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By Jennifer Achilles & Aaron Chase, Reed Smith LLP

Channeling Marie Kondo, the Tenth Circuit Court of Appeals recently attempted to tidy the mess created by the conflict between the Supreme Court's 2010 decision in **Morrison v. National Australia Bank Ltd.** and Congress's passage a month later of amendments to the federal securities laws in the form of the **Dodd-Frank Wall Street Reform & Consumer Protection Act**. The Tenth Circuit's January 24, 2019 opinion, **SEC v. Scoville**, is a quiet rejection of *Morrison's* standard in favor of the pre-2010 "conduct and effects" test. While the Tenth Circuit's goal of providing clarity to a muddy area of the law is laudable, *Scoville* ultimately leaves as many questions as answers and – and maybe this was the point – more or less begs either the Supreme Court or Congress (but hopefully not both simultaneously) to revisit an important issue of securities law.

In *Scoville*, the Tenth Circuit reviewed the standard for evaluating when the antifraud provisions of the securities laws apply in cases brought by the SEC or the United States. The court held that, when Congress passed Dodd-Frank, it intended to amend the substantive rather than jurisdictional provisions of the securities laws. Although not stated explicitly, *Scoville's* holding is that **§ 929P(b) of the Dodd-Frank Act** legislatively superseded one of the holdings in *Morrison* – albeit likely by accident.

Extraterritoriality of the Securities Laws Pre-2010

The legal dog's breakfast that the Tenth Circuit tried to clean up in *Scoville* can be traced to the Second Circuit's decision in *Morrison* over ten years ago. (Morrison v. National Australia Bank Ltd., **547 F.3d 167** (2nd Cir. 2008)). The issue was whether an action brought by foreign plaintiffs against a foreign issuer concerning securities transactions in foreign countries alleging violations of antifraud provisions of U.S. securities laws could survive a motion to dismiss. The *Morrison* plaintiffs were investors in an Australian bank whose stock lost value after the bank acquired an American mortgage servicing company. The plaintiffs alleged that misrepresentations by the American company's previous owners about the company's value caused the bank's stock to drop. The plaintiffs brought a private action under **§ 10(b)** of the **1934 Exchange Act**.

As was customary in the Second Circuit at the time, the court approached the extraterritorial reach of the securities laws as a question of subject matter jurisdiction, and applied the usual rules to answer it, namely the so-called "conduct and effects" test. That test, which had by then been adopted by other circuit courts, asked whether the alleged wrongful conduct either occurred in the United States or had a substantial effect in the United States or upon United States citizens. (Id. at 171). The Second Circuit concluded that the heart of the alleged fraud occurred in Australia, had no effect on the United States or U.S. residents, and that U.S. courts, therefore, lacked subject matter jurisdiction to hear the case. (Id. at 176-77). In declining jurisdiction, however, the Second Circuit highlighted the fact that when Congress had written the original securities laws in 1933 and 1934, it had failed to address the application of those laws to foreign securities transactions. In a footnote, the court "respectfully urge[d] that this significant omission receive the appropriate attention of Congress and the Securities and Exchange Commission." (Id. at n. 4). The *Morrison* plaintiffs appealed the decision to the U.S. Supreme Court.

The Supreme Court Upsets the Applecart

On June 24, 2010, in the final weeks leading up to Congress passing the Dodd-Frank Act, the Supreme Court issued its decision in Morrison. (Morrison v. National Australia Bank Ltd., **561 U.S. 247** (2010)). Before reaching the merits of the appeal, Justice Scalia, writing for the majority, addressed what he described as a "threshold error" made by the Second Circuit. Overturning decades of circuit-court level precedent, the court found that the extraterritorial reach of § 10(b) was a merits question, not a question of subject matter jurisdiction. On the merits, the Supreme Court found that, "On its face, § 10(b) contains nothing to suggest it applies abroad." (*Morrison*, 561 U.S. at 262). Finding no compelling reason to read any extraterritorial reach into the statute, the court concluded that § 10(b) had no such reach whatsoever. (Id. at 265.). Instead, the Court articulated a "transactional test" for determining whether an alleged violation of § 10(b) fell within the (purely domestic) reach of the statute. That test looks to "whether the purchase or sale [of a security] is made in the United States, or involves a security listed on a domestic exchange." (Id. at 269-70).

In short, with *Morrison*, the Supreme Court concluded that the extraterritoriality of § 10(b) was a merits question, not a question of subject matter jurisdiction; that the securities laws have no extraterritorial reach; and that the laws' domestic reach was limited to situations in which either a securities transaction took place in the U.S., or the securities at issue were listed on a U.S. exchange.

Congress Weighs In

On July 21, 2010, less than one month after *Morrison* was decided, Congress passed the Dodd-Frank Act. **Section 929P(b) of the Dodd-Frank Act** amended the jurisdictional provision of the securities laws as though the Supreme Court's *Morrison* decision had never been issued. Section 929P(b) was specifically tailored to codify the "conducts and effects" test that *Morrison* overruled. The amendment to the securities laws specified that a federal court had subject matter jurisdiction over a securities fraud claim brought by the SEC or the United States if there were either significant steps taken in the U.S. or the conduct had a foreseeable substantial effect in the U.S. (See **15 U.S.C. §§ 77v(c)** and **78aa(b)**).

For more than eight years after Dodd-Frank and *Morrison*, federal district courts deciding securities fraud cases brought by the government largely avoided deciding whether Section 929P(b) reinstated the "conduct and effects" test rejected in *Morrison*. (See, e.g., SEC v. Sabrdaran, **252 F. Supp. 3d 866**, 895 (N. D. Cal. 2017) ("Because, once again, the evidence here meets even *Morrison's* stricter test, the Court need not address the parties' dispute over whether Section 929P(b) of Dodd-Frank revived the broader tests that *Morrison* rejected."); SEC v. A Chicago Convention Ctr. LLC, **961 F. Supp. 2d 905**, 916-17 (N.D. Ill. 2013) ("The Court need not resolve this complex interpretation issue, however, because as explained below, under either the *Morrison* 'transactional' inquiry or the allegedly revived 'conducts and effects test,' the SEC's Complaint survives the present motion to dismiss.")). Until *Scoville*, no Circuit Court of Appeals considered the issue.

A Monsoon Rolls In

Scoville involved an alleged global Ponzi scheme orchestrated by one man operating out of his apartment in Utah. Charles Scoville sold internet traffic, online advertising products, and investment contracts through Traffic Monsoon, a Utah company, with approximately 90% of sales going to people living outside of the United States. (**Sec. & Exch. Comm'n v. Scoville, No. 17-4059, 2019 BL 22950 (10th Cir. Jan. 24, 2019)**). In July 2016, the **SEC initiated an enforcement action** alleging that Traffic Monsoon operated a classic Ponzi scheme by paying returns to earlier investors with funds received from later investors. The SEC charged the defendants with violations of the antifraud provisions of the securities laws, and obtained orders from the district court freezing the defendants' assets, appointing a receiver, and enjoining defendants from operating their business. The defendants appealed to the Tenth Circuit arguing, among other things, that the antifraud provisions of the securities laws do not apply to purchases outside the United States.

The Tenth Circuit began its analysis by noting that the Supreme Court developed a two-part test to evaluate whether a statute can apply to conduct outside of the U.S. The first step asks whether Congress affirmatively and unmistakably stated the statute applies outside of the U.S. If not, the statute can still apply if the conduct at issue involves a domestic application of the statute. (Id. at *6). Choosing to tackle the first question head-on, the Tenth Circuit held that, "Notwithstanding 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 conduct-and-effects test is satisfied." (Id. at *9).

In reaching that remarkably self-assured conclusion, the Tenth Circuit relied on the title that Congress gave to the amendments ("Strengthening Enforcement By The Commission"), as well as Congress's direction to the SEC to study whether private rights of action under the 1934 Act "should be extended" extraterritorially. According to *Scoville*, these facts implied that Congress was focused on the SEC's power rather than the reach of the federal courts (which would presumably be the same regardless of whether the plaintiff was the SEC or a private litigant).

In a concurring opinion, Judge Briscoe advocated for reaching the same result while side-stepping the conflict altogether. Noting that Traffic Monsoon was a Utah company, headquartered and operating out of the United States, that sold securities through servers based in the United States, the concurrence concluded that the securities laws applied because Traffic Monsoon had made sales or offers of securities in the United States. No extraterritorial application of the securities laws, therefore, was necessary.

Making Sense of the Aftermath

The Tenth Circuit recognized the conflict between *Morrison* and Dodd-Frank in cases brought by the government and acted, quite understandably, to try to bring some clarity to a confusing situation. Yet, one might reasonably question whether "it is clear," as *Scoville* concluded, that Congress "undoubtedly intended" that the substantive antifraud provisions should apply extraterritorially when the conduct and effects test is satisfied. It seems more likely that Congress intended to address only the extraterritoriality of the securities laws from a jurisdictional perspective. After all, that was what the Second Circuit had identified as the issue. Additionally, the plain language of the Dodd-Frank amendments begins with a pronouncement specifying when federal courts "shall have jurisdiction."

Ultimately, the Tenth Circuit's decision expands the SEC's authority to reach non-U.S. defendants and police conduct outside of the country. The conduct and effects test is a much easier standard to meet than the narrower domestic-applicability test articulated in *Morrison*. In a global marketplace, it can almost always be argued that the purchase or sale of securities occurring outside of the U.S. has a foreseeable substantial effect in the U.S.

It remains to be seen how other circuits will react to *Scoville*. It could be that the Tenth Circuit seized this case as an opportunity to take the first step towards a circuit split, thereby inviting the Supreme Court to weigh in once again on the extraterritoriality of the federal securities laws. If that comes to pass, hopefully Congress will actually read the decision so that it can decide whether or not it meets the Marie Kondo test and "sparks joy" before taking matters into its own hands.