ALERT MEMORANDUM

Tenth Circuit Affirms Ruling Allowing SEC to Bring Securities Fraud Claims Over Certain Foreign Transactions

January 30, 2019

Last week, in *SEC v. Scoville*, the U.S. Court of Appeals for the Tenth Circuit held that Dodd-Frank[1] allows the Securities and Exchange Commission to bring fraud claims based on sales of securities to foreign buyers where defendants engage in fraudulent conduct *within* the United States. In so holding, the Court concluded that Dodd-Frank abrogated in part the Supreme Court's rule, announced in *Morrison v. National Australia Bank Ltd.*, that fraud claims under the federal securities laws can only be brought with respect to transactions in securities listed on a U.S. exchange or transactions in other securities in the U.S.[2] If adopted more broadly, this ruling would restore in government enforcement actions the more expansive conduct-and-effects test that the *Morrison* Court rejected.

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[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

[2] *SEC v. Scoville*, No. 17-4049, 2019 WL 302867 (10th Cir. Jan 24, 2019).

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Background

Morrison and Dodd-Frank

As we previously discussed,[3] in 2010, the U.S. Supreme Court held in *Morrison* that Section 10(b) of the Securities Exchange Act provides a cause of action only for fraud "in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[4] The Court relied on the long-standing presumption that "[w]hen a statute gives no clear indication of an extraterritorial application, it has none,"[5] to conclude that Section 10(b) did not apply abroad. It then announced a new transactional test to replace the nearly four-decade old conduct-and-effects test widely applied by the Courts of Appeals.

Under the conduct-and-effects test, Section 10(b) applied to a transaction if the wrongful conduct occurred in the U.S. or had a substantial effect in the U.S. By contrast, under the more restrictive *Morrison* test, Section 10(b) reached frauds only in connection with a security listed on a U.S. exchange or otherwise bought or sold in the U.S.

While *Morrison* was pending, Congress was drafting Dodd-Frank. Section 929P(b) of that law provides that district courts have jurisdiction over claims under Section 17 of the Securities Act and the antifraud provisions of the Exchange Act brought by the SEC or DOJ, so long as the conduct-and-effects test has been satisfied. Congress finalized the language of Dodd-Frank just days after the Supreme Court issued its decision in *Morrison*.

Morrison held that Section 10(b) does not have extraterritorial application. But the restrictions *Morrison* announced go to whether a claim has been stated, not whether jurisdiction exists. Section 929P(b), on the other hand, addresses the courts' jurisdiction, not whether the antifraud sections apply extraterritorially.

The mismatch between *Morrison* (addressing Section 10(b)'s scope) and Section 929P(b) (addressing U.S. courts' jurisdiction to hear extraterritorial claims) left open the question whether Dodd-Frank in fact reinstated the conduct-and-effects test for governmental actions. The Tenth Circuit is the first federal Court of Appeals to rule on this issue.

Facts

The *Scoville* decision arises out of an SEC civil enforcement action against Traffic Monsoon, LLC, and its founder, Charles Scoville. The SEC alleged that the defendants operated a Ponzi scheme in violation of Exchange Act Section 10(b), Rule 10b-5 thereunder, and Securities Act Section 17(a).

Traffic Monsoon was an internet traffic exchange, which sold a variety of advertising services, including "visits to a purchaser's website in order to make that website look more popular than it really" was.[6] The SEC was concerned with a particular Traffic Monsoon product called an "Adpack." An Adpack entitled the purchaser to 1,000 visits to their website, 20 clicks on one of their online ads, and—most importantly—a share of up to $55.00 of Traffic Monsoon's revenue. However, the purchaser received revenue only for each day that she clicked on 50 internet ads for other Traffic Monsoon customers. Traffic Monsoon's website allowed members to make 50 clicks in about four minutes.

As a general rule, an Adpack purchaser would receive one dollar in revenue for each day she made the required clicks, allowing her to make a ten percent return on her initial investment in 55 days. There was no limit to the number of Adpacks a person could hold at one time. And the same four minutes of ad-clicking counted toward multiple Adpacks. Consistently rolling over Adpacks every 55 days could produce as much as a 66% annual return.

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[3] *District Judge Rules that Dodd-Frank Allows SEC to Bring Securities Fraud Claims Over Certain Foreign Transactions* (Apr. 3, 2017).

[4] *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 273 (2010).

[5] *Id.* at 255.

[6] *Scoville*, 2019 WL 302867, at *1.

A member could also earn a 10% commission on every Adpack purchased by members she recruited. Thus, for every $50.00 Adpack sold, Traffic Monsoon would pay around $60.00 in credits ($55.00 to the Adpack purchaser, plus five dollars to whoever recruited that purchaser).

Though Traffic Monsoon claimed otherwise, the SEC asserted that Adpacks were the primary (indeed, nearly the only) product they sold. And most Adpack purchasers did not use the clicks or visits that they were nominally purchasing—to them, according to the SEC, Adpacks were investments. The upshot is that the money being used to pay shares of revenue to earlier Adpack purchasers was almost entirely generated by new Adpack purchases. This, the SEC alleged, made Traffic Monsoon a Ponzi scheme posing as an internet traffic exchange.

In this interlocutory appeal, defendants challenged district court orders freezing assets, appointing a receiver, and preliminarily enjoining defendants from operating their business.

The Decision

On appeal, the Tenth Circuit rejected the defendants' arguments that their conduct fell outside Section 10(b), Rule 10b-5, and Section 17(a).

Extraterritoriality

The defendants first contended that, because 90% of Adpacks were purchased by individuals living outside the U.S., the SEC could not, under *Morrison*, pursue claims against them. All three panel judges disagreed, but not all for the same reasons.

The Majority. Senior Circuit Judge David Ebel, joined by Circuit Judge Harris Hartz, concluded that Dodd-Frank abrogated *Morrison* as to SEC actions under Section 17(a) of the Securities Act and the antifraud provisions of the Exchange Act.

The majority acknowledged Section 929P(b) amended only the jurisdictional provisions of the Securities Act and the Exchange Act, rather than the substantive provisions. Congress did not explicitly extend the substantive sections of those statutes to *create* claims based on extraterritorial transactions.

Nonetheless, the majority explained that—prior to *Morrison*—most federal courts understood the conduct-and-effects test's limits on the reach of federal securities laws to be jurisdictional. The Court held that, by drafting Dodd-Frank the way it did, Congress plainly intended to codify the conduct-and-effects test and expand the securities laws' reach in SEC actions to cover foreign transactions that satisfied the test.

Morrison, however, rejected the idea that the extraterritorial application of the securities laws was a matter of subject-matter jurisdiction, and was decided immediately before Dodd-Frank became law. Thus, courts would normally assume that Congress was aware of *Morrison* when it drafted Section 929P(b) and intended only to expand federal courts' jurisdiction to foreign transactions, not necessarily securities-fraud liability based on them.

But the majority emphasized that the *Morrison* decision came down on the very last day that the Congressional committee reconciling the House and Senate versions of Dodd-Frank met. Quoting the district court, the majority held that:

> It strains credulity to assume that legislators read *Morrison* on the last day that they met to negotiate the final version of a massive 850-page omnibus bill designed to overhaul large swaths of the United States financial regulations and consciously chose to enact Section 929P(b) against the background of the fundamental shift in securities law brought about by *Morrison*. Given the timing, the more reasonable assumption is that *Morrison* was issued too late in the legislative process to reasonably permit Congress to react to it.[7]

The majority also noted that, based on other provisions of Dodd-Frank, Congress appeared to believe that it had extended the antifraud provisions

[7] *Id.* at *9 (quoting *SEC v. Traffic Monsoon, LLC*, 245 F. Supp. 3d 1275, 1291–92 (D. Utah 2017)).

extraterritorially. Indeed, several members of Congress, including the drafter of Section 929P(b), expressed that view.[8]

Accordingly, the majority concluded that Dodd-Frank did abrogate *Morrison* as to specified governmental actions,[9] and went on to conclude that the defendants' conduct satisfied the conduct-and-effects test. After all, Scoville conceived and created Traffic Monsoon in the U.S.; the Adpacks were created in Utah; and the servers housing the website were located in the U.S.

The Concurrence. Circuit Judge Mary Briscoe concurred only in the result. She would have avoided the question whether Dodd-Frank partially abrogated *Morrison*. Instead, she would have held that the SEC's claims against Traffic Monsoon and Scoville satisfied *Morrison*'s transactional test.

The concurrence uses the "irrevocable liability test" developed by the Second Circuit in *Absolute Activist* to interpret what the Supreme Court in *Morrison* meant by "*domestic* purchases and sales."[10] Under that test:

> [I]n order to adequately allege the existence of a domestic transaction, it is sufficient for a plaintiff to allege . . . that the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security. . . . [Alternatively,] a sale of securities can [also] take place at the location in which title is transferred.[11]

In finding that the SEC's suit satisfied the "irrevocable liability" test, Judge Briscoe emphasized that Traffic Monsoon was based in and operated out of the U.S.; was registered as a corporation in Utah; and made its sales through servers located in the U.S. Moreover, Scoville, Traffic Monsoon's only employee, was a U.S. citizen; listed his Utah apartment as Traffic Monsoon's address; and filed organizational documents in Utah. In short, the concurrence emphasized the defendant-seller's location (rather than the plaintiff-buyer's) at the time the obligation was incurred as the critical fact establishing irrevocable liability.[12]

<u>Definition of a Security</u>

Separately, the panel unanimously rejected defendants' arguments that Adpacks were not securities under the federal securities statutes.

The panel held that Adpacks were investment contracts under the *Howey*[13] test, which requires: "(1) an investment, (2) in a common enterprise, (3) with a reasonable expectation of profits to be

[8] The majority's emphasis on the timing of the *Morrison* decision is interesting because all of the parties in *Morrison* agreed in their briefs well before the opinion was issued that—based on then-recently decided Supreme Court decisions—the Second Circuit erred in treating the extraterritoriality issue as jurisdictional. *Brief for Respondent* at 21–22, *Morrison v. Nat'l Austl. Bank, Ltd.*, 561 U.S. 247 (2010) (No. 08-1191); *Reply Brief of Petitioner* at 1, *Morrison v. Nat'l Austl. Bank, Ltd.*, 561 U.S. 247 (2010) (No. 08-1191).

[9] While *Scoville* considers an SEC action, Section 929P(b) also extends to specified DOJ securities actions.

[10] *Morrison*, 561 U.S. at 268 (emphasis in original).

[11] *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 68 (2d Cir. 2012).

[12] Judge Briscoe's concurrence did not focus on the difference between Section 17(a) and Section 10(b) claims even though at least one court has held that "the SEC need not prove that title has passed or irrevocable liability is incurred in the United States when it brings a claim under Section 17(a)" and that it is enough under 17(a) that an offer "is made in the United States." *SEC v. Tourre*, No. 10 Civ. 3229, 2013 WL 2407172, at *7, 9 (S.D.N.Y. June 4, 2013). The *Tourre* court observed that expansion of the reach of 17(a) does not pose the same "risk of enforcement activities conflicting with the laws of other countries" or "international plaintiffs . . . forum-shop[ping] for favorable securities laws or for the generous discovery rules of U.S. courts" as expanding Section 10(b), because "Section17(a) has no private right of action." *Id.* at *8.

[13] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

derived from the entrepreneurial or managerial efforts of others."[14] The court easily disposed of the first two elements.

With regard to the third element, the Supreme Court has previously said that, in order to satisfy the "efforts of others" prong, an investor must be "led to expect profits solely from the efforts of the promoter or a third party."[15] The defendants argued Adpack purchasers were not led to expect profits solely from Traffic Monsoon because they were aware that they themselves had to perform an action, namely to click on ads, to share in Traffic Monsoon's revenues.

The Tenth Circuit, however, had earlier held that, where an investor has some ability to contribute to a company's profits, "[i]nvestments [nonetheless] satisfy the third prong of the *Howey* test when the efforts made by those other than the investor are the ones which affect significantly the success or failure of the enterprise."[16] The panel explained that four minutes a day clicking on ads was too minimal a contribution to prevent Adpacks from qualifying as securities.

Implications

As the first circuit court decision adopting the SEC's longstanding view that Dodd-Frank partially abrogated *Morrison, Scoville* provides a strong precedent for the the SEC and DOJ to continue to bring more aggressive securities fraud claims in relation to certain foreign transactions, potentially increasing the risk of liability for companies offering securities globally. The majority's reasoning—if adopted more widely by other courts—may increase the risk of enforcement investigations for companies with significant U.S. operations or that engage in investor relations related activities in the U.S., but have no securities listed or sold here. The same may be true for companies located abroad but whose activities result in injury to investors in the U.S. market.[17]

Cleary Gottlieb maintains a strong focus on cross-border enforcement work and is prepared to assist its clients in addressing any increased risk this decision may bring.

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[14] *Scoville*, 2019 WL 302867, at *11 (quoting *SEC v. Shields*, 744 F.3d 633, 643 n.7 (10th Cir. 2014)).

[15] *Howey*, 328 U.S. at 298–99.

[16] *See Scoville*, 2019 WL 302869, at *12 (quoting *SEC v. Shields*, 744 F.3d at 645).

[17] It is worth noting however, *Morrison* still controls private causes of action brought under Section 10(b) of the Exchange Act (and, based on the application of *Morrison* by lower courts, under Sections 11 and 12 of the Securities Act as well).

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