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IN THE UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF UTAH

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| SECURITIES AND EXCHANGE COMMISSION,<br><br>Plaintiff,<br><br>v.<br><br>TRAFFIC MONSOON, LLC, a Utah Limited Liability Company, and CHARLES DAVID SCOVILLE, an individual,<br><br>Defendants. | **MOTION TO DISMISS**<br><br>Civil No. 2:16-cv-00832 JNP<br>Honorable Jill N. Parrish |

## STATEMENT OF RELIEF SOUGHT AND GROUNDS FOR MOTION

Under *Federal Rule of Civil Procedure 12(b)(6)* ("*Rule 12(b)(6)*"), Defendant Charles Scoville ("Scoville") moves this Court to dismiss the complaint (the "Complaint") filed by the Securities and Exchange Commission (the "SEC" or the "Commission") because it fails to allege

a cognizable theory of securities fraud. First, the Complaint fails to allege a domestic sale of securities as required by the Supreme Court's decision in *Morrison v. National Australia Bank*, 561 U.S. 247 (2010). Second, the Complaint relies on an alleged "scheme liability" theory that many courts (including other district courts in the 10th Circuit) have criticized. Third, the Complaint fails to plead the requisite intent needed to properly allege securities fraud under *Rule 9(b)* of the *Federal Rules of Civil Procedure*. Fourth, the Complaint fails to allege that the AdPacks sold by Traffic Monsoon were anything other than commercial contracts between two parties, and consequently fails to allege sufficient facts to establish an investment contract. Finally, assuming *arguendo* that AdPacks are Securities, the Complaint failed to consider the SEC's own appropriate exemptions from registration under *Section 5* of *The Securities Act of 1933.*

First, as to the 90% of sales of AdPacks to individuals outside the United States, the Complaint fails to allege that the AdPack purchases were "domestic sales" as required by the Supreme Court's decision in *Morrison*. The SEC's theory that AdPacks constitute domestic sales (as explained during the hearing on their motion for a preliminary injunction) is that the sales of AdPacks to buyers outside the United States were domestic sales because Traffic Monsoon's servers were in the United States. This theory suffers from two problems: the law does not determine location of a sale based on the location of servers and the Complaint is silent as to the location of the sales.

Second, as demonstrated in the Complaint and in the SEC's other recent arguments, their theory of fraud relies entirely on a theory of "scheme liability" and they maintain that the Complaint can succeed even in the absence of any material misrepresentation. However, this approach of using scheme liability in the absence of any material misrepresentations or omissions is not cognizable. Although scheme liability has been recognized by courts, it has only been

recognized where the scheme includes material false representations or otherwise represents a plan to hide some fundamental and material truth of the transaction from an investor or the public and is often used against secondary actors in some type of alleged scheme. Simply put, the law does not recognize a scheme to defraud without some fraud, that is without some allegation of material misrepresentations or attempts to mislead someone, which is absent here.

Third, the Complaint fails to allege facts sufficient to establish that Scoville acted with the requisite recklessness or scienter and fails to meet the requisite pleading standards because the allegations are either conclusory or not supported with the proper facts.

Fourth, the Complaint concludes that the sale of advertising services in the form of the AdPacks at issue in the Complaint are securities, but the factual allegations support nothing more than a finding that AdPacks are commercial contracts for the provision of services, not investment contracts. Therefore, the parties to the agreements were not involved in the purchase or sale of any securities.

Finally, in addition to failing to establish that AdPacks are securities, the Complaint fails to establish that even if AdPacks are securities how *Reg S* and *Section 3(a)(10)* of the *'33 Act* fail to provide Mr. Scoville with the proper exemptions from registration.

By failing to allege a domestic sale of securities, relying on a flawed theory of scheme liability, failing to allege facts sufficient to properly establish allege securities fraud under *Rule 9(b),* basing the Complaint on contracts that are not securities and failing to consider their own regulatory exemptions, the SEC has filed a flawed Complaint which fails to allege sufficient facts upon which relief can be granted. The Court should dismiss the Complaint.

## BACKGROUND

### I. THE ALLEGATIONS IN THE COMPLAINT

The SEC filed its complaint on July 26, 2016 (the "Complaint"). D.E. 2. In the Complaint, the SEC alleged that the Court has jurisdiction over this matter because certain acts took place in the District of Utah. Compl. at ¶¶ 8, 12. The Complaint contains no allegations of where the sales of AdPacks took place; also, it contains no allegations about the location of Traffic Monsoon's computer servers. The Complaint does allege, however, that more than 90% of AdPack purchasers were located outside of the United States, Compl. at ¶ 66, and that Scoville found new AdPack purchasers by attending international conferences. Compl. at ¶ 58.

As to misrepresentations, the Complaint alleges that:

- Traffic Monsoon's advertising business is an illusion designed to obscure the fact that it is offering and selling a security in a pure Ponzi scheme. Over 99% of Traffic Monsoon's revenue comes from the sale of AdPacks. Compl. at ¶¶ 4 and 5.

- Investors are not informed that the reserve fund is used to supplement the sharing of Traffic Monsoon profit. Compl. at ¶¶ 20 and 21.

- Traffic Monsoon's website falsely implies that revenues come from all its advertising products, rather than almost exclusively from AdPacks. Scoville also omits to disclose to investors that the shared profit is periodically supplemented by payments from the reserve fund at Scoville's discretion and is, therefore, not truly revenue sharing. Compl. at ¶¶ 38 - 40.

- Traffic Monsoon and Scoville represent to investors that the company generates profit from all the advertising services it sells. Scoville posted a statement on his website www.charlesscoville.com: "We sell 1 service LOWER in demand which includes a profit sharing position, and share profits from the services with HIGHER demand with those who click a minimum of 10 ads per day." Scoville does not disclose to investors that Traffic Monsoon's revenue comes almost exclusively from the sale of the AdPack product. Instead, Defendants imply that the majority of the revenue comes from the sale of Traffic Monsoon's many advertising products. Compl. at ¶¶ 33 and 34.

- Traffic Monsoon failed to timely disclose that PayPal had frozen Traffic Monsoon's funds. Compl. at ¶ 48.

- Scoville has never disclosed to investors that the PayPal freeze has expired, and has never informed members that they can request that their AdPack purchases be reversed. Since the freeze was lifted he has been withdrawing funds, apparently for his own benefit, as quickly as possible. Compl. at ¶ 57.

- Scoville is aware that the AdPacks could be considered an investment. In Traffic Monsoon's website and his YouTube videos, he goes out of his way to argue that the program does not involve a security or an investment. Compl. at ¶ 72.

- On his website and in his videos, Scoville deliberately avoids calling the $55 payout a "return". Compl. at ¶ 74.

## II. THE ALLEGATIONS IN THE COMPLAINT

The SEC seeks relief under *Sections 17(a)(1)* and *17(a)(3)* of the *Securities Act* for implementing a scheme to defraud investors. Compl. at ¶¶ 84-89. Notably the Comission does not seek relief based upon *Section 17(a)(2)*, which provides liability for obtaining money through false representations or omissions of material facts. Similarly, the Commission seeks relief under *Rule 10b-5(a)* and *(c)*, but not upon *Rule 10b-5(b)*, which provides liability for obtaining money through false representations or omissions of material facts. Compl. at ¶¶ 90-92. Finally, the SEC seeks relief under *Section 5* of the *Securities Act*, alleging the sale of unregistered securities. Compl. at ¶¶ 93-96.

# APPLICABLE LAW

## I. MOTION TO DISMISS STANDARD

To survive a motion to dismiss under *Rule 12(b)(6)*, a complaint must "contain sufficient factual matter" to state a claim for relief that is "plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). This "plausibility" standard requires that a complaint demonstrate more than "a sheer possibility that a defendant has acted unlawfully." *Id.* Rather, the factual allegations must be sufficient to "raise a

right to relief above the speculative level." *Twombly*, 550 U.S. at 545 (emphasis added). While the Court must "accept as true all well-pleaded factual allegations in the complaint and view them in the light most favorable to the [SEC]," *Burnett v. Mortg. Elec. Registration Sys.*, Inc., 706 F.3d 1231, 1235 (10th Cir.2013), "when legal conclusions are involved in the complaint 'the tenet that a court must accept as true all of the allegations contained in a complaint is inapplicable to [those] conclusions.'" *S.E.C. v. Shields*, 744 F.3d 633, 640 (10th Cir. 2014).

## II. THE SEC'S CAUSES OF ACTION

The first and second claims allege violations of *Sections 17(a)(1)* and *(3)* of the Securities *Act*, respectively. *Section 17(a)(1)* makes it unlawful to "employ any device, scheme, or artifice to defraud" and *Section 17(a)(3)* makes it unlawful to "engage in any transaction, practice, or course of business which operates or would operate as a fraud." 15 U.S.C. § 77q(a).

The SEC's third claim alleges violations of *Rule 10b-5(a)* and *(c)*. *Section 10b-5(a)* makes it a violation to, "employ any device, scheme, or artifice to defraud" and *10b-5(c)* makes it a violation to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."

Given the similarity in language and structure to *Rule 10b-5*, courts generally analyze claims under *Section 17(a)(1)* and *(3)* of the *Securities Act* in the same way as "scheme liability" claims under *Rule 10b-5(a)* and *(c)*, although claims under *Section 17(a)(3)* only require a showing of negligence as opposed to scienter. *SEC v. Kelly*, 817 F. Supp. 2d 340, 343 (S.D.N.Y. 2011). ("[C]laims under subsections (1) and (3) of Section 17(a) are treated the same as claims under subsections (a) and (c) of Rule 10b-5."); *Aaron v. SEC*, 446 U.S. 680, 697 (1980) ("It is our view, in sum, that the language of § 17(a) requires scienter under § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3)."). "[W]here the primary purpose and effect of a purported scheme is to make a public

misrepresentation or omission, courts have routinely rejected the SEC's attempt to bypass the elements necessary to impose 'misstatement' liability under *subsection (b)* by labeling the alleged misconduct a 'scheme' rather than a 'misstatement.'" *Kelly*, 817 F. Supp. 2d at 343. To make out a fraud claim under *Rule 10b-5(a)* and *(c)* the "scheme liability" claims must be premised on "an inherently deceptive act". *See, Id.*

The fourth claim in the Complaint is predicated on alleged violations of *Sections 5(a)* and *(c)* of the *Securities Act* 15 U.S.C. § 77e(a) and (c) which prohibits the sale of unregistered securities unless there is a qualified exemption available.

## ARGUMENT

### I. THE COMPLAINT SHOULD BE DISMISSED BECAUSE IT FAILS TO ADEQUATELY ALLEGE THE SALES OF ADPACKS ARE DOMESTIC TRANSACTIONS AS REQUIRED BY MORRISON.

The parties have extensively briefed, conducted an evidentiary hearing at least partially focused on, and argued the applicability of the Supreme Court's decision in *Morrison*. *See, e.g.* D.E. 32, 33, 38, 39, 49 and 53. Without belaboring the arguments already briefed and to be decided by this Court as part of the preliminary injunction, the Supreme Court held in *Morrison* that anti-fraud provisions of the U.S. securities laws only govern domestic sales of securities. *Morrison*, 561 U.S. at 266-70. Here the SEC's theory, assuming that the rule announced in *Morrison* was not overturned by Congress[1], is that because Traffic Monsoon's servers were in the United States, the sales took place in the United States, regardless of where Scoville—or more importantly, the buyer—were at the time they initiated the sale.

[1] The parties have also extensively briefed and argued the issue of whether Congress "fixed" the Supreme Court's decision in *Morrison* with Section 929 of the Dodd-Frank Act. See D.E. 49 and 53. To the extent this Court finds that Section 929 "fixed" *Morrison*, the arguments in this section would be largely inapplicable.

However, the SEC has not included in the Complaint any allegations regarding the location of the sale. In fact, to the extent they have alleged anything, the Complaint suggests that most of the actions constituting the sales took place outside the United States. (Compl. at ¶ 66). As such, the Complaint fails as a matter of law because the SEC has not pleaded that the alleged scheme involved "domestic" transactions—that is, transactions involving securities listed on a domestic exchange or domestic transactions in other securities—as required under the Supreme Court's decision in *Morrison*.

**A. The SEC Failed to Allege Any Facts Related to Domestic Transactions.**

The SEC bears the burden of alleging that securities transactions were domestic within the meaning of *Morrison*. *See SEC v. Goldman Sachs & Co.*, 790 F. Supp. 2d 147, 159 (S.D.N.Y. 2011) ("[T]he SEC bears the burden of alleging the IKB note purchases were domestic transactions."). Here, the Complaint does not allege any facts from which this Court could conclude that the sales of AdPacks were domestic sales of securities. Even the facts the SEC relied upon during the hearing on their motion for a preliminary injunction – the location of Traffic Monsoon's servers – are entirely absent from the Complaint. As such the Complaint fails to state a claim upon which this Court can grant relief and must be dismissed.

**B. The Location of Servers Does Not Determine Whether a Sale is a Domestic Sale of Securities.**

While that flaw is curable, the Court should dismiss the Complaint with prejudice as to the 90% of transactions that involve buyers outside the United States because the SEC cannot allege facts sufficient to establish a domestic sale of securities. Throughout the argument on the SEC's motion for a preliminary injunction, and during the evidentiary hearing on the matter, the SEC introduced only one fact upon which they rely to claim that the sales of AdPacks to

individuals outside the United States constitute domestic sales of securities: that Traffic Monsoon's computer servers were in the United States.

However, the location of a computer server does not dictate the location of a transaction. While the 10th Circuit has not addressed the issue of when sales are domestic transactions in securities, the Second Circuit has confronted the issue many times and held "that a plaintiff must allege facts suggesting that irrevocable liability was incurred or title was transferred within the United States." *Absolute Activist Value Master Fund Ltd. v. Ficeto,* 677 F.3d 60, 68 (2d Cir. 2012). "Absent factual allegations suggesting that the [parties] became irrevocably bound within the United States or that title was transferred within the United States . . . the mere assertion that transactions 'took place in the United States' is insufficient to adequately plead the existence of domestic transactions." *Id.* at 70. Neither in the Complaint, nor in the prior briefing on this topic, has the SEC pointed to any law that establishes that an e-commerce sale takes place where the computer server facilitating it is located.

In the only decision to contemplate a similar issue, Judge Rakoff of the Southern District of New York found that the fact that the securities transactions at issue were settled through an electronic process on servers maintained by the Depository Trust Company in New York was insufficient to establish a domestic sale. *In re Petrobras Sec. Litig.*, 150 F. Supp. 3d 337, 341 (S.D.N.Y. 2015). Judge Rakoff found a presumption that if any "action needed to carry out" securities sales took place in the United States then the sale also took place in the United States would render *Morrison* and its progeny "nugatory." *Id.* A rule determining the location of a sale by the location of a server would undermine, rather than enhance, the SEC's ability to enforce securities laws since the location of the server is both the most arbitrary and the most easily manipulable fact related to an e-commerce transaction.

In briefing the issue previously, the SEC pointed to no law in support of its theory that servers dictate the sale of a domestic sale of securities in an e-commerce transaction. Because there is no law supporting this proposition, the SEC simply cannot prevail in any action as to the 90% of the buyers who were not in the United States. Moreover, because this is a legal flaw, no opportunity to amend could cure it and the Complaint should be dismissed with prejudice as to those claims.

## II. THE SEC'S FRAUD CLAIMS UNDER THE SECURITIES AND EXCHANGE ACTS ARE DEFICIENT AS A MATTER OF LAW BECAUSE SCHEME LIABILITY REQUIRES A SHOWING OF SOME FRAUD.

### A. The SEC Fails To Plead Any Proper Securities Law Violations Because The Commission Fails To Properly Allege Scheme Liability.

Courts have routinely rejected the SEC's attempt to impose scheme liability without some misstatement or fraudulent conduct. *See, e.g., SEC v. Lucent Techs.,* 610 F.Supp.2d 342, 359–61 (D.N.J.2009); *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 177 (2d Cir.2005); *SEC v. KPMG LLP,* 412 F.Supp.2d 349, 377–78 (S.D.N.Y.2006); *SEC v. PIMCO Advisors Fund Mgmt. LLC,* 341 F.Supp.2d 454, 467 (S.D.N.Y.2004). Courts have not allowed *Subsections (a)* and *(c)* of *Rule 10b–5* to be used as a "back door into liability that are centered around a false statement or omission in violation of subsection (b) of Rule 10b–5." *In re Parmalat Sec. Litig.,* 376 F.Supp.2d 472, 503 (S.D.N.Y. 2005); *See also, Kelly,* 817 F. Supp. 2d at 343.

In an extensive opinion examining the topic of scheme liability the District of New Mexico explained that although the Tenth Circuit had not examined the issue, "[t]he Second, Eighth, and Ninth Circuits have held that scheme liability encompasses only actions which include deceptive conduct beyond assistance with a material misstatement or omission." *SEC v. Goldstone,* 952 F.Supp.2d 1060, 1203-06 (D.N.M.2013) (emphasis added) (citing *Pub. Pension Fund Grp. v. KV Pharma. Co.*, 679 F.3d 972, 987 (8th Cir.2012)("We join the Second and Ninth Circuits in

recognizing a scheme liability claim must be based on conduct beyond misrepresentations or omissions actionable under Rule 10b–5(b)."); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 ("A defendant may only be liable as part of a fraudulent scheme based upon misrepresentations and omissions under Rules 10b–5(a) or (c) when the scheme also encompasses conduct beyond those misrepresentations or omissions."); *Lentell v. Merrill Lynch & Co.*, 396 F.3d at 177 ("[W]here the sole basis for such claims is alleged misrepresentations or omissions, plaintiffs have not made out a market manipulation claim under Rule 10b–5(a) and (c)."). "Stated differently, scheme liability exists only where there is deceptive conduct going beyond misrepresentations." *S.E.C. v. St. Anselm Expl. Co.*, 936 F. Supp. 2d 1281, 1299 (D. Colo. 2013).

Thus, for the SEC to succeed on a securities fraud violation under their scheme liability claims, they must allege facts sufficient to make a plausible case that Traffic Monsoon attempted to deceive investors through more than simple misrepresentations; they must demonstrate that Mr. Scoville committed deceptive acts ***beyond***, not in lieu of, making fraudulent statements to investors. This means that at the very least the SEC must allege some facts in the Complaint that Mr. Scoville or Traffic Monsoon committed fraudulent acts that were capable of deceiving AdPack buyers about some material fact.

Rather than meet that standard by alleging material misrepresentations, the Complaint jumps into a circular theory that Scoville and Traffic Monsoon face scheme liability because there was a Ponzi scheme, even though Scoville did not make the misrepresentations that are typical in every Ponzi scheme. Traffic Monsoon did not promise returns and explicitly told AdPack buyers they would not share in revenue unless subsequent buyers made advertising purchases. In any event, the legal conclusion that Traffic Monsoon was a Ponzi scheme contained in the Complaint

is owed no deference and cannot meet the pleading requirements where the Complaint does not contain predicate factual allegations to establish a Ponzi scheme, which it does not. (Compl. at ¶ 72). Put another way, the SEC attempts to make its case that Scoville and Traffic Monsoon defrauded investors but never shows a promise that Traffic Monsoon made that it did not keep (or would not have kept absent the actions of PayPal in freezing accounts), or any other conduct common to a Ponzi scheme.

The Complaint does not allege any material misrepresentations. All of the allegations that the SEC claims are misrepresentations are either not false statements, are not material, or are not related to the sale of securities. A statement, even if false, is not material unless "there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *Matrixx Initiatives, Inc. v. Siracusano*, 563 U.S. 27, 38, 131 S. Ct. 1309, 1318, 179 L. Ed. 2d 398 (2011).

**1. Traffic Monsoon Did Not Misrepresent That Its Income Comes From All Of Its Advertising Products.**

The Complaint alleges as one misrepresentation that "Traffic Monsoon's website falsely implies that revenues come from all its advertising products, rather than almost exclusively from AdPacks." Compl. at ¶ 39. However, the statement on Traffic Monsoon's website, in the context of the rest of information contained in the Complaint, is not false. The Complaint does not allege that Traffic Monsoon received revenues only from AdPacks, in fact it received income from other products. The Complaint also does not allege that the revenue that was shared came only from AdPacks, in fact the income came from all of Traffic Monsoon's products. Rather, the Complaint manufactures a false statement that Traffic Monsoon never made, claiming that Traffic Monsoon's website "implies" that its income came primarily from non-AdPack advertising. But the Complaint

contains no facts that would establish that Traffic Monsoon implied anything about the source of the revenue it shared. The SEC cannot manufacture a misrepresentation by alleging a defendant made a false "implication." This argument is merely a straw man created by the SEC, apparently to paper over the fact that they were unable to identify any actual false statements on the Traffic Monsoon website.

**2. The Complaint Fails to Connect the Statements on CharlesScoville.net With the Fraud It Alleges.**

The Complaint alleges that Scoville misrepresented the popularity of various products on a different website, Charlesscoville.net, Compl. at ¶¶ 33 and 34, but the Complaint does not allege any facts to connect that website to Traffic Monsoon or the sale of AdPacks, nor does it allege when that statement was made or published or whether it was true at the time it was made. As far as the allegations in the Complaint are concerned, there is no indication that anyone ever saw the Charlesscoville.net website, much less connected the content of that website to attempts to sell AdPacks by Traffic Monsoon, or – most importantly – that the conduct was or materially misleading.

**3. The Alleged Mis-Statements About The Reserve Fund Demonstrate The SEC's Fundamental Misunderstanding Of What The Reserve Fund Is.**

The alleged misrepresentations related to the reserve fund are similarly unavailing. The Complaint itself alleges that the reserve fund was funded with the revenue of Traffic Monsoon. Compl. at ¶19. Indeed, the "reserve fund" is the largest single repository of Traffic Monsoon's revenue, representing 79% of every dollar paid for an AdPack; or $39.50 for each $50 AdPack. *Id.* Sharing reserve fund money is necessarily, by the very composition of the reserve fund, sharing the *revenue* of Traffic Monsoon. At most the Complaint's allegations regarding the reserve fund demonstrate that Traffic Monsoon shared revenue with customers out of two separate internal

accounting categories: "reserve fund" and "a fund for sharing profit with AdPack purchasers," both of which were funded by Traffic Monsoon revenue. Compl. at ¶19. The Complaint does not contain any facts to suggest that investors knew of the two internal accounting categories, that they were misled by Traffic Monsoon using two internal accounting categories of which they did not know, or that the revenue in the reserve fund was somehow qualitatively different from the revenue in the other fund. In short, this allegation fails to create a plausible allegation of false or misleading conduct. Further, there is nothing to establish that any alleged misrepresentation about this internal accounting was material.

**4. The Alleged Mis-Statements About PayPal Lack Merit.**

The SEC also claims that Traffic Monsoon made misstatements and omissions regarding the PayPal freeze. The Complaint fails to allege sufficient facts to establish that the PayPal freeze was required to be disclosed, much less immediately. Further the Complaint does not allege any law or standard dictating when Traffic Monsoon was required to disclose that PayPal had taken a unilateral action – one for which PayPal could potentially face legal liability – to freeze Traffic Monsoon's accounts. Moreover, the Complaint does not allege what statements PayPal made to Defendants about the duration of the freeze, such as that it could be, or would be, resolved. Lacking any such context, the allegations about PayPal fail to allege a plausible factual basis for liability.

In short, the apparent reason that the SEC does not make a misrepresentation case is that it cannot prove that Traffic Monsoon made any material misrepresentations. That being so, the courts do not allow the SEC to allege scheme liability as a fishing expedition when there is no proper allegations of fraud against the clients.

Given that the bulk of the SEC's Complaint is attaching conclusory labels such as "investment" and "Ponzi" to a company and its customers, those conclusory allegations are not

afforded deference nor do they provide sufficient support to overcome the pleading standards set out in *Twombly* and *Iqbal*. Moreover, scheme liability is *more than*, not less than or a substitute for deceptive conduct. *KV Pharmaceutical Co.*, 679 F.3d at 987; *Kelly*, 817 F.Supp.2d at 344. Allegations of a scheme based on the same misstatements that would form the basis of a misrepresentation claim under *Rule 10b–5(b)* and nothing more are not sufficient. *TCS Capital Management, LLC v. Apax Partners, L.P.*, 2008 WL 650385 at *22 (S.D.N.Y. Mar. 7, 2008) (rejecting Rule 10b–5(a) and (c) claims based solely on misrepresentations) *U.S. S.E.C. v. St. Anselm Expl. Co.*, 936 F. Supp. 2d 1281, 1298–99 (D. Colo. 2013). The Complaint should be dismissed since the SEC is attempting to use scheme liability as a "wild card" to cover-up that Traffic Monsoon did not make material misrepresentations.

**B. The Rise and Proper Use of Scheme Liability.**

The use of scheme liability by the SEC is a product of a series of cases, none of which allow for circumventing the pleading standards of *Rule 9(b)*. Prior to the Supreme Court's ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), scheme liability was involved in limited circumstance alleging securities fraud.[2] However, after the Supreme Court ruled in *Central Bank* that there is no private right of action against parties aiding and abetting securities law violations, private litigants began fashioning scheme liability claims against secondary actors as a replacement for the aiding and abetting claims they previously

[2] Such as market manipulation which generally refers to practices such as "wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476-77 (1977). For example, wash sale takes place when an individual is both the buyer and the seller of the security. Such transaction might create publicity about the security, inducing other, unsuspecting investors to purchase the security, usually at an artificially elevated price level. *See generally* Damian Moos, Note, *Pleading Around the Private Securities Litigation Reform Act: Reevaluating the Pleading Requirements for Market Manipulation Claims*, 78 S. CAL. L. REv. 763, 765-69 (2005) (describing the various market manipulation schemes).

brought. *See, e.g., Newby v. Enron Corp*. (*In re Enron Corp. Sec., Derivative & ERISA Litig.*), 235 F. Supp. 2d 549 (S.D. Tex. 2002); *In re Global Crossing, Ltd. Securities Litig., 322 F. Supp. 2d 319* (S.D.N.Y. 2004); and *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005)). As such, in the matter at hand, the Complaint fails to allege any involvement of secondary actors that would make a plausible allegation of scheme liability.

In 2002, the Supreme Court's ruling in *SEC v. Zandford* 535 U.S. 813 (2002) drew additional attention to scheme liability. In *Zandford*, a stock broker selling his customer's securities kept part of the profits of the sale, using them for his own benefit and telling the customer he had received less profit. The Supreme Court held that the broker violated *Rule 10b-5(a)* and *(c)* and thus committed securities fraud against his own customer. However, premised on the violations for *Rule 10b-5(a)* and *(c)* the Court noted that Congress sought "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." *Id.* at 819 (internal quotations and citations omitted), and while Zanford's actions were deceptive and a violation of *Rule 10(b)-5(a)* and *(c)*, Zandford was primarily liable because he hid (*i.e.* omitted to tell) the actual profits from his client and then used his client's money for himself, which formed the deceptive conduct beyond the omission. *Id.* at 813. Thus, the leading Supreme Court case on scheme liability rests on a foundation of a material omission followed by further deceptive conduct constituting the scheme.

Following *Zandford*, the majority of the circuits continue to apply scheme liability only in situations where either multiple parties or secondary actors are involved, or in situations where there was a scheme in addition to a fraudulent misrepresentation or omission. Here, because the Complaint does not allege any material misrepresentations or omissions or the involvement of secondary actors, it fails to follow the precedent of these scheme liability cases.

Because the cases on scheme liability require *more* than mere misrepresentations, the failure to allege even material misrepresentations means that the SEC has failed to state a claim for relief that is "plausible on its face." *Iqbal*, 556 U.S. at 678.

### C. The SEC's Own Argument Contradicts their Position that they can Plead Scheme Liability Without a Misrepresentation or Omission.

"[A]dmissions in the pleadings ... are in the nature of judicial admissions binding upon the parties, unless withdrawn or amended." *See Grynberg v. Bar S Servs., Inc.*, 527 F. App'x 736, 739 (10th Cir. 2013) (internal quotation marks omitted). In the filings made simultaneously with the Complaint, the SEC recognized the importance of providing a material misstatement as a baseline for proving securities fraud when they provide the following definition of a Ponzi scheme:

> "Ponzi schemes generally have the following four characteristics: (1) a dependence on funds provided from third-party investors; (2) a material misrepresentation or omission made by the operators of the scheme (3) payment or promise of payment of above market returns to investors; and (4) the scheme becomes increasingly insolvent with each subsequent investment. (emphasis added);

See D.E. 3-3 ¶ 30 on p. 7 of 129.

As such, in relying only on the scheme liability provisions and the misrepresentation provisions of *Rules 17(a)* and *10(b)-5*, the SEC falls short of the very standard they set in their briefing. The SEC's claims rest on the argument that Traffic Monsoon and Scoville face liability because there was a Ponzi scheme and therefore scheme liability, but they appear to be under the belief that they need not demonstrate any material false representations as long as they simply add the words "Ponzi scheme" to the Complaint. This is simply not true. Even the SEC's own definition of a Ponzi scheme requires a material misrepresentation, and their complaint fails to identify any actual material misrepresentation.

In virtually every Ponzi scheme the misrepresentation is that there is a separate business that will generate income (such as postage stamp arbitrage by Mr. Ponzi) that doesn't exist.

Similarly, in virtually every Ponzi scheme there is a guarantee of a fixed, and usually high, rate of return. See D.E. 3-3 ¶ 30 on p. 7 of 129. Here those key misrepresentations and cornerstone allegations to a Ponzi scheme are absent. Traffic Monsoon disclosed it would only share revenue if it generated money from the sale of advertising services (and AdPack owners clicked on others' websites each day), but it did not guarantee the money or promise any payment, much less, a high rate of return.

The Complaint lacks any allegations of the necessary misrepresentations or omissions required to secure a fraud claim or how there were any "promise of payment of above market returns to investors" or the how the "scheme becomes increasingly insolvent with each subsequent investment" that meet the *Rule 9(b)* standard of pleading with specificity applicable to the Complaint.

Given that the allegations that even arguably support a misrepresentation case are speculative and conclusory, the Complaint fails to allege fraud that is plausible on its face and should be dismissed (*See Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007) that the allegations must contain sufficient factual matter" to state a claim for relief that is "plausible on its face"). Therefore, the Complaint must be dismissed since the SEC fails to provide any substantive allegations that a material misstatement or omission existed.

## III. THE SEC'S COMPLAINT SHOULD BE DISMISSED BECAUSE THEIR SCIENTER CLAIMS ARE SPECULATIVE, AT BEST.

To bring a claim under *Rule 10b-5(a)* and *(c)* and *17(a)(1)*, the Supreme Court has stated the SEC must establish the defendant had the requisite mental intent to create fraud. The term "scienter" was used in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, n. 12, 96 S.Ct. 1375, 1381, n. 12, 47 L.Ed.2d 668, to refer to "a mental state embracing intent to deceive, manipulate, or

defraud." Scienter can be proven by showing either knowing or intentional misconduct or recklessness, that is, "conduct that is an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" *City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1258 (10th Cir. 2001) (quoting *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215, 1232 (10th Cir. 1996)).

In the Complaint, the SEC relies on two allegations to establish scienter: (1) by attaching the label of "Ponzi Scheme" to Defendants' business, they argue scienter is inferred (*See* Compl. ¶¶ 67 - 70), and (2) they claim Mr. Scoville must have known that AdPacks were securities because he carefully and repeatedly explained to customers that they were not a security or investment. (*See* Compl. ¶¶ 71 - 75). However, the Complaint does not contain enough factual allegations to support a cause of action and since the scienter element is one of the most important elements in a securities fraud violation, the Complaint should be dismissed.

**A. The Complaint Should be Dismissed Because the SEC's Claims that Scoville's Statements that AdPacks Were Not Investments or Securities Are Not Specific Enough to Meet a Fraud Claim.**

As with all complaints alleging fraud, the SEC must meet the higher pleading standards of *Rule 9* here. *Rule 9(b)* has specific requirements designed to protect defendants from unfounded and undeveloped claims of fraud -- to prevent "fishing expeditions." Indeed, "[t]he purposes of Rule 9(b) is to put the defendant on notice of the conduct complained of, to eliminate fraud actions in which all the facts are learned after discovery, to protect defendants from frivolous claims, and to protect defendants from the harm to their goodwill and reputation that may result from fraud claims." *United States ex rel. Baker v. Cmty. Health Sys.*, 709 F. Supp. 2d 1084, 1113 (D. N.M. 2010); *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 990 (10th Cir. 1992) ("a plaintiff

in a non-9(b) suit can sue now and discover later what his claim is, but a Rule 9(b) claimant must know what his claim is when he files.").

In order to serve these goals, *Rule 9(b)* requires that a plaintiff, at a minimum, allege the "time, place and contents" of the alleged misrepresentation, the identity of the party making the false statements, and the consequences thereof. *Koch*, 203 F.3d at 1236. The failure to comply with *Rule 9(b)'s* pleading requirements is treated as a failure to state a claim under *Rule 12(b)(6). See United States ex rel. Lacy v. New Horizons, Inc.*, 348 F. App'x 421, 429 (10th Cir. 2009) ("The district court properly dismissed this action. The claims raised either fail to state a claim or fail to plead fraud with particularity as required.").

Complaints, like the one brought by the SEC, fail because claims such as "the fact that Mr. Scoville was telling people that AdPacks were not securities demonstrates that he knew AdPacks were securities" falls short of this pleading standard. Compl. at ¶¶ 72-73. The SEC does not allege any facts that would provide a basis to conclude that Scoville did not believe that AdPacks were not securities. As such their conclusion that his statement that AdPacks were not securities demonstrates that he knew that they were securities is not supported by any well pled facts. This "fact," cannot meet the standard to prove the most important element in a securities fraud case: scienter.

**B. Scoville Did Not Operate a Ponzi Scheme.**

As noted earlier in this Motion, the SEC's accountant, Scott Frost, defined a Ponzi scheme as:

> Ponzi schemes generally have the following four characteristics: (1) a dependence on funds provided from third-party investors; (2) a material misrepresentation or omission made by the operators of the scheme (3) payment or promise of payment of above market returns to investors; and (4) the scheme becomes increasingly insolvent with each subsequent investment. (emphasis added)

See D.E. 3-3 ¶ 30 on p. 7 of 129. However, despite the standard the SEC has put forward, the Complaint fails to (1) "allege any material misrepresentations or omissions made by the operator of the scheme" and (2) did not make any "payments or promise of payments above market returns" (emphasis added).

**1. Traffic Monsoon Sold Advertising Services and Paid Commissions on the Sale of Advertising.**

The SEC's argument is premised on pretending that AdPacks are not an advertising service and that they are an investment obtained from future parties. By calling an AdPack an investment, ignoring the advertising component, and then treating revenue from subsequent AdPack sales as money from later investors, they create a rhetorical Ponzi scheme. However, the Complaint does not contain any well pled facts that establish that the advertising products were not real and can simply be ignored, as the SEC does. While the Complaint makes the conclusory allegation that AdPack purchasers "have no interest" in receiving advertising and that their "sole motivation in purchasing the AdPack is to earn the 10% return in 55 days" (See Compl. at ¶ 77), it contains no facts to support those conclusions. These kinds of conclusory allegations are insufficient to meet the pleading standard required.

In a similar vein, the SEC claims that while Traffic Monsoon distributed revenue from its sales of products, it would "imply that the majority of the revenue comes from the sale of Traffic Monsoon's many advertising products" rather than principally from AdPacks. (Compl. at ¶ 34). However, this is a naked conclusion with no factual support. The Complaint never claims that Traffic Monsoon made any representations whatsoever regarding the mix of revenue generated by its various advertising products. Indeed, Traffic Monsoon never made a representation about the percentage of its revenue derived from any particular advertising product. Here, the SEC is on both sides of the enforcement equation – creating out of wholecloth the very misrepresentation that they

later claim is false. But they never explain how this "implication" arose, or how that implication is based in any well pled facts. This is simply a conclusory allegation that cannot support the Complaint.

**2. AdPack Purchasers Were Not Promised Any "Returns."**

The second defining characteristic of a Ponzi scheme is that "investors are promised large returns for their investments." *In re M & L Bus. Mach. Co., Inc., 84 F.3d at 1332 n. 1*. That emphatically did not happen here. As alleged in the Complaint, "[t]he Traffic Monsoon website claims that there is no set timeframe for the investor's account to reach $55, or any assurance that it will ever in fact reach $55." (Compl. at ¶ 24). The Complaint continues, "[t]he website provides no assurance that the investor's 'bucket' will ever reach the $55 'fill line.'" (Compl. at ¶ 26).

According to the SEC's own investigation, and more importantly according to the allegations in the Complaint, Traffic Monsoon told AdPack purchasers that while they would receive at most $55 in revenue sharing, there was no guarantee that they would ever receive any commissions at all. *Id.* To put this in the general terms of the Ponzi definition—Traffic Monsoon did not promise AdPack purchasers any "returns" much less "large returns."

This is not a trivial factual difference. A Ponzi scheme operates by promising large returns to investors, paying some teaser investors those returns, and relying on them to recruit others, all while providing no service at all. Here, the Complaint fails to demonstrate Traffic Monsoon ever made promises of returns whatsoever. Furthermore, Traffic Monsoon's website explicitly told AdPack purchasers that they would get funds through revenue sharing on a daily basis provided that they were qualified for that day and there was revenue. Revenue sharing necessarily implies that there will only be funds available to AdPack purchasers if later customers purchase advertising, otherwise there will be no revenue to share. As the Complaint alleges, Traffic

Monsoon made this implication explicit. Compl. at ¶ 22. However, the Complaint, because it claims the advertising was a sham, conflates the basic business principle that a business needs sales and revenue to continue to operate with a Ponzi scheme.

As such, it was not a "pure Ponzi scheme" (*See* Compl. at ¶5) no matter how many times the Complaint affixes the label in its conclusory fashion.

## IV. THE COMPLAINT FAILS TO STATE A CLAIM BECAUSE CONDUCT LEGALLY PERMITTED UNDER THE TERMS OF THE CONTRACTS CANNOT BE DEEMED SECURITIES FRAUD JUST BY THE SEC'S MERE SAY SO.

### A. The Complaint Should be Dismissed Because it Fails to Make Any Proper Allegations that Any AdPack Purchasers Expected Profits for Anything Other than Services Performed.

The SEC cannot prevail on its claims unless the AdPacks were securities. The Complaint alleges that there were securities because the AdPacks were investment contracts. The Supreme Court has held that when determining whether a contract is an investment contract, the plaintiff must prove that there are "profits that investors seek on their investment, not the profits of the scheme in which they invest (emphasis added). 'Profits' in [this] sense of income or return [are], for example, dividends, other periodic payments, or the increased value of the investment. *S.E.C. v. Edwards*, 540 U.S. 389, 394, 124 S. Ct. 892, 897, 157 L. Ed. 2d 813 (2004).

Therefore, the SEC must allege that, based on the agreements, AdPack purchasers expect to receive profits outside of their 10% sales commissions (*See* Compl. at ¶ 19) and a possible additional commission for performing services for Traffic Monsoon, which are the profits of the "scheme" itself, not profits on the "investment." *See Whole Living, Inc. v. Tolman*, 344 F. Supp. 2d 739, 748 (D. Utah 2004). Put another way, this was not an investment contract because the only way an AdPack purchaser could get money in revenue sharing is if that AdPack purchaser later provided the very service that Traffic Monsoon was selling to others (clicks on other purchasers'

websites) and Traffic Monsoon realized revenue. This is not profit from an investment but rather payment for a service performed for Traffic Monsoon.

To make the foundational allegation that AdPacks are an investment contract, the Complaint must demonstrate there was: (1) an investment of money; (2) in a common enterprise; and (3) with the profits derived from the efforts of others. *See Howey*, 328 U.S. at 298–99. In this case, the Complaint offers nothing to demonstrate that there was an investment of money in any common enterprise that had profits. Rather, the Complaint attempts to disguise this deficiency by repeating the terms "Invest," "Investor," or "Investment" 81 times, while also acknowledging that Traffic Monsoon explicitly told people it was not an investment and should not be treated as one. Compl. at ¶ 73. The Complaint offers no evidence that any purchaser of an AdPack considered themselves to be an "investor" or that by purchasing an AdPack that they were "making an investment." In the absence of these factual predicate allegations, the Complaint's conclusory allegations about AdPacks as investments fail to meet the pleading standards of *Rule 9*.

**B. A Commercial Contract for the Purchase and Sale of Goods and Services Is Not a Security and Not Subject to the U.S. Securities Laws Just Because of a Rebate.**

The anti-fraud statutes do not give the SEC unrestrained discretion to bring suit whenever it finds a business objectionable. Here the Complaint makes clear that the AdPack transaction that parties entered was for the sale of advertising services, with the possibility, but not guarantee, of some amount of shared revenue, up to an additional $5.00 above the original price of the advertising purchased, in an unspecified amount of time. The buyers knew, because the website told them, that this shared revenue would only come if more advertising was sold. The SEC, though it filed a complaint containing all of these facts, largely ignores them. Instead it attempts to protect customers from themselves and the deals they knowingly made. However, that is not the Commission's mandate. The SEC is commanded by Congress to police U.S. based securities

transactions, not commercial agreements that they feel are objectionable, which is what the Complaint describes.

As the 2nd Circuit recently affirmed, federal fraud statutes are not meant to provide causes of action for even intentional breaches of contract—they are specifically intended to prosecute *fraud*. *See generally, U.S. ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650 (2d Cir. 2016) (holding that defendant could not be liable for mail or wire fraud for what was a simply an intentional breach of contract); *see also Erie Group LLC v. Guayaba Capital, LLC*, 110 F. Supp. 3d 501, 512 (S.D.N.Y. 2015) (dismissing securities fraud claims when the case "at its core" was about a contract dispute over fund expenses, not securities fraud violations). When a transaction's terms are disclosed, there is no fraud. *See Dujardin v. Liberty Media Corp.*, 359 F. Supp. 2d 337, 348 (S.D.N.Y. 2005) ("The naked assertion of concealment of material facts which is contradicted by published documents which expressly set forth the very facts allegedly concealed is insufficient to constitute actionable fraud.") (internal citations omitted); *Sable v. Southmark/Envicon Capital Corp.*, 819 F. Supp. 324, 333 (S.D.N.Y. 1993) ("[P]laintiffs cannot state a claim of misrepresentation premised upon facts that were admittedly disclosed.").

The Complaint brings an enforcement action based on an investment contract, but what the Complaint actually describes is a commercial contract for the sale of an AdPack with the opportunity to earn money for performing the very advertising services that Traffic Monsoon was selling. Therefore, the Complaint should be dismissed since the SEC has failed to allege how the AdPacks meet the definition of any type of securities under the U.S. securities laws.

## V. THE COMMISION'S SECTION 5 CLAIMS SHOULD BE DISMISSED BECAUSE THE CLAIMS FAIL TO RECOGNIZE THAT PROPER EXEMPTIONS EXIST.

### A. Even if the Sales of AdPacks Were Sales of Securities, At a Minimum 90% of Are Exempt From the Registration Requirements of Section 5.

Much Like the ruling in *Morrison,* with respect to the antifraud provisions of the federal securities laws, *Regulation S* adopts a "'territorial approach'" to the Securities Act's registration provisions and provides an exemption from the registration requirements of *Section 5* for foreign transactions. *See Europe and Overseas Commodity Traders,* 147 F.3d at 124 (quoting Offshore Offers and Sales, Securities Act Release No. 33-6863, 1990 WL 311658, at *5(Apr. 24, 1990)). *Regulation S* was issued by the SEC and exempts "offers and sales that occur outside the United States" from the Act's registration requirements. 17 C.F.R. §230.901. Under *Regulation S,* a sale is an offshore transaction if the buyer was located outside the United States when the buy order was entered. 17 CFR § 230.902(h)(1)(ii)(A). As such, in the case at hand, the Complaint again fails because it does not allege that the buyers were in the United States at the time the order to buy AdPacks was entered.

## CONCLUSION

The Complaint should be dismissed because the SEC fails to (1) allege facts sufficient to establish the sale of domestic securities as to at least 90% of the AdPack purchasers, (2) plead the proper elements of material misrepresentations or omission when pleading scheme liability (3) allege facts sufficient to lead to the plausible conclusion that Mr. Scoville acted with the requisite intent to defraud, and (4) properly allege securities, and not commercial contracts are at issue in this matter; and (5) fails to establish that the AdPacks were securities that were not within a valid registration exemption.

DATED: January 25, 2017

**WASHBURN LAW GROUP, LLC**

/s/ D. Loren Washburn
D. Loren Washburn

**CERTIFICATE OF SERVICE**

I hereby certify that on January 25, 2017, the foregoing **MOTION TO DISMISS** was served upon the person(s) named below, at the address set out below by Electronic Filing:

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