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Can The SEC Enforce Securities Laws Abroad?

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This week, the U.S. Court of Appeals for the Tenth Circuit will hear a case with far-reaching consequences, literally, for the U.S. Securities and Exchange Commission's enforcement activity. In SEC v. Traffic Monsoon LLC,[1] the commission is asking the court to hold that the principal anti-fraud provisions of the federal securities laws apply extraterritorially in commission enforcement actions and administrative proceedings so long as the alleged misconduct satisfies the "conduct and effects test," a test the Supreme Court dispatched in 2010. If the commission has its way, more aggressive overseas enforcement activity could be in store, even for misconduct not connected to a domestic securities transaction. In this article, we evaluate the legal and policy issues Traffic Monsoon raises.

Background

The heart of the commission's anti-fraud enforcement efforts is Rule 10b-5, adopted by the commission pursuant to Section 10(b) of the Securities Exchange Act of 1934.[2] Courts have interpreted Section 10(b) and Rule 10b-5 to provide a private cause of action to investors who lose money when they buy or sell securities in reliance on material misrepresentations or omissions, or a scheme, made recklessly or with an intent to deceive. The Exchange Act also authorizes the commission to bring civil actions and administrative proceedings to enforce Section 10(b), and the Securities Act of 1933 authorizes the commission to enforce Section 17(a), which is similar in scope and language to Rule 10b-5 but allows certain claims to be brought for mere negligence.[3]

Until the late 1960s, U.S. courts did not exercise subject-matter jurisdiction over Section 10(b) and 17(a) cases involving foreign securities transactions. Under a long-standing prudential principle of statutory construction, the "presumption against extraterritoriality," U.S. laws are presumed to apply only to conduct in the U.S. unless Congress indicates otherwise. The securities laws were silent on the issue.

From the late 1960s, however, the courts developed a more expansive view of their authority to hear those cases. Under the so-called "conduct and effects" test, courts exercised

jurisdiction when the conduct prohibited by those sections occurred in the U.S. or had a substantial effect in the U.S. or on U.S. citizens. Over time, the conduct and effects test made the U.S. "the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[4] The commission availed itself of the conduct and effects test, too.[5]

In 2010, however, the U.S. Supreme Court gutted the conduct and effects test. See Morrison v. National Australia Bank Ltd.[6] Morrison was a putative class action asserting than an Australian bank deceived Australian investors about the value of certain U.S. assets, in violation of Section 10(b). The district court and appeals court dismissed the lawsuit for lack of subject matter jurisdiction because the plaintiffs failed to satisfy the effects prong of the conduct and effects test. The Supreme Court affirmed the dismissal, but not on the basis of subject matter jurisdiction.

The issue was not jurisdiction, the court held. The Exchange Act plainly gave the district court subject matter jurisdiction to hear whether Section 10(b) applied to the bank's conduct.[7] Rather, the issue was the merits of the cause of action — did Section 10(b) itself prohibit extraterritorial misconduct? Citing the presumption against extraterritoriality, the court looked to the plain language of the Exchange Act and concluded that Section 10(b) prohibited only misconduct connected to securities bought or sold in the U.S. Because the bank's alleged misconduct did not satisfy this "transactional test," the investors failed to state a claim under Section 10(b).

Morrison's transactional test is widely understood to have replaced the conduct and effects test, at least for investor lawsuits under Section 10(b). Whether Morrison also restrains commission enforcement actions and administrative proceedings under Sections 10(b) and 17(a) is hotly debated. The commission argues it does not. In support, the commission points to the Dodd-Frank Act, passed by Congress a few weeks after Morrison. Section 929P(b) of the Dodd-Frank Act amended the Securities Act and the Exchange Act to give U.S. district courts subject matter jurisdiction over Sections 10(b) and 17(a) claims brought by the commission and connected to extraterritorial securities transactions, so long as the conduct and effects test is satisfied.[8] The commission steadfastly maintains that by passing Section 929P(b) on the heels of Morrison, Congress signaled its intention to preserve the conduct and effects test for enforcement actions and administrative proceedings under Sections 10(b) and 17(a).

Traffic Monsoon

Traffic Monsoon,[9] was the first district court decision to decide the post-Morrison application of the conducts and effects test in light of Section 929P(b).[10] The commission alleged that Traffic Monsoon, an internet advertising company, engaged in an illegal Ponzi scheme in violation of Sections 10(b) and 17(a). The scheme allegedly involved the sale of so-called "AdPacks," which the commission claims are securities. The commission moved to enjoin Traffic Monsoon's operations.

Opposing the motion, Traffic Monsoon argued that 90 percent of its customers bought AdPacks over the internet while located outside the U.S. and, under Morrison, the alleged misconduct in connection with the offer and sale of those AdPacks was beyond the reach of the securities laws. Section 929P(b) did not help the commission, Traffic Monsoon argued, because Congress only amended the jurisdictional provisions of the securities law, whereas the Supreme Court indicated in Morrison that extraterritoriality was an issue of substantive law, and even after Dodd-Frank, neither Section 10(b) nor Section 17(a) addresses conduct outside the U.S.

The court rejected Traffic Monsoon's arguments. It acknowledged that Congress has not amended Section 10(b) to address extraterritoriality. But it held that Section 929P(b)'s plain language and

legislative history are sufficient to overcome the presumption against extraterritoriality. The court noted that Congress drafted and was finalizing Section 929P(b) before Morrison was decided, and that it was commonly understood at the time that Section 10(b)'s extraterritorial application was a jurisdictional issue. Given that context, the court held, the jurisdictional amendments evidenced Congress' intent that Sections 10(b) and 17(a) apply extraterritorially for purposes of enforcement. The court then found that Traffic Monsoon took significant steps in the U.S. to further AdPack sales,[11] thereby satisfying the conduct prong of the conduct and effects test. Accordingly, it granted the commission's motion and entered a preliminary injunction against Traffic Monsoon.

Recognizing there is "'substantial ground for difference of opinion' as to whether Section 929P(b) of Dodd-Frank reinstated the conduct and effects test for litigation brought by the SEC," the court certified its order for interlocutory appeal to the Tenth Circuit.[12] In their appellate briefs, the parties advance many of the arguments advanced in the district court. The Tenth Circuit will hear the appeal on March 21. A ruling is expected later this year.

Discussion

The commission wants the Tenth Circuit to affirm the district court's conduct and effects holding. But the Tenth Circuit does not have to go nearly so far to rule in the commission's favor. The district court entered the preliminary injunction on alternative grounds — holding both that Section 929P(b)'s conduct and effects test applied to the SEC's enforcement of Sections 10(b) and 17(a), and that Traffic Monsoon's acts satisfied Morrison's transactional test.[13] Unless the Tenth Circuit finds the latter holding infirm, it need not, and should not, reach Section 929P(b) to affirm the injunction.

The commission's concern is not judicial constraint, however. As a bureaucratic and executive branch institution with a broad law enforcement mandate, its desire for a favorable ruling on the conduct and effects issue is understandable. Whether the commission needs such expansive authority is a separate question.

The following affinity scam hypothetical illustrates the point.

Jewish-American retirees residing in the U.S. use money from their U.S. bank accounts to buy shares of an Israeli company that lists only on the Tel Aviv Stock Exchange. The company turns out to be a sham and its public disclosures materially misleading. The commission arguably does not need the conduct and effects test to bring an enforcement action because the transactional test was satisfied when the investors irrevocably committed to the purchase in the U.S.

Now suppose the same investors, during their annual four-month sojourn in Israel, use money from their Israeli bank accounts to buy shares in the same company. The transactional test is not met, but arguably the commission could bring an enforcement action under the effects test set forth in Section 929P(b).

Should it? The Tenth Circuit has an opportunity to decide the question. But ultimately, Congress should not leave it to the courts to guess whether it wants the commission to enforce the securities laws abroad.

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[1] SEC v. Traffic Monsoon LLC, No. 17-4059.

[2] The statute provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ... (b) [t]o use or employ ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b). The rule provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

[3] The statute provides: "It shall be unlawful for any person in the offer or sale of any securities ... by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a).

[4] Morrison v. Nat'l Australia Bank Ltd., 561 U.S. 247, 270 (2010). The development of the conduct and effects test is summarized in Morrison at 255-61.

[5] See, e.g., SEC v. Berger, 322 F.3d 187 (2d Cir. 2003).

[6] Morrison v. National Australia Bank Ltd., 561 U.S. 247 (2010).

[7] At the time, the jurisdictional provision stated: "The district courts of the United States ... shall have exclusive jurisdiction of violations of [the Exchange Act] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder." 15 U.S.C. § 78aa(b).

[8] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929P(b), 124 Stat. 1376, 1864–65 (2010), codified at 15 U.S.C. §§ 77v(c), 78aa(b). The "conduct" subsection references "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." The "effects" subsection references "conduct occurring outside the United States that has a foreseeable substantial effect within the United States."

[9] Traffic Monsoon, 245 F. Supp. 3d 1275 (D. Ut. 2017).

[10] At least one district court before Traffic Monsoon analyzed the issue at some length. See SEC v.

Chicago Convention Ctr. LLC, 961 F. Supp. 2d 905, 909-16 (N.D. Ill. 2013). But it did not decide the issue because it concluded that the commission stated a claim under both the pre-Morrison conduct and effects test and Morrison's transactional test. See id. at 916-17. At least two district courts have held that the transactional test controls Section 17(a) actions, but neither analyzed the Section 929P(b) issue and both cited for support investor, not enforcement, actions brought under other provisions of the Securities Act. See SEC v. ICP Asset Mgmt. LLC, No. 10-cv-4791, 2012 WL 2359830, at *2 (S.D.N.Y. June 21, 2012), citing In re Vivendi Universal SA Sec. Litig., 842 F. Supp. 2d 522, 529 (S.D.N.Y. 2012); SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147, 164 (S.D.N.Y. 2011), citing In re Royal Bank of Scotland Grp. PLC Sec. Litig., 765 F. Supp. 2d 327, 338-39 (S.D.N.Y. 2011).

[11] Specifically, Traffic Monsoon's principal "created and promoted the AdPack investments over the internet while residing in Utah," and Traffic Monsoon itself did not dispute that "'significant steps' in furtherance of the AdPack sales were carried out in the United States." Id. at 1294.

[12] 245 F. Supp. 3d at 1304.

[13] Id. at 1294-95 ("Even if the court has erred in concluding that Section 929P(b) reinstated the conduct and effects test, all of the AdPack sales challenged by the SEC are domestic transactions under the Morrison transactional test" because in selling the AdPacks over the internet to both foreign and domestic purchasers, Traffic Monsoon, a Utah limited liability company, "incurred irrevocable liability in the United States to deliver this security."), citing Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 68 (2d Cir. 2012) (holding that the standard for determining whether an off-exchange security transaction occurred in the U.S. for purposes of Morrison's transactional test was whether the buyer or seller incurred irrevocable liability in the U.S.). Additionally, Traffic Monsoon argues that the AdPacks are not "securities" within the meaning of the U.S. securities laws. See Appellants' Opening Br., SEC v. Traffic Monsoon LLC, No. 17-4059, ECF Doc. No. 01019869299, at 22-25 (filed Sept. 13, 2017).