule Congressional intent and this Court's controlling precedent.

As Judge Friendly stated:

> We do not think Congress intended to allow the United States to be used as a base for manufacturing security devices for export, even when these are peddled only to foreigners. This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States.

ITT v. Vencap, Ltd., 519 F.2d 1001, 1017 (2d Cir. 1975). Even Judge Jones has acknowledged in another case the importance of Judge Friendly's holding. See Europe & Overseas Commodity Traders, S.A. v. Banque Paribas London, 940 F. Supp. 528, 535 (S.D.N.Y. 1996) (Jones, J.), aff'd

147 F.3d 118 (2d Cir. 1998). The holding of ITT and subsequent precedent of this Court mandate reversal of the district court's opinion.

The central question presented on this appeal is whether a massive accounting fraud perpetrated by a U.S.-based subsidiary in the State of Florida, by Florida residents, is actionable under the U.S. securities laws when that fraudulent financial information is then consolidated by the subsidiary's overseas corporate parent for inclusion in the parent's financial statements. Under the relevant "conduct" test used by this Court, the answer is most certainly yes. This is *not* a case where the predicate fraudulent acts underlying the misleading statements occurred overseas; to the contrary, the day-to-day misconduct that rendered the defendants' public statements false and misleading took place on American soil at HomeSide's offices in Jacksonville, Florida. A finding here that the court does not have subject matter jurisdiction over the defrauded foreign investors' claims would disregard this Court's holdings during the past 30 years and, to use the words of Judge Friendly, as repeated by Judge Jones, ignore the policy that "Congress does not want the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are

peddled only to foreigners." Europe & Overseas Commodity Traders, S.A., 940 F. Supp. at 535.

ARGUMENT

I. THE COMPLAINT ALLEGES SUFFICIENT FACTS TO SUPPORT SUBJECT MATTER JURISDICTION OVER THE FOREIGN PLAINTIFFS' CLAIMS

A. The Conduct Test Provides That Jurisdiction Exists Over Conduct Occurring Predominantly In The United States

The district court has subject matter jurisdiction over the claims of the Foreign Plaintiffs and all other Australian purchasers of NAB's common stock because the predicate acts underlying the fraud occurred right here on American soil. "It is elementary that the anti-fraud provisions of the federal securities laws apply to many transactions which are neither within the registration requirements nor on organized American markets." Europe & Overseas Commodity Traders v. Banque Paribas London, 147 F.3d 118, 123 (2d Cir. 1998) (citing Bersch, 519 F.2d at 986). Indeed, the courts plainly recognize that "subject matter jurisdiction may extend to claims involving transnational securities frauds." Berger, 322 F.3d at 192.

Under the so-called "conduct test," first articulated by this Court in Bersch v. Drexel Firestone, Inc., 519 F.2d 974 (2d Cir. 1975), subject matter jurisdiction exists when:

> (1) the defendant's activities in the United States were more than 'merely preparatory' to a securities fraud conducted elsewhere, and (2) the activities or culpable failures to act within the United States 'directly caused' the claimed losses.

Berger, 322 F.3d at 193 (citing Itoba Ltd. v. Lep Group PLC, 54 F.3d 118, 122 (2d Cir. 1995)).

Activities within the United States that are not sufficient to sustain subject matter jurisdiction are those which can be fairly characterized as "relatively small in comparison to those abroad" or "far removed from the consummation of the fraud." Rohrer v. FSI Futures, Inc., 981 F. Supp. 270, 277 (S.D.N.Y. 1997) (Haight, J.) (citing Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Bros. Int'l Ltd., 928 F. Supp. 398, 403 (S.D.N.Y. 1996)). Conversely, the federal courts *do* have subject matter jurisdiction over foreign purchasers' claims "when substantial acts in furtherance of the fraud [are] committed within the United States." Berger, 372 F.3d at 193 (internal quotations omitted) (citing Psimenos v. E.F. Hutton & Co., 722 F.2d 1041, 1043 (2d Cir. 1983)).

As this Court explained in Psimenos:

> Bersch reveals that our true concern was that we entertain suits by aliens only where conduct *material to* the completion of the fraud occurred in the United States. Mere preparatory activities, and conduct far removed from the consummation of the fraud, will not suffice to establish jurisdiction.

Psimenos, 722 F.2d at 1046 (emphasis added). See also Carr v. Equistar Offshore, Ltd, No. 94 Civ. 5567 (DLC), 1995 WL 562178, at *6 (S.D.N.Y. Sept. 21, 1995) (Cote, J.) ("[W]here defendants have undertaken significant steps in the United States in furtherance of a fraudulent scheme, United States courts have jurisdiction over suits arising from that conduct even if the final transaction occurs outside the United States and involves a foreign plaintiff.") (citing Alfadda v. Fenn, 935 F.2d 475, 478 (2d Cir. 1991)).

B. The District Court's Decision Contravenes The Restatement Of Foreign Relations Law

The conduct standard set forth by this Court conforms with the Restatement of Foreign Relations Law, which provides that jurisdiction exists over:

> conduct occurring predominantly in the United States that is related to a transaction in securities, even if the transaction takes place outside the United States.

Restatement (Second) of Foreign Relations Law of the United States § 416(1)(d) (1987). This is true "even as applied to securities sold outside the United States or to persons who are not United States nationals or residents." Id. Comment a.

Moreover,

> The reasonableness of the exercise of jurisdiction depends not only on the territorial links of a given activity with the United States, but also on *the character* of the activity to be regulated. Thus, *an interest in punishing fraudulent or manipulative conduct is entitled to greater weight than are routine administrative requirements*.

Id. (emphases added). This Court has heavily relied on the Restatement of the Foreign Relations Law in the securities area. See, e.g., Itoba Ltd. v. Lep Group PLC, 54 F.3d 118, 124 (2d Cir. 1995); Alfadda v. Fenn, 935 F.2d 475, 479 (2d Cir. 1991); Bersch, 519 F.2d at 985. Accordingly, this Court must correct the district court's undermining of the Restatement as well as this Court's precedent.

C. The Fraud At HomeSide Clearly Satisfies The Conduct Test Since It Occurred Within This Nation's Borders; The District Court Pointedly Ignored Other Relevant Decisions In Reaching Its Decision To The Contrary

The conduct test is clearly met here, where the accounting fraud that Florida-based HomeSide engaged in "within this nation's borders [comprised] the very factual predicates of the fraud which lie at the heart of plaintiffs' case." In re Gaming Lottery Sec. Litig., 58 F. Supp. 2d 62, 74 (S.D.N.Y. 1999) (Patterson, J.). That HomeSide was cooking its books was *itself* the fraud, or at very least "part of a single fraudulent scheme" to inflate its MSR and, in turn, NAB's stock price. Id. at 75. Without HomeSide's improper conduct here in the United States, *NAB's and the other defendants' public statements simply would not have been false or misleading*.

The district court's holding would render superfluous the conduct test, in effect converting it into a "from where the misstatements originated and emanated" test. Under such a standard, foreign entities with U.S. subsidiaries could brazenly turn a blind eye to their subsidiaries' misconduct while enjoying immunity from American securities laws – regardless of how much misconduct occurred on U.S. soil – provided that the foreign entities create and disseminate their financial statements from abroad. Such an

absurd result would surely “embolden those who wish to defraud foreign securities purchasers or sellers to use the United States as a base of operations” and “would, in effect, create a haven for such defrauders and manipulators.” S.E.C. v. Kasser, 548 F.2d 109, 116 (3d Cir. 1977). Clearly this is not the result Congress intended. Europe & Overseas Commodity Traders, S.A., 940 F. Supp. at 535 (“Congress does not want the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners”).

Indeed, just as the “Congress that passed [the Exchange Act] in the midst of the depression could hardly have been expected to foresee the development of off-shore funds thirty years later,” Bersch, 519 F.2d at 993, Congress in the 1930s could not have envisioned the rapid globalization of the late-twentieth century that gave birth to multinational conglomerates with subsidiaries and assets dispersed all over the planet. In this present-day reality, adopting the rule that the defendants advocate would “allow the United States to become a ‘Barbary Coast’ . . . harboring international securities ‘pirates.’” Kasser, 548 F.2d at 116.

Other courts, cognizant of the incongruity of such a result, have explicitly or implicitly rejected the district court’s rule, which the district

court itself acknowledged. "The Court is mindful of decisions of other judges in this district which reached contrary results to Froese and Bayer in arguably similar cases." (SPA. 18) (citing Alstom, 406 F. Supp. 2d at 362-63, 387; In re Gaming Lottery, 58 F. Supp. 2d at 74-75); see also Berger, 322 F.3d at 193-195. Accord Itoba Ltd., 54 F.3d at 124 (holding that "the sites of preparations for SEC filings should not be determinative of jurisdictional questions"). Those courts' true concern rightly was the question of *where* the *conduct* occurred that rendered the statements at issue misleading.

In S.E.C. v. Berger, Berger, a New York resident, had formed an offshore investment company (the "Fund") organized under the laws of the British Virgin Islands. 322 F.3d at 188-89. Berger was also the Fund's investment adviser. As a result of the investments the Fund made at Berger's direction, the Fund suffered enormous financial losses. However, rather than reporting the losses to the Fund's investors, Berger, working in New York, created fraudulent account summaries that masked the losses. Id. at 189. He then sent the doctored summaries each month to the Fund's administrator in Bermuda, who in turn used Berger's fictitious summaries to create monthly account statements for the Fund's investors. From Bermuda,

the administrator then mailed the incorrect monthly statements to the Fund's various overseas investors. Id.

In support of his motion to dismiss, Berger argued that the district court lacked subject matter jurisdiction because his activities in New York were "merely preparatory" to the fraud. Id. at 193. According to Berger, "the inaccurate monthly account statements, prepared and mailed to investors by the Fund administrator in Bermuda, constitute[d] the heart of the fraud," and "the activity *directly* causing harm to investors occurred in Bermuda." Id. at 194-95 (emphasis in original). This Court, in affirming the district court's denial of Berger's motion to dismiss, held that "*the fraudulent conduct was carried out entirely by Berger in New York*." Id. at 195 (emphasis added). This Court also found that the distribution of the fraudulent statements by the Fund's administrator in Bermuda simply "*provided a means for Berger to distribute false information that he had already fraudulently concocted in the United States.*" Id. (emphasis added).

Like the facts in Berger, Florida residents at HomeSide in Jacksonville, Florida hatched their scheme *in the United States* to inflate the value of HomeSide's MSR; perpetrated their scheme *in the United States* by manipulating the PSAs and other assumptions in their financial models so as

to achieve their earnings targets; and then simply transmitted those numbers *from the United States* to NAB's headquarters in Australia, which in turn "distribute[d] false information that [HomeSide] had already fraudulently concocted in the United States."

Judge Patterson's ruling in In re Gaming Lottery is also instructive. There the plaintiffs had moved to certify a class of American and Canadian investors that had purchased the common stock of defendant GLC, a Canadian corporation, on the Nasdaq and Toronto Stock Exchange ("TSE"), respectively. The plaintiffs alleged that GLC and other defendants made false and misleading statements and omissions concerning the company's acquisition of Specialty Manufacturing Inc ("SM"), an American corporation. Id. at 64. Specifically, the plaintiffs alleged that GLC falsely represented to the public that it had completed its acquisition of SM, when in fact, GLC had failed to first obtain the requisite regulatory approval from the State of Washington. Id. at 65. GLC then improperly consolidated SM's financial results with its own, resulting in an increase in GLC's revenues and, in turn, its stock price. Id.

The defendants moved to dismiss the Canadian investors from the plaintiff class on the basis that the court did not have subject matter

jurisdiction over those foreign plaintiffs' claims. Judge Patterson, applying the conduct test, rejected the defendants' arguments, finding that GLC's conduct constituted sufficient conduct within the United States to support subject matter jurisdiction: "GLC's United States conduct was far more than 'merely preparatory' to the fraud; *its activities within the nation's borders are the very factual predicates of the fraud which lie at the heart of plaintiffs' case*." Id. at 74 (emphasis added). Judge Patterson also found that GLC's misstatements and omissions concerning SM "directly caused" the foreign plaintiffs' injuries because GLC's misstatements about SM "artificially inflated the price of GLC stock on the TSE . . . directly causing injury to non-United States residents who purchased the stock on the TSE." Id.

So too, here, HomeSide's improper inflation of its MSR in Florida from at least 1999 through September 2001 comprised "the very factual predicates of the fraud which lie at the heart of plaintiffs' case." Moreover, defendants' repeated misstatements and omissions concerning HomeSide directly caused plaintiffs' injuries because those misstatements "artificially inflated the price of [NAB]'s stock on the [Australian Stock Exchange] . . .

directly causing injury to non-United States residents who purchased the stock." Id.

Finally, in In re Alstom SA Sec. Litig., 406 F. Supp. 2d 346, 369 (S.D.N.Y. 2005) (Marrero, J.), the court considered allegations of multiple frauds at Alstom S.A., the French industrial conglomerate. With respect to the alleged frauds that occurred at *European* subsidiaries of Alstom, the court held that all "of these actions took place in France," id. at 395, and declined to exercise subject matter jurisdiction over the claims against the European subsidiaries.

By contrast, the court upheld U.S. jurisdiction over a separate fraud perpetrated by Alstom's *domestic* U.S. subsidiary. The court observed that the subsidiary was "located in New York and the fraud, if any in fact occurred, was concocted and executed" by the subsidiary inside the United States. Id. at 396.

In language equally applicable here, the court held that:

> The false [financial] documents may have been sent to Alstom headquarters in France and incorporated into the Company's financial reports, but, as was the case in Berger, the mailing of the fraudulent documents for publication outside of the United States does not render the conduct in the United States any less of a cause of plaintiffs' losses.

Id. at 396.

D. The District Court's Reliance On Bersch, Froese And Bayer Was Misplaced

While the district court stated that "[t]he instant case can fairly be said to fall somewhere in between Bersch (upon which Defendants rely) and Berger (upon which Plaintiffs rely)" (SPA. 16), the district court nonetheless concluded that "[a]s was the case in Bersch, Froese and Bayer, 'at most the acts in the United States helped to make the gun where the bullet was fired' from – and at – places abroad. See Bersch, 519 F.2d at 987." (SPA. 19)

First, the facts of Bersch are distinguishable in important ways from the facts in this case. In Bersch, a Canadian company had made several public offerings of its common stock to investors outside the United States, though some shares were purchased by American investors, including the lead plaintiff Howard Bersch. Id. at 979-81. After the price of the shares dropped significantly, Bersch sued the company and its American underwriters on behalf of all foreign and domestic purchasers of the company's stock, alleging that the offering materials failed to disclose certain material facts. Id. at 981. However, the material omissions that the plaintiffs alleged should have been disclosed in the prospectuses at issue concerned matters *outside* the U.S. (e.g., the defendant company's alleged

illegal activities abroad and the "chaotic condition" of the books and records of the company and its subsidiaries). Id. at 981. The activities that actually took place in the United States – meetings regarding one of the three offerings; retaining U.S.-based law firms and accountants in connection with that offering; drafting or reviewing part of one of the prospectuses in New York – are quintessential examples of what the court meant by acts that are "merely preparatory" to a fraud. Id. at 981, 985 n.24.

Moreover, the activities of the underwriters and accountants in Bersch – failing to use "due diligence with regard to their prospectuses" and not properly auditing the defendant's financials – some of which occurred on U.S. soil, could only, at best, be described as "culpable nonfeasance," which the court in Bersch equated with acts that are "merely preparatory." Id. at 981, 987. Those facts are a far cry from the facts here, where Florida residents at Florida-based HomeSide cooked the company's books in the United States over the course of several years, under the watchful eye of Thompson, the NAB officer stationed at HomeSide. That accounting fraud,

in turn, made NAB's and HomeSide's public statements false and misleading.[11]

In Froese v. Staff, No. 02 CV 5744 (RO), 2003 WL 21523979 (S.D.N.Y. July 7, 2003) (Owen, J.), a German plaintiff alleged that the domestic subsidiary of a German corporation engaged in "channel stuffing," which rendered the financial results of the foreign parent corporation false and misleading. By channel stuffing, the plaintiff alleged that the subsidiary "delivered to and endeavored to force their retail network to accept [product] despite no demand, with perhaps secret assurances that the goods, if unsold, could be returned." Id. at *1. The Froese court, in a two-page decision, found that it had no jurisdiction over the claims of the German plaintiff because "the fraud itself occurred, if at all, when the allegedly fraudulent statements were conceived, engineered, and published in Germany." See id. at *2.

[11] Where the predicate acts of the fraud at issue occur in the United States, as in the case at bar, the situation can hardly be characterized as "the acts in the United States helped to make the gun whence the bullet was fired from places abroad." (SPA. 19) (citing Bersch, 519 F.2d at 997). Instead, HomeSide's fraudulent conduct in Florida can be said to have manufactured the gun *and the bullet* that NAB fired, injuring both Australian and American investors. This Court should not deny jurisdiction over the claims of a class of Foreign Plaintiffs struck by a bullet bearing the moniker, "Made in America."

However, Judge Owen in Froese conflated the causation element of a securities fraud claim with the conduct test. In holding that plaintiffs' losses were caused by press releases and an annual report prepared and issued by the German parent company in Germany, and were not caused by the channel stuffing at the U.S. subsidiary, the court concluded that it did not have jurisdiction under the conduct or effects test. Id. at *1-2. Thus, in Froese it was not the subsidiary's channel stuffing that was improper, but rather the German parent company's misrepresentations regarding the practice.

In this case, on the other hand, NAB's American subsidiary fraudulently reported financials to its parent company that resulted from accounting fraud that occurred solely in this country. As such, the fraud was conceived and executed on American soil and was only later reported by NAB in Australia.

Similarly, In re Bayer AG Sec. Litig., 423 F. Supp. 2d 105 (S.D.N.Y. 2005) (Pauley, J.), did not involve persistent, methodical accounting fraud in the United States. Rather, plaintiffs in In re Bayer AG Sec. Litig. alleged "that Bayer Corp.[, the United States subsidiary of a German-based parent, Bayer AG,] suppressed information regarding the adverse effects of Baycol

in the United States; that Bayer Corp. issued a false press release and misleading SEC filings were made in the United States; and that the object of the fraud was to establish a United States market for Baycol." 423 F. Supp. 2d at 111. The court held that these facts constituted "mere commentary about activities occurring in the United States [that] does not satisfy this Circuit's stringent conduct test, which focuses on defendants' *activities* in the United States." Id. at 113 (emphasis in original).

The accounting fraud alleged here is not "mere commentary" as alleged in In re Bayer AG Sec. Litig., but constitutes pervasive fraudulent *activity* that satisfies this Court's conduct test.

E. The Relevant "Tipping" Factors Support Subject Matter Jurisdiction

This Court has held that in especially close cases, certain "tipping factors" may be considered, such as "transaction on a U.S. exchange, economic activity in the U.S., harm to a U.S. party, or activity by a U.S. person or entity meriting redress." Europe & Overseas Commodity Traders, S.A., 147 F.3d at 130. Since the district court itself acknowledged that "the instant case presents a close call . . ." (SPA. 18), the court should have, but did not, consider the relevant tipping factors. These factors also support subject matter jurisdiction here.

First, it is not disputed that NAB's securities, in the form of ADRs, traded on the New York Stock Exchange. (A. 72)

Second, NAB and HomeSide conducted significant economic activity in the United States. During the relevant time period, HomeSide was the sixth largest mortgage servicer in the United States. (A. 82)

Third, there was activity by United States persons and entity meriting redress. Three of the four individual defendants in this action – Harris, Race and Wilson – were Florida residents and the senior officers of HomeSide who directed the accounting fraud. HomeSide was a Florida-based corporation that was the vehicle for the accounting fraud. It is axiomatic that accounting fraud violates the federal securities laws and merits redress. U.S. v. Ebbers, 458 F.3d 110, 126 (2d Cir. 2006) (securities fraud conviction affirmed "where the evidence showed that accounting methods known to be misleading – although perhaps at times fortuitously in compliance with particular GAAP rules – were used for the express purpose of intentionally misstating WorldCom's financial condition and artificially inflating its stock price").

Accordingly, these "tipping factors" are additional factors supporting subject matter jurisdiction here. See, e.g., Leonard v. Garantia Banking Ltd.,

No. 98 CIV 4848 (LMM), 1999 WL 944802, at *6 (S.D.N.Y. Oct. 19, 1999) (McKenna, J.) ("In sum, this Court finds that trading of ADRs on the NYSE satisfies the conduct test, and any "tipping of the scales" which might be required by [Europe & Overseas Commod. Traders, S.A.] is present . . . ").

II. ASSUMING ARGUENDO THAT NO SUBJECT MATTER JURISDICTION EXISTED OVER NAB AND CICUTTI, THE DISTRICT COURT ERRED IN NOT ALLOWING THE FOREIGN PLAINTIFFS TO PROCEED AGAINST THE FLORIDA-BASED DEFENDANTS

A. The Florida-Based Defendants May Be Held Liable As Primary Violators Of Section 10(b)

The district court held that "HomeSide's alleged conduct – however it may be classified – is not in itself *securities* fraud. It amounts to, at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad." (SPA. 19) (emphasis in original). However, this holding is erroneous and ignores that plaintiffs properly state a Section 10(b) misrepresentation claim against the Florida-based defendants: HomeSide, Harris, Race and Wilson.

It is axiomatic that HomeSide, Harris, Race and Wilson can be held primarily liable for the misstatements in NAB's public filings and press releases since these Florida-based "defendants were the original and knowing source of a misrepresentation and that [the Florida-based]

defendants knew or should have known that misrepresentation would be communicated to investors . . . ." Kidder Peabody, 10 F. Supp. 2d 398, 407 (S.D.N.Y. 1998) (Jones, J.) (holding that a corporate subsidiary could be held primarily liable under Section 10(b) for statements made by the corporate parent where it was alleged that the subsidiary was the "original and knowing source" of the misstatements).

The facts at issue here closely mirror those in Kidder Peabody, Menkes v. Stolt-Nielsen S.A., No. 3:03 CV 409 (DJS), 2006 WL 1699603 (D. Conn. June 19, 2006) (Squatrito, J.), and In re LaBranche Sec. Litig., 405 F. Supp. 2d 333 (S.D.N.Y. 2005) (Sweet, J.).[12] In Kidder Peabody, plaintiffs alleged that defendants violated the federal securities laws by making or causing to be made public statements that incorporated false profits generated through the use of phantom trades. There was no dispute that Kidder, Peabody & Co. ("Kidder"), then a wholly-owned subsidiary of General Electric Company ("GE"), provided GE with financial data on a quarterly basis, which was incorporated in GE's financial statements and quarterly and annual reports. Kidder Peabody, 10 F. Supp. 2d at 407. The

[12] In each of these decisions, the district courts found that both the parent company and the subsidiary were primary violators and upheld the securities claims against them. Menkes, 2006 WL 1699603, at *6; LaBranche, 403 F. Supp. 2d at 364; Kidder Peabody, 10 F. Supp. 2d at 420.

court held that "[g]iven these facts, it is clear that [the Kidder] defendants should be held liable for GE's misstatements if the other requirements of primary liability are met." Id.

Similarly, in Menkes v. Stolt-Nielsen S.A., plaintiffs alleged that defendants violated the securities laws by issuing a number of public statements during the class period that were false or misleading because of undisclosed illegal activity at Connecticut based Stolt-Nielsen Transportation Group, Inc. ("SNTG"), a subsidiary of Stolt-Nielsen S.A. ("SNSA"), an entity incorporated in Luxembourg. Two of SNTG's officers named as defendants in the action, Samuel Cooperman and Reginald J.R. Lee, moved to dismiss on the grounds, inter alia, that there was no independent basis for holding them personally liable for any alleged Section 10(b) violation since all the alleged misstatements were issued by the foreign parent company, SNSA, and not the domestic subsidiary, SNTG, where the illegal activity occurred.

The court rejected this argument and held, in language applicable here:

> SNTG, Cooperman, and Lee can be held primarily liable for violating Section 10(b). Their conduct goes well beyond simply enabling or turning a blind eye to SNSA's fraud and rises to the level of

> active participation in the dissemination of false or misleading information. Plaintiffs allege that Cooperman and Lee had knowledge of SNTG's anti-competitive conduct alleged in the complaint as early as 1988 . . . . Plaintiffs also allege that Cooperman and Lee were in a position to disclose the anti-competitive conduct to SNSA and render SNSA's statements regarding SNTG's activities complete and truthful, but, at best, they failed to do so, or at worst, they conspired with SNSA to "mask and conceal the improper activities implemented by SNTG in connection with its antitrust measures. . . ." In either instance, SNTG, Cooperman and Lee could be held responsible for the false or misleading statements attributed to SNSA because SNSA was either a mere conduit for SNTG, through Cooperman and Lee, to perpetrate a fraud or was a co-conspirator.

Id. at *7.

Finally, in In re LaBranche Sec. Litig., the court held that LaBranche LLC, a wholly-owned subsidiary of LaBranche & Co., could be held primarily liable under Section 10(b) for LaBranche & Co.'s dissemination of false financial information to the public regarding the operations at the subsidiary, LaBranche LLC. "[I]t is reasonable to infer that LaBranche LLC's financial data were incorporated directly into LaBranche & Co.'s public statements regarding the earnings of its specialist operations. Therefore, even though LaBranche & Co. failed to explicitly identify LaBranche LLC as the source of the information concerning revenue and

earnings of its specialist operations, the misrepresentations may be constructively attributed to LaBranche LLC." Id. at 352.

Here, as in the cases cited above, Harris, Race and Wilson had knowledge of and directed the accounting fraud at HomeSide. HomeSide, Harris, Race and Wilson were in a position to disclose the accounting fraud to NAB and render NAB's statements regarding HomeSide's activities complete and truthful, but they failed to do so. They implemented the fraud under the nose of NAB's appointed officer, Thompson, and carried it out in his presence. HomeSide, Harris, Race and Wilson may be held responsible for the false and misleading statements attributed to NAB because NAB was either a mere conduit for HomeSide, through Harris, Race and Wilson, to perpetrate a fraud or the Florida-based defendants were co-conspirators with NAB.

As the LaBranche court aptly stated, to hold that the Florida-based defendants are not primary violators:

> would enable parent companies to create subsidiaries under which all of its business would be conducted and then to shield the subsidiaries from Section 10(b) liability by disseminating the subsidiary's false information.

LaBranche, 405 F. Supp. 2d at 352. That result is unacceptable and improper under the federal securities laws and applicable precedent.

B. As The Foreign Plaintiffs Have A Claim Against The Florida-Based Defendants As Primary Violators, The District Court Should Have Permitted The Foreign Plaintiffs To Proceed With Their Claims Against These Domestic Defendants

Having established the appropriate and supportable theory of liability against the Florida-based defendants (i.e., as primary violators of Section 10(b)), relevant conduct must be examined to parse what parts of the alleged fraud took place in the United States and which parts were formulated abroad.

Because the Florida-based defendants' conduct constituted a fully formed fraudulent scheme – and not acts "merely preparatory" to a fraud – foreign plaintiffs' Section 10(b) allegations independently satisfy the two-prong Itoba test for subject matter jurisdiction: the Florida-based defendants' accounting fraud was executed entirely within the United States, and but for this scheme, foreign plaintiffs would not have suffered injury. See Itoba Ltd., 54 F.3d at 122. It is by now well settled that United States courts have subject matter jurisdiction over the claims of foreign plaintiff classes who have suffered harm as a result of conduct carried out

substantially in the United States. See In re Alstom SA Sec. Litig., 406 F. Supp. 2d at 382-86 (discussing standards and ruling that foreign purchasers of foreign securities may proceed on claims as to which domestic fraudulent conduct was substantial); In re Vivendi Universal, S.A. Sec. Litig., 381 F. Supp. 2d 158, 169-70 (S.D.N.Y. 2003), upheld on motion for reconsideration, No. 02 Civ. 5571 (RJH), 2004 WL 2375830 (S.D.N.Y. Oct. 22, 2004) (finding subject matter jurisdiction over claims brought by foreign plaintiffs); In re Gaming Lottery Sec. Litig., 58 F. Supp. 2d at 73-76 (same).

The domestic conduct here at issue is sufficiently substantial to create subject matter jurisdiction. As this Court observed over two decades ago:

> The conduct test does not center its inquiry on whether domestic investors or markets are affected, but on the nature of conduct within the United States as it relates to carrying out the alleged fraudulent scheme, on the theory that Congress did not want "to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners." Vencap, supra, 519 F.2d at 1017.

Psimenos, 722 F.2d at 1045.

In refusing to exercise jurisdiction over the Foreign Plaintiffs' claims, the district court ignored controlling precedent with respect to the conduct test. The only rationale for HomeSide's manipulations and deceptions was

to boost the share price of NAB securities, in violation of the securities laws. Precluding Foreign Plaintiffs from pursuing a remedy against HomeSide, Harris, Race and Wilson would effectively sanction the Florida-based defendants' use of the United States as a base for manufacturing false reports of HomeSide's financial health.

C. The Foreign Plaintiffs Also May Proceed Against The Florida-Based Defendants Based On Their Scheme Liability Allegations

The Foreign Plaintiffs have pled, and are entitled to prove, that they were injured by the Florida-based defendants' perpetration of a fraudulent scheme in violation of Rule 10b-5(a) and (c). Even assuming the district court was correct in ruling that Foreign Plaintiffs cannot pursue claims against NAB and Cicutti in United States courts for their fraudulent statements they prepared and disseminated abroad, it erred in dismissing the Foreign Plaintiffs' claims against HomeSide, Harris, Race and Wilson. In doing so, the district court ignored the variety of fraudulent and deceptive conduct that Rule 10b-5 prohibits.

Rule 10b-5(a) makes it unlawful for "any person," "directly or indirectly," to "employ any device, scheme, or artifice to defraud." The Supreme Court has stated that "any manipulative or deceptive device or

contrivance" in Section 10(b) includes a "scheme," Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.20 (1976), and that Section 10(b) applies to "complex securities frauds" in which "there are likely to be multiple violators" Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994). Rule 10b-5(c) makes it unlawful for "any person," "directly or indirectly," to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . . ."

As the SEC stated in its amicus brief in In re HomeStore.com, Inc. Sec. Litig., 452 F.3d 1040 (9th Cir. 2006) (available at www.sec.gov/litigation/briefs/homestore_102104.pdf):

> It has long been accepted that Section 10(b), and Rule 10b-5(a) and (c) thereunder, cover conduct beyond the making of false statements and misleading omissions, which are covered by Rule 10b-5(b). The Supreme Court has stated that Section 10(b) encompasses deceptive "practices," Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475-76 (1977), deceptive "conduct," id. at 475 n.15; United States v. O'Hagan, 521 U.S. 642, 659 (1997), and deceptive "acts," Central Bank, 511 U.S. at 173. In the recent [SEC v.] Zandford, [535 U.S. 813 (2002)] decision, where the [Supreme] Court considered a fraudulent scheme under Rule 10b-5(a) and a course of business that operated as a fraud under Rule 10b-5(c), the Court concluded: "Indeed, each time respondent 'exercised his

> power of disposition [of his customers' securities] for his own benefit,' that *conduct, 'without more*,' was a fraud." Zandford, 535 U.S. at 815 (emphasis added); see Affiliated Ute Citizens v. United States, 406 U.S. 128, 152 (1972) (noting that while Rule 10b-5(b) targets false statements or omissions, paragraphs (a) and (c) "are not so restricted"); [U.S. v.] Charnay, 537 F.2d [341] at 350 [9th Cir. 1976] (clauses (a) and (c) prohibit deceptive "practices").

Id. at 13-14.

Accordingly, injured plaintiffs, including the injured Foreign Plaintiffs here, may pursue remedies under the Rule both for fraudulent misstatements and for deceptive or fraudulent schemes not explicitly involving false representations or misleading omissions. In re Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 335 (S.D.N.Y. 2004) (Lynch, J.); see also In re Parmalat Sec. Litig., 376 F. Supp. 2d 472, 491-92 (S.D.N.Y. 2005) (Kaplan, J.) (elements of claims pled under 10b-5(b) are distinct from those for 10b-5(a) and (c) claims).

As Judge Lynch observed in In re Global Crossing Ltd., a scheme alleged under subsections (a) and (c) is broadly defined to "encompass the use of '*any* device, scheme or artifice,' or '*any* act, practice, or course of business' used to perpetrate a fraud on investors.'" 322 F. Supp. 2d at 336 (citing 17 C.F.R. § 240.10b-5(a), (c)) (emphasis in original). The court

further noted that “a cause of action exists under subsections (a) and (c) for behavior that constitutes participation in a fraudulent scheme, even absent a fraudulent statement by the defendants.” Id. at 335. Accordingly, the Foreign Plaintiffs may pursue remedies under the Rule both for fraudulent misstatements and for deceptive or fraudulent schemes not explicitly involving false representations or misleading omissions. Indeed, the actions of the Florida-based defendants here – the creation and implementation of fraudulent accounting practices at HomeSide, which were designed to inflate HomeSide’s earnings and mislead investors – constitute manipulative or deceptive conduct as part of a scheme to defraud.

Scheme liability was held adequately pled in In re Parmalat Sec. Litig., 383 F. Supp. 2d 616 (S.D.N.Y. 2005), as against defendants who created and controlled shell companies that engaged in sham transactions contrived to permit Parmalat to book fake receivables, obscure embezzlement, and make the company’s financial health appear more robust than it was. “[T]hese transactions were ‘inventions, projects, or schemes with the tendency to deceive because they created the appearance of a conventional’ sale and loan ‘when, in fact, the reality was quite different.’” Parmalat, 383 F. Supp. 2d at 625-26.

Similarly, the court in Global Crossing observed that if defendant Arthur Andersen's alleged conduct – which included the masterminding of misleading accounting and sham swap transactions – did not "make out a claim for engaging in 'any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,' then it is hard to imagine what would." Global Crossing, 322 F. Supp. 2d at 337. The Global Crossing decision also invokes the well-established principle that conduct is "manipulative" in the meaning of § 10(b) if it is "intentional or willful [and] designed to deceive or defraud investors by controlling or artificially affecting the price of securities." Id., quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). The Florida-based defendants' alleged knowing and planned manipulations, like the conduct alleged in Parmalat and Global Crossing, were designed to provide false comfort to investors by deceitfully portraying HomeSide's financial health and prospects as better than they were. As the courts found in those cases, HomeSide's conduct was manipulative and deceitful, and, as intended, affected the price of NAB securities.

CONCLUSION

For the reasons stated above, Plaintiffs-Appellants Robert Morrison, Russell Leslie Owen and Brian and Geraldine Silverlock respectfully request that this Court reverse the district court's judgment dismissing the claims of foreign purchasers of NAB securities.

Dated: New York, New York
May 2, 2007

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s/ James W. Johnson
Attorney for Plaintiffs-Appellants
Dated: May 2, 2007

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SPECIAL APPENDIX

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
--------------------------------x
In re NATIONAL AUSTRALIA BANK SECURITIES LITIGATION
--------------------------------x

03 Civ. 6537 (BSJ)

Order

BARBARA S. JONES
UNITED STATES DISTRICT JUDGE

INTRODUCTION

The Consolidated Class Action Complaint (the "Complaint") in this action was filed by Russell Leslie Owen ("Owen"), Brian and Geraldine Silverlock (collectively, the "Lead Foreign Plaintiffs"), and Robert Morrison (the "Lead Domestic Plaintiff"), on their own behalf and on behalf of all others similarly situated (collectively, the "Plaintiffs"). Defendants National Australia Bank Limited ("NAB" or "Bank") and Frank Cicutto, Hugh Harris, Kevin Race, W. Blake Wilson, and Washington Mutual Bank, F.A., as successor in interest to HomeSide Lending, Inc. ("HomeSide"), move to dismiss the complaint for lack of subject matter jurisdiction under Rule 12(b)(1), and for failure to state a claim under Rule 12(b)(6) of the Federal Rules of Civil Procedure.

The Complaint alleges that the Defendants violated section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act'), 15 U.S.C. §§ 78j(b) and 78t(a), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240-10b-5. As explained

further below, the Complaint alleges that the Defendants made false and misleading statements concerning HomeSide's operations and its contributions to NAB's financial health in filings with the Securities and Exchange Commission ("SEC"), foreign securities exchanges, the domestic and international press, and in corporate documents. The Complaint further alleges that the fraudulent and misleading statements were intended to, and did, artificially inflate the prices of NAB's securities and eventually caused losses to Plaintiffs, who are investors in NAB securities. The Complaint also alleges that certain of NAB's and HomeSide's officers, in their capacities as controlling persons, violated section 20(a) of the Exchange Act.

For the reasons explained below, the Complaint is DISMISSED, with leave to file an amended complaint with respect to domestic plaintiffs only.

BACKGROUND

Defendant NAB is Australia's largest bank, organized under the laws of Australia and headquartered there.[1] "Ordinary shares"[2] of NAB's stock trade on Australian and other foreign exchanges, but not on any United States exchange. Only certain

[1] Defendant Cicutto was at all relevant times NAB's managing director and chief executive officer.

[2] "Ordinary shares" are the equivalent in Australia of "common stock" in the United States.

instruments called American Depositary Receipts ("ADRs"),[3] which represent quantities of NAB ordinary shares, are traded on the New York Stock Exchange ("NYSE").

NAB acquired HomeSide in 1998 as part of NAB's efforts to expand its international presence. HomeSide was then a mortgage service provider located in Jacksonville, Florida.[4] Its principal source of income was the fees that it generated for servicing mortgages. The present value of those fees was calculated using an internal valuation model, and was booked by NAB on its balance sheet as an asset called Mortgage Servicing Rights ("MSR"). HomeSide itself had no publicly traded securities during the relevant period.

During the proposed class period, the NAB defendants allegedly made various statements in SEC filings, the Bank's annual reports and in other contexts, asserting HomeSide's profitability and its contribution to NAB's overall profitability. The HomeSide defendants also allegedly made

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[3] "An ADR is a receipt that is issued by a depositary bank that represents a specified amount of a foreign security that has been deposited with a foreign branch or agent of the depositary, known as the custodian. The holder of an ADR is not the title owner of the underlying shares; the title owner of those shares is either the depositary, the custodian, or their agent. ADRs are tradable in the same manner as any other registered American security, may be listed on any of the major exchanges in the United States or traded over the counter, and are subject to the [federal securities laws.] This makes trading an ADR simpler and more secure for American investors than trading in the underlying security in the foreign market." *Pinker v. Roche Holdings Ltd.*, 292 F.3d 361, 367 (3d Cir. 2002) (citations omitted).

[4] NAB purchased HomeSide in 1998, then sold it to Washington Mutual Bank in December 2001. Defendants Harris, Race and Wilson were HomeSide's chief

various false public statements relating to HomeSide's prospects and economic health. A number of these statements are detailed in the Complaint.

In July 2001, NAB announced that it would book a charge of $450 million because of a fiscal year writedown of the value of HomeSide's MSR (the "July Writedown"). As a consequence of the July Writedown, NAB's ordinary shares and its ADRs each fell by more than 5% on their respective markets. Then, in September 2001, NAB announced it would incur a further $1.75 billion writedown (the "September Writedown"), having determined that the carrying value of HomeSide's MSR exceeded its fair value. $1.16 billion of the September Writedown was attributed to a combination of incorrect rate assumptions in HomeSide's MSR valuation model and changed assumptions in that modeling; the remaining $590 million was attributed to a writedown of good-will relating to HomeSide. In response to the September Writedown, NAB's ordinary shares fell by nearly 13% on the Australian market, and its ADRs fell by slightly more than 11.5% on the NYSE.

It is from these price drops that Plaintiffs claim a loss. The Lead Foreign Plaintiffs are residents of Australia, who purchased NAB's ordinary shares on an Australian exchange in

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executive officer, chief operating officer, and chief financial officer, respectively, during the relevant period.

2001. The Lead Domestic Plaintiff is a United States resident who purchased the Bank's ADRs on the NYSE.

The Complaint alleges a fraudulent scheme, in that: (1) HomeSide, at the direction of the HomeSide officers, and at least with the knowing acquiescence of the NAB defendants, knowingly used unrealistic financial models in order to artificially inflate its MSR values;[5] (2) the Defendants' various statements as to HomeSide's profitability and its contribution to NAB's profitability were consequently false and intentionally misleading; and (3) the alleged fraud, when revealed, caused losses for the owners of NAB's securities.

DISCUSSION

I. THIS COURT LACKS SUBJECT MATTER JURISDICTION OVER THE LEAD FOREIGN PLAINTIFFS' CLAIMS

Defendants move to dismiss the Lead Foreign Plaintiffs from the Complaint for lack of subject matter jurisdiction, under Fed.R.Civ.P. 12(b)(1), on the ground that the transactions of which these plaintiffs complain is fundamentally foreign in nature, and thus beyond the scope of this Court's jurisdiction

[5] The Complaint sets out in some detail HomeSide's use, during several months of 2000, of certain financial assumptions in its MSR valuation models. These models diverged, in some instances rather sharply, from the assumptions published by Bloomberg Media Interactive, which are described in the Complaint as "an accepted industry standard." The Complaint alleges that it was HomeSide's knowing use of these non-standard assumptions that allowed it, and NAB to show unwarranted profitability.

under the Exchange Act.[6]

A. Standard for Rule 12(b)(1) Dismissal

A plaintiff bears the burden of proving by a preponderance of the evidence that subject matter jurisdiction exists. *See McNutt v. General Motors Acceptance Corp.*, 298 U.S. 178, 189, (1936); *Luckett v. Bure*, 290 F.3d 493, 496-97 (2d Cir. 2002). Jurisdictional allegations must be shown affirmatively, and may not be inferred favorably to the party asserting it. *See Shipping Fin. Servs. Corp. v. Drakos*, 140 F.3d 129, 131 (2d Cir. 1998). In resolving a factual challenge to subject matter jurisdiction, this court may consider evidence outside of the pleadings. *See Makarova v. United States*, 201 F.3d 110, 113 (2d Cir. 2000); *see also Kamen v. American Tel. & Tel. Co.*, 791 F.2d 1006 1011 (2d Cir. 1986).

B. Subject Matter Jurisdiction Under the Exchange Act

The Exchange Act itself is silent as to its extraterritorial reach. *Itoba Ltd. v. Lep Group PLC*, 54 F.3d 118, 121 (2d Cir. 1995); *Europe & Overseas Commodity Traders, S.A. v. Banque Paribas London*, 940 F. Supp. 528, 533 (S.D.N.Y. 1996), *aff'd*, 147 F.3d 118 (2d Cir. 1998). Consequently,

[6] Defendants do not advance the same jurisdictional defense against the Lead Domestic Plaintiff, who purports to represent a class of investors who purchased the Bank's ADRs during the proposed class period. There is no dispute that the securities law extends to protect domestic investors who purchase securities in domestic markets. *See Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993, 997 (2d Cir. 1975). However, as explained in Point

"[w]hen, as here, a court is confronted with transactions that on any view are predominantly foreign, it must seek to determine whether Congress would have wished the precious resources of the United States courts and law enforcement agencies to be devoted to them rather than leave the problem to foreign countries." *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 985 (2d Cir. 1975); *see also In re Alstom S.A. Secur. Litig.*, 406 F. Supp. 2d 346, 375 (S.D.N.Y. 2005) ("[I]nsofar as the Second Circuit's subject matter jurisdiction doctrine viewed as a whole suggests an overlying principle . . . it is one that, in the final analysis, is grounded on congressional policy as bounded by a standard of reasonableness."). The presumption in such a case is against extending jurisdiction. *Cf. Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 31 (D.C. Cir. 1987); *Europe & Overseas Commodity Traders*, 147 F.3d at 131.

Guided by these principles, the Second Circuit developed two tests for determining whether district courts have subject matter jurisdiction over foreign plaintiffs alleging violations of the Exchange Act's anti-fraud provisions: the "effects" test and the "conduct" test. *See Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1336-37 (2d Cir. 1972); *Schoenbaum v.*

II, *supra*, the Lead Domestic Plaintiff is dismissed from the action on other grounds.

Firstbrook, 405 F.2d 200, 206-09, *modified en banc on other grounds*, 405 F.2d 215 (2d Cir. 1968).

Under the effects test, a district court may exercise jurisdiction over foreign plaintiffs where the alleged illegal activity causes a "substantial effect" on United States investors or markets. *See Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir. 1991) (citations omitted). Because the effects in the United States must be substantial to confer jurisdiction under this test, it is not satisfied when predominantly foreign-based fraud only tangentially impacts the United States market, such as by affecting general investor confidence. *See, e.g., Bersch*, 519 F.2d at 987-88.

Under the conduct test, a district court may exercise jurisdiction if a defendant's conduct in the United States was more than "merely preparatory" to the fraud, and particular acts or culpable failures to act within the United States "directly caused" losses to foreign investors abroad. *See Bersch*, 519 F.2d at 993; *accord Psimenos v. E.F. Hutton & Co.*, 722 F.2d 1041, 1046 (2d Cir. 1983); *SEC v. Berger*, 322 F.3d 187, 193 (2d Cir. 2003).

While articulation of the conduct test is easy, its application is not. Aside from the pertinent residence of the parties, the courts in this circuit generally look to the "the material elements of the conduct alleged to comprise the fraud

at issue," subdivided by the venue and the extent to which particular acts occurred in the United States versus abroad. *See Alstom*, 406 F. Supp. 2d at 371 (citations omitted). This analytical undertaking is complicated by the commercial realities that imbue modern international securities transactions. *See id.* at 372.

> [T]he conduct constituting the charged fraud causing the asserted financial losses is rarely a single act readily traceable in its entirety to a discrete time and place. Rather, more commonly, the alleged misdeeds may comprise but one aspect of a scheme on a larger scale, a link in a transactional chain forming a continuum that spreads out to multiple jurisdictions. Identifying where the charged fraud starts and where it culminates, and what comprises the numerous material points and participants in the transactions in between, inevitably presents formidable challenges.

Id. The complexity of the required analysis means that individual cases are decided on very fine distinctions. *See id.* at 374 ("[T]he presence or absence of any single factor which was considered significant in other cases dealing with the question of federal jurisdiction in transnational securities cases is not necessarily dispositive in future cases." (quoting *IIT v. Cornfeld*, 619 F.2d 909, 918 (2d Cir. 1980))). In general, however, "a case in which the alleged fraud was committed by foreign defendants on foreign individuals in a foreign country" is not what the securities laws of this country

were designed to remedy. *See Tri Star Farms Ltd. v. Marconi, PLC*, 225 F. Supp. 2d 567, 578 (W.D. Pa. 2002).

The Second Circuit has instructed that the effects and conduct tests may be considered collectively in determining jurisdiction. *See Itoba*, 54 F.3d at 22 ("[A]n admixture or combination of the two [tests] often gives a better picture of whether there is sufficient United States involvement to justify the exercise of jurisdiction by an American court."). However, where the effects of an alleged fraud are predominantly foreign, the amount of domestic conduct and its nexus to the alleged injury required to sustain jurisdiction is at its greatest. *See generally Bersch*, 519 F.2d at 987-88. That is especially true in a class action involving both foreign and domestic plaintiffs, such as this, where the danger exists that a "very small tail" may be "wagging an elephant." *See IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1018, n.31 (2d Cir. 1975); *accord Bersch*, 519 F.2d at 996 (2d Cir. 1975) (noting that "[t]he management of a class action with many thousands of class members imposes tremendous burdens on overtaxed district courts," especially "when they are abroad.").

C. **<u>The Foreign Plaintiffs Have Failed to Demonstrate Subject Matter Jurisdiction Over their Claims</u>**

Weighing the totality of the factors here, the Court finds that the Lead Foreign Plaintiffs have failed to meet their burden of demonstrating that subject matter jurisdiction exists.

To begin, the alleged fraud had very little -- if any -- demonstrable effect on the United States market. The Lead Foreign Plaintiffs do not appear to contend otherwise. At most, the alleged fraud *may* have adversely impacted domestic ADR purchasers. As explained *infra* in Point II, however, the Lead Domestic Plaintiff who represents the proposed ADR subclass has not even demonstrated any damage during the relevant period. Moreover, because the aggregate value of the ADRs represented a mere 1.1% of NAB's nearly one-and-a-half billion ordinary shares, any effect on the United States market from the alleged fraud pales in comparison to the effect on the foreign markets.

Nor is the alleged domestic conduct sufficient to confer this Court with jurisdiction. The domestic conduct upon which the Plaintiffs rely consists of HomeSide's allegedly improper valuation of its future cash flow by using and/or manipulating a valuation model for its MDRs that HomeSide allegedly knew yielded unrealistic results. Plaintiffs contend that this conduct provides a basis for subject matter jurisdiction on the

theory that the statements made by NAB in Australia and relied upon by NAB investors simply would not have been fraudulent but-for HomeSide's alleged impropriety.

Defendants maintain, however, that HomeSide's alleged misconduct (even if true) is insufficient to confer jurisdiction in that it did not "directly cause" the Lead Foreign Plaintiffs' alleged loss. Rather, Defendants claim, the alleged securities fraud was committed -- if at all -- only when NAB distributed the allegedly false information to the Lead Foreign Plaintiffs abroad. In support of their position, Defendants heavily rely on the Second Circuit's seminal and oft-cited "conduct test" decision in *Bersch*, 519 F.2d 974 (2d Cir. 1975).

In *Bersch*, a Canadian company made a series of public offerings of its common stock to investors outside of the United States. *Bersch*, 519 F.2d at 979-80. The shares were purchased mostly by foreigners and traded on foreign exchanges, although some of the shares ended up in the hands of Americans. *Id.* Shortly after the offerings, the price of the shares plummeted. *Id.* at 981. The domestic plaintiff brought a proposed class action on behalf of all domestic and foreign purchasers of the Canadian company's stock. *Id.* In his complaint, he alleged that the offering materials failed to disclose material facts, and that a variety of conduct occurred in the United States. *Id.* Specifically, he claimed that the underwriters and their

agents had met in New York on a number of occasions to plan the offering; that an American law firm and American accounting firm helped prepare the offering; that parts of the allegedly false prospectus were drafted and reviewed in New York; and that bank accounts were opened in New York in anticipation of deposits from the offering. *Id.* at 985, n.24.

In reversing the district court, the Second Circuit in *Bersch* held that no subject matter jurisdiction existed as to the foreign purchasers because the alleged domestic conduct was merely preparatory and did not "directly cause[]" the alleged loss *Id.* at 987. The Court explained:

> The fraud, if there was one, *was committed by placing the allegedly false and misleading prospectus in the purchasers' hands*. Here the final prospectus emanated from a foreign source . . . . Not only do we not have the case where all the misrepresentations were communicated in the nation whose law is sought to be applied . . . or the case where a substantial part of them were . . . but we do not even have the oft-cited case of the shooting of a bullet across a state line where the state of the shooting as well as of the state of the hitting may have an interest in imposing its law. At most the acts in the United States helped to make the gun whence the bullet was fired from places abroad . . . .

Id. at 987 (emphasis added).

As applied to the facts of this case, Defendants claim that *Bersch* is controlling. Specifically, they argue that notwithstanding the alleged domestic conduct by HomeSide, the allegedly fraudulent statements were "fired" from Australia at

predominantly foreign plaintiffs who purchased NAB stock on that country's stock exchange.

The Lead Foreign Plaintiffs attempt to distinguish *Bersch* on the ground that the alleged domestic conduct in that case was more far removed from the ultimate commission of the fraud than is the case here. Plaintiffs also point out that *Bersch* was not the last, or only, word on the issue. For example, in *Vencap* -- decided the same day as *Bersch* -- the Second Circuit explained that Congress did not intend "to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners." *Vencap*, 519 F.2d at 1017. Moreover, in *Itoba*, the Second Circuit explained that the "situs of preparations for SEC filings should not be determinative of jurisdictional questions." 54 F.3d at 124.[7]

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[7] As the court in *Alstom* explained:

> [T]he Second Circuit has instructed that whether the alleged misrepresentations were actually made in the United States, or in another country, or whether a material domestic act directly caused the alleged harm, is not in and of itself determinative. Nor is the site of the preparation of registration statements filed in this country by itself a sufficient jurisdictional consideration. . . . In fact, the Circuit Court has cautioned against mechanical reliance on any particular factor as a sufficient decisional guide from one case to another.

406 F. Supp. 2d at 374-75 (citations omitted).

The Second Circuit applied these principles in *SEC v. Berger*, upon which Plaintiffs heavily rely. There, the defendant was a New York resident who had formed an offshore investment company (the "Fund") organized under the laws of the British Virgin Islands. *Berger*, 322 F.3d at 188. The Fund "invested . . . in stocks on domestic securities exchanges" largely through a brokerage account at Bear Stearns in New York that "cleared all of its transactions" in New York City. *Id.* Ultimately, the Fund suffered significant financial losses as a result of investments which were made at the defendant's direction. *Id.* at 189. Rather than report the losses to investors, however, the defendant admittedly created fraudulent account summaries in New York to mask the shortfalls. *Id.* These summaries were used in two fraudulent ways: first, they were incorporated into "the Fund's annual financial statements, which were created . . . in New York and made available for potential investors to review; and second, "the fictitious financial statements" prepared in New York were "sent offshore to the Fund's administrators, and then calculations based on these statements were retransmitted back into this country and abroad" to prospective and then-existing shareholders. *Id.* at 189; *see also id.* at 194. The Second Circuit held that subject matter jurisdiction existed on these facts, explaining that "while operating entirely from New York, [the defendant]

executed a massive fraud upon hundreds of investors involving transactions on United States exchanges." *Id.* at 195. According to the Court, the fact that the statements that ultimately conveyed the fraudulent information to investors were prepared and mailed in Bermuda" was immaterial. *Id.* That was so because the preparation and mailing "was not itself fraudulent," as "[t]he Fund [a]dministrator was simply acting under [the defendant's] instruction," who himself had concocted the scheme in New York. *Id.*

The instant case can fairly be said to fall somewhere in between *Bersch* (upon which Defendants rely) and *Berger* (upon which Plaintiffs rely). While the amount and significance of the alleged domestic conduct is greater in this case than in *Bersch*, it falls far short of the alleged conduct in *Berger*. Unlike in *Berger* -- and more like *Bersch* -- the securities at issue here are predominantly foreign securities traded on foreign exchanges. And whereas in *Berger* "the fraudulent conduct was carried out *entirely*" in the United States, 322 F.3d at 195 (emphasis added), a significant, if not predominant, amount of the material conduct in this case occurred a half-world away.

That the allegedly false statements pertained to NAB's domestically based subsidiary does not change the result. In this regard, the Court finds instructive Judge Owen's decision

in *Froese v. Staff*, which involved similar allegations as those presented here. *See Froese*, No. 02 CV 5744 (RO), 2003 WL 21523979 (S.D.N.Y. July 7, 2003). The plaintiffs in *Froese* were investors in a German clothing company, who incurred losses due to artificially inflated earnings statements the corporate defendant prepared and disseminated from Germany. *Id.*, at * 1. Those statements had been inflated because the defendant's U.S. subsidiary had allegedly engaged in "channel stuffing," a practice whereby "revenues [are] overstated by including amounts for products that the company delivered to and endeavored to force their retail network to accept despite no demand, with perhaps secret assurances that the goods, if unsold, could be returned." *Id.* Notwithstanding that the allegedly inflated financial information emanated from the United States, Judge Owen found that jurisdiction was absent because the allegedly fraudulent statements were "conceived, engineered and published in Germany," and that it was "these misstatements and not any activity which [led] to the alleged misrepresentations which 'directly caused' the financial losses." *Id.*, at * 2.

Also instructive is Judge Pauley's decision in *In re Bayer AG Secur. Litig.*, 423 F. Supp. 2d 105 (S.D.N.Y. 2005). There, the putative class action plaintiffs were investors in the securities of German-based Bayer AG, which sold its securities primarily in foreign markets and, to a lesser extent, in the

form of ADRs in the United States. *See id.* at 107. The plaintiffs attempted to premise jurisdiction over a subclass of foreign plaintiffs by alleging that Bayer AG's wholly owned United States subsidiary made fraudulently aggressive projections about the profitability of a particular pharmaceutical, which projections formed the basis of misleading statements made by Bayer AG and were relied upon by the foreign plaintiffs abroad. *Id.* at 109, 111. In declining to extend jurisdiction to the foreign plaintiffs, the court gave significant weight to the "location from where [the] allegedly false statements emanated" -- which was Germany -- as such dissemination "embodie[d] the heart of the alleged fraud." *Id.* at 111 (internal quotes, marks and citations omitted).[8]

While the instant case presents a close call, the Court is ultimately left with the impression that the Lead Foreign

[8] This Court is mindful of decisions by other judges in this district which reached contrary results to *Froese* and *Bayer* in arguably similar cases. For example, in *Alstom*, Judge Marrero found that jurisdiction existed over a class of foreign plaintiffs, who alleged that: (i) "accounting improprieties" at a United States subsidiary led to significant errors in its financial statements; and (ii) that such statements were incorporated into the financial statements of the foreign parent, which were distributed and relied upon by investors abroad. *Alstom*, 406 F. Supp. 2d at 362-63, 387. And in *In re Gaming Lottery Secur. Litig.*, Judge Patterson found that jurisdiction existed over a class of foreign plaintiffs who alleged that: (i) the Canadian based Gaming Lottery Corporation ("GLC") had acquired a United States subsidiary, Specialty Manufacturing Inc. ("SM"), without obtaining state regulatory approval; (ii) falsely represented to the investing public that this acquisition was completed when it had not been; (iii) consolidated SM's financial results with those of GLC; and (iv) misled the plaintiffs by making announcements of other United States acquisitions that were certain to fail once those state regulators learned of GLC's deception concerning SM. *See* 58 F. Supp. 2d 62, 65 (S.D.N.Y. 1999). Regardless of the jurisdictional

Plaintiffs have not met their burden of demonstrating that Congress intended to extend the reach of its laws to the predominantly foreign securities transactions at issue here. As was the case in *Bersch, Froese* and *Bayer*, "[a]t most the acts in the United States helped to make the gun whence the bullet was fired" from -- and at -- places abroad. *See Bersch*, 519 F.2d at 937.

HomeSide's alleged conduct -- however it may be classified -- is not in itself *securities* fraud. It amounts to, at most, a link in the chain of an alleged overall securities fraud scheme that culminated abroad. Thus, while Plaintiffs urge that there would have been no securities fraud but-for the domestic conduct, they fail to appreciate that the domestic conduct would be immaterial to its Rule 10b-5 claim but-for (i) the allegedly knowing incorporation of HomeSide's false information; (ii) in public filings and statements made abroad; (iii) to investors abroad; (iv) who detrimentally relied on the information in purchasing securities abroad.[9]

decisions in *Alstom* and *Gaming Lottery*, I believe that the allegations before me in this case warrant a different result.

[9] While NAB filed certain forms with the SEC that incorporated the allegedly fraudulent representations disseminated in comparable filings abroad, that cannot provide a basis for jurisdiction as to the Lead Foreign Plaintiffs, who do not allege that they were even aware of the SEC filings, much less relied upon them. *See, e.g., In re Baan Co. Secur. Litig.*, 103 F. Supp. 2d 1, 10 (D. D.C. 2000) ("To establish jurisdiction, [foreign] plaintiffs must allege that the filings with the SEC or other fraudulent actions in the United States were "a substantial or significant contributing cause of the decision to purchase stock") (internal marks and citations omitted); *Tri-Star*

On balance, it is the foreign acts -- not any domestic ones -- that 'directly caused' the alleged harm here. *See Bersch*, 519 F.2d at 993; *see also Froese*, 2003 WL 21523979, at * 2; *Bayer*, 423 F. Supp. 2d at 111-12. Accordingly, the Lead Foreign Plaintiffs are dismissed from the action because this Court lacks subject matter jurisdiction over their claims. *See Bersch*, 519 F.2d at 997 ("eliminat[ing] from the class action all purchasers other than [those] who were residents or citizens of the United States.").

II. THE LEAD DOMESTIC PLAINTIFF LACKS STANDING AND HAS OTHERWISE FAILED TO STATE A CLAIM FOR RELIEF

The Defendants separately move to dismiss from the action the sole Lead Domestic Plaintiff -- Mr. Morrison -- who is the only named plaintiff purporting to assert damages on behalf of similarly situated purchasers of the Bank's ADRs on the NYSE. Defendants maintain that Mr. Morrison lacks standing, and has otherwise failed to state a claim, because he has failed to allege that he suffered any damages from the alleged fraud. The Court agrees.

Pecuniary loss is an essential element of a Rule 10b-5 claim for money damages. *See Commercial Union Assur. Co. v.*

Fanns, 225 F. Supp. 2d at 579 n.13 (stating that "the inclusion of alleged misrepresentations in reports filed with the SEC . . . are insubstantial in comparison to the conduct that allegedly occurred abroad and that this conduct could not have played a significant role in any losses sustained by the foreign investors."); *accord Bayer*, 423 F. Supp. 2d at 112; *Nathan Gordon Trust v. Northgate*, 148 F.R.D. 105, 108 (S.D.N.Y. 1993).

Milken, 17 F.3d 608, 613 (2d Cir. 1994). The measure of damages in private securities fraud actions are subject to the Private Securities Litigation Reform Act ("PSLRA"), Pub.L. No. 104-67, 109 Stat. 737 (1995) (codified in pertinent part at 15 U.S.C. § 78u-4(e)(1)). As relevant, section 78u-4(e)(1) provides that where a plaintiff purchases a security during a putative class period, his recovery is limited to the amount by which his purchase price exceeds the security's mean price during the 90-day period immediately following the correcting disclosure (the so-called "lookback period"). 15 U.S.C. § 78u-4(e)(1).[10]

By operation of this provision, "if the mean trading price of a security during the 90-day period following the correction is greater than the price at which the plaintiff purchased his stock then that plaintiff would recover nothing under the PSLRA's limitation on damages." *In re Mego Fin. Corp. Sec.*

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[10] Subject to an exception not pertinent here, 15 U.S.C. § 78u-4(e)(1) provides in relevant part:

> [I]n any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

15 U.S.C. § 78u-4(e)(1). This provision was in large part enacted to prevent putative plaintiffs from seizing upon short-term price swings in the market.

Litig., 213 F.3d 454, 461 (9th Cir. 2000) (emphasis in original). That is the case here.

The Lead Domestic Plaintiff states in his PSLRA certification that his only purchase of NAB's securities during the proposed class period was a purchase of 125 ADRs on August 11, 2000, at a price of $74 per security. The mean trading price during the statutory lookback period was $75 -- one dollar more than what he originally paid for the securities. (*See* Declaration of George T. Conway III, Ex. W.)[11] Because the Lead Domestic Plaintiff has failed to allege that he was damaged in any way by the alleged fraud, he lacks standing in this action and has otherwise failed to state a claim for relief.

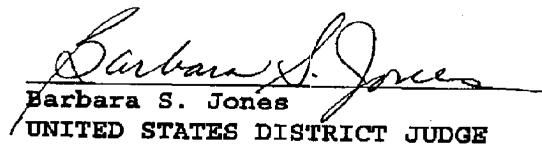
CONCLUSION

For the reasons explained in Parts I and II, *supra*, no named plaintiff remains in this action. Accordingly, the Complaint is DISMISSED. Plaintiffs' counsel, however, is granted leave to substitute a lead domestic plaintiff and to

[11] This Court is authorized to take judicial notice of publicly reported stock prices. *E.g.*, *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 245 n.9 (S.D.N.Y. 2003).

otherwise amend the pleadings with respect to ADR purchasers only.

SO ORDERED:



Barbara S. Jones
UNITED STATES DISTRICT JUDGE

New York, New York
October 25, 2006

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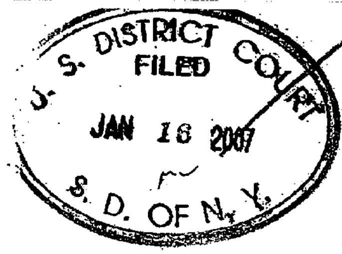

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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In re NATIONAL AUSTRALIA BANK, SECURITIES LITIGATION,

--X

03 CIVIL 6537 (BSJ)

JUDGMENT

Whereas on January 9, 2007, the parties having stipulated and agreed to dismiss the amended complaint with prejudice, which the Court so ordered, and the matter having come before the Honorable Barbara S. Jones, United States District Judge, and the Court, on January 10, 2007, having rendered its Order directing the Clerk of the Court to enter a final judgment in this matter, it is,

ORDERED, ADJUDGED AND DECREED: That for the reasons stated in the Court's Order dated January 10, 2007, the amended complaint is dismissed with prejudice.

Dated: New York, New York
January 12, 2007

J. MICHAEL McMAHON

Clerk of Court

BY:

Deputy Clerk

JAN 17 2007 12:00 PM

THIS DOCUMENT WAS ENTERED ON THE DOCKET ON 1/16/07