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10th Circuit Reinstates “Conduct-and-Effects” Test in SEC Enforcement Actions, Superseding *Morrison*

Last week the United States Court of Appeals for the Tenth Circuit considered the scope of the SEC’s authority to bring a civil enforcement action under the antifraud provisions of the federal securities laws arising from a securities transaction that occurred outside the United States. In *SEC v. Scoville*, No. 17-4059 (10th Cir. Jan. 24, 2019), the Tenth Circuit decided that the SEC may bring such an action if the alleged violation meets the “conduct-and-effects” test set forth in the Dodd-Frank Act.¹ That test is satisfied if either of two conditions is met. First, the test is satisfied for actions 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.” And second, the test is also satisfied for actions involving “conduct occurring outside the United States that has a foreseeable substantial effect within the United States.”

As the Tenth Circuit acknowledged, the United States Supreme Court’s decision in *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010), rejected a judge-made version of the “conduct-and-effects” test. More specifically, *Morrison* disapproved case law in which the lower federal courts had developed and applied the “conduct-and-effects” test to determine when the antifraud provisions of the federal securities laws extend to extraterritorial securities transactions. In the Tenth Circuit’s view, however, the Dodd-Frank Act, which became effective less than three weeks after the Supreme Court announced its decision in *Morrison*, reinstated the “conduct-and-effects” test for actions brought by the SEC or the United States. Private actions under the antifraud provisions of the federal securities laws will continue to be governed by the more restrictive approach to extraterritoriality described in *Morrison*.

Background

Section 10(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) prohibits the use of “any manipulative or deceptive device” “in connection with the purchase or sale of any security.”² Section 17(a) of the Securities Act of 1933 (the “Securities Act”) prohibits the use of “any device, scheme, or artifice to

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864-65 (2010) (amending Section 22 of the Securities Act of 1933 by adding new subsection (c), 15 U.S.C. § 77v(c), and amending Section 27 of the Securities Exchange Act of 1934 by adding new subsection (b), 15 U.S.C. § 78aa(b)).

² 15 U.S.C. § 78j(b).

defraud” “in the offer or sale of any securities.”³ Neither statute, however, states whether these antifraud provisions cover securities transactions that occur outside the United States.

Before *Morrison*, courts throughout the country had for decades applied what became known as the “conduct-and-effects” test to decide, on a case-by-case basis, whether the antifraud provisions of the Exchange Act and the Securities Act applied extraterritorially. The result of a combination of distinct tests articulated in two Second Circuit cases,⁴ the “conduct-and-effects” test asked “whether the wrongful conduct occurred in the United States” and “whether the wrongful conduct had a substantial effect in the United States or upon United States citizens.”⁵

The Supreme Court’s 2010 decision in *Morrison* rejected this test. As a general matter, there is a “longstanding principle of American law ‘that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.’”⁶ *Morrison* held that because there was “no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially[,] . . . it does not.”⁷ *Morrison* accordingly held that Section 10(b) does *not* apply to securities transactions that occur outside the United States. *Morrison* also clarified that whether Section 10(b) applies extraterritorially does not involve a question of subject-matter jurisdiction, but rather a question concerning the merits of the claim.⁸

Just weeks after the Supreme Court issued its decision in *Morrison*, the Dodd-Frank Act became effective. As relevant here, Dodd-Frank amended the jurisdictional sections of both the Exchange Act and the Securities Act to state that federal courts “shall have jurisdiction” over actions “brought or instituted by the [Securities and Exchange] Commission or the United States” under the antifraud provisions of those statutes if the actions satisfy the statutory “conduct-and-effects” test that is quoted in the first paragraph of this alert.⁹ Dodd-Frank did not amend the substantive antifraud provisions.

Dodd-Frank thus appears to indicate that if an action is brought by the SEC or the United States, and if the action satisfies the statutory “conduct-and-effects” test, the antifraud provisions of the federal securities laws will apply. Dodd-Frank, however, sought to achieve that result through amendments to

³ 15 U.S.C. § 77q(a)(1).

⁴ See *Schoenbaum v. Firstbrook*, 405 F.2d 200 (2d Cir. 1968); *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972).

⁵ *SEC v. Berger*, 322 F.3d 187, 192 (2d Cir. 2003).

⁶ *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991) (quoting *Foley Bros., Inc. v. Filardo*, 336 U.S. 281, 285 (1949)).

⁷ *Morrison v. Nat’l Australia Bank Ltd.*, 561 U.S. 247, 265 (2010).

⁸ *Id.* at 253-54.

⁹ Securities Act § 22(c), 15 U.S.C. § 77v(c); Exchange Act § 27(b), 15 U.S.C. § 78aa(b).

the jurisdictional sections of the Exchange Act and the Securities Act, whereas *Morrison* had explained that extraterritorial application of the securities laws does not involve a jurisdictional question. Arguably, then, Dodd-Frank's amendments had not overcome the limits placed by *Morrison* on the substantive scope of the antifraud provisions in the two statutes.

The *Scoville* Decision

In *Scoville*, the SEC initiated a civil enforcement action under the federal securities laws against Traffic Monsoon, LLC, an internet traffic exchange business, and its principal, Charles Scoville. The SEC alleged that the business was a Ponzi scheme. Traffic Monsoon sold "Adpacks," which guaranteed purchasers a certain number of visits to their websites and clicks on their advertisements. Ninety percent of all Adpacks were purchased by people who live outside the United States.

The district court entered a preliminary injunction that barred the continued operation of the business and granted other relief. Scoville appealed to the Tenth Circuit and argued, among other things, that the antifraud provisions of the federal securities laws did not apply to Adpack purchases made by people outside the United States.

The Tenth Circuit rejected that argument. The court held 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."¹⁰ The "context and historical background" relied upon by the Tenth Circuit included the fact that the relevant Dodd-Frank amendments had first been proposed in Congress in October 2009, well before the *Morrison* decision. As the court also noted, the title of the section in Dodd-Frank that included the operative amendments is "STRENGTHENING ENFORCEMENT BY THE COMMISSION." Additionally, one of the section's original drafters "stated that the purpose of that provision was to make clear that the antifraud provisions apply extraterritorially in enforcement actions."¹¹ In the Tenth Circuit's view, "Congress ha[d] 'affirmatively and unmistakably' indicated that the antifraud provisions of the federal securities acts apply extraterritorially when the statutory conduct-and-effects test is met."¹²

Consequences

At least in the Tenth Circuit, the SEC and the United States may bring actions for alleged federal securities fraud based on transactions that occurred outside the United States if the actions satisfy the "conduct-

¹⁰ *SEC v. Scoville*, No. 17-4059, 2019 WL 302867, at *9 (10th Cir. Jan. 24, 2019).

¹¹ *Id.* at *8-9.

¹² *Id.* at *10.

and-effects” test, as codified in the Dodd-Frank Act. Private actions for federal securities fraud, in contrast, will continue to be governed by *Morrison*.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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