For First Time, Federal Appellate Court Holds That Dodd-Frank Broadened Extraterritorial Reach of SEC Enforcement Actions

In the first federal appellate court opinion to interpret Section 929P(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), the 10th Circuit Court of Appeals issued a decision last week that makes it easier for the U.S. Securities and Exchange Commission (the “SEC”) to bring enforcement actions in connection with securities law violations that take place outside the United States.

Affirming a grant of injunctive relief, the 10th Circuit in SEC v. Scoville and Traffic Monsoon held that the SEC can rely on the broader “conduct-and-effects test” to determine whether the U.S. federal securities laws reach conduct outside the United States, rather than having to satisfy the more stringent test set out in 2010 by the U.S. Supreme Court in Morrison v. National Australia Bank.

The case involves an enforcement action by the SEC, which alleged that Charles Scoville and his company, Traffic Monsoon, LLC (together, the “defendants”), violated the antifraud provisions of the U.S. federal securities laws1 by operating a Ponzi scheme involving the sale of bundled internet advertising services that allowed a purchaser to share in some of Traffic Monsoon’s revenue (“Adpacks”). The district court granted the SEC’s request for injunctive relief, rejecting the defendants’ arguments that the U.S. federal securities laws did not apply because the Adpacks were not securities and almost all the Adpacks purchasers resided outside the United States.

The 10th Circuit affirmed, holding that the Adpacks were securities.2 More importantly, however, the 10th Circuit agreed with the lower court that the U.S. federal securities laws reached Traffic Monsoon’s sales to customers outside the United States because, applying the conduct-and-effects test, the company undertook significant conduct in the United States to make those sales to persons abroad.

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1 Specifically, the SEC alleged that the defendants violated Section 17(a)(1) and (a)(3) of the U.S. Securities Act of 1933 (the “Securities Act”) and Section 10(b) of the U.S. Securities Exchange Act of 1934 (the “Exchange Act”) and Rule 10b-5 thereunder.

2 The court held that the Adpacks were “investment contracts” under SEC v. W.J. Howey Co., 328 U.S. 293 (1946), as they involved an investment in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.
This is noteworthy because in 2010, the Supreme Court rejected the conduct-and-effects test for determining the extraterritorial reach of Section 10(b) and Rule 10b-5 and replaced it with a new “transactional” test. Under the conduct-and-effects test, such provisions applied extraterritorially when wrongful conduct occurred in the United States or when conduct outside the United States had a “substantial effect” in the United States or upon United States citizens. The new transactional test under *Morrison* restricted the reach of Section 10(b) and Rule 10b-5 to “transactions in securities listed on domestic exchanges” and “domestic transactions in other securities.” Later lower court cases have also applied *Morrison* to the Securities Act’s antifraud provisions.\(^3\)

Shortly following *Morrison*, the Dodd-Frank Act attempted to reinstate the conduct-and-effects test for civil securities law enforcement actions brought by the SEC or the U.S. government. In such cases, Section 929P(b) of the Dodd-Frank Act provides the U.S. courts with jurisdiction in cases 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.

It has been an open question since then whether the language in the Act is sufficient to overturn *Morrison* with respect to civil enforcement actions. The key problem is that the Dodd-Frank Act language only amended the subject-matter jurisdiction provisions of the securities laws. The *Morrison* decision, however, did not question whether the courts had subject-matter jurisdiction to hear the case; rather, it restricted the substantive reach of the Exchange Act itself.

In the *Traffic Monsoon* decision, the court concluded that “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.” Quoting the district court’s opinion, the Tenth Circuit held that although courts usually presume that Congress is familiar with judicial precedent when enacting laws, the short time between when *Morrison* was issued and the adoption of the Dodd-Frank Act undermines that presumption, and that the provision’s title and statements by the provision’s drafter indicate that Congress intended for the antifraud provisions to apply extraterritorially.

The court then found that the defendants’ conduct within the United States – which included the creation of the company in the United States, Scoville’s promotion of the Adpacks while residing in Utah, and the physical location in the

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United States of the servers housing the company’s website – constituted significant steps in furtherance of the violation of Rule 10b-5 and Section 17(a).

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Under this decision, SEC enforcement actions can now reach a much broader range of conduct extraterritorially than actions by private plaintiffs can – at least in cases brought in the 10th Circuit, which covers Colorado, Kansas, New Mexico, Oklahoma, Utah and Wyoming. Neither the Second Circuit (covering New York) nor the Ninth Circuit (covering California) has addressed the issue yet. The defendants have not yet indicated whether they will appeal the decision to the Supreme Court.

We will continue to monitor developments in this area and welcome any queries you may have.

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4 In her concurrence to the decision, Judge Briscoe noted that the U.S. federal securities laws could have applied to the sale of the Adpacks as “domestic” transactions under Morrison, since Traffic Monsoon sold Adpacks through computer servers based solely in the United States.