ALERT MEMORANDUM

District Judge Rules That Dodd-Frank Allows SEC to Bring Securities Fraud Claims Over Certain Foreign Transactions

April 3, 2017

Last week a Utah federal judge ruled that a provision of Dodd-Frank[1] authorizes the U.S. Securities and Exchange Commission ("SEC") to bring fraud claims concerning securities bought or sold entirely outside the United States or involving entirely foreign investors, so long as wrongful conduct occurred in or had a substantial effect within the United States.[2] If adopted more widely, this decision would exempt the SEC from 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 securities listed on U.S. exchanges or certain domestic transactions and subject those claims to the prior conduct and effects test that the Supreme Court in *Morrison* had found to be overly broad, vague and difficult to apply.

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In reaching her decision, District Judge Jill N. Parrish certified the order for interlocutory review, recognizing that this is an issue of first impression and that there is "substantial ground for difference of opinion."[3] Despite the uncertainty of whether the court's ruling will survive and be adopted more broadly, this decision raises the possibility that foreign companies with no securities listed or sold in the United States may face a greater threat of federal securities liability from the SEC and U.S. Department of Justice ("DOJ"). We summarize below the court's decision and its practical implications.

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

[2] *SEC v. Traffic Monsoon, LLC*, No. 2:16-cv-00832-JNP, 2017 WL 1166333 (D. Utah Mar. 28, 2017).

[3] *Id.* at *21.

Background and History

On June 24, 2010, the U.S. Supreme Court issued its decision in *Morrison*, holding that Section 10(b) of the 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] There, the Court recited the long-standing presumption against extraterritorial application of U.S. law: "[w]hen a statute gives no clear indication of an extraterritorial application, it has none."[5] Finding that the presumption against the extraterritorial application of a statute had not been overcome, the Court replaced the nearly four-decade old conduct and effects test widely applied by the Courts of Appeals with a transactional test.

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

While *Morrison* was pending in the Supreme Court, Congress was drafting Dodd-Frank, which clarified in Section 929P(b) that U.S. district courts have jurisdiction over Securities Act and Exchange Act claims 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* clarified that there is no jurisdictional limit on the extraterritorial application of Section 10(b); rather this restriction is derived from the meaning of the statute, interpreted through the presumption against extraterritorial application of U.S. law. Section 929P(b), on the other hand, only addresses the jurisdiction of the courts and not whether the securities laws can be applied extraterritorially.

Given this possible conflict between *Morrison* and Section 929P(b) and the timing of these developments, several district courts have questioned whether Dodd-Frank reinstated the conduct and effects test for actions brought by the SEC or whether *Morrison*'s transactional test applies. Judge Parrish's decision in *Traffic Monsoon* is the first federal ruling deciding this issue.

The Decision

This decision arises out of an SEC action against an internet advertising company, Traffic Monsoon, in which the agency alleges that the company is engaged in an illegal Ponzi scheme in violation of Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, as well as Section 17(a) of the Securities Act. In response to the SEC's motion for a preliminary injunction, Traffic Monsoon argued, pursuant to *Morrison*, that the SEC does not have the authority to regulate the majority of its transactions, which it argued were primarily foreign as 90% of customers purchased its securities over the internet while located outside the United States. The SEC argued that the language of Section 929P(b) and its history demonstrate that Congress intended to reinstate the conduct and effects test with respect to SEC enforcement actions involving transnational securities fraud. The SEC, thus, contended that the federal securities laws apply because defendants' conduct in creating, marketing, selling, and managing its investment scheme occurred within the United States.

The court agreed with the SEC and held that Dodd-Frank superseded *Morrison* such that the conduct and effects test applies in SEC securities actions. The court held that the judicial presumption against the extraterritorial application of a statute is rebutted here based on indications of congressional intent that under Section 929P(b), Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act apply to foreign transactions, so long as the conduct and effects test has been satisfied.

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

[5] *Id.* at 248.

Section 929P(b) was first drafted prior to *Morrison*, at a time in which circuit courts widely applied the conduct and effects test. In this pre-*Morrison* context, the court reasoned that Dodd-Frank merely codified the prevailing standard. Given that the last meeting to reconcile the House and Senate bills occurred on the day the Supreme Court issued *Morrison*, the court stated that "[i]t strains credulity" to assume that legislators considered the decision in finalizing the bill.[6] Judge Parrish concluded, "[t]o conform Section 929P(b) to the *Morrison* opinion at the last minute would be like requiring a steaming battleship to turn on a dime to retrieve a lifejacket that fell overboard," and "[t]hus the court does not presume that Congress intended Section 929P(b) to be a nullity."[7]

The court also noted that legislators who worked on the bill explicitly expressed their understanding that Dodd-Frank codified the conduct and effects test. Further, because Section 929P(b) would be a nullity if *Morrison* applied to SEC actions under Sections 10(b) and 17(a), the court reasoned that the assumption that Congress intended the amendment "to be mere surplusage, with no discernable effect, flies in the face of reason."[8] The court explained, "[i]t would be pointless to clarify that district courts had jurisdiction to hear Section 10(b) and 17(a) claims based on certain extraterritorial transactions unless Congress also intended that these statutes be applied extraterritorially."[9]

In sum, the court held that the text of Section 929P(b), the legal landscape in which the bill was drafted, its legislative history, as well as the express purpose of the section indicate Congress's intent that the SEC be permitted to bring securities fraud claims with respect to extraterritorial transactions either where "significant steps in furtherance of" the violations occurred in the United States, or the conduct had a "foreseeable substantial effect" domestically.[10] While the court's decision is in the context of an SEC action, Section 929P(b) applies to an "action or proceeding brought or instituted by the [Securities and Exchange] Commission or the United States"[11] and, as such, extends to securities actions brought by the DOJ.

The court also went on to hold that the transactions at issue were, in any event, domestic under both the conduct and effects test and *Morrison*'s transactional test, and ultimately granted the SEC's request for a preliminary injunction. The court certified the order for interlocutory review, acknowledging that it contains several controlling questions of law for which there is "substantial ground for difference of opinion."[12]

Implications of the Decision

The *Traffic Monsoon* decision allows the SEC and DOJ to bring securities fraud claims in relation to certain foreign transactions, increasing the risk of liability for companies offering securities globally. Thus, if the decision is adopted more widely, it may mean that companies with significant U.S. operations, but no securities listed or sold here, may be at greater risk for SEC and DOJ investigations arising out of securities transactions that were marketed abroad to foreign investors. The decision, however, is on appeal and its implications will depend on the Tenth Circuit's interpretation as well as whether it is accepted more widely among other circuit courts. Moreover, the implications for Judge Parrish's decision are limited to SEC and DOJ actions. As such, *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), providing companies offering securities abroad a meaningful basis to support a motion to dismiss.

[6] *Traffic Monsoon*, 2017 WL 1166333, at *11.

[7] *Id.*

[8] *Id.* at *13.

[9] *Id.* at *12.

[10] *Id.* at *13.

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864–65 (2010) (emphasis added).

[12] *Traffic Monsoon*, 2017 WL 1166333, at *21.

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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