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A Derivative in Need

RESCUING U.S. SECURITY-BASED SWAPS FROM THE RACE TO THE BOTTOM

"Derivatives in and of themselves are not evil. There's nothing evil about how they're traded, how they're accounted for, and how they're financed, like any other financial instrument, if done properly."[1]

INTRODUCTION

Ever since the 2007–2008 global financial crisis, the term "derivative" has become somewhat of a dirty word—at least in the financial context.[2] This stigma resulted from a combination of general misunderstanding and widespread confusion as to the actual mechanics of some derivatives,[3] mixed with the blame that policymakers placed on over-the-counter (OTC) derivatives[4] for inciting and contributing to the crisis.[5] The reality, however, is

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[1] Vince Veneziani, *Q&A With Jim Chanos Part I: "Greece Is A Prelude,"* BUS. INSIDER (Apr. 13, 2010, 9:36 AM), http://www.businessinsider.com/interview-with-jim-chanos-on-dubai-greece-derivatives-2010-4 [http://perma.cc/3UXA-XRZD]. Jim Chanos is president of the Manhattan-based hedge fund called Kynikos Associates and has made a name for himself by correctly betting on the decline of major companies, including Tyco, Worldcom, and Enron. *Id.*

[2] Henry Tricks, *Dirty Words*, ECONOMIST (Nov. 19, 2008), http://www.economist.com/node/12494685 [http://perma.cc/S3P9-TM4E]; *see also* David Ott, *Dirty Words of Finance*, ACROPOLIS INV. MGMT. (Oct. 13, 2014), http://acrinv.com/dirty-words-of-finance/ [http://perma.cc/DL3Z-XH9R] (comparing the term "derivative" to George Carlin's list of "'seven dirty words' that [are] unsuitable for television").

[3] "When [they think of] 'derivatives,' most people are lucky if they can conjure up anything but an indistinct fog." Andrew Beattie, *The Barnyard Basics of Derivatives*, INVESTOPEDIA, http://www.investopedia.com/articles/basics/07/derivatives_basics.asp [http://perma.cc/A5R4-VD39] (last visited Nov. 30, 2015); *see also* Thomas J. Molony, *Still Floating: Security-Based Swap Agreements After Dodd-Frank*, 42 SETON HALL L. REV. 953, 953 (2012) (noting the confusion that exists as to the meaning and scope of the term "security-based swap agreement").

[4] See *infra* Sections I.A, I.D for a detailed history and explanation of OTC derivatives.

[5] Erik F. Gerding, *Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension*, 8 BERKLEY BUS. L.J. 29, 30 (2011); *see also* Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 205-15 (2011) (explaining the risks of credit derivatives and how they contributed to the financial crisis).

that "[t]his opprobrium is entirely undeserved."[6] In fact, some derivatives have the singular ability to provide investors with exposure to difficult-to-reach markets, hedging protection, and speculation opportunities.[7] One such product in this family is known as the security-based swap.[8]

The security-based swap is, in the most simplified terms, a financial instrument that allows investors to manage risk.[9] Its core utility stems from its unique structure, which allows investors to capture the gains and losses of an equity (or an index) without purchasing the stock itself.[10] These swaps often reference securities in a jurisdiction foreign to that of the investor and thus are sometimes referred to as "cross-border security-based swaps." In general, the importance of security-based swaps to the global financial system cannot be denied, as they (along with a related class of derivatives known as forwards) represent roughly $2.5 trillion worth of the outstanding amount of all OTC contracts worldwide—a staggering $630.1 trillion—as of December 2014.[11] As a result of this popularity, the U.S. judicial and legislative branches have taken steps to increase the scrutiny directed toward security-based swaps in an effort to prevent and combat securities fraud, the likes of which could cause investors and markets significant harm.

Despite efforts to clarify the U.S. approach to regulating OTC derivatives, the landscape of securities fraud policies governing security-based swaps continues to fluctuate.[12] In the

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[6] JOHN J. STEPHENS, MANAGING CURRENCY RISK: USING FINANCIAL DERIVATIVES 10 (2001).

[7] *See infra* Sections I.B, I.C. In this note, the term "hedging" refers to the act of protecting one's existing trades against unexpected and unfavorable market movements (a defensive strategy), while "speculation" refers to the act of placing new trades based on predictions of future market movements in order to profit (an offensive strategy). *See Hedge*, INVESTOPEDIA, http://www.investopedia.com/terms/h/hedge.asp [http://perma.cc/JKD8-GZW5] (last visited Nov. 30, 2015); *Speculation*, INVESTOPEDIA, http://www.investopedia.com/terms/s/speculation.asp [http://perma.cc/MRH7-ALLL] (last visited Nov. 30, 2015).

[8] This derivative is referred to by a variety of names, including "security-based swap" (15 U.S.C. § 78c-1(b) (2012)), "securities-based swap" (15 U.S.C. § 78j(b) (2012)), and "equity swap" (7 U.S.C. § 1a(47)(A)(iii)(XI) (2012)). This note will generally use the term "security-based swap." All swaps—including security-based swaps—are derivatives, but not all derivatives are swaps. *See infra* Section I.A.

[9] *See Derivative*, INVESTOPEDIA, http://www.investopedia.com/terms/d/derivative.asp [http://perma.cc/23VG-KD5U] (last visited Nov. 30, 2015).

[10] *See infra* Section I.C.

[11] BANK FOR INT'L SETTLEMENTS, BIS DERIVATIVES STATISTICS tbl.19 (2014), http://www.bis.org/statistics/dt1920a.pdf [http://perma.cc/7HP4-X6X4] [hereinafter BIS TABLE 19].

[12] For a narrative on recent changes to private rights of action and SEC-initiated litigation, see Mark A. Kornfeld, *Tracking New Developments in Securities Litigation*, *in* NEW DEVELOPMENTS IN SECURITIES LITIGATION (2014).

judicial arena, courts have struggled to pin down a clear and concise standard to use when determining whether to apply U.S. securities fraud laws in cases involving cross-border security-based swaps. The difficulty stems from a principle referred to as "the presumption against extraterritoriality," which establishes courts' reluctance to apply U.S. laws to foreign conduct without an express congressional directive to do so and reflects U.S. courts' fear of impairing international comity.[13]

Based on the presumption against extraterritoriality, in 2010, the Supreme Court held in *Morrison v. National Australia Bank Ltd.* that in the cross-border derivative context, privately raised securities fraud claims should be examined under a new "transactional test," which focuses on the location of the transaction and the parties to it.[14] Though this test purports to establish a bright-line rule, subsequent cases have quickly exposed its inherent ambiguity, sending courts freewheeling into uncharted territory as they attempt to refine it. The most recent effort to interpret *Morrison* as it applies to cross-border derivatives was the Second Circuit's August 2014 decision in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*.[15]

The *Parkcentral* decision, which focused on cross-border security-based swaps, added a new layer to *Morrison*'s transactional test by mandating that the parties' domestic location be viewed as a *necessary*—but not on its own *sufficient*—factor to authorize the application of U.S. securities fraud laws in cases where the alleged fraudulent conduct occurred in a foreign jurisdiction.[16] Only an individualized factual analysis can now establish sufficient cause to invoke U.S. securities laws.[17] Problematically, the court in *Parkcentral* did not express an opinion about the novel test utilized by the district court, which ignored the Supreme Court's emphasis on the location of the parties and focused instead on the "economic reality" of the transaction.[18] The district court's economic reality test effectively prohibits U.S. parties to cross-border security-based swap transactions from litigating actions of securities fraud within the United States. Without domestic recourse, U.S. parties have

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[13] *See infra* Section I.D.

[14] Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 269-70 (2010).

[15] Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

[16] *Id.* at 214.

[17] *Id.* at 217.

[18] Elliott Assocs. v. Porsche Auto. Holding SE, 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010), *aff'd sub nom.* Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

become attractive targets for foreign perpetrators of securities fraud. The Second Circuit's failure to expose this flaw and expressly reject the economic reality test preserves the test's viability for future cases, which in turn risks decisions that are not consistent with *Morrison*.

Meanwhile, Congress has intensified its regulation of derivatives through the Dodd-Frank Act.[19] This legislation, enacted in response to the 2007–2008 financial crisis, was designed in part to reduce systemic risk and increase transparency in OTC markets.[20] The U.S. Securities and Exchange Commission (SEC), as part of its responsibilities under Dodd-Frank, issued interpretive guidance to clarify the scope of some of Dodd-Frank's security-based-swap-related policies. This included refining the definition of a "U.S. person," which determines what parties will be subject to Dodd-Frank's requirements.[21] Notably, some foreign subsidiaries of U.S. companies are not included in this definition merely because of their connection to their U.S. parent.[22] This approach differs from the policies of foreign nations and encourages U.S. investors to transfer investments abroad in order to avoid the cost of compliance with Dodd-Frank.[23]

The combined effect of the *Parkcentral* decision and the SEC's interpretive guidance has been to encourage security-based swap investors to shift investments away from U.S. markets and into foreign jurisdictions. Between the cost of compliance with Dodd-Frank and the lack of domestic protection against securities fraud in U.S. courts, these U.S. investors are incentivized to "race to the bottom" and seek deregulated, lower cost, foreign jurisdictions in which to conduct trades. This embeds risk-increasing "regulatory arbitrage" in the global OTC derivative system and threatens to foster the systemic risk that Dodd-Frank was designed to minimize.[24]

This note argues that the confluence of judicial and legislative measures taken to regulate derivatives will transform

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[19] Investor Protection and Securities Reform Act of 2010, Pub. L. No. 111-203, 124 Stat. 1822 (codified as amended in separate sections of 15 U.S.C.).

[20] CHATHAM FIN., THE END-USER GUIDES TO DERIVATIVES REGULATION: OVERVIEW OF TITLE VII OF THE DODD-FRANK ACT 1 (2012), http://www.chathamfinancial.com/wp-content/uploads/2012/08/Chatham-Financial-Overview-of-Title-VII-of-the-Dodd-Frank-Act.pdf [http://perma.cc/FDZ2-9XA7].

[21] Application of "Sec.-Based Swap Dealer" & "Major Sec.-Based Swap Participant" Definitions to Cross-Border Sec.-Based Swap Activities; Republican, 79 Fed. Reg. 47,278, 47,303-13 (Aug. 12, 2014) (to be codified at 17 C.F.R. 240, 241, 250) [hereinafter The August Publication].

[22] *Id.* at 47,308.

[23] *See infra* Sections II.B.3.ii, III.C.

[24] *See infra* Section II.B.3.

the otherwise strong U.S. OTC derivatives market into an unattractive environment that is especially hostile to U.S. parties in cross-border security-based swap agreements. Therefore, in order to recapture investment by making the regulatory landscape in the United States more hospitable to security-based swap investors while still maintaining the newly minted safeguards against systemic risk, this note advocates for a two-pronged solution. First, there must be a conclusive dismissal of the economic reality test, and second, there must be global cooperation and consistency in regulating OTC security-based swap markets.

Part I of this note describes the history of derivatives and significance of the "over-the-counter" classification. It explains the workings of security-based swaps, their utility as a derivative, and the Dodd-Frank reforms enacted to increase supervision of their trading.

Part II focuses on the U.S. security-based swap market's impending contraction and its possible implications. This Part begins by analyzing the private-sector hostility towards cross-border security-based swaps, first by describing the state of the law that led to the *Parkcentral* decision and then by examining the decision itself, with an emphasis on its failure to address the economic reality test. This Part then analyzes the public sector's narrowing of the security-based swap market by focusing on the negative economic impact and potential regulatory arbitrage promoted by the SEC's definition of a U.S. person. Part II concludes by synthesizing the private and public sector issues to illustrate the damaging effect they will have on the U.S. market for security-based swaps: an unfriendly environment for domestic investors that leaves room for them to shift their investment abroad.

Finally, Part III advocates for a two-pronged solution. First, it proposes eliminating the economic reality test as a standard for determining the applicability of U.S. securities fraud laws. Second, it calls for a coordinated global effort to manage systemic risk in OTC markets to thereby eliminate a risk-preserving race to the bottom. Together, these measures can attract increased investment in the U.S. market for security-based swaps while properly protecting those who invest in it.

I. UNDERSTANDING SECURITY-BASED SWAPS

To fully comprehend the regulatory environment that controls cross-border security-based swaps, it is important to first understand the swaps' genesis, the mechanics of the swap

agreement itself, the economic benefits that swaps generate, and the size of the swap market.

A. *History of OTC Derivatives and Swaps*

Just like forwards, futures, and options,[25] a swap is a financial instrument known as a derivative, which is defined as "a financial contract whose value depends on the values of one or more underlying assets or indexes of asset values."[26] Simply put, the central focus of a derivative is on allocating risk, because the underlying reference asset[27] of the derivative controls the contract's value;[28] the type of asset that is referenced and its relation to an investor's other assets can alter the investor's overall risk profile. Derivatives first became popular in 1848, when the Chicago Board of Trade began offering forwards, also known as "to arrive" contracts, on grain.[29] And despite the bad reputation the word "derivative" may have developed following the 2007–2008 financial crisis,[30] financial derivatives have always played an important role in commerce.

Swaps have roots that reach back to 1981.[31] In that year, International Business Machines Corporation (IBM) sought to take advantage of an increasingly strong U.S. dollar. Meanwhile, the World Bank wanted "to borrow in Swiss francs and West German marks," but it could not do so on its own.[32] Although the full details of the transaction were never published, the core of the agreement was for the World Bank to provide U.S. dollar interest payments to IBM in exchange for

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[25] Similar to swaps, these instruments are also derivatives that can be used to hedge risk or speculate. *See Derivative*, *supra* note 9. The details of these derivatives fall beyond the scope of this note; simply recall that the term "derivative" is a broad categorization that includes multiple financial instruments, including swaps. *See supra* text accompanying note 8.

[26] Christian Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction, and Dodd-Frank: The Implications of US Global OTC Derivative Regulation*, 14 NEV. L.J. 542, 547 (2014).

[27] A "reference asset can be infinitely many things—an interest rate or exchange rate, an index of bonds or mortgage-backed securities (MBS), commodity prices, or the weather." Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1295 (2014).

[28] *Id.*

[29] *History of the CFTC: US Futures Trading and Regulation Before the Creation of the CFTC*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/About/HistoryoftheCFTC/history_precftc [http://perma.cc/8JB7-BUBH] (last visited Nov. 30, 2015).

[30] *See* Tricks, *supra* note 2.

[31] Reuters, *I.B.M. in Deal on Currency*, N.Y. TIMES (Aug. 18, 1981), http://www.nytimes.com/1981/08/18/business/ibm-in-deal-on-currency.html [http://perma.cc/5UQ4-WQAU].

[32] *Id.*

assuming IBM's franc- and mark-denominated debt, thereby giving birth to the first interest rate swap.[33]

As swaps joined the global family of financial instruments, the agreements were divided between exchange-traded and OTC derivatives—common classifications for financial instruments.[34] Exchange-traded derivatives involve an intermediary (a clearinghouse or the exchange itself), are highly standardized, and consequently restrict customization of their features, such as underlying assets or maturity dates.[35] By contrast, OTC derivatives are negotiated privately, without an intermediary.[36] This affords opposing parties to the deal (counterparties) limitless possibilities[37] when negotiating the terms of their contract.[38]

According to the Bank for International Settlements' semiannual statistical analysis, as of December 2014, the outstanding notional amount[39] of all OTC derivatives worldwide was approximately $630.1 trillion, with a gross market value of $20.9 trillion.[40] The astounding magnitude of this global market makes it an arena that cannot be ignored from a regulatory perspective, and as scrutiny of OTC markets has increased, the swap derivative has become the "principal focus of regulatory attention since the [2007–2008] crisis."[41] As Gary Gensler, former chairman of the Commodity Futures Trading Commission (CFTC), asserted, "[t]hough there were many causes to the crisis in 2008, it is evident that [OTC] swaps . . . played a central role."[42] Even some members of the upper echelon of professional investing have recognized derivatives' latent risks and avoided trading them altogether.[43] Those fears notwithstanding, the 4.84% increase in the total

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[33] *Id.*

[34] Griffith, *supra* note 27, at 1297.

[35] *Id.*

[36] *Id.* at 1298.

[37] For further description of OTC derivatives' customization, see Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 735 (2002) (noting that "OTC derivatives . . . are made-to-order" and "[i]t is difficult to overestimate the power and value of customized derivatives").

[38] Griffith, *supra* note 27, at 1298.

[39] Notional amounts are described *infra* note 46.

[40] BIS TABLE 19, *supra* note 11 (corresponding with a $612 billion gross market value for the worldwide total amount of equity-linked specific contracts).

[41] Griffith, *supra* note 27, at 1298.

[42] Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n, Remarks before the London School of Economics (Oct. 13, 2011), http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-93 [http://perma.cc/9J6M-FFL6].

[43] WARREN E. BUFFETT, BERKSHIRE HATHAWAY INC. 2002 ANNUAL REPORT 15 (2003), http://www.berkshirehathaway.com/2002ar/2002ar.pdf [http://perma.cc/W5QE-HTD4] (characterizing derivatives as "financial weapons of mass destruction").

outstanding notional amount of all OTC derivatives contracts from December 2010 to December 2014 may suggest that the majority of investors deem the benefits of derivatives to outweigh the risks.[44]

B. *Anatomy of a Security-Based Swap*

The structure of security-based swaps is the key to their unique and crucial utility in the cross-border context. In essence, any general swap transaction is an agreement between two parties "to exchange cash flows over a specified period of time."[45] This is best exemplified by the simplest and most common type of swap, known as a "plain vanilla" interest rate swap, which occurs when

> Party A agrees to pay Party B a predetermined, fixed rate of interest on a notional principal on specific dates for a specified period of time. Concurrently, Party B agrees to make payments based on a floating interest rate to Party A on that same notional principal on the same specified dates for the same specified time period.[46]

In these agreements, the floating rate of interest is frequently based on a benchmark, such as the London Interbank Offered Rate (LIBOR).[47]

These same principles apply to security-based swaps, but there, "at least one party's payments . . . [are] based on the return

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[44] *Compare* BIS TABLE 19, *supra* note 11 (listing the notional value for December 2014), *with* BANK FOR INT'L SETTLEMENTS, STATISTICAL RELEASE: OTC DERIVATIVES STATISTICS AT END-JUNE 2012, at 14 (Nov. 2014), http://www.bis.org/publ/otc_hy1211.pdf [http://perma.cc/3VV3-KFWM] (listing the notional value for December 2010, denoted as "H2 2010"). The 4.83% figure is determined as follows: 630,149 – 601,046 = 29,103; 29,103 / 601,046 = .0484205868; .0484 * 100 = 4.84%.

[45] Jake Saifman, *XIV. International Derivatives Policy and the CFTC's Proposed Rules on Overseas Swaps*, 33 REV. BANKING & FIN. L. 556, 557 (2014).

[46] Michael McCaffrey, *An Introduction to Swaps*, INVESTOPEDIA, http://www.investopedia.com/articles/optioninvestor/07/swaps.asp#axzz1uiFvypXs [http://perma.cc/87N5-6CCG] (last visited Nov. 30, 2015) [hereinafter McCaffrey, *An Introduction to Swaps*]. The notional principle is "the predetermined dollar amount[] on which the exchanged interest payments are based. Notional principal never changes hands in the transaction, which is why it is considered notional, or theoretical. Neither party pays or receives the notional principal amount at any time; only interest rate payments change hands." Root, *Notional Principle Amount*, INVESTOPEDIA (Nov. 24, 2003), http://www.investopedia.com/terms/n/notionalprincipalamount.asp [http://perma.cc/NWJ9-95Q2]; *see also* Molony, *supra* note 3, at 953-54 (explaining the exchanges that take place in a swap transaction and the treatment of the notional principle).

[47] McCaffrey, *An Introduction to Swaps*, *supra* note 46. Recently, there has been significant turmoil originating from allegations that LIBOR is "fixed" by the member banks which determine it. For further reading, see *The Libor Scandal: The Rotten Heart of Finance*, ECONOMIST (July 7, 2012), http://www.economist.com/node/21558281 [http://perma.cc/7CL2-TZRS]; Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283, 1323-24 (2013).

on a stock or [equity] index."[48] Similar to a plain-vanilla interest rate swap, the opposing party's payment can "be based on a floating interest rate," such as LIBOR, a fixed rate, or on another stock or equity index's return.[49] These swaps can also be structured so that notional principle is either fixed or floating.

While all swap agreements begin with "an initial value of zero," in security-based swaps, "with the passage of time and change of market conditions, the swap may have a negative value for one party and a positive value for the other party."[50] This is because, unlike interest rates, the return on a company's stock or on an index—which references equities (e.g., the S&P 500)—can be negative.[51] The downside is compounded by the potential threat that accompanies all swaps: that the party with the negative value will default.[52] This counterparty credit risk, which is greater in security-based swaps than in interest rate swaps (as a result of equities' potential for negative returns and counterparties' desire to avoid them), can be caused by a number of factors and is very difficult to predict.[53]

C. *What Makes Security-Based Swaps Valuable?*

In general, the core utility of swaps is their ability to provide investors with a unique and non-capital-intensive form of speculation, a risk management tool, and a form of financing that they either (a) might not have available to them, or (b) might not be able to profit from on their own.[54] For instance, "domestic firm[s] can usually receive better [interest] rates than a foreign firm," so a U.S. firm and a U.K. firm can both achieve the benefits of a domestic rate in a foreign market if each borrows in their respective country and then the firms

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[48] DON M. CHANCE, *Equity Swaps*, *in* ESSAYS IN DERIVATIVES 67 (2d ed. 2008).

[49] *Id.*

[50] *Introduction to Swaps*, FIN. TRAIN, http://financetrain.com/introduction-to-swaps [http://perma.cc/L83Q-LVF4] (last visited Nov. 30, 2015).

[51] CHANCE, supra note 48, at 67.

[52] *Id.*

[53] Ian A. Cooper & Antonio S. Mello, *The Default Risk of Swaps*, 46 J. OF FIN. 597, 599 (1991) (discussing factors that create counterparty credit risk, such as "the value of the swap at the default date, the event that will trigger the swap default, the relationship between the value of the swap and the event triggering default, and the rule for sharing claims in default").

[54] *What Are Interest Rate Swaps and How Do They Work*, PIMCO (Jan. 2008), http://europe.pimco.com/EN/Education/Pages/InterestRateSwapsBasics1-08.aspx [http://perma.cc/VV3H-D8NK]. While this article focuses on interest rate swaps, the benefits described are shared by security-based swaps as well.

swap their favorable interest rates.[55] Additionally, swaps are of immense value to investors who look to hedge against volatile returns (of interest rates or equities) "by reducing the uncertainty of future cash flows . . . [,] allow[ing] companies to revise their debt conditions to take advantage of current or expected future market conditions," and providing exposure to foreign markets.[56]

By their nature, security-based swaps are tailored to managing issues that arise from cross-border investing. For example, Investor A, who owns only U.S. stocks, can face hurdles when trying to internationally diversify his portfolio. Simply selling domestic stock to buy foreign stock, while seemingly workable, is actually inefficient due to the high transaction costs[57] typically associated with buying and selling foreign stocks.[58] This issue is often compounded by conflicting legal requirements, the investors' diminished ability to obtain a foreign company's financial information, "custodial fees, and, in particular, the dividend withholding tax."[59]

Enter the security-based swap. If Investor A and a foreign counterparty, Investor B, agree to exchange the returns on their respective equity indices, both parties will avoid the transaction costs of purchasing the equity itself while still receiving the gains (or losses) of the foreign equity index; the originally sought after diversification is achieved. Furthermore, these parties can add another component to the transaction by hedging against currency risk.[60] In our example, Investor A could participate in the growth of the foreign stock market without exposing his

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[55] Nicola Sargeant, *How Do Companies Benefit From Interest Rate and Currency Swaps?*, INVESTOPEDIA, http://www.investopedia.com/ask/answers/06/benefitsofswaps.asp [http://perma.cc/7R88-HZGZ] (last visited Nov. 30, 2015) [hereinafter Sargeant, *How Do Companies Benefit?*]; *see also* McCaffrey, *An Introduction to Swaps*, *supra* note 46 (describing how swaps can be used to meet a company's commercial needs or benefit from a comparative advantage).

[56] Sargeant, *How Do Companies Benefit?*, *supra* note 55.

[57] "Transaction costs include brokers' commissions and spreads (the difference between the price the dealer paid for a security and the price the buyer pays)." Root, *Transaction Costs*, INVESTOPEDIA (Nov. 24, 2003) http://www.investopedia.com/terms/t/transactioncosts.asp#ixzz3jrqpNGqZ [http://perma.cc/SZ74-2L6Y].

[58] CHANCE, *supra* note 48, at 67.

[59] *Id.*

[60] *Id.* at 67-68. Currency risk refers to the possibility that the value of the currency used in the transaction will decline before the transaction is completed, which will therefore result in a loss when the profits from the transaction are converted into the domestic currency. *See* Root, *Currency Risk*, INVESTOPEDIA (May 11, 2005), http://www.investopedia.com/terms/c/currencyrisk.asp [http://perma.cc/3V2B-537P]. *Compare* CHANCE, *supra* note 48, at 68-69 (describing the benefits of hedging currency risk through the use of a security-based swap), *with* Feder, *supra* note 37, at 718-19 (noting that some corporations prefer to "self-insure" their currency risks as an alternative to using derivatives).

transaction to currency risk by basing the foreign payments on a U.S. dollar notional amount.[61] Conversely, parties to security-based swaps have the ability to double their gains (or losses) by receiving payments based on a foreign currency denominated notional principle.[62] As the name might suggest, security-based swaps can also reference a specific stock. Though less common than using an index as the base, these contracts can aid individuals, such as executives of a firm, who would otherwise have no way to hedge against their large exposure to a particular stock (possibly because of SEC regulations).[63]

If nothing else, the sheer magnitude of the ever-expanding swap market demonstrates the value that companies and investors derive from engaging in swap transactions—value that has contributed to the "meteoric expansion [of the OTC market] over the past several decades."[64] According to the Bank for International Settlements, equity-linked forward and swap contracts accounted for $2.495 trillion of the outstanding notional amount of all OTC contracts as of December 2014, which represented an uptick of $218 billion over just 12 months.[65] Critically, the forwards and swaps linked to U.S. equities only accounted for $881 billion of the $2.495 trillion outstanding total, leaving agreements linked to foreign equities to account for the remaining $1.614 trillion.[66] This means that large companies and savvy investors who hope to remain competitive need to participate in cross-border security-based swaps to some degree, because their peers are most likely realizing gains through their own participation. By the same token, global policymakers can ill afford to ignore the swap market; deregulation could encourage reckless spending and fraud, which could lead to the failure of large companies and general havoc in national economies. Accordingly, there is both a private-sector need to grant investors the ability to protect themselves against fraudulent transactions and an incentive for

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[61] CHANCE, *supra* note 48, at 67-68; *see also Notional Principal Amount*, *supra* note 46 and accompanying text (explaining the concept of a notional amount).

[62] CHANCE, *supra* note 48, at 67-68.

[63] *Id.* For a detailed explanation of the various permutations that can be made from security-based swaps and their pricing methodology, see John F. Marshall & Robert P. Yuyuenyonwatana, *Equity Swaps: Structures, Uses, and Pricing*, *in* FINANCIAL ENGINEERING, THE HANDBOOK OF EQUITY DERIVATIVES 343-60 (Jack Clark Francis et al. eds., 2000).

[64] David He, Note, *Beyond Securities Fraud: The Territorial Reach of U.S. Laws After* Morrison v. N.A.B., 2013 COLUM. BUS. L. REV. 148, 179 n.128 (2013).

[65] *See* BIS TABLE 19, *supra* note 11.

[66] BANK FOR INT'L SETTLEMENTS, BIS DERIVATIVES STATISTICS, tbl. 22B (2014), http://www.bis.org/statistics/dt22b22c.pdf [http://perma.cc/T5UK-G3VD].

the public sector to develop regulations on a global scale through coordination with foreign policymakers.

D. Dodd-Frank and OTC Derivatives Reforms

Beginning in 1989, the OTC derivatives market was given a long regulatory leash.[67] The trend towards regulatory liberalization culminated with the Commodities Futures Modernization Act of 2000, which allowed qualified counterparties to exclude many of their OTC derivatives transactions from regulation.[68] While this allowed for exponential growth in the OTC derivatives markets, the 2007–2008 financial crisis "revealed fundamental weaknesses in the OTC market, including lack of price transparency, opacity of risk characteristics and insufficient collateralization."[69] Investors generally did not understand or did not have information on the true risks of their investments, and this contributed to inadequate collateral requirements that did not provide the necessary security in cases of default.

To address these structural flaws, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law.[70] With regard to swaps, Title VII of Dodd-Frank established a new regulatory framework for the derivatives[71] and sought to "reduce and contain systemic risk and to increase transparency in the OTC derivatives market"[72] through four main provisions:

> (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants (each, an "MSP"); (2) imposing clearing and trade execution requirements on standardized derivatives products; (3) creating rigorous recordkeeping and data reporting regimes with respect to swaps, including real-time public reporting; and (4) enhancing the Commission's rulemaking and

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[67] For instance, the CFTC established a nonexclusive "safe harbor" provision for transactions that met certain qualifications that sheltered them from regulation. Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989); *see also* Lucy McKinstry, Note, *Regulating a Global Market: The Extraterritorial Challenge of Dodd-Frank's Margin Requirements for Uncleared OTC Derivatives & a Mutual Recognition Solution*, 51 COLUM. J. TRANSNAT'L L. 776, 791 (2013) (detailing the derivatives market's "transition to regulatory liberalization").

[68] McKinstry, *supra* note 67, at 792.

[69] *Id.* at 794.

[70] *Id.* at 781-82; *see* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[71] Title VII separated swaps into three categories: "swaps," "security-based swaps," and "mixed swaps." 7 U.S.C. § 1a(47) (2012) (definition of "Swap"); 15 U.S.C. § 78c(a)(68) (2012) (definition of "security-based swap"); 7 U.S.C. § 1a(47)(D) (2012) (definition of "Mixed swap"); 15 U.S.C. § 78c(a)(68)(D) (2012) (definition of "Mixed swap").

[72] CHATHAM FIN., *supra* note 20, at 1.

> enforcement authorities over all registered entities, intermediaries, and swap counterparties subject to the Commission's oversight.[73]

In furtherance of provision (4), Title VII also required the CFTC and the SEC to create new regulatory regimes for swaps and security-based swaps, respectively.[74]

Also included in the thousand plus pages of Dodd-Frank was Title IX, termed the Investor Protection and Securities Reform Act of 2010.[75] The purpose of this section, which made alterations to the Securities Exchange Act of 1934, was to expand the extraterritorial reach of U.S. securities fraud regulations, thereby allowing the SEC to skirt the presumption against extraterritoriality after the U.S. Supreme Court's decision in *Morrison*.[76] This presumption, which the court in *Morrison* used as the basis for its landmark decision, "is a longstanding principle of American law" that states that "legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States."[77] Hence, in the context of securities litigation, this presumption's predisposition to prevent U.S. securities laws from applying to international transactions can significantly alter the protection afforded to parties in cross-border security-based swap transactions.

II. THE CONTRACTION OF THE U.S. SECURITY-BASED SWAP MARKET

Before Dodd-Frank and the 2007–2008 financial crisis, the regulatory landscape governing swaps and other OTC derivatives was much different than what it has evolved into today. The developing negative synergy between recently decided cases, which give too much deference to the presumption against extraterritoriality, and the SEC's application of Dodd-Frank in the cross-border security-based swap context, has led to an environment that leaves no incentive for private investors to conduct security-based swap transactions within the borders of the United States.

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[73] Commodities Futures Trading Commission, Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45293 (July 26, 2013) (to be codified at 17 C.F.R. ch. 1) (citation omitted).

[74] McKinstry, *supra* note 67, at 795.

[75] Investor Protection and Securities Reform Act of 2010, Pub. L. No. 111-203, 124 Stat. 1822 (codified as amended in separate sections of 15 U.S.C.).

[76] Kornfeld, *supra* note 12, at *12; *see infra* Section II.A.2.

[77] Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 255 (2010) (quoting EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 248 (1991)).

A. *The Toll on the Private Sector:* Elliott*'s Test Eliminates Private Recourse*

Prompted by the 1929 stock market crash, the Roosevelt administration developed groundbreaking regulations to govern "the purchase and sale of publicly traded securities."[78] The first major resulting piece of legislation was the Securities Act of 1933, which dealt with original issues of securities in the primary market.[79] Congress did not ignore the secondary market, though, and the Securities Exchange Act of 1934 specifically acknowledged "the tremendous prominence of the secondary trading market and the need to extend federal regulation to include both securities issued and also those outstanding" by creating the SEC and granting it authority to conduct securities-related civil investigations.[80]

Among the various provisions of the Securities Exchange Act of 1934, Section 10(b), together with its implementing SEC Rule 10b-5, has become the most commonly used, forceful, and controversial tool for alleging securities fraud. Section 10(b) prohibits fraudulent conduct "in connection with the purchase or sale of any security."[81] Rule 10b-5 further specifies that a cause of action exists when a defendant knowingly makes a material misrepresentation or omission that is relied upon by a plaintiff and that causes an economic loss to the plaintiff.[82] Courts have consistently found that this protection applies to actions brought by the SEC and private

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[78] Jacob True, *What Counts as a Domestic Transaction Anymore: The Second Circuit and Other Lower Courts' Struggles in Interpreting the Supreme Court's Intent in* Morrison v. Australia National Bank *When Dealing with Derivative Securities Transactions*, 10 HASTINGS BUS. L.J. 513, 516 (2014).

[79] 15 U.S.C. § 77a (2012). The primary market is where securities are sold by companies to the public for the first time. This is opposed to the secondary market, where stocks are traded freely between investors. *A Look at Primary and Secondary Markets*, INVESTOPEDIA, http://www.investopedia.com/articles/02/101102.asp [http://perma.cc/P7TL-RKA9] (last visited Nov. 30, 2015).

[80] He, *supra* note 64, at 154.

[81] 15 U.S.C. § 78j(b) (2012).

[82] 17 C.F.R. § 240.10b-5 (2010) ("It shall be unlawful for any person, directly or indirectly, by the user 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.").

rights of action, despite a lack of express language within the statute to that effect.[83]

The controversy surrounding Rule 10b-5 in this context stems from its applicability outside of the United States. Congress did not address whether, and to what extent, section 10(b)'s reach would expand beyond the geographic borders of the United States to include foreign investors, foreign defendants, and foreign transactions. This "foreign-cubed" scenario caused friction with the presumption against extraterritoriality and remained a source of uncertainty until the Supreme Court's 2010 decision in *Morrison v. NAB*, which delineated two purportedly bright-line scenarios that would give rise to a cause of action under section 10(b).[84] But because of the complex and highly individualized nature of the instruments that make up the financial industry, courts quickly discovered that applying *Morrison* often involved fitting a square peg into a round hole. As a result, lower courts created layers of interpretation that attempted to adapt *Morrison* to a wide array of factual circumstances.[85] One such layer was created in *Elliott Associates v. Porsche Automobil Holding SE*, where a district court in the Southern District of New York utilized a new "economic reality" test that ultimately missed the mark and incorrectly interpreted *Morrison*.[86]

1. The Law Before *Morrison*

Forty years before the Supreme Court announced its decision in *Morrison*, courts were left to their own devices when interpreting the extraterritorial impact of 10b-5. When the Second Circuit decided *Schoenbaum v. Firstbrook*, it created the effects test, which laid the groundwork for the accepted standard.[87] In *Schoenbaum*, the Second Circuit held that the strength of the legislative interest in protecting U.S. investors

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[83] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

[84] Foreign-cubed cases are implicated when a "(1) *foreign* plaintiff[ ] is suing (2) a *foreign* issuer in an American court for violations of American securities laws based on securities transactions in (3) *foreign* countries." Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 172 (2d Cir. 2008) *aff'd*, 561 U.S. 247 (2010).

[85] *See* Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60 (2d Cir. 2012); United States v. Martoma, No. 12-cr-973, 2013 WL 6632676 (S.D.N.Y. 2013); U.S. SEC v. Chicago Convention Ctr., LLC, 961 F. Supp. 2d 905 (N.D. Ill. 2013); *In re* Société Générale Sec. Litig., No. 08-cv-2495, 2010 WL 3910286 (S.D.N.Y. 2010).

[86] Elliott Assocs. v. Porsche Auto. Holding SE, 759 F. Supp. 2d 469 (S.D.N.Y. 2010), *aff'd sub nom*. Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

[87] Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir. 1968), *abrogated by* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).

and the U.S. market justified the regulation of foreign conduct that results in harmful effects within the United States.[88] The Second Circuit later added to the *Schoenbaum* standard by establishing the conduct test in *Leasco Data Processing Equipment Corp. v. Maxwell*, which made protection available to plaintiffs when the stocks in question were listed on foreign exchanges and in foreign-cubed cases.[89] The conduct test was refined several years after its inception,[90] and together with the effects test became the prevailing standard (aptly referred to as the "conduct and effects test") that courts applied in securities antifraud cases in the decades leading up to *Morrison*.[91]

2. Setting a New Standard: *Morrison* and *Absolute Activist*

The *Morrison* decision overhauled the conduct and effects test and created a new foundation for Rule 10b-5 lawsuits, at least with respect to privately raised actions. In 1998, National Australia Bank (NAB) acquired HomeSide Lending, Inc. (HomeSide), a Florida-based mortgage servicing company.[92] For three years from the time of the acquisition, NAB executives "touted the success of HomeSide's business," which had significantly contributed to an increase in NAB's stock price.[93] In July 2001, however, NAB announced that it would be forced to write down[94] the value of HomeSide's assets due to HomeSide's improper accounting methods and faulty valuation models. The total cost of the write-down amounted to more than $2 billion over two months.[95]

Four of NAB's investors[96] responded by bringing suit against the company and alleging, among other claims, that

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[88] *Schoenbaum*, 405 F.2d at 208.

[89] Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972), *abrogated by* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).

[90] *See* Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 1000 (2d Cir. 1975), *abrogated by* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010); IIT v. Vencap, Ltd., 519 F.2d 1001, 1017-1018 (2d Cir. 1975), *abrogated by* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).

[91] He, *supra* note 64, at 158. Although the conduct and effects test became the standard, courts did not apply it consistently. *Id.*

[92] NAB was "one of the 'Big Four' Australian banks, and one of the world's fifty largest banks by assets." *Id.* at 159.

[93] *Morrison*, 561 U.S. at 251-52.

[94] A "write-down" refers to reducing the listed value of an asset on a company's financial statements. *See Write-Down*, INVESTOPEDIA, http://www.investopedia.com/terms/w/writedown.asp [http://perma.cc/R672-5MN9] (last visited Nov. 30, 2015).

[95] *Morrison*, 561 U.S. at 252.

[96] Three of the plaintiffs were Australian owners of NAB's ordinary shares. The fourth plaintiff, Robert Morrison, was an American investor in NAB's ADRs.

NAB had violated section 10(b) of the Securities Exchange Act by artificially raising the price of its shares through its support and promotion of HomeSide's indiscretions.[97] Problematically for these investors, NAB's shares were not offered on any U.S. exchange.[98] This led the district court in the Southern District of New York to grant NAB's motion to dismiss, and the Second Circuit later affirmed.[99] After granting certiorari, the Supreme Court affirmed the decision of the lower courts in 2010, but on different grounds.

Justice Scalia, writing for the majority, first dispelled the notion that section 10(b)'s extraterritorial reach was an issue of subject-matter jurisdiction.[100] With the issue reframed as a question of statutory interpretation, the Court examined the text of section 10(b) and determined that, based upon the presumption against extraterritoriality, Congress intended for the Exchange Act to apply to foreign-cubed cases where the defendant sought to "conceal a domestic violation, or might cause what would otherwise be a domestic violation to escape on a technicality."[101] In the Court's view, the conduct and effects test did not sufficiently reflect this tenet, because "the focus of the Exchange Act is . . . upon [the] purchases and sales of securities in the United States."[102] As a replacement test, the Court developed a two-pronged, bright-line transactional test that recognizes the existence of a cause of action under section 10(b) only when the deception relates to either (1) "transactions in securities listed on domestic exchanges," or (2) "domestic transactions in other securities."[103] The plaintiffs' claims against NAB did not meet the new standard and were dismissed.

As the Supreme Court created a rule, so were the lower courts left to interpret it. And while "transactions in securities listed on domestic exchanges" is fairly straightforward, *Morrison* "provide[d] little guidance as to what constitutes a domestic purchase or sale."[104] The Second Circuit was tasked with interpreting this second prong in *Absolute Activist Value*

Although his claim was dismissed for failure to allege damages, he remained a named petitioner. *Id.* at 252, 252 n.1. For an explanation of ADRs, see *infra* Section III.A.

[97] *Morrison*, 561 U.S. at 252-53.

[98] *Id.* at 251.

[99] Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 177 (2d Cir. 2008) *aff'd*, 561 U.S. 247 (2010).

[100] *Morrison*, 561 U.S. at 254.

[101] *Id.* at 264.

[102] *Id.* at 266.

[103] *Id.* at 267.

[104] Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 67 (2d Cir. 2012).

Master Fund Ltd. v. Ficeto.[105] There, the court found that in order for a transaction in a foreign-listed security to be considered domestic, one party must incur "irrevocable liability," meaning "that the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security."[106] Yet despite its own holding in *Absolute Activist*, the Second Circuit elected not to apply the irrevocable liability test just two years later in *Parkcentral* and instead endeavored to add another level of interpretation to *Morrison*'s transactional test.

3. A Crack in the Foundation: *Elliott* and *Parkcentral*

Parkcentral was the Second Circuit's opportunity to remedy the legal quagmire that resulted from the transactional test created in *Morrison*—this time with a specific focus on privately brought actions involving security-based swaps. In affirming the district court's ruling, the Second Circuit concentrated its analysis on whether a domestic transaction or listing is either necessary or sufficient to state a claim under section 10(b).[107] The court, however, did not address the appropriateness of the economic reality test that the district court used to dismiss the plaintiffs' claims and therefore did not consider whether the economic reality test is consistent with *Morrison*. Problematically, it is not.

Parkcentral began as two consolidated actions in which 39 hedge funds, approximately half of which were organized under foreign jurisdictions, sought the enforcement of rule 10b-5 against German automaker Porsche.[108] The complaint was originally filed in the Southern District of New York under the name *Elliott Associates v. Porsche Automobil Holding SE*.[109] In the complaint, the plaintiff hedge funds described entering into security-based swap agreements with counterparties that they alleged were, to varying degrees, located within the United

[105] *Id.* at 62.

[106] *Id.* at 68.

[107] Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198, 214-16 (2d Cir. 2014).

[108] Elliott Assocs. v. Porsche Auto. Holding SE, 759 F. Supp. 2d 469, 471 (S.D.N.Y. 2010), *aff'd sub nom.* Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

[109] *Id.*

States.[110] "The swap agreements contained New York choice-of-law provisions and forum selection clauses designating New York federal and state courts as the forum in which legal disputes would be heard."[111] But Porsche was not a party to any of the plaintiffs' swaps, nor was Porsche's stock the referenced security in any of the transactions.[112]

In fact, the referenced shares were of another German auto manufacturer and one of Porsche's competitors, Volkswagen (VW). The swaps were structured such that they would emulate a "short" position on VW's stock—the hedge funds would profit if the value of VW shares fell and absorb losses if the value rose.[113] The plaintiffs allegedly "bet on . . . [the] decline" of VW's shares based on Porsche's public statements denouncing its interest in a takeover of the company.[114] This led plaintiffs to believe that VW's shares were overvalued and would therefore decline in share price, resulting in a profit to the plaintiffs' swap agreements.[115]

In actuality, the price moved sharply in the opposite direction. Porsche eventually announced that it was close to reaching a "domination agreement" with VW, which under German law "allows the acquiring firm [in a takeover] to control the target firm's decisions."[116] The news of the takeover caused the price of VW's shares to nearly quintuple in value as investors who—similar to plaintiffs—had bet on a decline in the value of VW's shares were forced to "scramble to purchase the shares they needed to unwind their short sales and limit their losses."[117] Plaintiffs asserted that this was "part of a secret plan to take over [VW]" that Porsche perpetrated in order to avoid

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[110] *Parkcentral Glob. Hub Ltd.*, 763 F.3d at 207 ("Some of the plaintiffs allege that their investment managers took all steps necessary to transact the securities-based swap agreements from their offices in New York City. Others allege that their investment managers signed a confirmation required by [the] . . . swap counterparty in New York City. Still others allege more specifically that their swap transactions were entered into, terminated, and based entirely in the United States, with Deutsche Bank in New York acting as the counterparty, or that their swap agreements were entered into with New York-based Morgan Stanley in the United States, or that their counterparties were acting . . . on behalf of financial institutions located in New York . . . ." (citations omitted)).

[111] *Id.*

[112] *Id.* Such is the advantage of a security-based swap, which allows parties to bet on the returns of an equity without involving the issuing party. *See supra* Section I.C.

[113] *Elliott Assocs.*, 759 F. Supp. 2d at 471.

[114] *Parkcentral Glob. Hub Ltd.*, 763 F.3d at 203.

[115] *Id.*

[116] *Id.* at 202 n.1.

[117] *Id.* at 205.

German securities laws regarding takeovers.[118] The hedge funds' losses totaled approximately $38 billion.[119]

To begin its analysis, the court noted that "[i]t is eminently clear that, as a general matter, § 10(b) applies with equal force to securities and securities-based swap agreements."[120] This afforded security-based swaps an important and definitive place within the domestic protective scope of Rule 10b-5.[121] But the court continued its discussion, stating: (a) because the plaintiffs' swaps were "effectively transacted on a foreign exchange" and were therefore "economically equivalent to the purchase of VW's shares," and (b) because the value of a security-based swap is necessarily dependent on the value of the underlying security, "the nature of the reference security must play a role in determining whether a transnational swap agreement may be afforded the protection of § 10(b)."[122] The court therefore looked beyond the geographic bases of the swaps and the parties and instead examined the location of the shares—in this case, VW's stock—from which the security-based swaps derived their value.

The result, according to the court, was the "*economic reality* . . . that Plaintiffs' swap agreements . . . [were] essentially 'transactions conducted upon foreign exchanges and markets,' and not 'domestic transactions' that merit the protection of § 10(b)."[123] Based on this "economic reality" or "functional equivalent" test, the court dismissed the plaintiffs' claims, and the plaintiffs appealed to the Second Circuit.

Although the Second Circuit noted that *Elliott* was decided after *Morrison* but before *Absolute Activist*, it did not utilize the irrevocable liability standard in its review of the swaps' domestic characteristics. Instead, the court added another tier to the growing list of *Morrison*-spawned interpretive guidelines. "A question of potentially determinative importance," the court opined, "is whether, under *Morrison*, a domestic transaction in a security (or a transaction in a domestically listed security)—in addition to being a *necessary* element of a domestic § 10(b) claim—is also *sufficient* to make a particular invocation of § 10(b) appropriately domestic."[124] The court held that while a domestic

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118 *Elliott Assocs.*, 759 F. Supp. 2d at 470.
119 *Parkcentral Glob. Hub Ltd.*, 763 F.3d at 205.
120 *Elliott Assocs.*, 759 F. Supp. 2d at 475.
121 *Id.*
122 *Id.* at 475-76.
123 *Id.* (emphasis added).
124 *Parkcentral Glob. Hub Ltd.*, 763 F.3d at 214.

transaction is necessary to invoke section 10(b), it is not always sufficient based on the details of the parties and the transactions.[125]

This fact-driven rubric reinforced the presumption against extraterritoriality and reflected the court's fear that, were all domestic transactions viewed as sufficient to satisfy the *Morrison* test, foreign parties anywhere in the world could be haled into U.S. courts for wholly foreign conduct.[126] The court went on to explain the validity of its "necessary versus sufficient" analysis:

> If the domestic execution of the plaintiffs' agreements could alone suffice to invoke § 10(b) liability with respect to the defendants' alleged conduct *in this case*, then it would subject to U.S. securities laws conduct that occurred in a foreign country, concerning securities in a foreign company, traded entirely on foreign exchanges, in the absence of any congressional provision addressing the incompatibility of U.S. and foreign law nearly certain to arise. That is a result *Morrison* plainly did not contemplate and that the Court's reasoning does not, we think, permit.[127]

Notably, the court limited its opinion by narrowing its holding to the case at hand, stating, "We do not purport to proffer a test that will reliably determine when a particular invocation of § 10(b) will be deemed appropriately domestic or impermissibly extraterritorial."[128]

This case-by-case, factually intensive analysis seems at first glance to run contrary to *Morrison*'s purpose, which was to create a bright-line transactional test governing the extraterritorial application of U.S. securities laws. As the Second Circuit noted, however, "the [Supreme] Court did not *say* that . . . [a domestic securities transaction] was sufficient to make . . . [section 10(b)] applicable."[129] The Second Circuit's reluctance to create a bright-line test demonstrated a respect for the rapidly transforming nature of financial derivatives and a recognition that, just as a bright-line test can be a beacon for those who wish to abide by the law, it can also be a lighthouse for those who wish to avoid it.[130]

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[125] *Id.* at 215.
[126] *Id.* at 213-14.
[127] *Id.* at 215-16.
[128] *Id.* at 217.
[129] *Id.* at 215.
[130] This and other concerns were espoused by Judge Leval in his concurrence. *Id.* at 218-21 (Leval, J., concurring).

4. *Elliott*'s Economic Reality Test Inaccurately Interprets *Morrison*

The issue with the *Parkcentral* ruling is not the somewhat amorphous new level of interpretation it added to *Morrison*'s transactional test, but rather its failure to explicitly rule on whether the economic reality test applied by the district court was consistent with the spirit of *Morrison*'s transactional test. Before the Second Circuit issued the *Parkcentral* decision, courts and scholars alike expressed skepticism of whether the use of the economic reality test in *Elliott* was an accurate adaptation of the *Morrison* framework. In *Wu v. Stomber*, the District Court for the District of Columbia declined to follow *Elliott*'s reasoning, stating,

> [T]he "functional equivalent" gloss that the *Elliott* . . . court[ ] ha[s] developed is inconsistent with the bright line test set forth by the Supreme Court in *Morrison*, which focuses specifically and exclusively on where the plaintiff's purchase occurred. The Supreme Court was clear in its holding that "the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States."[131]

Many scholars and practitioners similarly criticized the economic reality test for wrongly interpreting the language of *Morrison*—the crux of their arguments similarly concentrating on the economic reality test's failure to embody *Morrison*'s sole focus on location.[132] As former SEC Commissioner Roberta

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[131] Wu v. Stomber, 883 F. Supp. 2d 233, 253 (D.D.C. 2012) (quoting Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 266 (2010)).

[132] *See* Christina M. Corcoran, *The Post-Morrison Challenge—The Growing Irrelevance of a Transaction-Based Test in an Interconnected World: An Analysis of the Extraterritorial Application of Section 10(b) of the Securities Exchange Act of 1934 and the International Comity Implications in the Wake of* Morrison, 26 N.Y. INT'L L. REV. 77, 89 (2013) ("While the [*Elliott*] court's rationale makes sense from a policy perspective, it does not fit squarely within the guidelines of *Morrison*'s transaction-based test, which applies section 10(b) to 'the purchase or sale of any other security in the United States.'"); Roger W. Kirby, *Access to United States Courts by Purchasers of Foreign Listed Securities in the Aftermath of* Morrison v. National Australia Bank Ltd., 7 HASTINGS BUS. L.J. 223, 255 (2011) ("Although a purpose built decision like *Morrison* might arrive at the same conclusion as the district court in [*Elliott*], what is 'eminently clear' is that the decision in . . . [*Elliott*] is analytically unsound. Swaps generally settle in relation to the referenced instrument or index, and generally do not result in the purchase or sale of an actual share of stock. The actual holding of bright-lined *Morrison* was that § 10(b) explicitly reaches 'the purchase or sale of any other [than American Stock Exchange] security in the United States.' The swap instruments in question were securities purchased or sold in the United States. The decision in . . . [*Elliott*] was wrongly decided."); *see also* JONATHAN E. RICHMAN & RALPH C. FERRARA, U.S. APPEALS COURT REJECTS BRIGHT-LINE TEST FOR EXTRATERRITORIAL REACH OF U.S. SECURITIES LAWS, WORLD SEC. L. REPORT 4 (Sept. 5, 2014) (highlighting the Second Circuit's

Karmel prophesized in 2013, "[I]t is unlikely that consistency in the application of the *Morrison* standard will occur."[133] Such is the case in the wake of *Elliott*.

A prime example of this inconsistency occurs in the treatment of American Depository Receipts (ADRs), which are certificates issued by U.S. banks that represent the stock of a foreign company.[134] The Southern District of New York's jurisprudence holds that transactions in ADRs will only fall under U.S. securities laws if the ADRs are traded on a U.S. exchange, regardless of the fact that the economic reality of an OTC-traded ADR versus an exchange-traded ADR may be exactly the same, the only difference being the formality of the market.[135]

The court in *Parkcentral* chose not only to decline to use the economic reality test, but also to leave the test's validity entirely unaddressed. The Second Circuit thus missed the opportunity to announce that the economic reality test was an inaccurate interpretation of *Morrison*. Quite simply, if all parties to a transaction are located within the United States, the contract includes U.S. choice-of-law and forum selection clauses, and the transaction is in fact completed in the United States, then because the "purchases and sales of securities [occurred] in the United States," the requirements of *Morrison* are met. Indeed, the Second Circuit itself stated in *Absolute Activist* that

> we do not believe . . . [irrevocable liability] is the only way to locate a securities transaction . . . . [T]o sufficiently allege a domestic securities transaction in securities not listed on a domestic exchange, we hold that a plaintiff must allege facts suggesting that irrevocable liability was incurred *or* title was transferred within the United States.[136]

The economic reality analysis does not reflect this truth.

This test is especially detrimental to parties who transact in security-based swaps. Part of the unique and inherent value of these derivatives is their ability to realize the gains and losses of a stock without forcing either party to purchase the actual

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failure in the *Parkcentral* decision to "resolve whether the economic-reality analysis is consistent with Morrison").

[133] Roberta S. Karmel, *The Application of* 'Morrison' *To SEC and Criminal Cases*, N.Y. L.J., Oct. 17, 2013, at 3.

[134] *See infra* Part III (describing ADRs in greater detail).

[135] *Compare In re* Société Générale Sec. Litig., No. 08-cv-2495, 2010 WL 3910286 (S.D.N.Y. 2010) (declining to apply U.S. laws to OTC-ADR transactions), *with* United States v. Martoma, No. 12-cr-973, 2013 WL 6632676 (S.D.N.Y. 2013) (applying U.S. laws to exchange-traded ADR transactions). See *infra* Section III.A for a detailed description of ADRs.

[136] Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 68 (2d Cir. 2012) (emphasis added).

referenced shares. In addition, these swaps frequently reference international stocks, as they are commonly used to gain exposure to foreign markets.[137] The economic reality test effectively leaves U.S. swap participants without domestic recourse when the referenced shares are of a foreign company on a foreign exchange.

Importantly, the Second Circuit did not impliedly affirm the utility of the economic reality test in its *Parkcentral* decision. Even though the *Parkcentral* court billed its "necessary versus sufficient" analysis as an interpretation of *Morrison*'s test, in reality, it created an entirely new, discrete test. Now, a party must first satisfy the *Morrison* requirement of a domestic transaction by location *and then* satisfy the *Parkcentral* factual analysis. This creates a hostile environment for any privately raised Rule 10b-5 actions that involve cross-border security-based swaps.

B. *The Toll on the Public Sector: The SEC's Final Rules and Interpretive Guidance Miss the Mark*

While *Morrison* and its progeny have significantly eroded the viability of a private right of action for securities fraud in the context of security-based swaps, because of the Dodd-Frank Act, public rights of action have not been affected in the same manner. Title VII of Dodd-Frank created a new regulatory framework for the use of swaps, with the objective of increasing transparency and reducing system-wide risk.[138] On August 12, 2014, the SEC adopted finalized rules and guidance to address this new framework in the context of cross-border security-based swaps in "Application of 'Security-Based Swap Dealer' and 'Major Security-Based Swap Participant' Definitions to Cross-Border Security-Based Swap Activities; Republication" (the August Publication).[139] These rules and guidance were intended to clarify "the application of the Title VII definitions of 'security-based swap dealer' and 'major security-based swap participant' in the cross-border context."[140] While the August Publication did provide a new level of clarification to Dodd-Frank's applicability in this area, its approach may discourage investors from engaging in security-based swaps with U.S. counterparties.

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[137] Indeed, the SEC recognized that "[s]ecurity-based swap transactions are largely cross-border in practice." The August Publication, *supra* note 21, at 47,280.

[138] *See supra* Section I.D.

[139] The August Publication, *supra* note 21.

[140] *Id.* at 47,278.

1. The SEC's Authority Post-*Morrison*

When the Supreme Court decided *Morrison*, one of its major concerns was a fear that rebuffing the presumption against extraterritoriality would degrade the principles of international comity. In a pointed statement, Justice Scalia noted that "[t]he probability of incompatibility with the applicable laws of other countries is so obvious that if Congress intended such foreign application 'it would have addressed the subject of conflicts with foreign laws and procedures.'"[141] Congress swiftly answered this call with Title IX of the Dodd-Frank Act.[142]

Title IX contains section 929P(b), an "eleventh-hour" provision, which—though "hastily drafted and subject to much criticism"—expressed Congress's clear intention that "the validity of securities fraud actions brought by the U.S. government would continue to be measured by the conduct and effects tests rather than the transactional test."[143] Notwithstanding the ensuing debate that took place as to whether the language and context of section 929P(b) was merely a jurisdictional matter, courts have generally agreed that publicly raised securities actions (e.g., SEC actions) are now examined under the conduct and effects test, in spite of *Morrison*.[144] According to the SEC, its authority to bring securities actions will best foster confidence in the U.S. securities market.[145]

2. Encouraging Exodus: The SEC's Definition of a U.S. Person

The August Publication focuses on Title VII's definitions of "security-based swap dealer"[146] and "major security-based swap participant"[147] in the cross-border context, with a minimum threshold analysis related to those definitions.[148] Entities falling under those definitions are subject to increased regulation of their swap dealing activities and the accompanying expense of creating

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[141] Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 269 (2010) (citing EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 256 (1991)).

[142] *See supra* Section I.D.

[143] He, *supra* note 64, at 166.

[144] *See*, *e.g.*, U.S. SEC v. Chi. Convention Ctr., LLC, 961 F. Supp. 2d 905, 913 (N.D. Ill. 2013) ("Interpreting Section 929P(b) as jurisdictional, rather than as a partial refutation of *Morrison*, may, therefore, run contrary to a cardinal principle of statutory construction to avoid superfluous portions of statutes.").

[145] The August Publication, *supra* note 21, at 47,361.

[146] 15 U.S.C.A. § 78c(a)(71) (2012).

[147] *Id.* at § 78c(a)(67).

[148] The August Publication, *supra* note 21, at 47,278.

systems to ensure compliance with those regulations—with one exception: "'security-based swap dealer' entities that engage in a '*de minimis*' quantity of security-based swap dealing activity with or on behalf of customers."[149] A person can take advantage of the de minimis exception if their "[security-based swap] dealing activity over the preceding 12 months does not exceed a gross notional amount of $3 billion, subject to a phase-in level of $8 billion."[150] Thus, if an entity can exempt its swap dealing under the de minimis limit, it will avoid the cost of compliance that accompanies increased regulatory requirements.[151]

In the cross-border context, "U.S. persons [must] apply all of their dealing transactions against the *de minimis* threshold[ ], including activity they conduct through their foreign branches."[152] On the other hand, non-U.S. persons are held to a more lenient standard that requires them to count fewer types of transactions against their de minimis calculations.[153] Consequently, compliance with the August Publication hinges on the definition of a U.S. person. After considering comments provided by other regulatory entities and market participants,[154] the SEC defined a U.S. person as

> [A] Any natural person resident in the United States; [B] Any partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States; [C] Any account (whether discretionary or non-discretionary) of a U.S. person; or [D] Any estate of a decedent who was a resident of the United States at the time of death.[155]

Crucially, this definition does not recognize a foreign subsidiary of a U.S. company as a U.S. person "merely by virtue of its

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[149] *Id.* at 47,301.

[150] *Id.* at 47,301.

[151] The cost of regulatory compliance is often significant enough to dictate some corporate decisions. "Dodd-Frank regulation and the G20 Commitments effectively require market participants to completely change how they trade, settle, and clear OTC derivatives, demanding large amounts of additional margin, new relationships, documentation, and business practices. Many view the regulations as burdensome, costly, and excessive." Johnson, *supra* note 26, at 544; *see also infra* Section III.C (discussing the G20 commitments).

[152] The August Publication, *supra* note 21, at 47,302.

[153] *Id.* at 47,301.

[154] *See Comments on Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/comments/s7-02-13/s70213.shtml [http://perma.cc/REV6-WJHB] [hereinafter August Publication Comments] (last visited Nov. 30, 2015).

[155] The August Publication, *supra* note 21, at 47,306.

relationship with its U.S. parent."[156] Neither does "a foreign person with a U.S. subsidiary . . . [become] a U.S. person simply by virtue of its relationship with its U.S. subsidiary."[157] Ultimately, "[u]nder the final definition, the status of a legal person as a U.S. person has no bearing on whether separately incorporated or organized legal persons in its affiliated corporate group are U.S. persons."[158] Therefore, the de minimis benchmark that is applied to U.S. persons is not automatically applied to subsidiaries and affiliates of U.S. persons. The result is a detrimental economic impact on the U.S. swap market, as well as an impediment to quelling global systemic risk.

3. The August Publication's Failure to Adequately Manage Risk and Support the U.S. Swap Market

The August Publication's attempt to add guidance to the use of cross-border security-based swap activities was a laudable and necessary undertaking in the wake of Dodd-Frank's financial industry reforms. But it has flaws. At the forefront of the issues generated by the August Publication is its overt willingness to create and maintain a loophole that allows security-based swap dealers to skirt the new regulations. Indeed, perhaps the best "guidance" the August Publication has provided to U.S. investors is to avoid domestic markets for any security-based swap transactions.

The glaring loophole—although in light of the SEC's recognition and acceptance of it, it is perhaps best described as an acquiescence—of the August Publication is its definition of a U.S. person. Prior to adopting the August Publication—and within it, the final definition of a U.S. person—the SEC released a proposed set of rules in May 2013 (May 2013 proposal).[159] The May 2013 proposal allowed the SEC to accept comments from other regulators, investors, and legal professionals in order to gauge the industry's response to the SEC's application of Dodd-Frank Title VII definitions in the cross-border context.[160] The Commission received 36 comments

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[156] *Id.* at 47,308.

[157] *Id.*

[158] *Id.*

[159] Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 69490, 78 Fed. Reg. 30,968 (May 23, 2013) (to be codified at 17 C.F.R. 240, 242, 249).

[160] August Publication Comments, *supra* note 154.

in total, the majority of which addressed, at least partially, the definitions that were the focus of the August Publication.[161]

Many commenters' concerns specifically focused on the definition of a U.S. person. Their reasons for concern were twofold. The first was that the definition was likely to have an adverse impact on the way companies raise capital, as well as on the efficiency and competition of the domestic U.S. market for security-based swaps.[162] The second cause for concern arose from the disunity between the May 2013 proposal and other global efforts to regulate security-based swaps; this has opened the door for system-wide, risk-fostering regulatory arbitrage.[163]

i. Adverse Economic Impact on the U.S. Security-Based Swap Market

The SEC asserted in the August Publication that its decision to designate foreign branches of U.S. banks—but *not* separately capitalized foreign subsidiaries—as U.S. persons for purposes of de minimis calculations reflects the notion that "major security-based swap participant calculation thresholds [should] include the positions of such persons that are most likely to cause risk to the U.S. financial system at the threshold levels set in the major security-based swap participant definition."[164] This inequitable treatment creates a likelihood, acknowledged by the SEC, that competition in the U.S. security-based swap market will weaken investment and drive it into foreign jurisdictions.[165]

Namely, non-U.S. persons will be reluctant to engage in security-based swaps with U.S.-based counterparties. Because non-U.S. persons will trigger the application of additional requirements when their transactions with U.S. persons rise

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[161] The August Publication, *supra* note 21, at 47,281. A number of commenters also addressed aspects of the proposal that are outside the scope of this release, and a few of those commenters only addressed issues that were outside the scope of this release (for example, addressing only proposed Regulation SBSR). "We will consider those comments in connection with the relevant rulemakings." *Id.* at 47,281 n.24.

[162] *See, e.g.*, Americans for Financial Reform, Comment Letter on Cross-Border Security Based Swaps Activities 4-8 (Aug. 22, 2013), http://www.sec.gov/comments/s7-02-13/s70213-54.pdf [http://perma.cc/84M9-RPV9].

[163] *See, e.g.*, BETTER MARKETS, RE: CROSS-BORDER SECURITY-BASED SWAP ACTIVITIES; RE-PROPOSAL OF REGULATION SBSR AND CERTAIN RULE AND FORMS RELATING TO THE REGISTRATION OF SECURITY-BASED SWAP DEALERS AND MAJOR SECURITY-BASED SWAP PARTICIPANTS (RELEASE NO. 34-69490; FILE NOS. S7-02-13; S7-34-10; S7-40-11) 9, 14-15 (Aug. 22, 2013), http://www.sec.gov/comments/s7-02-13/s70213-42.pdf [http://perma.cc/TUC3-65UG].

[164] The August Publication, *supra* note 21, at 47,355.

[165] *Id.* at 47,361-62.

above the de minimis level, the incentive for non-U.S. persons is to avoid the cost of compliance by dealing with other non-U.S. persons. Conclusively, the August Publication notes, "Indeed, some entities may determine that the compliance costs arising from the requirements of Title VII warrant exiting the security-based swap market in the United States entirely."[166]

The significance of the economic impact aside, a potentially graver risk arises from the notion that U.S. entities might externalize the cost of regulatory compliance by creating "separately-capitalized foreign subsidiaries to conduct their security-based swap operations."[167] Should entities that are currently engaged in domestic swap transactions follow this hypothesis and exit the U.S. security-based swap market, the liquidity of such swaps will be greatly reduced.[168] This will lead to higher price spreads and higher barriers to entry (based on the already concentrated nature of dealing activity),[169] thereby impeding the entry of new security-based swap participants who could "compete away spreads."[170]

The eventual manifestation of this hypothesis requires little speculation. Corporations and governments have historically been drawn to deregulated environments where they can gain a competitive edge and attract business; this trend is known as the "race to the bottom."[171] At present, and in a similar context, widespread corporate inversions are creating a race to the bottom between U.S. companies seeking favorable tax treatment. While the intricacies of these inversions are beyond the scope of this note, they are in essence a means for a corporation to change the jurisdiction in which it is domiciled.[172] Using inversions, a number of U.S. companies, including Burger King, Pfizer, Walgreens, and Medtronic, have

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[166] *Id.* at 47,362.

[167] *Id.*

[168] "Liquidity" refers to "[t]he ability to convert an asset to cash quickly." Root, *Liquidity*, INVESTOPEDIA, http://www.investopedia.com/terms/l/liquidity.asp [http://perma.cc/AWR3-6VZU] (last visited Nov. 30, 2015).

[169] The August Publication, *supra* note 21, at 47,362.

[170] *Id.*

[171] *See Financial Regulatory Reform: The International Context: Hearing Before the Comm. on Fin. Servs.*, 112th Cong. 12 (2011) (statement of Lael Brainard, Under Sec'y for Int'l Affairs) ("The risk of regulatory arbitrage carries real impacts. It means a race to the bottom for standards and protections. It means the potential loss of jobs in the American financial sector if firms move overseas.").

[172] A corporation "inverts" when it acquires a related foreign company so that it may domicile its headquarters in a foreign jurisdiction, thereby avoiding the regulations and taxes of the domestic one. *See* Brent Radcliffe, *Corporate Inversion*, INVESTOPEDIA, http://www.investopedia.com/terms/c/corporateinversion.asp [http://perma.cc/HDT4-8Z5N] (last visited Nov. 30, 2015).

changed or considered changing their legally recognized headquarters to avoid the U.S. corporate tax rate.[173] This anecdotal evidence bears a strong resemblance to the issues of competition discussed in the August Publication and serves as a warning that, given the opportunity to operate in deregulated jurisdictions, companies (in the case of security-based swaps, U.S. banks and other investors) *will* abandon domestic transactions in favor of more competitive foreign operations.

It should be noted, as the SEC is quick to highlight, that there may be competitive benefits associated with the August Publication's definition of a U.S. person.[174] The SEC emphasized that the August Publication's rules and guidance might "allow registered dealers to credibly signal high quality, better risk management, and better counterparty protection relative to foreign unregistered dealers that compete for the same order flow."[175] There is some truth to this, as more risk-averse investors (i.e., pension funds and municipalities) may gravitate toward the more transparent and "high-quality" market. To the extent that entities engaged in U.S. security-based swaps have not already left the domestic market, however, it is unlikely that enough of a surge of interest in U.S. markets will occur to entice dealers to conduct their security-based swap activities within the United States.

ii. Regulatory Arbitrage

Commenters on the May 2013 Proposal also voiced concerns about the differing approaches to regulating swaps taken by the SEC and CFTC. These comments emphasized the diverging definitions of "U.S. person" adopted by each entity. This divergence, according to some commenters, creates a risk of regulatory arbitrage that will lead to inefficiencies in the domestic U.S. financial system and hamper efforts to minimize

[173] *See* Peter Loftus, *Pfizer Hasn't Ruled Out Potential Inversions, Chief Says*, WALL ST. J. (Oct. 28, 2014, 11:59 AM), http://www.wsj.com/articles/pfizer-narrows-outlook-as-results-top-estimates-1414495030 [http://perma.cc/S5U9-JFZB]; John D. McKinnon & Damien Paletta, *Burger King-Tim Hortons Merger Raises Tax-Inversion Issue*, WALL ST. J. (Aug. 25, 2014, 7:40 PM), http://www.wsj.com/articles/burger-king-tim-hortons-merger-plan-raises-tax-inversion-issue-1409010049 [http://perma.cc/6WAK-E7SS]; Paul Ziobro, *Walgreen Weighs Riding Tax-Inversion Wave*, WALL ST. J. (July 15, 2014, 7:21 PM), http://www.wsj.com/articles/walgreen-weighs-riding-tax-inversion-wave-1405453698 [http://perma.cc/EBG3-Z2FE]; *Medtronics's Tax Inversion Lesson*, WALL ST. J. (Aug. 13, 2014, 8:45 AM), http://www.wsj.com/articles/medtronics-tax-lesson-1407883241 [http://perma.cc/XE3W-BXCB].

[174] The August Publication, *supra* note 21, at 47,362.

[175] *Id.*

systemic risk.[176] The larger threat, however, comes from the parallel hazard that may result from regulatory arbitrage on a global scale.

Arbitrage is defined as "the simultaneous buying and selling of identical securities in different markets, with the hope of profiting from the price difference between those markets."[177] In its most commonly associated context of purchasing and selling securities, arbitrage is essentially a strategy to earn money based on differences in bid/ask prices among sellers, rather than any actual change in the value of the security. It is therefore a result of market inefficiencies, since a security with a constant value should be worth the same price to different purchasers.[178]

Regulatory arbitrage functions in a similar manner to securities arbitrage, with the difference being that, instead of seeking price differentials for securities, parties seek out jurisdictions that have adopted reduced regulations in order to win business from entities that operate in highly regulated jurisdictions.[179] The result is a dangerous slippery slope that may lead "to a race to the bottom among regulatory authorities and the ultimate failure to achieve the regulatory goal."[180]

Critically, the heart of the "problem" of regulatory arbitrage is that when a foreign regulatory scheme and a domestic scheme do not protect against the same risks or do not reach the same levels of protection, systemic risk remains prevalent.[181] That is not to say, however, that the existence of two different regimes is necessarily a problem. Mere *differences* between foreign and domestic policies, *as long as they effectively achieve the same goal*, do not create regulatory arbitrage—or at least, they do not create *problematic* regulatory arbitrage[182]—since the ultimate objective is still reached in both jurisdictions.[183] The problem of regulatory arbitrage has been accurately summed up as:

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[176] *See, e.g.*, AMERICANS FOR FINANCIAL REFORM, RE: CROSS-BORDER SECURITY BASED SWAPS ACTIVITIES; FILE NOS. S7-02-13; S7-34-10; S7-40-11 4-8 (Aug. 22, 2013), http://www.sec.gov/comments/s7-02-13/s70213-54.pdf [http://perma.cc/7HHF-ELAL].

[177] *Arbitrage*, BLACK'S LAW DICTIONARY (10th ed. 2014).

[178] Root, *Arbitrage*, INVESTOPEDIA, http://www.investopedia.com/terms/a/arbitrage.asp [http://perma.cc/NCJ5-BVAS] (last visited Nov. 30, 2015).

[179] Griffith, *supra* note 27, at 1293.

[180] *Id.*

[181] *Id.* at 1362.

[182] *See infra* note 234 and accompanying text (explaining how arbitrage may in some instances be beneficial).

[183] Griffith, *supra* note 27, at 1327.

> A regulated entity's movement of business from Jurisdiction A, which has adopted efficient Regulatory Strategy X addressing Problem Y, to Jurisdiction B, which has defected from efficient Regulatory Strategy X (for reasons of moral hazard or agency costs or other) and therefore fails to adequately address Problem Y and in which it is therefore less costly to conduct business.[184]

While regulatory arbitrage is often thought of on a global country-to-country scale, it can also arise between two domestic agencies with similar regulatory scopes and mandates. As it did the SEC, Title VII of Dodd-Frank also required the CFTC to adopt a new regulatory regime governing the swaps that Dodd-Frank designated as within the CFTC's ambit.[185] The CFTC's final rules and guidance, released in July 2013, included a definition of a U.S. person under which a company's subsidiaries are more likely to have their transactions counted toward the de minimis threshold calculation than under the SEC's scheme.[186] This divergence prefigures a global hazard that jurisdictions with unequal regulations will relocate—rather than eliminate—the systemic risk that Dodd-Frank seeks to combat.

If foreign jurisdictions do not adopt schemes with similar force and objectives as Dodd-Frank, then race-to-the-bottom mechanics indicate that "Dodd-Frank may instead turn the traditionally robust and innovative US OTC derivative market into an island, where the only participants are those that have no other options as to where and with whom they can trade."[187] Furthermore, the alleged safety of the refined U.S. markets "may be illusory if swap activity moves to unregulated markets that may, in the long run, have a systemic effect on the United States if such trading results in outsized losses."[188] In this sense, regulatory arbitrage will have the effect of moving the origination of systemic risk from one location to another without actually reducing the risk itself, thereby preserving U.S.-based parties' exposure to the dangers thought to be allayed by Dodd-Frank.

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[184] *Id.*

[185] *See supra* Section I.D. While the SEC regulates security-based swaps, the CFTC governs interest rate swaps, commodity-based swaps, and currency swaps, among other derivatives. OFFICE OF PUBLIC AFFAIRS, COMMODITY FUTURES TRADING COMMISSION, Q & A—FINAL RULES AND INTERPRETATIONS 1, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd_qa_final.pdf [http://perma.cc/6X33-C75J] (last visited Nov. 30, 2015).

[186] *See* Griffith, *supra* note 27, at 1332-33.

[187] Johnson, *supra* note 26, at 543.

[188] *Id.*

C. The Tolls on the Private and Public Sectors Converge

Now the question is how the synthesis of the economic reality test from *Elliott*, combined with the August Publication's definition of a U.S. person, will affect the viability of U.S. security-based swaps. Under the current state of the law, *Elliott*'s economic reality test dictates that U.S.-based investors are not entitled to a private right of action to bring claims of securities fraud when those investors transact in security-based swaps with foreign-cubed characteristics. This holds true even when the locations of both parties to the swap, as well as the location of the transaction itself, are within the United States, which contravenes the plain-letter intent of the Supreme Court's decision in *Morrison*.

Nevertheless, the inherent value and efficacy of security-based swaps is in their unique ability to provide exposure to foreign markets. The resulting bottom line is that U.S. investors, unable to seek protection from securities fraud within their domestic borders, are at risk of being targeted by foreign perpetrators of securities fraud. As 42 law professors collectively opined in a *Morrison*-prompted comment to the SEC, "[c]omity does not require that the U.S. tolerate or protect fraudulent conduct that emanates from or has significant effects within its borders."[189] The reality is quite the opposite, for the "sake of judicial clarity" cannot be seen as a superseding interest to "the U.S. government's responsibility to protect its citizens."[190]

Meanwhile, in the public sector, the regulatory environment has become equally hostile to equity swaps. Indeed, Congress, through Dodd-Frank, reinstated the SEC's ability to bring public causes of action attacking securities fraud under the familiar conduct and effects test. This offensive capability notwithstanding, the definition of a U.S. person in the August Publication will have the effect of removing most security-based swap activity from U.S. markets and will thus diminish opportunities for the more lenient standard to be applied. While this standard may allow the SEC to pursue foreign perpetrators of securities fraud more so than the economic reality test would, it is by no means a catch-all standard that will instill investors with confidence in the SEC's ability to protect transactions. When combined, the negative

[189] Forty-Two Law Professors, Comments on Study on Extraterritorial Private Rights of Action, SEC File No. 4-617, 10 (Feb. 18, 2011), http://www.sec.gov/comments/4-617/4617-28.pdf [http://perma.cc/7DKJ-UYTA].

[190] Corcoran, *supra* note 132, at 101.

synergy of the economic reality test and the August Publication creates an unfortunate reality: cross-border security-based swaps in U.S. markets will lose their utility and become a less attractive derivative.

The key to this inference is the focus on the location of the swap transaction within the United States. Since their inception, security-based swaps have skyrocketed in global popularity and continue to do so today.[191] Their structure is too unique and provides too many benefits for investors to completely abandon them if they hope to stay competitive in today's financial universe. It is not the global popularity of the derivative itself, however, that is waning—it is the popularity of security-based swaps conducted by parties within the United States. In light of the economic reality test's litigation-dismissive stance on security-based swaps, the cost of compliance with Dodd-Frank's rules and the August Publication's subsidiary exemption offer no incentive for conducting security-based swaps within the United States. An investor in cross-border security-based swaps who is located in the United States—and who, as a result of the economic reality test, would likely not be able to bring a claim of securities fraud in the United States anyway—would be better served by transacting her swaps through a foreign party in a jurisdiction where she may be able to retain the benefits of a more opaque market and where the transaction costs will be lower.[192]

The end result will be a U.S. market that begins to lose its internationally competitive edge. As investors move their transactions abroad, large banks and other facilities that conduct security-based swaps will similarly flock to deregulated foreign markets and become arbitrageurs in a regulatory race to the bottom. The ensuing loss of investment will damage the U.S. economy just as it begins to regain stability after the 2007–2008 financial crisis.

On the one hand, the predilection towards exhaustive regulation and transparency demanded by Dodd-Frank and championed by the August Publication was intended to avoid a crisis similar to that of 2007–2008.[193] To that end, the synergy of the economic reality test and the August Publication will

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[191] *See supra* Section I.C.

[192] *See supra* Section II.B.3.

[193] *See* CHATHAM FIN., *supra* note 20, at 1 (explaining the objectives of Title VII of Dodd-Frank).

indeed be a significant force in preventing fraud from occurring within the United States with respect to security-based swaps.

On the other hand, the fraud that will now no longer occur within the United States is better thought of as simply being displaced, rather than extinguished. Parties to these transactions are still exposed to fraud—it simply emanates from another market. Furthermore, U.S. parties who conduct security-based swaps in foreign jurisdictions and are defrauded will be economically harmed just the same as if they were defrauded in the United States. It is therefore clear that the current efforts to regulate and litigate cross-border security-based swaps cannot suffice as the definitive regime. The horizon for these derivatives needs to be changed, and the $881 billion[194] question is: how?

III. FIXING THE U.S. MARKET FOR SECURITY-BASED SWAPS WHILE STRENGTHENING THE REGULATORY HORIZON

There are two potential alterations to the United States' current regulatory environment, which—combined with global cooperation—could strengthen the U.S. market for security-based swaps. The first possible domestic reform involves the way in which cross-border security-based swaps are structured. Such a remedy would require investors to modify their cross-border security-based swaps to avoid falling under the purview of the economic reality test. While these modifications could create swaps that would entitle investors to private recourse for securities fraud, they would do so at the expense of restraining investors' ability to freely invest in a manner of their choosing. Therefore, such modifications should not be viewed as a viable means of attracting investment.

The second and more effective domestic change would be to the newly issued judicial standards that govern these derivatives and that discourage investors from utilizing U.S. markets. In the case of cross-border security-based swaps, changing the standard that governs transactions, rather than the characteristics of the transaction itself, is a superior remedy for a number of reasons. Chiefly, the bulk of the value of security-based swaps comes from their structure, which allows them to provide otherwise inaccessible exposure to the returns on foreign equities and indices. Officially eliminating the economic reality test would uphold the language and intent

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[194] BIS DERIVATIVES STATISTICS, tbl. 22B, *supra* note 66.

of *Morrison* and, because of the "necessary versus sufficient" analysis in *Parkcentral*, would still give deference to the presumption against extraterritoriality.

It must be noted, however, that these two solutions share one flaw—neither deals with deterring the cost of compliance and the regulatory arbitrage created by Dodd-Frank. There is no judicial remedy that could stem the race to the bottom absent some exceedingly creative modification to the anatomy of security-based swaps. This modification would need to transform the swap into a novel instrument to which Dodd-Frank does not apply[195] and therefore does not subject purchasers to the cost of complying with Dodd-Frank. The reforms to be made in this regard depend upon a global effort to establish some form of standardization for trading OTC derivatives in order to level the playing field between international regulatory schemes and stem the race to the bottom.

A. Drawbacks to Altering the Structure of Security-Based Swaps

One answer to denying a private right of action to U.S. parties in cross-border security-based swaps is to alter the structure of the swaps so that they do not appear to be "transactions conducted upon foreign exchanges and markets."[196] The swaps in *Elliott* occurred, as many security-based swaps do, with strong ties to a foreign jurisdiction: the referenced security was of a German company (VW); the shares were not traded on U.S. exchanges; and the defendant Porsche was a German company.[197] So to comply with *Elliott*, some facet of the agreement must change so that it no longer represents the economic reality of a nondomestic transaction.

Presumably, the underlying equity must remain that of a *foreign* company to create the beneficial hedging and market access opportunities that are the driving forces behind security-based swaps.[198] Furthermore, as was the case in *Elliott*, U.S. investors cannot always control the foreignness of the entities that may attempt to defraud them, nor can U.S. investors hand-pick the defendants that have ties to the United States.

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[195] The likes of which fall beyond the scope of this note.

[196] Elliott Assocs. v. Porsche Auto. Holding SE, 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010), *aff'd sub nom.* Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

[197] *Id.*

[198] CHANCE, *supra* note 48, at 68.

That leaves the possibility of altering the underlying referenced stock in order to create security-based swaps that square with *Elliott*'s economic reality test.

Referencing ADRs instead of foreign shares of stock could possibly create a security-based swap that comports with the economic reality test. ADRs are certificates issued by U.S. banks and represent a share of a foreign company.[199] ADRs are similar to the stock of a U.S. company;[200] they can be traded on a U.S. exchange or OTC market[201] and must be registered with the SEC.[202] They differ in that "[a]n ADR may represent the underlying shares on a one-for-one basis, or may represent a fraction of a share or multiple shares . . . . The use of a ratio allows ADRs to be priced at an amount more typical of U.S. market share prices."[203] This means that ADRs have stronger ties to the domestic U.S. market than do the shares of foreign companies listed on foreign exchanges. Therefore, a swap transaction that references an ADR as opposed to the actual foreign shares of a non-U.S. company has the potential to pass the economic reality test. Plaintiffs who show that they intentionally tied a swap to an ADR and who conduct the transaction in the U.S. will be better able to argue that the economic reality of the agreement was to establish a domestic transaction.

Still, the ADR solution is far from perfect. First and foremost, it confines investors to referencing a limited number of foreign companies because many companies do not issue any ADRs.[204] This diminishes the hedging and exposure-providing functions of security-based swaps. The remedy's bigger flaw, however, is a legal hurdle. In April 2012, the SEC released the "Study on the Cross-Border Scope of the Private Right of Action Under section 10(b) of the Securities Exchange Act of 1934" (PRA Study), which gauged the ability of nongovernmental investors to bring suit under section 10(b) under both past and

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[199] OFFICE OF INVESTOR EDUCATION AND ADVOCACY, U.S. SECS. AND EXCH. COMM'N, INVESTOR BULLETIN: AMERICAN DEPOSITORY RECEIPTS 1 (2012), http://www.sec.gov/investor/alerts/adr-bulletin.pdf [http://perma.cc/9ATL-HMP4] [hereinafter ADR Report]. They may also represent a percentage of a share, a single share, or multiple shares of a foreign company. *Id.*

[200] *Id.*

[201] *Id.*

[202] *Id.* at 2.

[203] *Id.* at 1.

[204] *See* SEC STAFF, U.S. SECS. AND EXCH. COMM'N, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934, at 45 (Apr. 2012), http://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf [http://perma.cc/X2C2-9DH2].

present legal standards.[205] In one section, the PRA Study concluded that, with respect to whether section 10(b) covers purchases and sales of ADRs, transactions will only pass *Morrison*'s transactional test *sometimes*.[206] Specifically, the report summarized that while courts have found that transactions involving ADRs fall within the scope of *Morrison*'s first prong when they are conducted on domestic securities exchanges,[207] the District Court for the Southern District of New York did not extend the same acceptance to ADR transactions in the OTC market.[208]

The *Société Générale* court's refusal to find that OTC-ADR transactions satisfy *Morrison*'s first prong is especially detrimental to the ADR-tied swap solution. Not only are investors who seek to reference ADRs in their security-based swaps limited by the number of available companies that issue ADRs, they are also limited to the much smaller subset of companies whose ADRs trade on U.S. exchanges rather than in the OTC market. These constraints significantly weaken the value of a solution that is based on altering the actual structure of security-based swaps.

B. Advantages of Eliminating the Economic Reality Test

A second and more effective method of making the United States more attractive to security-based swap investors would be to increase the ability of those investors to bring private securities fraud actions under section 10(b) by eliminating *Elliott*'s economic reality test. Since the economic reality test is already inconsistent with the language of *Morrison*, abandoning it would maintain consistency and demystify the transactional test without forcing investors to restructure their investments. This could all be done without abandoning the central tenet of the Supreme Court's decision in *Morrison*: the presumption against extraterritoriality.[209] As the Court explained, "the focus of the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States."[210] Thus, *Elliott*'s

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[205] *See generally id.* (examining investors' ability to bring claims of securities fraud in the wake of *Morrison* and section 929P(b)(2) of Title IX of Dodd-Frank).

[206] *Id.* at 30-31.

[207] *Id.* at 30 n.110.

[208] *In re* Société Générale Sec. Litig., No. 08-cv-2495, 2010 WL 3910286, at *6-7 (S.D.N.Y. Sept. 29, 2010).

[209] Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 248 (2010).

[210] *Id.* at 266.

"functional equivalent" gloss is at odds with *Morrison* on a fundamental level; *Elliott*'s focus is not on geographic location, but on the location of the economic impact of a transaction.[211] Repealing the test would therefore help eliminate inconsistencies in the judiciary's approach to securities fraud.

Admittedly, the *Elliott* court was spurred by a legitimate concern when it created the economic reality test in the first place. The court expressed a particular aversion to creating a rule that would "interfere with foreign securities regulation."[212] Abandoning the economic reality test, however, would better allay this concern for three reasons. First, eliminating the test would not automatically and unduly subject wholly foreign parties to U.S. courts due to the "necessary versus sufficient" analysis conducted in *Parkcentral*, which upholds the presumption against extraterritoriality on its own.[213] By repealing the economic reality test, private investors, such as those in *Elliott*, would not be barred from bringing suit simply because their swaps, while based entirely domestically in some cases,[214] resembled short sales on foreign exchanges.[215] These plaintiffs would clear *Morrison*'s geographic hurdle and then be given an opportunity to establish that the facts of their transaction entitle them to domestic recourse in accordance with the *Parkcentral* case-by-case review. Furthermore, plaintiffs like those in *Parkcentral* who were allegedly harmed by fraud that was not perpetrated in the United States[216] and could not show a stronger connection to the United States would still be barred from bringing suit, thus preserving the presumption against extraterritoriality. Essentially, repealing the economic reality test would give nongovernmental investors a fighting chance to establish that the location of their transaction, combined with the facts of the alleged fraud, is sufficient to invoke domestic securities laws.

A second reason to abandon the economic reality test is that potential regulatory conflicts should not force the United States "to forgo its own objectives for the sake of harmony."[217] At

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[211] *See supra* notes 129-30.

[212] Elliott Assocs. v. Porsche Auto. Holding SE, 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010), *aff'd sub nom.* Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198 (2d Cir. 2014).

[213] Parkcentral Glob. Hub Ltd. v. Porsche Auto. Holdings SE, 763 F.3d 198, 214 (2d Cir. 2014).

[214] *See supra* note 110 and accompanying text.

[215] *Elliott Assocs.*, 759 F. Supp. 2d at 476.

[216] *Parkcentral*, 763 F.3d at 207 ("Porsche's allegedly deceptive conduct occurred primarily in Germany . . . .").

[217] Corcoran, *supra* note 132, at 103.

the outset, it is clear that cross-border transactions in this context could possibly implicate the regulatory interests of both states;[218] repealing *Elliott*'s standard while preserving *Parkcentral*'s opens the door for U.S. participants in cross-border security-based swaps to seek domestic recourse and therefore deters foreign perpetrators of securities fraud from actively targeting U.S. investors. Conversely, what is not clear is whether the application of section 10(b) with a *Parkcentral* gloss would create a conflict in the first place, potentially obviating the presumption against extraterritoriality completely. The Supreme Court has held that with respect to international comity, no conflict of laws exists "where a person subject to regulation by two states can comply with the laws of both."[219] Instead, comity is only implicated when there is a true, direct conflict between U.S. laws and those of a foreign state.[220] Although U.S. securities laws are generally expansive and require that companies make added disclosures,[221] "a true conflict with foreign law would only be implicated if . . . the laws of other nations expressly prohibit certain mandated disclosures."[222] Repealing the economic reality test would therefore have no discernable negative influence on the presumption against extraterritoriality.

The third and final reason to repeal the economic reality test is that affording U.S. investors a chance to bring private suits would supplement the SEC's attempts to prevent securities fraud in light of its limited resources.[223] SEC Commissioner Luis Aguilar, in a lengthy dissent to the PRA Study, opined that

> [t]he truth of the matter is that the SEC, does not, and will not, ever have enough resources to investigate all of the fraud cases that exist . . . . In fact, even if the SEC exercises its discretion to bring a case, rarely are investors made whole . . . . In light of the limited

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[218] *Id.*

[219] Hartford Fire Ins. Co. v. California, 509 U.S. 764, 799 (1993) (citing RESTATEMENT (THIRD) FOREIGN RELATIONS LAW § 403, cmt. e).

[220] *Id.*

[221] *See generally* Tanja Boskovic et al., *Comparing European and U.S. Securities Regulations: MiFID Versus Corresponding U.S. Regulations* 33-34 (World Bank, Working Paper No. 184, 2009), http://siteresources.worldbank.org/ECAEXT/Resources/258598-1256842123621/6525333-1263245503321/European_US_SecuritiesRegulations.pdf [http://perma.cc/4AT9-Q62Y] (discussing the similarities and differences between U.S. and European securities regulations).

[222] Corcoran, *supra* note 132, at 102.

[223] *Id.* at 103.

> resources available to the SEC, private enforcement of the federal securities laws is a necessary tool to combat securities fraud.[224]

Repealing the economic reality test while preserving the *Parkcentral* analysis will therefore give deference to the presumption against extraterritoriality, deter foreign perpetrators of fraud from targeting U.S. investors, and supplement the SEC's efforts to pursue securities fraud, all while preserving the structure, and by extension the value, of cross-border security-based swaps.

C. *Global Regulatory Coordination*

For all the benefits of repealing the economic reality test, one issue that remains unresolved is the regulatory arbitrage that would result from investors seeking to avoid the cost of compliance with Dodd-Frank. Reconfiguring the U.S. environment for security-based swaps is therefore incomplete. While the renewed possibility of bringing private suits may attract U.S. investors back to the domestic market, the race to the bottom will still compel them to conduct security-based swaps in deregulated jurisdictions abroad, thereby preserving the systemic risks that Dodd-Frank seeks to eliminate. This necessarily implicates a coordinated response that goes beyond international borders. To remedy the push and pull of an increased compliance mandate, the "bottom" to which investors race must be rebalanced through similar compliance programs, so that all jurisdictions are equally secure and the cost of compliance is homogenized across jurisdictions.

After the 2007–2008 financial crisis, financial policymakers in some of the world's largest economies sought to coordinate OTC markets through the G-20.[225] This group represents "85 per cent of the world economy, 76 per cent of global trade, and two-thirds of the world's population, including more than half of the world's poor."[226] At a series of meetings beginning in 2008, the G-20 concluded, among other things, that "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms . . . and cleared through

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[224] Luis A. Aguilar, *Statement by Commissioner: Defrauded Investors Deserve Their Day in Court*, U.S. SECS. AND EXCH. COMM'N 4 (Apr. 11, 2012), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171490204#.VL6WX0fF-Sp [http://perma.cc/635J-89DG].

[225] The G-20 is comprised of 19 countries and the European Union. *The G20*, AUSTL. GOV'T, http://www.dfat.gov.au/trade/g20/ [http://perma.cc/CEB5-N4DD] (last visited Nov. 30, 2015).

[226] *Id.*

central counterparties."[227] Central counterparty clearing thus became the cornerstone of the unified global response to combating systemic risk in derivative transactions.[228]

There has been progress towards fully implementing the unified response, though the extent of such progress is uncertain. In its most recent report chronicling the global progress of OTC derivatives market reforms, the Financial Stability Board (FSB), an international body that seeks to promote financial stability by coordinating national finance authorities,[229] noted that "[m]arket participants in general appear to be making good progress," but "regulatory uncertainty has held back the finalization of preparations by some market participants."[230] This report was issued by the FSB as part of its role to "monitor[ ] the progress of the implementation of OTC derivative market reforms."[231] Similarly, the SEC and CFTC issued the "Joint Report on International Swap Regulation,"[232] in which the agencies concluded that "[t]he G-20 leaders have agreed to the OTC derivatives commitments, but it is still too early to determine precisely where there is alignment internationally and where there may be gaps or inconsistencies."[233] Thus, complete global reform has not yet been realized.

Until global cooperation translates into global compliance and standardized protections, the cost of compliance will not be uniform, regulatory arbitrage will take place to the detriment of the U.S. market as investors avoid the cost of compliance with Dodd-Frank, and U.S. investors will still be exposed to the risks that Dodd-Frank attempts to contain. It is quite possibly true that in this context, a "uniform" global response does not

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[227] Griffith, *supra* note 27, at 1310.

[228] For an explanation of central counterparty clearing, see *id.* at 1311-17. The details of this regulatory strategy fall beyond the scope of this note. It is relevant, however, as an example of a globally unified response to risk in OTC derivative markets.

[229] For a further description of the FSB, see *About the* FSB, FIN. STABILITY BOARD, http://www.financialstabilityboard.org/about/ [http://perma.cc/3J6S-YSA4] (last visited Nov. 30, 2015).

[230] FIN. STABILITY BD., OTC DERIVATIVES MARKET REFORMS: SIXTH PROGRESS REPORT ON IMPLEMENTATION 1 (Sept. 2, 2013), http://www.financialstabilityboard.org/publications/r_130902b.pdf [http://perma.cc/4B9S-8NR8].

[231] Johnson, *supra* note 26, at 560.

[232] COMMODITY FUTURES TRADING COMM'N & U.S. SEC. EXCH. COMM'N, JOINT REPORT ON INTERNATIONAL SWAP REGULATION 111 (2012), http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf [http://perma.cc/Q6LV-6RSQ]. "Congress required the CFTC and the SEC to study the regulation of OTC derivatives across the United States, Asia, and Europe in hopes of identifying areas of potential regulatory arbitrage." Johnson, *supra* note 26, at 562.

[233] JOINT REPORT, *supra* note 232, at 111. One such "gap" was in the Brazilian regulatory scheme, which does not mandate or plan to mandate clearing of OTC derivatives. Griffith, *supra* note 27, at 1323 n.153.

necessarily mandate that every nation adopt the same exact rules but instead allows countries to mutually recognize one another's regulatory schemes so long as each scheme protects against the same risks and to the same degree.[234] But a uniform objective must exist to some extent to prevent regulatory arbitrage. Under Dodd-Frank, the cost of compliance with the perceived-safe U.S. regime has increased above the cost of compliance with competing jurisdictions and has thereby encouraged investors to conduct swap transactions abroad. The United States must therefore make a concerted and resolute push towards achieving global implementation of the G-20 commitments by supporting the FSB as it persuades G-20 members to accept and honor their pledges to combat systemic risk. The full and *active* support of the United States will increase the FSB's influence and the likelihood that standardization will be achieved, which will in turn protect the U.S. security-based swap market by leveling the regulatory playing field and retaining investments in U.S. markets.

CONCLUSION

When the *Elliott* court created the economic reality test in an effort to interpret *Morrison*, it mistakenly went beyond the Supreme Court's intention. *Elliott*'s "functional equivalent" gloss is too deferential to the presumption against extraterritoriality at the expense of U.S. investors who stand little chance of meeting the test's requirements in the context of cross-border security-based swaps. Compounding matters, the *Parkcentral* court, while developing a viable "necessary versus sufficient" analysis in its own right, did not reject the economic reality test and thereby left the door open for the test's use in other cases. Meanwhile, the SEC's definition of a U.S. person under Dodd-Frank, in light of the still-fragmented system of global

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[234] In fact, some scholars see such uniformity as incredibly dangerous. As Fordham Law School Professor Sean Griffith has stated:

> Uniformity, by definition, means all jurisdictions regulate in the same way, but if financial market crises have taught us anything, it is that regulators often do not anticipate the next crisis. Thus, if all jurisdictions regulate in the same way, and if, as has often been the case in the past, their chosen regulatory approach fails to account for an emergent crisis, then world financial markets will be more exposed to systemic risk than they might have been had some jurisdictions regulated differently.

Griffith, *supra* note 27, at 1293-94. According to this view, regulatory arbitrage between different regulatory regimes may be beneficial, *so long as* the regimes effectively address and contain systemic risk in their own manner. *Id.*

regulation, discourages investment in the U.S. OTC derivatives market. Combined, these measures significantly weaken the United States' ability to attract investment in security-based swaps at a time when those investments are vital to remaining competitive in the global economy.

Reclaiming commercial strength in this area requires a two-pronged approach. First, repealing the economic reality test will render the U.S. swap market more attractive to security-based swap investors by making domestic protection against securities fraud a legitimate safeguard, rather than a remote possibility. Second, achieving global implementation of some degree of uniform regulation in OTC markets will safely reduce systemic risk, normalize compliance costs, and eliminate the economic disadvantage the United States suffers due to the expense of complying with Dodd-Frank. Although past performance may not necessarily indicate future results,[235] the historic growth of the security-based swap market may suggest that it will continue expanding into a global force to be reckoned with. Whether the United States will benefit as the preeminent forum for transactions in these derivatives or simply become an indistinguishable market without a competitive advantage remains to be seen.

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[235] OFFICE OF INV. EDUC. AND ADVOCACY, INVESTOR BULLETIN: HOW TO READ A MUTUAL FUND SHAREHOLDER REPORT 4, https://www.sec.gov/investor/alerts/ib_readmfreport.pdf [http://perma.cc/22UE-JTUN] (last visited Nov. 30, 2015).

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