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Monsoon in the Forecast? SEC Enforcement after *Scoville*

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The Securities and Exchange Commission may police extraterritorial misconduct so long as it satisfies the conduct and effects test adopted by Congress in Section 929P(b) of the Dodd-Frank Act, a panel of the U.S. Court of Appeals for the Tenth Circuit has held. *See S.E.C. v. Scoville*, No. 17-4059, ___ F.3d ___, 2019 WL 302867 (10th Cir. Jan. 24, 2019). Affirming a district court decision on an issue of first impression, the panel's two-judge majority had little doubt that Section 929P(b) overcame the presumption against the extraterritorial application of U.S. law. The majority was not persuaded that *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), a private securities fraud lawsuit in which the Court dispatched the conduct and effects test only weeks before Congress passed Dodd-Frank, required a different result. Nor was the majority swayed by the concurring member of the panel, who observed that the panel could have affirmed under the transactional test adopted in *Morrison*. Unless and until the Supreme Court or Congress weighs in, *Scoville* presages more aggressive overseas enforcement activity, even in cases, unlike *Scoville*, where the misconduct is not connected to domestic securities transactions.

Background

The heart of the Commission's antifraud enforcement efforts is Rule 10b-5, adopted by the Commission pursuant to Section 10(b) of the Securities Exchange Act of 1934. Courts have interpreted Section 10(b) and Rule 10b-5 to provide a private cause of action to investors who lose money when they buy or sell securities in reliance on fraudulent statements, omissions, or schemes. The Exchange Act also authorizes the Commission to bring civil actions and administrative proceedings to enforce Section 10(b), and the Securities Act of 1933 authorizes the Commission to enforce Section 17(a), which is similar in scope and language to Rule 10b-5 but allows certain claims to be brought for mere negligence.

Until the late 1960s, U.S. courts did not exercise subject-matter jurisdiction over Section 10(b) and 17(a) cases involving foreign securities transactions. Under a longstanding prudential principle of statutory construction, the "presumption against extraterritoriality," U.S. laws are presumed to apply only to conduct in the U.S. unless Congress indicates otherwise. The securities laws were silent on the issue.

From the late 1960s, however, the courts developed a more expansive view of their authority to hear those cases. Under the conduct and effects test, courts exercised jurisdiction when the conduct prohibited by the antifraud provisions occurred in the U.S. or had a substantial effect in the U.S. or on U.S. citizens. Over time, the conduct and effects test made the U.S. "the Shangri-La

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of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[1] The Commission availed itself of the conduct and effects test, too.[2]

In 2010, however, the Supreme Court gutted the conduct and effects test. *See Morrison*, 561 U.S. 247. *Morrison* was a putative class action asserting that Australian investors, holding shares issued in Australia by an Australian bank, were deceived about the value of certain U.S. assets held by the bank, in violation of Section 10(b). The district court and appeals court dismissed the lawsuit for lack of subject-matter jurisdiction because the plaintiffs failed to satisfy the effects prong of the conduct and effects test. The Supreme Court affirmed the dismissal, but not on the basis of subject-matter jurisdiction.

The issue was not jurisdiction, the Court held. The Exchange Act plainly gave the district court subject-matter jurisdiction to hear whether Section 10(b) applied to the bank's conduct.[3] Rather, the issue was the merits of the cause of action – did Section 10(b) itself prohibit extraterritorial misconduct? Citing the presumption against extraterritoriality, the Court looked to the plain language of the Exchange Act and concluded that Section 10(b) prohibited only misconduct connected to securities bought or sold in the U.S. Because the bank's alleged misconduct did not satisfy this "transactional test," the investors failed to state a claim under Section 10(b).

Morrison's transactional test is widely understood to have replaced the conduct and effects test, at least for investor lawsuits under Section 10(b). Whether *Morrison* also restrains Commission enforcement actions and administrative proceedings under Sections 10(b) and 17(a) has been hotly contested. The Commission has argued it does not. In support, the Commission has pointed to the Dodd-Frank Act, passed by Congress a few weeks after *Morrison*. Section 929P(b) of the Act amended the Securities Act and the Exchange Act to expressly give U.S. district courts subject-matter jurisdiction over Section 10(b) and 17(a) claims brought by the Commission and connected to extraterritorial activity, including overseas securities transactions, so long as the conduct and effects test is satisfied.[4] The Commission has steadfastly maintained that by passing Section 929P(b) on the heels of *Morrison*, Congress signaled its intention to preserve the conduct and effects test for enforcement actions and administrative proceedings under Sections 10(b) and 17(a).

Traffic Monsoon

Traffic Monsoon – as *Scoville* was captioned in the district court – was the first district court decision to decide the post-*Morrison* application of the conducts and effects test in light of Section 929P(b).

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1 *Morrison*, 561 U.S. at 270. The development of the conduct and effects test is summarized in *Morrison* at 255-61.

2 *See, e.g., S.E.C. v. Berger*, 322 F.3d 187 (2d Cir. 2003).

3 At the time, the jurisdictional provision stated: "The district courts of the United States ... shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder." 15 U.S.C. § 78aa(b). Section 929P(b) of the Dodd-Frank Act subsequently amended the jurisdictional provision.

4 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864–65 (2010), codified at 15 U.S.C. §§ 77v(c) [Section 22(c)], 78aa(b) [Section 27(b)]. The "conduct" subsection references "conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors." The "effects" subsection references "conduct occurring outside the United States that has a foreseeable substantial effect within the United States."

See 245 F. Supp. 3d 1275 (D. Ut. 2017).[5] The Commission alleged that Traffic Monsoon, an internet advertising company, engaged in an illegal Ponzi scheme in violation of Sections 10(b) and 17(a). The scheme allegedly involved the sale of so-called "AdPacks," which the Commission claimed are securities. The Commission moved to preliminarily enjoin Traffic Monsoon's operations.

Opposing the motion, Traffic Monsoon argued that 90 percent of its customers bought AdPacks over the internet while located outside the U.S. and, under *Morrison*, the alleged misconduct in connection with the offer and sale of those AdPacks was beyond the reach of the securities laws. Section 929P(b) did not help the Commission, Traffic Monsoon argued, because Congress only amended the jurisdictional provisions of the securities law, whereas the Supreme Court indicated in *Morrison* that extraterritoriality was an issue of substantive law, and even after Dodd-Frank, neither Section 10(b) nor Section 17(a) addresses conduct outside the U.S.

The district court rejected Traffic Monsoon's arguments. It acknowledged that Congress has not amended Sections 17(a) or 10(b) to address extraterritoriality. But it held that Section 929P(b)'s plain language and legislative history are sufficient to overcome the presumption against extraterritoriality. The court noted that Congress drafted and was finalizing Section 929P(b) before *Morrison* was decided, and that it was commonly understood at the time that Section 10(b)'s extraterritorial application was a jurisdictional issue. Given that context, the court held, the jurisdictional amendments evidenced Congress's intent that Sections 10(b) and 17(a) apply extraterritorially for purposes of enforcement. The court then found that Traffic Monsoon took significant steps in the U.S. to further AdPack sales,[6] thereby satisfying the conduct prong of the conduct and effects test. Accordingly, it granted the Commission's motion and entered a preliminary injunction against Traffic Monsoon.

Recognizing there is "'substantial ground for difference of opinion' as to whether Section 929P(b) of Dodd-Frank reinstated the conduct and effects test for litigation brought by the SEC," the court certified its order for interlocutory appeal to the Tenth Circuit. 245 F. Supp. 3d at 1304.

Scoville

A three-judge panel of the Tenth Circuit affirmed the district court's entry of the preliminary injunction, but split on the reason why. *See* 2019 WL 302867. A two-judge majority affirmed the district court's extraterritoriality analysis. It stated that the Supreme Court had established a two-step

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5 At least one district court before *Traffic Monsoon* analyzed the issue at some length. *See S.E.C. v. Chicago Convention Ctr., LLC*, 961 F. Supp. 2d 905, 909-16 (N.D. Ill. 2013). But it did not decide the issue because it concluded that the Commission stated a claim under both the pre-*Morrison* conduct and effects test and *Morrison*'s transactional test. *See id.* at 916-17. At least two district courts have held that the transactional test controls enforcement actions under Sections 10(b) and 17(a), but neither analyzed the Section 929P(b) issue and both cited for support investor, not enforcement, actions brought under other provisions of the Securities Act. *See S.E.C. v. ICP Asset Mgmt., LLC*, No. 10-cv-4791, 2012 WL 2359830, at *2 (S.D.N.Y. June 21, 2012), citing *In re Vivendi Universal, S.A., Sec. Litig.*, 842 F. Supp. 2d 522, 529 (S.D.N.Y. 2012); *S.E.C. v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 164 (S.D.N.Y. 2011), citing *In re Royal Bank of Scotland Grp. PLC Sec. Litig.*, 765 F. Supp. 2d 327, 338-39 (S.D.N.Y. 2011).

6 Specifically, Traffic Monsoon's principal "created and promoted the AdPack investments over the internet while residing in Utah," and Traffic Monsoon itself did not dispute that "'significant steps' in furtherance of the AdPack sales were carried out in the United States." *Id.* at 1294.

framework for deciding questions of extraterritoriality. "The first step asks whether the presumption against extraterritoriality has been rebutted." If it has not, "the second step … asks whether the case involves a domestic application of the statute." If either step is satisfied, "the statute applies to the challenged conduct." *Id.* at *6 (internal quotation marks, citations omitted).

The majority held that it could resolve the appeal "at step one." Tracing the same path as the district court, it was "clear" to the majority that with Section 929P(b), "Congress 'affirmatively and unmistakably' directed that [the antifraud] provisions apply extraterritorially in an enforcement action." *Id.* at *9 (quoting *RJR Nabisco, Inc. v. European Cmty.*, 136 S. Ct. 2090, 2100 (2016)).

Next, the majority considered whether Traffic Monsoon's sales, and offers to sell, AdPacks to customers located outside the U.S. satisfied the conduct and effects test. Again, they agreed with the district court's conclusion, holding that defendants "conduct within the United States … constitute[d] significant steps in furtherance of the violation of Rule 10b-5 and Section 17(a)." *Id.* at *10 (internal quotation marks, citation omitted). As a result of that ruling, a ruling that the AdPacks constituted securities under the *Howey* test, and a ruling that the SEC had shown a likelihood of succeeding on the merits, the majority affirmed the district court's preliminary injunction against defendants' activities.

Unpersuaded that the AdPack sales were foreign sales, the panel's third member would have affirmed at step two. "Under any common sense reading of *Morrison* and § 10(b), Traffic Monsoon made several securities sales in the United States." *Id.* at *16.

Discussion

Scoville is a significant victory for the SEC. Since Dodd-Frank was enacted, the Commission has sought – and has now attained – appellate court confirmation of the extraterritorial enforcement power that it perceived the Act bestowed. The Commission will likely waste little time in wielding that power.

How long it will be able to do so remains to be seen. The district court in *Scoville* entered the preliminary injunction on alternative grounds – holding both that Section 929P(b)'s conduct and effects test applied to the SEC's enforcement of Sections 10(b) and 17(a), and that Traffic Monsoon's acts satisfied *Morrison's* transactional test.[7] Accordingly, the appellate panel did not have to go as far as it did to affirm – a fact future defendants undoubtedly will highlight, especially outside the Tenth Circuit.

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7 *See* 245 F. Supp. 3d at 1294-95 ("Even if the court has erred in concluding that Section 929P(b) reinstated the conduct and effects test, all of the AdPack sales challenged by the SEC are domestic transactions under the *Morrison* transactional test" because in selling the AdPacks over the internet to both foreign and domestic purchasers, Traffic Monsoon, a Utah limited liability company, "incurred irrevocable liability in the United States to deliver this security."), citing *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68 (2d Cir. 2012) (holding that the standard for determining whether an off-exchange security transaction occurred in the U.S. for purposes of *Morrison*'s transactional test was whether the buyer or seller incurred irrevocable liability in the U.S.). Judge Briscoe noted not only this aspect of the district court's ruling, but also that the SEC advanced the alternative ground on appeal. *See* 2019 WL 302867, at *15.

Nor was the panel faced with a situation where the SEC's jurisdictional rubber literally hits the road – entirely extraterritorial conduct, including overseas securities transactions, where the Commission relies on the alleged effects of that conduct in the U.S. to justify its jurisdiction. That fact pattern, which implicates only the statute's effects prong and fails *Morrison's* transactional test, might compel a court to take a hard look at the issue in a way the *Scoville* panel did not have to.

In such a case, the court might take note of the textual distinction between the two prongs of the conduct and effects test. The former addresses "conduct within the United States that constitutes significant steps in furtherance of the violation [of the antifraud provisions], *even if the securities transaction occurs outside the United States and involves only foreign investors*" (emphasis added); the latter addresses "conduct occurring outside the United States that has a foreseeable substantial effect within the United States." That the effects prong lacks the italicized language suggests that Congress intended for that prong to apply only if the extraterritorial misconduct were connected to a domestic securities transaction.

The hypothetical case highlights a broader question about the limit of the SEC's extraterritorial reach. Some will argue that *Morrison's* transactional test is sufficient to accommodate the Commission's law enforcement needs. Others will worry that the conduct and effects test is needed to prevent the U.S. from becoming a base for securities scams abroad in addition to deterring foreign scams that have an impact in the U.S., regardless of where the securities transaction occurs. The majority in *Scoville* seems to have concluded that Congress resolved the question with Dodd-Frank and favored expansive SEC jurisdiction. Whether other courts will agree, or Congress will clarify, is only a matter of time.