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IN THE UNITED STATES DISTRICT COURT
DISTRICT OF UTAH, CENTRAL DIVISION

SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF, v. TRAFFIC MONSOON, LLC, a Utah Limited Liability Company and CHARLES D. SCOVILLE, an individual, DEFENDANTS.	**PLAINTIFF'S SURREPLY IN OPPOSITION TO MOTION TO SET ASIDE RECEIVERSHIP** Case No.: 2:16-cv-00832-JNP Judge Jill N. Parrish

Plaintiff, Securities and Exchange Commission (the "Commission"), by and through its counsel of record, respectfully submits this Surrpely in Opposition to Motion to Set Aside Receivership ("Opposition").

In his Motion to Set Aside Receivership ("Motion"), defendant Charles D. Scoville ("Scoville") requests that the Court either set aside the receivership and asset freeze altogether, or, at the very least, set aside the receivership and replace it with a limited asset freeze of approximately $15 million. In his Reply in support of this Motion, Scoville raises issues that

were not raised in or addressed by the Motion or the Commission's Opposition. Specifically, Scoville argues that he did not act with scienter and that Traffic Monsoon did not constitute a Ponzi scheme. Reply, Doc. No. 45, pp. 12-16. Although these arguments were addressed in the parties' separate briefing on the Commission's request for a preliminary injunction, their inclusion in the Reply here necessitates a brief response from the Commission.

ARGUMENT

I. TRAFFIC MONSOON WAS OPERATING AS A PONZI SCHEME.

Scoville argues that Traffic Monsoon did not constitute a security because 1) customers were not investors, 2) there were no misrepresentations, and 3) Traffic Monsoon was solvent at all times. None of these arguments have merit.

First and foremost, AdPacks are securities, and thus AdPack buyers are investors, because the AdPacks satisfy the three-part test for investment contracts outlined in *SEC v. W.J. Howey & Co.*, 328 U.S. 293, 301 (1946). To reiterate what has already been argued at length, Traffic Monsoon's AdPack involved (1) an investment of money, (2) in a common enterprise, (3) with a profit derived from the efforts of others. *Id.* Evaluating whether an instrument constitutes a security is a substantive legal analysis that takes into consideration the economic realities of the transaction. The considerations included in this legal analysis (the three part test) *do not include* what label the seller places upon the instrument or what the buyer agrees it should be called. Because the AdPack satisfies all three prongs of the *Howey* test, it is legally irrelevant whether Scoville insisted that it be called a product, or whether he can identify one or many investors who are willing to agree that they didn't consider themselves investors. A Rose will always be a Rose, after all, because it is a Rose. That is true irrespective of whether someone insists that it should be called a Daisy.

Additionally, it is inaccurate to state, as Scoville does in his Reply, that customers weren't investors because "thousands of AdPack purchasers never qualified and therefore clearly valued only the advertising, not the opportunity to obtain commissions." Reply, p. 14. The Declaration of Ray Strong, attached as Exhibit C to Scoville's own Reply, demonstrates that

worldwide, of the 107,057 individuals that purchased AdPacks, 105,925 qualified to earn a return by clicking ads. That is 99% of all AdPack buyers. In the United States the number is even more dramatic. Of the 7,656 AdPack buyers, 7,620 qualified for a return by clicking ads. *See id.* Only 36 people that purchased an AdPack in the U.S. failed to qualify by clicking ads. Of course this makes sense, as the advertising services embedded in the $50 AdPack were available for $11 if purchased separately. It would have made no sense, and would have been a waste of money, for them to spend the extra $39 to purchase the advertising services via an AdPack. The AdPack buyers purchased the instrument for the opportunity to earn a return. As such, they were investors, and they were purchasing securities.

Second, Scoville's argument that he did not make any material misrepresentations is entirely beside the point and indicates a misunderstanding of the legal claims brought by the Commission here. This is a scheme and course of business fraud case under Section 17(a)(1) and (3) of the Securities Act and Section 10b-5(a) and (c) of the Securities Exchange Act ("Exchange Act"). *See* Complaint, Doc. No. 2, pp. 16-17. This is not a misrepresentation case, which would have been filed under Section 17(a)(2) of the Securities Act and 10b-5(b) of the Exchange Act.

As numerous courts have recognized, "[t]he conduct necessary to form a Rule 10b-5(a) or (c) violation can vary widely, but presumably these sections are intended to cover different conduct than Rule 10b-5(b)." *Swack v. Credit Suisse First Boston*, 383 F.Supp.2d 223, 238 (D. Mass. 2004). To sufficiently state a claim under Rule 10b-5(a) and (c), the Commission must allege that (1) the defendant committed a deceptive or manipulative act or conducted his business, (2) in furtherance of the alleged scheme to defraud, (3) with scienter. *See In re Alstom SA Sec. Litig.*, 406 F.Supp.2d 433, 474 (S.D.N.Y. 2005). *See also SEC v. Patel*, 2009 WL 3151143 at *8 (D.N.H. 2009) ("subsections (a) and (c) encompass much more than illegal trading activity: they encompass the use of *any* device, scheme or artifice, or *any* act, practice, or course of business used to perpetrate a fraud on investors.") (emphasis in original) (internal citations omitted); *In re Global Crossing Ltd. Sec. Litig.*, 322 F.Supp.2d 319, 337 (S.D.N.Y.

2004) (finding sufficient allegations of fraud to support a case under Rule 10b-5(a) and (c)). The operation of a Ponzi scheme is an inherently fraudulent scheme and course of business, and as such violates these provisions whether or not the defendant is alleged to have made material misstatements in connection with its operation. *See, e.g., SEC v. Management Solutions*, 2013 WL 4501088 at *7 (D. Utah Aug. 22, 2013) (unpublished) ("The general pattern courts look for when labeling a scheme as "Ponzi" is "any sort of inherently fraudulent arrangement under which the debtor-transferor must utilize after-acquired investment funds to pay off previous investors in order to forestall disclosure of the fraud.").

Although Scoville may have made, and almost certainly did make, material misrepresentations regarding his business operations and how he was funding investor returns, those misrepresentations, at least at this stage of the litigation, are not central to the Commission's case. Rather, the central focus of the Commission's case here is Scoville's scheme, practice, and course of business that operated as fraud upon Traffic Monsoon investors. It is sufficient that the Commission has alleged that Scoville conducted a fraudulent scheme, practice, and course of business in his operation of a Ponzi scheme.

Third, Scoville and Traffic Monsoon were not solvent at any time they operated the business – a hallmark distinction of an ongoing Ponzi scheme. At the outset, for each $50 investment by a customer, Traffic Monsoon owed the customer back $55 (the original $50, plus a $5 return). Traffic Monsoon therefore was immediately in the hole $5 to each investor – it generated no income from the $50 investment and in fact lost money through the transaction. This problem compounded with each "repurchase" of an AdPack, as Traffic Monsoon owed each investor an additional $5 for each repurchase, without having taken in any new funds. For example, after the initial purchase and two additional "repurchases," Traffic Monsoon would owe an investor $65, the initial $50 plus an additional $15 in returns. And this doesn't even take into consideration the additional $5 referral commission payments Scoville paid to many Traffic Monsoon investors. If Traffic Monsoon had any meaningful revenue stream to draw from to pay these returns it would be one thing, but approximately 99% of all Traffic Monsoon revenue was

derived exclusively from the sale of AdPacks (over $173 million from AdPacks out of $175.9 million in total revenue). It was simply not making money through any other means. Clearly, the only source from which Traffic Monsoon could draw to pay these compounding returns and referral payments was the sale of new AdPacks – thus further multiplying the cascading obligations owed to Traffic Monsoon investors.

From its very first sale of an AdPack, and its obligation to pay back the sale price plus a $5 return, Traffic Monsoon was insolvent. By the time the Commission filed this action, it had become stupendously insolvent. It had created a hole so deep it could never have gotten free, and it was only a matter of time before the entire operation failed – as all such schemes are destined to do. Traffic Monsoon was dependent upon future sales of AdPacks to finance the returns it was paying to previous AdPack purchasers. It therefore "utilized after-acquired investment funds to pay off previous investors," thereby operating as an insolvent Ponzi scheme. *Management Solutions*, 2013 WL 4501088 at *7.

II. SCOVILLE ACTED WITH SCIENTER IN OPERATING A PONZI SCHEME.

Scoville also argues, once again, that he did not act with scienter because the Utah Division of Securities apparently opined, on a separate, previous undertaking that included, among other things, a product that resembled an AdPack, that the business didn't violate the Utah securities laws. Nothing in Scoville's second Declaration on this point makes it any more relevant now than it was before. To the extent that an inquiry into a different business by a separate governmental agency could possibly have any bearing on his scienter, it has no bearing here because absolutely nothing is known about what prompted the inquiry, what issue the Division of Securities was looking at, whether it conducted any substantive review that included documents, testimony, or other inquiries, and what informed its opinion. As such, it is simply not relevant to the issue of Scoville's scienter in this matter.

As an initial matter, because Scoville was operating a Ponzi scheme, the "question of intent to defraud is not debatable." *Conroy v. Shott*, 363 F.2d 90, 92 (6th Cir. 1966); *see also In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528, 535 (9th Cir. 1990)

("debtor's actual intent to hinder, delay or defraud its creditors may be inferred from the mere existence of a Ponzi scheme"). By operating a Ponzi scheme, Scoville acted with scienter. That is where the inquiry legally ends.

Notwithstanding this legal reality, in contending that the Division of Securities' investigation somehow obviates this scienter, Scoville asks the Court to trust him in saying that he "received a request from Brandon Dally of the Utah Division of Securities into the business practices of the AdProfits and the sale of AdPacks." Reply, Ex. A, Declaration of Charles D. Scoville. Importantly, there is nothing in the record, other than Scoville's self-serving testimony, that in any way documents what issue the Division of Securities was looking into or what evidence it obtained and considered. There are no document requests or subpoenas, no informal requests, no email communications (other than the one attached to his initial declaration that provides no helpful information), no attempts to demonstrate what information was provided to or obtained by the Division, nothing at all that bears on this matter. Did the Division of Securities actually look into the similar product, or was it looking at some other aspect of the business operations or products? Did it know that the company was offering a profit sharing position that (apparently) constituted all of the revenue of the company? Did sales of that product in fact constitute all of the revenue of the company, or was there (unlike the case here) another revenue source? Did Scoville provide any testimony in connection with the inquiry? These are but a few of the many questions that are raised in connection with Scoville's argument, none of which can be answered here. Because of this, any reference or allusion to the Division of Securities' inquiry into AdHitProfits is, in fact, irrelevant to this matter and should be disregarded.

Scoville was selling a security. His customers were investors who purchased the AdPacks in order to obtain a return. The operation was an insolvent Ponzi scheme that was destined to fail when, not if, Scoville ran out of investors who were willing to infuse the scheme with new revenue. In operating a Ponzi scheme, Scoville is legally deemed to have the requisite

scienter to support the Commission's fraud claims here. For all of these reasons, Scoville's Motion should be denied.

CONCLUSION

Based on the foregoing, the Commission respectfully requests that this Court deny the defendant's Motion to Set Aside Receivership.

Respectfully submitted this 27th day of October, 2016.

/s/ Daniel J. Wadley
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CERTIFICATE OF SERVICE

I hereby certify that on October 27, 2016, I caused to be filed the forgoing using the Court's CM/ECF System. A true and correct copy of the document was served on all parties entitled to service through the Court's CM/ECF System.

/s/ Marlea Furlong
Marlea Furlong