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First Appellate Decision Holds that SEC Can Bring Extraterritorial Enforcement Action Based on Conduct or Effects in United States

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The Court of Appeals for the Tenth Circuit held today that the Securities and Exchange Commission may bring an enforcement action based on allegedly foreign securities transactions involving non-U.S. residents if sufficient conduct occurred in the United States.

The ruling in S*EC v. Scoville and Traffic Monsoon, LLC* (No. 17-4059) is the first appellate decision to resolve whether the Dodd-Frank Act succeeded in allowing the Government to pursue such claims. The court acknowledged that the Act's grant of "jurisdiction" to federal courts over enforcement actions relating to non-U.S. securities transactions had inartfully responded to the Supreme Court's ruling in *Morrison v. National Australia Bank*, which had limited the substantive scope of the federal securities laws to U.S.-based transactions and had held that the extraterritorial reach of U.S. law is not a "jurisdictional" issue. But the court ruled that, despite Congress's mistake in framing Dodd-Frank's provisions as "jurisdictional," rather than substantive, Congress had clearly intended to allow the SEC and the United States to sue based on conduct or effects within the United States, regardless of where the securities transactions occurred.

Legal Background

For several decades before the Supreme Court's 2010 decision in *Morrison*, courts throughout the country had allowed private plaintiffs and the Government to bring "extraterritorial" claims under the federal securities laws based on some version of the "conduct and effects" test. That test examined whether significant wrongful *conduct* related to the transaction had occurred in the United States or whether the wrongful conduct had had a substantial *effect* in the United States. Courts had also generally viewed the test as relating to subject-matter jurisdiction over extraterritorial securities claims.

In 2010, the Supreme Court threw out the "conduct and effects" test and announced a new "transactional" test for determining the federal securities laws' reach. The *Morrison* decision held that the securities laws apply only to alleged misstatements or omissions made "in connection with the purchase or sale of [*i*] a security listed on an American stock exchange, and [*ii*] the purchase or sale of any other security in the United States." The Court also made clear that the scope of the federal securities laws is not a "jurisdictional" issue at all; it concerns the substance of the securities statutes.

The *Morrison* decision was announced on June 24, 2010. On July 21, 2010 – less than one month later – President Obama signed the 850-page Dodd-Frank Act, several sections of which addressed the federal securities laws' extraterritorial application. Section 929P(b) of the Act added language to the Securities Act and the Securities Exchange Act stating that the federal district courts "shall have *jurisdiction* of any action or proceeding brought or instituted by the [SEC] or the United States" alleging a securities-law violation involving:

- "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; or
- "conduct occurring outside the United States that has a foreseeable substantial effect within the United States" (emphasis added).

Thus, the Dodd-Frank Act appeared to be an effort to restore the "conduct and effects" test, rather than a transactional test, for governmental (but not private) securities actions. However, the Act was framed in terms of courts' "jurisdiction" over those actions, even though Morrison had held four weeks earlier that the securities laws' extraterritorial scope is not a jurisdictional issue. Dodd-Frank did not amend the substantive liability provisions of the Exchange Act or the Securities Act.

The *Traffic Monsoon* Decision

Traffic Monsoon is a Utah-based company that allegedly makes most of its money selling advertising packages to "members." Approximately 90% of those members reside outside the United States and presumably bought the ad packages while in their home countries. The SEC alleged that the sale of the packages constituted an illegal Ponzi scheme in violation of § 10(b) of the Exchange Act and § 17 of the Securities Act.

Defendants argued that, at least as to the non-U.S. transactions, the court could not enjoin the allegedly illegal activity because the non-U.S. customers had purchased the ad packs over the internet while located outside the United States. The SEC, in turn, asserted that, regardless of where the transactions had occurred, the Dodd-Frank amendments allowed the SEC to pursue its claims based on significant, allegedly wrongful *conduct* in the United States. These dueling contentions squarely raised the issue whether Dodd-Frank's "jurisdictional" amendment had altered the *substance* of the securities laws for SEC enforcement actions based on the "conduct and effects" test.

The District Court's Ruling

The District Court acknowledged that defendants were correct that "the plain language of Section 929P(b) did not explicitly overturn the core holding of *Morrison*," in that § 929P(b) addressed only the court's "jurisdiction" without amending the substantive scope of the securities statutes. But the court nevertheless held that Congress had intended the Dodd-Frank amendments to allow the SEC and the United States to bring securities-law claims under the "conduct and effects" test even though the statute speaks in only "jurisdictional" terms.

The court observed that the initial versions of the Dodd-Frank amendments had been drafted before the *Morrison* decision, in response to the Second Circuit's urging Congress to clarify federal courts' "jurisdiction" to apply the securities laws to non-U.S. transactions. The conference report on Dodd-Frank was issued only five days after the *Morrison* decision. While Congress is deemed to be familiar with Supreme Court precedents when it enacts legislation, "the more reasonable assumption is that *Morrison* was issued too late in the legislative process to reasonably permit Congress to react to it." As the court noted: "To 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 had fallen overboard."

The court therefore applied the "conduct" test and concluded that the SEC's allegations satisfied that test: defendants had operated in the United States while allegedly defrauding foreign investors. But the court also held in the alternative that the SEC's allegations satisfied *Morrison*'s transactional test, because defendants had sold their products over the internet and had incurred irrevocable liability in the United States to deliver the products to the buyers, wherever located.

The Tenth Circuit's Decision

The Tenth Circuit affirmed. The majority concluded that Congress "clearly indicated" through the Dodd-Frank amendments "that the antifraud provisions apply when either significant steps are taken in the United States to further a violation of those antifraud provisions or conduct outside the United States has a foreseeable substantial effect within the United States." (The third member of the panel concurred in the judgment, seeing no need to reach the Dodd-Frank issue because she viewed the transactions as sufficiently domestic under *Morrison*.)

The majority retraced the overlapping chronologies of the "conduct and effects" test, the *Morrison* case, and the evolution of the Dodd-Frank Act. The court explained that the "conduct and effects" test had originally been viewed as a jurisdictional issue, that the Second Circuit in 2008 had urged Congress to address the reach of the antifraud provisions, and that Congress had started doing so in 2009, with proposed amendments that eventually became § 929P(b) of the Dodd-Frank Act. In the middle of this activity, the Supreme Court ruled in 2010 that the extraterritorial application of the federal securities laws is not a jurisdictional issue, but that decision was issued on the final day of the joint congressional committee's efforts to iron out differences between the House and Senate versions of what became the Dodd-Frank amendments. Any discontinuity between the *Morrison* decision and Dodd-Frank's "jurisdictional" amendments thus slipped through the cracks.

The majority therefore ruled that, "[n]otwithstanding the placement of the Dodd-Frank amendments in the jurisdictional provisions of the securities acts, given the context and historical background surrounding Congress's enactment of those amendments, it is clear to us that Congress undoubtedly intended that the substantive antifraud provisions should apply extraterritorially when the statutory conduct-and-effects test is satisfied."

Implications

The *Scoville* ruling is probably not unexpected. Even though Congress failed to conform the Dodd-Frank amendments to *Morrison*'s decree about what is and is not "jurisdictional," Congress's intent seems to have been relatively clear.*Scoville* is the first appellate case to squarely resolve the alleged drafting problem in Dodd-Frank, just as the District Court's decision was the first lower-court ruling to have done so. Prior district-court decisions had dodged the issue by determining that the SEC's allegations satisfied *Morrison*'s transactional test, regardless of whether the "conduct and effects" test might apply.

The Tenth Circuit's decision will not affect private securities actions, because the Dodd-Frank amendments apply only to governmental proceedings. And even as to governmental proceedings, the decision's practical impact might not be too great. As the District Court's ruling and the Tenth Circuit concurrence illustrate, the Government might be able to satisfy *Morrison*'s transactional test without having to invoke Dodd-Frank's "conduct and effects" standard.

Nevertheless, one can imagine situations where the availability of a "conduct and effects" analysis might be important to the Government's ability to plead a violation of the securities laws. The *Scoville* case now sanctions that alternative approach.

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