U.S. Regulation of the International Securities and Derivatives Markets, § 12.01, SECURITIES

U.S. Regulation of the International Securities and Derivatives Markets
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The threshold question in determining the applicability of the U.S. securities laws to a particular transaction is whether "securities" are involved. It is not always clear whether an instrument at issue is a security for purposes of these laws.

[1] Statutory Definitions of “Security”

The Securities Act defines the term "security" as:

unless the context otherwise requires … any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. [1]

Likewise, the Exchange Act defines "security" as:

unless the context otherwise requires … any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of

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interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. [2]

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As can be seen, the definitions are essentially lists of categories of instruments. [3] Although the definitions differ slightly, the Supreme Court has consistently held that the respective definitions are essentially the same. [4] The Investment Company Act, the Advisers Act and state codes also contain definitions of security. [5] The Investment Company Act's definition of security, discussed in Chapter 15, is virtually identical to the definition in the Securities Act. Nevertheless, it has been interpreted by the SEC to include a broader group of instruments than is included in the Securities Act's definition or the Exchange Act's definition, such as, for example, certificates of deposit, commercial loans,

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interaffiliate loans and other loans made in the ordinary course of business by a financial or commercial institution. [6]

The definitions of "security" in the Acts list instruments (*e.g.*, stock, notes and bonds) that are within the public's general understanding of what a security is. However, even these instruments are not always securities for purposes of the Acts. The definitions are each prefaced by "unless the context otherwise requires" and courts have used this preface to exclude certain instruments listed in the definitions.

In addition, each definition contains the general catchall of any "instrument commonly known as a security." This catchall has been viewed as an indication that Congress intended courts to include instruments not specifically listed.

The process of determining the scope of the definitions of security in the Acts has been evolutionary. Throughout the process, the SEC has urged a broad interpretation of the definitions on the theory that a broad interpretation will better protect investors. Congress has occasionally amended the definitions. [7] Finally, since the enactment of the definitions in 1933 and 1934, substantial case law has developed concerning whether or not particular instruments are included. [8]

[2] Analysis of Certain Instruments Under the U.S. Securities Laws

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U.S. courts, in considering whether a particular instrument is a security, have interpreted the definitions with the understanding that "Congress intended the …[Acts] to cover those instruments ordinarily and commonly considered to be securities in the commercial world." [9] The courts have not articulated a single analytic framework for determining when an instrument would "ordinarily and commonly [be] considered to be a security." Instead, their analyses have varied depending on the type of instrument in question. [10] In the cases discussed below, the courts have analyzed certain notes, stock, certificates of deposit, investment contracts, loan participations, and options on securities in light of the definitions of security. However, these cases, as well as the related statutory and agency interpretations, illustrate the major issues that courts have considered when determining whether an instrument is a security.

[a] Notes

In *Reves v. Ernst & Young*, [11] the Supreme Court addressed the issue of when a "note" is a security. Guidance with respect to this issue was needed because, in spite of the inclusion of "note" in the definitions of "security" in the Acts, it was widely accepted that many notes were not securities. "Note" is a broad term with meanings ranging from an exchange-listed bond to a note given by a consumer purchasing a home appliance on credit. [12] The former is generally considered to be a security. The latter generally is not.

Before *Reves*, lower courts in the United States adopted a variety of approaches for determining whether a particular note was a security. Some courts, including the Eighth Circuit in its decision reviewed by the Supreme

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Court in *Reves*, adopted a test that first asked whether a note could be viewed as an "investment contract," as a precondition to its being classified as a security. Under this test, a note is a security if it evidences an investment in a common enterprise, with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. [13] Other courts inquired into whether the note was issued in an "investment" as opposed to a "commercial" or "consumer" context. Only the former was regarded as a security entitled to the protection of the securities laws. [14] A third approach of lower U.S. courts before *Reves*, the so-called "family resemblance" test that the Supreme Court adopted in a modified form in *Reves*, begins the analysis with a presumption that any note having a term of more than nine months is a security. [15] This presumption, however, was rebuttable and certain types of notes are recognized as self-evidently not securities. Thus, an issuer could rebut the presumption that a note is a security if it could show that its note had a strong "family resemblance" to a previously recognized judicial exception to the definition of a security.

As adopted by the Supreme Court in *Reves*, the list of instruments commonly denominated as "notes" that nonetheless are not regarded as securities includes, but is not limited to:

> [(i) a] note delivered in a consumer financing, [(ii) a] note secured by a mortgage on a home, [(iii) a] short-term note secured by a lien on a small business or some of its assets, [(iv) a] note evidencing a ‘character’ loan to a bank customer, [(v)] short-term notes secured by an assignment of accounts receivable, [(vi) a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of a customer of a broker, it is collateralized) [and (vii)] notes evidencing loans by commercial banks for current operations. [16]

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Recognizing that types of notes not listed under the test may also not be "securities," the Court listed four additional factors to be considered under the "family resemblance" test:

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."
>
> Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment."
>
> Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.
>
> Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Acts [*i.e.*, Securities Act and Exchange Act] unnecessary. [17]

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In applying these standards to the facts of the *Reves* case, the Court had "little difficulty" in deciding that the notes at issue were securities. [18] In *Reves*, an agricultural cooperative (the "Co-op") sold promissory notes that were widely distributed, uncollateralized and uninsured. The proceeds of the notes were used for working capital. The Co-op advertised the notes as investments. After the Co-op went bankrupt, some of the noteholders sued the Co-op's auditors under the fraud provisions of the Exchange Act. The auditors claimed that they could not be found liable because the notes were not securities. [19]

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The Court concluded that the Co-op's notes were securities because, under the family resemblance test, (i) the notes did not closely resemble any of the seven listed types of notes that are not considered securities and (ii) a consideration of the notes in light of the four additional factors described above also indicated that the notes were securities. [20]

The Court rejected any resemblance to the listed types of notes that are not considered securities without any detailed discussion, but did discuss the application of the four factors. The Court held that the notes were likely to be securities in light of the first factor because the seller's motivation was to raise capital for its business and the buyer's motivation was to earn a profit in the form of interest. [21] It reached the same conclusion when it considered the notes in light of the second factor, finding that, even though the notes were not traded on an exchange, their distribution to a "broad segment of the public" was enough "to establish the requisite 'common trading.'" [22] In considering the third factor, the Court found that the public would have perceived that the notes were securities because they had been advertised as "investments" and "there were no countervailing factors that would have led a reasonable person to question this characterization." [23] Finally, in considering the fourth factor, the Court found "no risk-reducing factor to suggest that [the notes were] not in fact securities." [24]

[b] Stock

In sharp contrast to the later approach the Supreme Court took in *Reves*, requiring a thorough analysis of the instrument, the Court had previously held in *Landreth Timber Co. v. Landreth* [25] that "stock" is generally a security for purposes of the Acts regardless of the economic circumstances surrounding its sale. In *Landreth Timber*, a family sold a timber mill to a small group of investors in a negotiated transaction. The sale was structured as a transfer of stock in the mill

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rather than as the sale of the business' assets. After the business failed, the buyers sued the sellers, alleging violation of the registration provisions of the Securities Act and fraud under the Exchange Act. The sellers argued that the Acts should not apply to the sale of 100% of the stock of a closely held corporation because the economic realities of the transaction indicate that the buyers were entrepreneurs taking over a business rather than passive investors in securities. [26] The Court rejected the sellers' arguments. The Court held that the mill's common stock was the paradigm of a security and that, therefore, there is no need to look beyond the characteristics of the instrument to the underlying economic realities of the transaction. [27] The Court's holding suggests that common stock, in whatever context it is sold, is *per se* a security within the ambit of the Acts so long as it "bears stock's usual characteristics[, including] (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." [28]

Thus, anyone who sells a U.S. business through a sale of stock should be aware that the U.S. securities laws will apply to the transaction. If the business

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subsequently fails or does not perform as well as expected, the buyer may sue the seller under Rule 10b-5 under the Exchange Act for fraud in connection with the purchase or sale of securities, claiming, for example, that the seller failed to disclose material risks of the business. [29]

[c] Bank Certificates of Deposit

As discussed above, the Supreme Court in *Reves* indicated that risk-reducing factors may indicate that a note is not a security. Such risk-reducing factors were the basis for the Court's prior decision in *Marine Bank*, where it ruled that a certificate of deposit issued by a federally regulated and insured bank is not a security. [30] In *Marine Bank* the plaintiffs purchased from the defendant bank a certificate of deposit (the "CD"), which was insured by a federal agency. The plaintiffs purchased the CD in order to pledge it to the bank to secure the bank's loan to a company. In exchange for the pledge, plaintiffs were to receive a percentage of the company's profits. Plaintiffs alleged that the bank had represented to them that the loan would be used as working capital for the company. In fact, the company was deeply indebted to the bank and to others, and the loan was principally used to pay off such indebtedness. When the company became bankrupt soon thereafter, plaintiffs sued, claiming *inter alia* that the bank had violated the fraud provisions of the Exchange Act because it had actively solicited their purchase and pledge of the CD without disclosing either the great indebtedness of the company or that the bank intended to repay itself from the proceeds of the loan. [31]

The Court held that the Exchange Act did not apply to the transaction because the CD was not a security. Although the Court noted that the CD shared several characteristics with other long-term debt obligations that are commonly viewed as securities, it concluded that the federal insurer virtually guaranteed payment on the CD and that holders of certificates of deposit issued by federally regulated banks thus are "abundantly protected under the federal banking laws." The Court held that federal insurance and regulation rendered it unnecessary to subject issuers of bank certificates of deposit to liability under the fraud provisions of the Acts. [32]

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The Court explicitly left open the possibility that certificates of deposit may be securities in other contexts. [33] This has led to speculation as to whether unconventional certificates of deposit are subject to the Acts. For example, the denomination of the CD in *Marine Bank* exceeded the applicable federal insurance limit by $10,000, [34] yet the Court held that federal insurance and regulation rendered application of the Acts unnecessary. It is the subject of speculation whether the Court would have reached the same conclusion if the denomination of the CD had been several times the federal insurance limit (federal insurance is currently limited to $250,000 per account). [35]

The *Marine Bank* analysis has prompted other U.S. courts to rule that certificates of deposit issued by state-regulated or foreign government-regulated institutions are also not securities subject to the Acts, although these extensions of *Marine Bank* have not been considered by the Supreme Court. [36] These courts declined to limit the *Marine Bank* exclusion to federally regulated institutions, with the Ninth Circuit concluding instead that it should apply whenever "a bank is sufficiently well regulated that there is virtually no risk that insolvency will prevent it from repaying the holder of one of its certificates of deposit in full." [37] In contrast, the Fourth Circuit reasoned that the *Marine Bank* holding must turn on the "comprehensiveness" of federal deposit insurance rather than its effectiveness; otherwise a court would have to inquire in each case "whether, at the time a given CD is issued, the regulatory and insurance schema in place was sufficiently well managed or well positioned … potentially lead[ing] to a court concluding that the same bank could one year issue a CD that was not a security, but that due to a change in effectiveness of the regulatory, insurance protection, the next year an identical CD would be a security." [38] The SEC argued against the extension of *Marine Bank* to foreign government regulated institutions in the Ninth Circuit case, stating both that Congress did not intend this result (as evidenced by the requirement in the Securities Act that foreign governments and central banks must register obligations sold to the public in the United States) and that such an application of *Marine Bank* would require a case-by-case analysis of the adequacy of foreign regulation (which the SEC and the courts are not well equipped to perform). [39]

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[d] Investment Contracts

Investment contracts are included in the statutory definitions as a separate category of instruments that are securities. In *SEC v. W.J. Howey Co.*, [40] the Supreme Court defined investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." [41] *Howey* was one of the Supreme Court's first pronouncements on the definition of "security" under the U.S. securities laws. [42] After the decision, the *Howey* definition of investment contract (the so-called "*Howey* test") was invoked by some lower courts for decades to determine whether other instruments are securities. As discussed above, the Supreme Court has since held that in certain other contexts (*e.g., Reves*, with respect to notes, and *Landreth Timber*, with respect to stock), other tests apply. However, *Howey* can be expected to remain a potent analytical

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tool with respect to instruments to which no other tests have been held to apply. [43]

In *Howey*, defendants sold to plaintiffs parcels of land in citrus fruit groves and service contracts under which defendants cultivated and developed the groves, including harvesting and marketing the crops. The service contracts had terms of several years and gave defendants complete possession over the land and full discretion and authority over cultivation, harvesting and marketing. The purchasers had no right to enter their land and no right to specific fruit. Rather, the fruit from all land controlled by defendants was pooled and plaintiffs received checks at harvest time representing a proportionate share of profits. Purchasers generally resided far from the groves and lacked the equipment and experience needed to cultivate, harvest and market citrus products. [44]

Defendants argued that the land sales and service contracts were separate transactions and did not involve securities subject to the Securities Act. The Supreme Court disagreed. It held that plaintiffs invested money in a "common enterprise" (the citrus groves) with the expectation of receiving profits through the efforts of defendants. The transaction was an investment contract subject to the Securities Act, analogous to any other transaction (*e.g.*, purchase of common stock) where "investors provide the capital and share in the earnings and profits [and] the promoters manage, control and operate the enterprise." [45]

This "investment contract" concept has since been used as a catchall term under which claimants have argued that transactions that would otherwise not involve securities should be subject to the Acts. For example, in *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [46] the Second Circuit held, relying on a footnote in *Marine Bank* that explicitly left open the possibility that certificates of deposit could be securities under some circumstances, [47] that federally insured certificates of deposit were securities when they

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were sold in a manner that satisfied the Supreme Court's test for determining what constitutes an "investment contract." [48] The defendants sold certificates of deposit to plaintiffs under a marketing program (the "Program") in which defendants screened a variety of bank or savings and loan issuers against insolvency risks and negotiated rates of return on behalf of investors. Defendants also maintained a secondary market in certificates of deposit sold under the Program so that investors who wished to liquidate their investments would not have to incur penalties imposed by issuers for early redemption. Plaintiffs claimed that the defendants' promotional materials for the Program failed to disclose defendants' commissions from the issuers and thus violated the fraud provisions of the Acts. [49]

The *Gary Plastic* court noted that under *Marine Bank* a conventional certificate of deposit purchased from an issuing bank is not a security. However, the court held that certificates of deposit sold through the Program were investment contracts because investors expected to receive profits through the extra services provided by defendants. The court further held that the certificates of deposit sold through the Program represented essentially a joint effort by the issuers of the certificates of deposit and the defendants and distinguished the facts of *Marine Bank* by reasoning that, although federal banking laws may protect investors from the abuses and misrepresentations of the issuers, the Acts were necessary to protect investors from the abuses and

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misrepresentations of defendants. [50]

In *SEC v. Edwards*, [51] the Supreme Court, reversing the Eleventh Circuit, held that an arrangement for the sale and leaseback of pay telephones was an investment contract and thus a security for purposes of the Acts. Pursuant to the arrangement, investors would purchase a pay telephone from ETS Payphones and lease it back to ETS in exchange for a fixed monthly fee. Investors "were not involved in the day-to-day operation of the payphones they owned. [Instead,] ETS selected the site for the phone, installed the equipment, arranged for connection and long-distance service, collected coin revenues, and maintained and repaired the phones." [52]

The Eleventh Circuit had held that "profits" for the purposes of the *Howey* test "require[d] either a participation in earnings by the investor or capital appreciation." [53] Therefore, the investors' entitlement to a fixed return meant that they

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did not have the required expectation of profits. Moreover, because the investors had a contractually guaranteed entitlement to a fixed return, any "profits" on their part would not "be derived solely from the efforts of others." [54]

The Supreme Court rejected the Eleventh Circuit's analysis and conclusions. The Court held that "[t]here is no reason to distinguish between promises of fixed returns and promises of variable returns" for purposes of the *Howey* test. [55] The Court noted a particular concern that a different holding would permit evasion of the securities laws by promising a particular rate of return in an investment contract. [56] The Court also rejected the argument that a contractual entitlement to a return would not be derived solely from the efforts of others for purposes of the *Howey* analysis. [57]

Notably, in a footnote to the *Reves* decision, the Court had stated that although "profits" in the context of notes meant "a valuable return on investment," which included interest, "profit" was defined more restrictively in applying the *Howey* test. [58] That footnote suggested that the *Reves* test was the only appropriate framework to analyze a promise of fixed returns. In *Edwards*, however, the Court stated that the dictum in *Reves* was incorrect, and held that fixed returns could constitute profits for purposes of the *Howey* test. [59] This holding increases the probability that a fixed return investment scheme that does not constitute a security under the *Reves* test may nevertheless constitute an investment contract under *Howey*.

The Fourth Circuit, in *Robinson v. Glynn*, [60] refused to determine categorically whether membership interests in a limited liability company constitute investment contracts. [61] Instead, it focused principally on the extent to which LLC members were able to participate actively in the management of the entity, and thus were either passive investors in need of the protection of the securities laws or more active investors not in need of those protections. In *Robinson*, the fact that the investor had the power to appoint board members, was in fact a board member and officer and had to consent before the entity could incur indebtedness outside the normal course of business led the court to conclude that the interest was not an investment contract and a security, even though the investor did not have sole managerial control over the entity. [62] The court left open the

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possibility that LLC interests could constitute securities where members were unable as a practical matter to exercise any meaningful control over the entity.

Other circuits faced with fact patterns where investors had far less control than in *Robinson* have held that their respective ownership interests were investment contracts, and therefore securities. In *SEC v. Merchant Capital*, [63] the Eleventh Circuit relied on a pre-circuit split Fifth Circuit precedent to hold that interests in Colorado registered limited liability partnerships [64] were investment contracts where the partners (i) had powers similar to those of limited partners, (ii) were "completely inexperienced" in the relevant industry and (iii) were dependent on the manager to run the business. [65]

The Second Circuit in *United States v. Leonard* [66] also held that, notwithstanding the terms of an LLC's organizational documents, a jury trial's conclusion that the LLC interests were securities was supported by sufficient evidence. "'[I]nterim managers' [had]… decided almost every significant issue" regarding the enterprise

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before investors purchased interests in the LLC; investors did not negotiate the terms of the LLC organizational documents; investors had "no particular experience" in the relevant industry; "[a]nd their number and geographic dispersion left investors particularly dependent on centralized management." [67]

The District of Columbia Circuit, in *SEC v. Life Partners, Inc.*, [68] ruled that viatical settlement contracts [69] "are not securities … because the profits from their purchase do not derive predominantly from the efforts of a [third] party." [70] Life Partners, Inc. ("LPI") sold fractional interests in insurance policies to retail investors, either individually or through such investors' Individual Retirement Accounts ("IRAs"). In LPI's programs, LPI performed certain pre-purchase functions, such as evaluating the insured's medical condition, reviewing his policy and negotiating a purchase price. In certain versions of the programs, LPI also engaged in post-purchase activities, including administration and distribution of death benefits. Under its original scheme, LPI was the record owner of the insurance policy, though investors remained the beneficial owners. Other iterations of the program involved listing the individual investors as record owners and providing no post-purchase services, except to the extent that an investor chose to use an agent of LPI as its agent to settle the insurance contract. [71]

In considering whether LPI's contracts were properly characterized as securities for purposes of the Securities Act, the court applied the *Howey* test. Looking first at the issue of profits, the court held that the investor in a viatical settlement has an expectation of profits because it is not purchasing the unmatured policy claims for current consumption. Rather, the investor seeks a financial return on its investment. [72] The court also held that a "common enterprise" was present because LPI's viatical settlements involved a pooling of funds to purchase an insurance policy that may result in a profit or loss to investors depending upon the life span of the insured. [73] The court concluded, however, that none of LPI's or its agents' pre- or post-purchase functions—amounting to no more than finder-promoter and simple ministerial activities—qualified as the entrepreneurial "efforts of others"; consequently, this element of the *Howey* test was not satisfied. [74] The court also held that the notes issued to IRAs by trusts investing in the viatical settlement contracts were not securities for purposes of the federal securities laws. [75]

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Relying in part on the reasoning, though not the result, in *Life Partners*, the District of Columbia Circuit in *Liberty Property Trust v. Republic Properties Corp.* [76] held that two individuals who were board members and officers of a real estate investment trust ("REIT") that owned 88% of a limited partnership "did not exercise sufficient control of the limited partnership to disqualify their units as securities." [77] The court reasoned that the REIT had six trustees and ten executive officers at the time of its initial public offering of trust interests, and therefore the defendants' "two votes were a minority of the board." [78] Furthermore, although the defendants controlled the REIT board when it had just three members during its formation, the court noted that the defendants expected the board to expand as part of the transactions in connection with the public offering and that, under the *Howey* test, "they ‘expected’ to profit from the efforts of the independent trustees added" to the board. [79]

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Together with the Supreme Court's ruling in *SEC v. Edwards*, [80] these cases may be indicative of an increased willingness of federal courts, in certain circumstances, to characterize contractual arrangements as "investment contracts" for purposes of the securities laws. [81]

[e] Loan Participations

As the *Gary Plastic* decision demonstrates, a transaction may be subject to the Acts even if an underlying instrument would not be a security if sold in other contexts. Transactions therefore must be examined in their entirety to determine whether they involve securities. For example, even if a note issued to a commercial bank by its customer is not a security under *Reves*, a separate analysis is required to determine whether loan derivative products (such as loan participations or syndications) [82] based on the note and sold by the originator are securities. Although the Supreme Court has not yet ruled on loan participations or syndications, lower courts have almost unanimously held that loan participations and syndications made in the normal course are not

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securities. Some of these courts based their decisions on the "commercial" nature of the underlying transactions, stating that the Acts were intended to apply to instruments issued in an "investment" context but not to instruments issued in a "commercial" context. [83]

Other courts have considered and rejected arguments that a participation or syndication satisfies the *Howey* "investment contract" test described above because participants are receiving profits (in the form of interest paid on the loan) from the efforts of the originating bank, which negotiated (and presumably provided monitoring and administrative services for) the loan. [84] In light of the

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Supreme Court's decision in *Edwards*, [85] however, the applicability of the investment contract test would appear to turn *not* on whether the participants are receiving interest rather than equity appreciation as a profit return, but, as discussed above, whether the underlying arrangement is commercial or investment in nature. [86]

Future plaintiffs will undoubtedly also argue that loan derivative products should be analyzed as notes under *Reves* (in addition to investment contracts under *Howey*). For example, in *Banco Espanol de Credito v. Security Pacific National Bank*, [87] the Second Circuit analyzed certain loan participations under *Reves* and concluded that such participations were not securities. The participations were sold by Security Pacific as part of a loan note program that, according to the SEC, was marketed to borrowers by Security Pacific as being a more profitable alternative to the issuance of commercial paper. [88] Under the program, Security Pacific loaned money to Integrated Resources, Inc. and immediately resold pieces of the loan to institutional investors. The investors sued Security Pacific under the fraud provisions of the Securities Act after Integrated failed to repay the loan, claiming that Security Pacific had concealed material nonpublic information about Integrated's deteriorating financial condition from them. The Second Circuit ruled that the investors could not claim under the fraud provisions of the Securities Act because the participations were analogous to loans

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issued by banks for commercial purposes, which, under *Reves*, are a type of note that is not a security. [89] The court also considered the participations in light of the four standards articulated by the Supreme Court in *Reves* for determining whether a note is a security and found that the motivation of the participants was for commercial (rather than investment) purposes, the participations were offered exclusively to institutional and corporate entities and not to the general public, the investors were on notice through contractual provisions that the participations were not investments in business enterprises and the existence of a regulatory scheme over the purchase and sale of loan participations of national banks makes application of the federal securities laws unnecessary. [90]

The SEC strongly disagreed with the court's analysis, arguing among other points that only the most "traditional" loan notes or participations should fall outside the definition of "security." [91] The SEC distinguished the Security Pacific loan participation program in *Banco Espanol* from a traditional program on the basis of the number and type of participants, the sales approach and the availability of information regarding the borrower. It stated that in a traditional program there would be only a small number of financial institutions as participants, financial institutions would become participants through referrals from the initiating bank's loan department and all information available to the initiating bank would be made available to participants. In the Security Pacific program, on the other hand, there were large numbers of diverse participants (including mutual funds and money managers), potential participants were contacted through "cold calls" from a sales desk and, although the initiating bank provided publicly available information to participants on request, it withheld nonpublic information from participants.

The participations sold under the Security Pacific program resemble commercial paper more than they resemble traditional loan participations in the way they were marketed and in the group of investors targeted. Commercial paper is well recognized as a security under the Securities Act. [92] Many other banks have

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loan participation programs similar to Security Pacific's [93] and, at least in the Second Circuit, investors are now in the anomalous position that they are protected by the fraud provisions of the securities laws when they buy commercial paper but are not so protected when they buy notes that are economically virtually identical to commercial paper from commercial banks. [94]

Other courts may disagree with the Second Circuit's *Banco Espanol* analysis that loan derivative products such as loan participations are not securities under *Reves*. [95] It is questionable whether such loan derivative products have a family resemblance to any of the instruments in the family resemblance test's list of exceptions to the definition of a security. And under the four additional standards articulated by the Supreme Court in *Reves*, some of these instruments may not escape categorization as securities.

First, it may be difficult to prove that the motivations of the buyer are for a "commercial" rather than an "investment" purpose, especially if not all of the participants are financial institutions.

Second, if the documentation for the loan derivative product is standardized and the product is offered to a large number of prospective investors without restrictions on transfer (both within and outside the commercial banking

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community), it may be difficult to prove that there is no "common trading market." [96]

Third, it will be difficult to predict whether the loan derivative products will be viewed as securities by nonbank investors because this view is a subjective one.

Fourth, these instruments are not federally insured and may not be covered by some other regulatory scheme that could obviate the need for the protection of the securities laws. [97]

Finally, the transactions may appear to a court more like repackaging of the loan, which, as discussed below, is thought to involve the sale of a security separate from the underlying loan itself.

In addition, loan participations that do not convey a beneficial interest in the underlying loan may be regarded as a swap or security-based swap under the Dodd-Frank Act. [98]

[f] Options on Securities and the Status of Swaps as "Securities"

[i] *Introduction*

[ii] *Background*

In contrast to certain other jurisdictions, the fundamental differences in approach to the regulation of securities, futures contracts, over-the-counter ("OTC") derivatives, banking products and insurance products in the United States have made the categorization of new financial instruments a prerequisite to the evaluation of the regulatory consequences of transacting in them, including which regulator has regulatory authority over a particular financial instrument.

The two principal U.S. regimes of historical significance are the regulation of securities under the U.S. securities laws and the regulation of futures contracts under the Commodity Exchange Act ("CEA"). [98.1] These regimes fundamentally

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differ in structure, approach and regulatory objective. Whether, and the extent to which, an instrument is subject to one regime or the other (a security, subject to regulation under the U.S. securities laws, a futures contract subject to regulation under the CEA, or both) has historically determined whether, and the circumstances under which, the instrument may be offered, sold or entered into in the United States or to or with U.S. persons. Title VII of the Dodd-Frank Act, which created new regulatory categories for "swaps" (subject to regulation under the CEA), "security-based swaps" (subject to regulation under the U.S. securities laws) and "mixed swaps" (subject to regulation under both the CEA and the U.S. securities laws), has further complicated the determination of the

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regulatory consequences of financial instruments categorization. [98.2]

As described below, over the years these regulatory regimes have applied to various extents to (i) derivatives referencing securities or securities indices, and (ii) securities products (such as structured notes) embedding exposure to non-securities reference assets or measures.

[iii] *The 1974 Amendments to the CEA*

Prior to 1974, the differences in regulatory schemes applicable to securities, on the one hand, and futures contracts, on the other hand, had no appreciable effect on the U.S. capital markets. In 1974, Congress, through an amendment to the CEA (the "1974 Amendments"), granted the CFTC exclusive jurisdiction over financial futures and options on certain financial interests (in addition to the agricultural commodities traditionally regulated under the CEA). [98.3] The expanded scope of the CEA, together with the proliferation of derivative financial instruments, gave rise to regulatory problems relating to whether the SEC or CFTC could properly exercise regulatory authority over a particular instrument, including whether the CEA applied to derivative or hybrid

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instruments that were not contemplated at the time of the 1974 Amendments. The determination that the CEA applies to an instrument has historically been significant because the exclusive jurisdiction provision of the CEA may preempt regulatory regimes that otherwise would be applicable, such as the U.S. securities laws. In addition, the CEA generally prohibits transactions in futures contracts (and prior to the Dodd-Frank Act, prohibited transactions in commodity options) that are not entered into on or subject to the rules of CFTC-regulated or non-U.S. trading facilities (so-called "off-exchange transactions"), absent a specified exemption. As the securities and financial derivatives markets developed into a more integrated, global market, the CFTC's exclusive jurisdiction (and the limited exemptions therefrom) and the uncertain division of regulatory authority between the SEC and CFTC created serious problems for issuers, market professionals and the U.S. capital markets generally. The breadth of the CFTC's exclusive jurisdiction under the 1974 Amendments resulted in a number of disputes between the CFTC and the SEC.

[iv] *The Shad-Johnson Accord*

Shortly after the 1974 Amendments became effective, the SEC asserted that such amendments had not deprived the SEC of jurisdiction over a futures contract that involved a "security" within the meaning of the Securities Act or the Exchange Act, even if the futures contract was traded on a contract market (*i.e.*, a futures exchange regulated by the CFTC). In 1981, the SEC and the CFTC met to resolve their differences, and in 1983 Congress codified the resulting jurisdictional accord (the "Shad-Johnson Accord"). [98.4]

As a result of the Shad-Johnson Accord, the CFTC retained jurisdiction over: (i) options on all commodities other than securities, (ii) futures contracts and options on futures contracts, including futures contracts and options on futures contracts on permitted securities indices, foreign currencies and permitted individual exempt securities (*e.g.*, U.S. government and agency securities), [98.5] and (iii) futures contracts, options on futures contracts and options (other than options traded on a national securities exchange) on foreign currencies. [98.6] The Shad-Johnson Accord required any securities index or group of securities underlying a futures contract be broad-based in order for the CFTC to have exclusive jurisdiction over that futures contract, and mandated that the SEC and

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CFTC cooperate in determining, upon application by a contract market, whether particular stock index futures contracts met that test. [98.7] Futures on individual nonexempt securities (other than as referenced above) and narrow-based indices of such securities were prohibited. The SEC retained jurisdiction over (i) options on securities and securities indices (whether or not broad-based), [98.8] (ii) options on foreign currencies traded on a

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U.S. national securities exchange and (iii) the offer and sale of securities issued by commodity pools. [98.9]

The Shad-Johnson Accord did not, however, completely settle jurisdictional disputes between the CFTC and the SEC. The increasing prevalence in the capital markets of hybrid instruments combining features of securities and derivative instruments [98.10] and OTC derivatives linked to the value of a security or a commodity reignited the debate over the jurisdiction of the CFTC. [98.11]

[v] *The Commodity Futures Modernization Act of 2000*

The Commodity Futures Modernization Act of 2000 ("CFMA") [98.12] addressed or eliminated the most significant uncertainties as to the applicability of the CEA under prior law by creating broad, clearly defined exclusions and exemptions from SEC and CFTC regulation for a wide range of OTC derivatives between qualifying counterparties and hybrid instruments indexed to the value, level or rate of a commodity, including OTC derivatives and hybrid instruments indexed to securities. Importantly, the CFMA eliminated the prohibitions created by the Shad-Johnson Accord by establishing a regulatory framework for the trading of futures contracts on individual nonexempt securities and narrow-based indices of such securities. Thus, while the CFMA did not address certain fundamental definitional issues, such as the futures contract definition, for a time the

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CFMA's broad exclusions and exemptive provisions provided practical relief for the capital markets and OTC derivatives markets.

[vi] *The Dodd-Frank Act Wall Street Reform and Consumer Protection Act*

In response to views that the unregulated nature of the OTC derivatives market contributed to the 2007-2008 financial crisis, the Dodd-Frank Act [98.13] repealed the CFMA's exclusions for OTC derivatives from substantive regulation under the CEA and the U.S. securities laws. In their place, Title VII of the Dodd-Frank Act established a regime of substantially parallel regulation for swaps involving single nonexempt securities, loans and narrow-based security indices ("security-based swaps") [98.14]—to be administered by the SEC—and swaps involving other financial interests and commodities ("swaps")—to be administered by the CFTC. At the same time, Title VII of the Dodd Frank Act preserved (and excluded from regulation as swaps or security-based swaps) those categories of derivatives based on or referencing securities that were already subject to regulation as "securities" under the U.S. securities laws, including: securities options; [98.15] security future products; [98.16] contracts for the purchase or sale of a security on a fixed, variable or contingent basis, such as a forward contract providing for the deferred physical delivery of securities; [98.17] and notes, bonds or other evidences of indebtedness regulated as securities. [98.18]

[vii] *Options on Securities*

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[A] Generally

Any put, call, straddle, option, or privilege on any security, certificate of deposit or group or index of securities (including any interest therein or based on the value thereof) is expressly included in the definition of "security." [98.19] Any such instrument is also generally excluded from regulation under the CEA [98.20] and is expressly excluded from the Dodd-Frank Act's definition of "swap" [98.21] (and, as a result, "security-based swap"). As a result, options on securities, unlike futures contracts, swaps or security-based swaps, are not subject to exchange-trading or clearing requirements under the CEA or the Exchange Act. Accordingly, the question of whether an instrument should be respected as an option on a security, rather than a futures contract, swap or security-based swap, is critical. This is particularly the case for derivatives based on broad-based security indices because the determination of whether such a derivative constitutes an option on securities, on the one

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hand, or a futures contract or swap, on the other, also determines whether it is subject to SEC or CFTC jurisdiction.

Several courts (and the agencies) have had occasion to evaluate whether certain derivatives constituted options on securities. Although some of those precedents pre-date the CFMA and the Dodd-Frank Act, their analysis remains relevant in distinguishing options on securities from futures contracts, swaps and security-based swaps.

In *Procter & Gamble*, [98.22] the U.S. District Court for the Southern District of Ohio analyzed an interest rate swap—referred to as the "5s/30s swap" —pursuant to which Bankers Trust ("BT") agreed to pay the plaintiff, Procter & Gamble ("P&G"), for five years a specified percentage on a notional amount of $200 million, in exchange for P&G's agreement to pay BT a floating rate of interest tied to the commercial paper rate plus, after the first six months, a spread that was to be based on the then-prevailing five-year constant maturity U.S. Treasury yield and the price of 30-year U.S. Treasury bonds. [98.23] When interest rates

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in the United States and Germany rose substantially, putting P&G's position significantly "out-of-the-money," P&G unwound the swap and brought suit alleging, among other claims, securities fraud.

The threshold question for the court in considering the claim of securities fraud was whether the "5s/30s swap" was a security for purposes of the federal securities laws. As part of its analysis, the court considered whether the swap was an option on securities. [98.24] Five-year notes and 30-year Treasuries are securities; therefore, P&G argued, the "5s/30s swap" was an option on securities.

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According to the court, however, because the optionee had no right to exercise an option or take possession of any securities, the swap could not be regarded as an option. [98.25]

This element of the court's ruling in *Procter & Gamble* departs from an earlier administrative decision by the SEC involving a swap that had some similarities to the "5s/30s swap." In *In re BT Securities Corp.* ("*Gibson*"), [98.26] Gibson Greetings, Inc. ("Gibson Greetings") entered into what was called a "Treasury-Linked Swap" with BT Securities Corporation ("BT Securities") in order to hedge against losses under another swap transaction. Under this agreement, Gibson Greetings was to pay to BT Securities a variable rate on a notional amount and was to receive that same variable rate plus a fixed spread on the same notional amount. This structure provided, in substance, for nothing more than a payment of a fixed amount, the spread, by BT Securities to Gibson Greetings. At maturity, Gibson Greetings was to pay the notional amount and was to receive the lesser of (i) 102% of the notional amount or (ii) an amount calculated

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based on a formula whose value depended on the spread between a 30-year Treasury security and the average of the bid and offered yields of a two-year Treasury note. Although the transaction was in the form of a bilateral swap agreement, the SEC, presumably looking through the form to the economic substance of the transaction, which lacked bilateral exposure, characterized this transaction as essentially a cash-settled put option, written by Gibson Greetings, on a group or index of government securities. [98.27] Such put options are among those instruments listed in the definition of "security" and, accordingly, the Treasury-Linked Swap was found to be subject to the federal securities laws. [98.28]

The swap agreements in *Procter & Gamble* and in *Gibson* can be distinguished on their facts. As noted above, the payment obligations in the *Gibson* swap resulted not in bilateral executory payment obligations, but in an obligation of one party to make a fixed payment to the other that is not dissimilar to a delayed payment option premium. Moreover, it was the aggregate of the cash flows under the "swap" in *Gibson* that was characterized by the SEC as a put option. By contrast, the *Procter & Gamble* swap involved an option-like payment feature embedded in an otherwise bilateral executory interest rate swap. The dicta in the court's decision in *Procter & Gamble* and the SEC's administrative decision in *Gibson* cannot be reconciled, however, insofar as the court in *Procter & Gamble* opined that an option on a security, in order to be a security, must involve the actual right (not

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subject to automatic exercise) to purchase or sell a security. [98.29]

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In *Caiola v. Citibank* ("*Caiola*"), [98.30] the U.S. Court of Appeals for the Second Circuit, reversing a decision of the district court [98.31] that relied in large part on the conclusion expressed in *Procter & Gamble*, held that a cash-settled option on a security is a security. Caiola had alleged that Citibank violated § 10(b) of the Exchange Act in connection with a series of synthetic securities trading arrangements (essentially forms of equity swaps and cash-settled options) by, among other actions, shifting from a "delta hedging" strategy to a strategy in which Citibank purchased and held the securities underlying Caiola's synthetic positions and thereby affecting the value of the underlying securities and of Caiola's synthetic positions. The transactions at issue were structured to permit Caiola to replicate certain economic characteristics of positions in Phillip Morris stock and listed options. Under the equity swap arrangements, Caiola was entitled to receive from Citibank the amount of appreciation in the underlying security (as well as any dividends payable with respect to that security) but was required to pay to Citibank the amount of any depreciation in the value of the underlying security, along with "interest" on the notional value of the contract.

As in *Procter & Gamble*, a threshold question in assessing the securities fraud claim was whether the transactions involved the purchase or sale of a security. Caiola raised two arguments in this regard: (i) that Citibank was acting as his agent in effecting transactions in the underlying security as part of its hedging activity and (ii) that the synthetic trading arrangements were themselves securities. [98.32]

The district court had dismissed Caiola's claims on the grounds that, among other reasons, (i) he lacked standing because he was not a purchaser or seller of securities and (ii) his synthetic transactions were not "securities" as defined in the Exchange Act (relying on the conclusion in *Procter & Gamble*).

With respect to Caiola's first claim, the Second Circuit found that Caiola's complaint sufficiently alleged that Citibank had acted as agent for Caiola's account in its hedging transactions in the underlying security.

With respect to the question of whether the synthetic transactions were themselves securities, the Second Circuit found that Caiola's cash-settled OTC options on the value of a security were securities under § 3(a)(10) of the Exchange Act. The court rejected the reasoning in *Procter & Gamble*, finding that the language of § 3(a)(10) covered an option based on the value of a single

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security as well as a group or index of securities and cash-settled as well as physically-settled options. [98.33]

[viii] *Treatment of Collars and Deep-in-the-Money Options; Distinction Between Equity Swaps, Equity Futures and Equity Options*

Another set of issues involves determining when a transaction documented as an equity collar [98.34] or deep-in-the-money option [98.35] may be subject to recharacterization as a swap or security-based swap (or a futures contract) or, conversely, when the transfer of less than all of the price risk under a cash-settled

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swap or security-based swap may subject the swap or security-based swap to potential recharacterization as one or more securities options.

There is no dispositive precedent as to the point at which the two exercise levels of a collar are sufficiently close that the collar would not be viewed as a pair of options but would instead be viewed as a swap or security-based swap (or a futures contract). Conversely, there is no dispositive precedent as to the circumstances, if any, in which the two exercise levels of a collar are sufficiently far apart that the collar may be viewed as a pair of options, rather than as a swap or security-based swap (or a futures contract). [98.36]

Similarly, there is no dispositive precedent as to the point at which an "option" is sufficiently deep-in-the-money

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to raise the possibility that it would not be respected as a securities option and instead be viewed as a swap or security-based swap (or a futures contract). Conversely, there is no dispositive precedent as to the point, if any, at which a swap or security-based swap has a sufficiently option-like payout profile to raise the possibility that it may be viewed as a securities option that is excluded from regulation as a swap or security-based swap.

Applicable securities and commodities law precedents have consistently purported to categorize instruments based on the underlying economic substance of the particular transactions in question and, while not necessarily disregarding the form of a transaction entirely, have rejected the proposition that form should be dispositive. [98.37]

Precedents addressing whether a deep-in-the-money option should be respected as an option have consistently looked to whether the exercise price of the option was so low as to make exercise of the option a virtual certainty as a matter of rational economic behavior. [98.38] (An analogous approach, in the context

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of a collar, would be to look to whether the exercise prices are so close together as to make exercise of one of the component options a virtual certainty as a matter of rational economic behavior.)

Despite this consistent body of analogous precedent, [98.39] the CFTC staff, in the context of distinguishing between futures contracts and options, appears to have ignored this approach and to have adopted an approach implying a significantly narrower view of a *bona fide* option and a concomitantly broader view of the CFTC's potential jurisdictional authority under the CEA. [98.40]

Specifically, in a 1994 interpretive letter, [98.41] CFTC staff was requested to grant no-action relief for options in which the exercise price would, at issuance, be set in-the-money by an amount to be determined using a formula based primarily on a measure of the "annualized standard deviation of the natural logarithm of the daily returns on an investment in the stock" over the preceding year. [98.42] According to the request, this formula would have resulted in a "reasonable possibility" that the options would expire unexercised (*i.e.*, with the stock price out-of-the-money). [98.43]

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CFTC staff declined to grant relief on the basis requested and instead limited the amount that the options would be permitted to be in-the-money at the time of listing by requiring, in the case of a call option, that the exercise price of the option be set at a level no lower than the level resulting from rounding the then prevailing stock price downward to the nearest $2.50 increment, in the case of stocks priced below $25, or to the nearest $5.00 increment, in the case of stocks priced above $25. According to CFTC staff, the resulting options would have "predominantly option-like attributes rather than futures-like attributes because they should reflect a return based on one-way indexing as opposed to two-way indexing." [98.44]

Although the CFTC staff's no-action guidelines are both clear and simple to apply, the staff response did not provide a rationale or basis for its conclusion that a "predominance" test is the appropriate standard for determining whether an in-the-money option should be respected as an option. Nor did CFTC staff explain why the fundamental attribute of an option is "one-way" indexation. Finally, it is not clear from the CFTC staff's analysis how the limitations imposed in the interpretive letter by virtue of the rounding guidelines result in indexation that is "predominantly" option-like—particularly in light of the fact that the guidelines do not appear to take account of considerations such as the term of the option, the amount of the premium for the option (in relation to the price of the underlying stock), the probability at issuance that the option will expire unexercised, or the price behavior (*e.g.*, volatility) of the underlying stock. For these and related considerations, the "likelihood of exercise" analysis employed in the other precedents cited above appears more persuasive than the approach adopted by CFTC staff.

[ix] *Status of Swaps as "Securities"*

Prior to the enactment of the CFMA, the status of swap agreements and similar derivatives linked to securities under the U.S. securities laws was subject

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to some uncertainty. Swaps and such other derivatives developed long after the enactment of the definitions of "security" and do not readily fit into any of the categories of instruments enumerated in the definitions.

The first attempt to resolve these issues statutorily came in the CFMA, which addressed certain jurisdictional questions by amending the Acts and the GLB Act to exclude certain qualifying "swap agreements" from the definition of security for purposes of those statutes. Those amendments also provided that qualifying swap agreements relating to securities, while not securities themselves, remained subject to the fraud, manipulation and insider trading prohibitions under those Acts.

In the Dodd-Frank Act, however, Congress repealed the CFMA exclusions and instead categorized a wide range of swaps and other derivatives relating to securities as security-based swaps. [98.45] In addition, the Dodd-Frank Act amended the definition of "security" in the Acts to include any "security-based swap." At the same time, the Dodd-Frank Act categorized certain swaps linked to securities both as "swaps" subject to plenary CFTC jurisdiction and also as "security-based swap agreements" subject to SEC antifraud jurisdiction, but not defined as "securities." Still other swap transactions are exclusively subject to CFTC jurisdiction. Finally, as noted above, options on securities are separately regulated as "securities," and excluded from regulation as a "swap" or "security-based swap."

[x] *Swaps on Single Nonexempt Securities and Narrow-Based Securities Indices*

The Dodd-Frank Act defines any swap based on a single nonexempt security or loan or based on a narrow-based security index as a "security-based swap." [98.46] It then defines any security-based swap as a security. [98.47] As a result, many instruments previously excluded by the CFMA from substantive regulation by the SEC are subject to the full range of federal securities laws and regulations and self-regulatory organization rules applicable to securities, although the SEC and FINRA have granted interim relief for security-based swaps. [98.48]

[xi] *Swaps on Single Exempt Securities and Broad-Based Securities Indices*

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The Dodd-Frank Act defines any swap based on a single exempt security (other than a municipal security) or based on a broad-based security index as a "swap." Swaps are subject to regulation by the CFTC and are not defined as "securities." However, the Dodd-Frank Act also defined swaps based on a single exempt security (other than a municipal security) or based on a broad-based security index as "security-based swap agreements," which are subject to SEC antifraud and antimanipulation jurisdiction.

[xii] *Other Swaps*

Swaps based on interests or measures, such as interest rate swaps or swaps based on nonfinancial interests, are categorized under the Dodd-Frank Act as "swaps." They are also subject to exclusive CFTC jurisdiction if traded on a designated contract market ("DCM") or swap execution facility ("SEF"). [98.49] As a result, such instruments should not be subject to SEC jurisdiction or regulation as securities.

[g] Other Instruments

The cases discussed in this section demonstrate that the definitions of "security" in the Acts enumerate instruments that would not ordinarily be considered securities when examined in their commercial contexts. It is also true that instruments that are not enumerated may nonetheless be securities subject to the Acts.

Claimants (including the SEC) wishing to bring a non-enumerated instrument within the definitions have generally argued that the instrument shares so many characteristics with an enumerated security that it should be considered equivalent to the enumerated security. Where the non-enumerated instrument is not similar to an

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enumerated security, claimants have often argued instead that the instrument should be treated as an "investment contract" or an "instrument commonly known as a security" (terms that are often used together as catchall provisions in the definitions). In each case, the relevant factors in the analysis may include the manner of the offering, type of investor audience, manner of promotion, expectation of the parties and nature of the return on the investment. For example, as is demonstrated in the cases discussed above, an instrument is more likely to be considered a security if it is marketed to the general public, its purchasers are passive investors without expertise in the particular business area

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involved, [99] the parties or the public would generally consider the instrument a security or, with respect to investment contracts, the return on the investment is contingent on the profits of the enterprise.

In recent years, a host of new instruments has been developed that represent "repackaged" underlying instruments. The underlying instruments may not be securities when examined individually. However, a separate analysis of the new instrument is necessary.

For example, many originators of residential mortgage loans have repackaged their mortgage loans as mortgage-backed securities. Typically, ownership of a pool of mortgages is transferred to a trust that issues instruments evidencing a right to receive a proportional share of future payments on the pool of loans. The loan originator thus transfers the risk of loss on the loans and earns cash from the sale of the instruments. In addition, the originator often retains a contractual right to "service" the loans (*i.e.*, collect payments, run foreclosure proceedings, *etc.*), for which it receives a fee. Under *Reves*, the underlying mortgage loans are not securities. [100] However, instruments evidencing interests in a pool of mortgage loans typically are considered securities under an "investment contract" analysis because investors anticipate a profit that is based at least partially on the efforts of the originator and servicer of the loans. [101]

Footnotes

1 § 2(a)(1) of the Securities Act.

2 § 3(a)(10) of the Exchange Act.

3 In addition to listing categories of instruments that are securities, both Acts list "exempted securities." Exempted securities listed in the Securities Act include *inter alia* securities issued or guaranteed by the United States, any state or any political subdivision of a state, certain securities issued by banks or savings and loan associations, certain short-term commercial paper, certain insurance company securities and certain security futures. *See* § 3 of the Securities Act. Security futures are generally defined as futures contracts on individual nonexempt securities or narrow-based groups or indices thereof. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5][c]. Security futures are exempted securities for purposes of the Securities Act if they are listed on a national securities exchange or national securities association and are cleared by a registered securities clearing agency or derivatives clearing organization. § 3(a)(14) of the Securities Act. Exempted securities listed in the Exchange Act include *inter alia* certain securities issued or guaranteed by the United States, municipal securities (a term that includes certain securities issued or guaranteed by a state or an agency, instrumentality or political subdivision of a state) and certain insurance company securities. *See* § 3(a)(12) of the Exchange Act. Notwithstanding their categorization as "exempted securities," these securities generally may not be exempt from certain provisions of the related Act. For example, municipal securities that are exempted securities under the Exchange Act are not exempt from certain provisions of that Act relating to broker-dealer registration. *See* § 3(a)(12)(B)(ii) of the Exchange Act.

4 *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982) (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975). *But see Financial Security Assurance, Inc. v. Stephens, Inc.*, 500 F.3d 1276 (11 Cir. 2007) (rejecting the standing of an insurer of municipal bonds that became the owner of the bonds upon a default by the issuer to bring a Rule 10b-5 claim in part because guarantees are not within the definition of "security" in § 3(a)(10) of the Exchange Act).

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5 *See* § 2(a)(36) of the Investment Company Act and § 202(a)(18) of the Investment Advisers Act; *see, e.g.*, CAL. CORP. CODE § 25019 and DEL. CODE ANN. tit. 6, § 73-103(20).

6 In fact, although bank certificates of deposit were effectively excluded from the Securities Act's definition of security in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), Congress amended the Investment Company Act's definition in 1982 *inter alia* to make clear that such obligations would be included. Act of October 13, 1982, Pub. L. No. 97-303, § 5, 96 Stat. 1409 (1982).

7 For example, the Commodity Futures Modernization Act of 2000 ("CFMA") expanded the definitions to expressly include any "security future." *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16. More recently, § 761(a) of the Dodd-Frank Act has expanded the definition to include any "security-based swap," which had formerly been excluded from the definition of "security" by the CFMA. In addition, the SEC has in the past called for legislative amendment of the definition of "security" to include loan participations under certain circumstances. SEC TODAY, Vol. 94-190, Oct. 5, 1994. Because the Commodity Exchange Act ("CEA") vests the Commodity Futures Trading Commission ("CFTC") (and not the SEC) with exclusive jurisdiction over certain commodity options, such options are not securities. These commodity options, as well as other instruments that may be subject to the commodities laws, are discussed more fully in U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.17[2].

8 It is fair to say that participants in financial transactions in the United States assert often self-serving interpretations of the definitions that may vary over the course of a transaction and from transaction to transaction. Thus, many transactions have been characterized in complaints as the purchase and sale of securities, requiring the courts to decide what types of instruments should be included in the Acts' definitions of "security."

9 *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982). The U.S. Supreme Court has further articulated this congressional intent as a balance between the following two concerns: Congress intentionally defined "security" in broad and general terms because it intended its definition of "security" to be "sufficiently broad to encompass virtually any instrument that might be sold as an investment." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990), *reh'g denied*, 494 U.S. 1092 (1990). However, Congress could not have intended its definitions to be all-inclusive because it did not want the Acts to "provide a broad federal remedy for all fraud." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990), *reh'g denied*, 494 U.S. 1092 (1990) (quoting *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982)).

10 The Supreme Court has stated, for example, that it would be inappropriate to subject a "note" to the same analysis under which it had determined that an "investment contract" was a security in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *Reves v. Ernst & Young*, 494 U.S. 56, 64 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

11 *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

12 *See, e.g.*, *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 (1985) ("'[N]ote' may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context.").

13 *See, e.g.*, *Arthur Young & Co. v. Reves*, 856 F.2d 52, 54 (8th Cir. 1988), *rev'd sub nom. Reves v. Ernst & Young*, 494 U.S. 56, *reh'g denied*, 494 U.S. 1092 (1990). Investment contracts are discussed in § 12.01[2][d].

14 *See, e.g.*, *Futura Development Corp. v. Centex Corp.*, 761 F.2d 33, 40–41 (1st Cir. 1985), *cert. denied*, 474 U.S. 850 (1985). The Supreme Court noted in *Reves* that it regarded this "investment versus commercial" test as merely another way of "formulating the same general approach" as the "family resemblance" test it adopted. *Reves v. Ernst & Young*, 494 U.S. 56, 64 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

15 *See, e.g.*, *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984), *cert. denied*, 469 U.S. 884 (1984) (modifying *Exchange National Bank holding*).

16 *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990), *reh'g denied*, 494 U.S. 1092 (1990) (adopting the list of

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notes identified by the Second Circuit as not being securities in *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976) and *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984)) (internal quotation marks and citations omitted).

17 *Reves v. Ernst & Young*, 494 U.S. 56, 66–67 (1990), *reh'g denied*, 494 U.S. 1092 (1990) (internal quotation marks and citations omitted).

18 *Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990), *reh'g denied*, 494 U.S. 1092 (1990); *see also Stoiber v. SEC*, 161 F.3d 745 (D.C. Cir. 1998) (finding certain promissory notes to be securities under the *Reves* test despite their distribution to a limited number of individuals and the absence of any secondary trading), *cert. denied*, 526 U.S. 1069 (1999).

19 *Reves v. Ernst & Young*, 494 U.S. 56, 58–59 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

20 *Reves v. Ernst & Young*, 494 U.S. 56, 67–68 (1990), *reh'g denied*, 494 U.S. 1092 (1990); *see also SEC v. Smart*, No. 2:09-CV-00224 (DAK), 2011 WL 2297659 (D. Utah, June 8, 2011), *aff'd*, 678 F.3d 850 (10th Cir. 2012); *SEC v. Novus Technologies, LLC*, No. 2:07-CV-235-TC, 2010 WL 4180550 (D. Utah Oct. 20, 2010), *aff'd*, 732 F.3d 1151 (10th Cir. 2013) (each holding that instruments an issuer called "promissory notes" were securities under both the *Reves* and *Howey* tests).

21 *Reves v. Ernst & Young*, 494 U.S. 56, 67–68 (1990), *reh'g denied*, 494 U.S. 1092 (1990). *See also* § 12.01[2][d] for a discussion of "profits" in the context of notes.

22 *Reves v. Ernst & Young*, 494 U.S. 56, 68 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

23 *Reves v. Ernst & Young*, 494 U.S. 56, 69 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

24 *Reves v. Ernst & Young*, 494 U.S. 56, 69 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

25 *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) ("*Landreth Timber*").

26 *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 684–85 (1985).

27 *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985).

28 *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985) (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975)). The Court emphasized that such "usual characteristics" were derived from common stock and that "[v]arious types of preferred stock may have different characteristics and still be covered by the Acts." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.2 (1985); *see also, Bass v. Janney Montgomery Scott, Inc.*, 210 F.3d 577 (6th Cir. 2000) (concluding that stock warrants received by an investor in exchange for bridge loans qualified as securities, regardless of the circumstances in which they changed hands); *cf. Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001) (assuming in an action under Rule 10b-5 under the Exchange Act, citing plaintiff's failure to challenge it on appeal, that an option to purchase stock on a cable television system was a "security"). In contrast, an instrument named "stock" that does not share the characteristics of common stock is not *per se* a security. The Supreme Court held in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), that shares of stock in a government-subsidized cooperative apartment corporation were not securities. The shares lacked several characteristics of common stock: they did not carry the right to receive dividends upon an apportionment of profits, were not negotiable, could not be pledged or hypothecated, conferred no voting rights in proportion to the number of shares owned and could not appreciate in value. *See also Giuffre Organization Ltd. v. Euromotorsport Racing, Inc.*, 141 F.3d 1216 (7th Cir. 1998) (holding a "share of stock" in Championship Auto Racing Teams, Inc., not to be a security for purposes of the federal securities laws because the linkage between investment and participation in automobile racing competition resulted in the share being more similar to a franchise than to an investment in corporate securities). Courts have also rejected the argument that equity interests similar to stock in certain respects, such as membership interests in limited liability companies or limited partnerships, constitute stock for purposes of the definition of security, while either leaving open the possibility that such interests may be investment contracts under appropriate circumstances, *see Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003), or holding that such interests were investment contracts, *see Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335 (D.C. Cir. 2009); *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008); *SEC v. Merchant Capital, LLC*, 483

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F.3d 747 (11th Cir. 2007). *But see Haddad v. RAV Bah., Ltd.*, 240 F. App'x 821 (11th Cir. 2007) (holding that an interest may be considered a security where the agreement between the parties is titled "Shareholder's Agreement," discusses securities, and refers to holders of the interest as "stockholders").

29 Rule 10b-5 under the Exchange Act is discussed in § 11.04[2].

30 *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982); *see also Dubach v. Weitzel*, 135 F.3d 590, 592 (8th Cir. 1998) (applying *Marine Bank* to a certificate of deposit issued by a credit union). A certificate of deposit is a time deposit with a specific maturity evidenced by a certificate. Certificates of deposit issued by U.S. banks or savings and loan associations are usually federally insured. Many foreign certificates of deposit are also government insured.

31 *Marine Bank v. Weaver*, 455 U.S. 551, 553–54 (1982).

32 *Marine Bank v. Weaver*, 455 U.S. 551, 557–59 (1982).

33 *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982).

34 At that time, the federal insurance limit was $40,000. The face amount of the CD in *Marine Bank* was $50,000.

35 The Court in *Marine Bank* appeared to take some comfort in the 1980 Annual Report of the Federal Deposit Insurance Corporation ("FDIC"), which, according to the Court, stated that since inception of federal banking insurance, "nearly all depositors in failing banks insured by the FDIC have received payment in full, even payment for the portions of their deposits above the amount insured." *Marine Bank v. Weaver*, 455 U.S. 551, 558 (1982). The FDIC's 2009 Annual Report emphasized that even with the increase in bank failures in 2009, all insured deposits were paid, and depositors with account values in excess of the insurance limit nevertheless received $21 million in disbursements. 2009 Annual Report of the [FDIC] 46 (2010), *available at* http://www.fdic.gov/about/strategic/report/2009annualreport/AR09final.pdf. Similarly, all insured deposits were also paid in connection with bank failures in 2010, and depositors with account values in excess of the insurance limit received a total of $5 million. 2010 Annual Report Highlights of the [FDIC] (2011), *available at* http://www.fdic.gov/about/strategic/report/2010highlight/chpt1-03.html.

36 *See, e.g.*, *Wolf v. Banamex*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985) ("*Banamex*"); *Tafflin v. Levitt*, 865 F.2d 595 (4th Cir. 1989); *contra Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772 (10th Cir. 1989), *vacated and remanded*, 494 U.S. 1014, *aff'd on reh'g*, 900 F.2d 1485 (10th Cir. 1990), *cert. denied*, 498 U.S. 958 (1990) ("*Holloway*").

37 *Wolf v. Banamex*, 739 F.2d 1458, 1463 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985). *See generally* Randall W. Quinn, *After Reves v. Ernst & Young*, *When are Certificates of Deposit Notes Subject to Rule 10b-5 of the Securities Exchange Act?*, 46 BUS. LAW. 173 (Nov. 1990) ("*Quinn*").

38 *Tafflin v. Levitt*, 865 F.2d 595, 599 (4th Cir. 1989). Note also the discussion of *Gary Plastics Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* at *infra* Note 46 and accompanying text, where the Second Circuit distinguished the facts of *Marine Bank* and held that the certificates of deposit at issue were securities because the court found them to be investment contracts entered into pursuant to a marketing program.

39 Quinn at 182, citing Brief for the SEC as Amicus Curiae, *Wolf v. Banamex*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985), at 10. This article also notes that the SEC has sidestepped the issue of the interplay between *Marine Bank* and state regulation, stating that "[the SEC's] brief in *Holloway* argued that because Oklahoma trust company regulation was not as comprehensive as Oklahoma bank regulation, the court need not reach the question of whether state regulation might ever be sufficient to invoke the *Marine Bank* exclusion." Quinn at 182.

40 *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("*Howey*").

41 *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

42 In a case decided three years before *Howey*, the Court held that an investment scheme involving the assignment of oil leases and the drilling of test wells by the promoters was an investment contract under the Securities Act. *See SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

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43 *See, e.g., Matassarin v. Lynch*, 174 F.3d 549 (5th Cir. 1999), *reh'g en banc denied*, 189 F.3d 471 (1999), *cert. denied*, 528 U.S. 1116 (2000) (holding interests in an employee stock ownership plan not to be securities under the *Howey* test because the interest did not involve a voluntary investment choice); *Allen v. Lloyd's of London*, 94 F.3d 923 (4th Cir. 1996) (holding neither the initial investment by Lloyd's Names nor their interests under a Lloyd's settlement plan to restructure insurance underwriting interests to be securities under the *Howey* test); *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1282–83 (S.D. Ohio 1996) ("*Procter & Gamble*") (finding that two leveraged derivatives did not satisfy the *Howey* criteria and thus were not "investment contracts" or "instruments commonly known as securities"); *In re J.P. Jeanneret Associates, Inc.*, 769 F. Supp. 2d 340 (S.D.N.Y. 2011) (finding discretionary investment management contracts to be "securities" under the *Howey* test).

44 *SEC v. W.J. Howey Co.*, 328 U.S. 293, 295–96 (1946).

45 *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946).

46 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985) ("*Gary Plastic*").

47 *See Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982).

48 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 240 (2d Cir. 1985).

49 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 232 (2d Cir. 1985).

50 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 239–42 (2d Cir. 1985).

51 *SEC v. Edwards*, 540 U.S. 389 (2004).

52 *SEC v. Edwards*, 540 U.S. 389, 391–92 (2004).

53 *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1284 (11th Cir. 2002) (*per curiam*).

54 *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1285 (11th Cir. 2002) (*per curiam*).

55 *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

56 *SEC v. Edwards*, 540 U.S. 389, 395 (2004).

57 *SEC v. Edwards*, 540 U.S. 389, 397 (2004).

58 *Reves v. Ernst & Young*, 494 U.S. 56, 68 n.4 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

59 *SEC v. Edwards*, 540 U.S. 389, 396–97 (2004).

60 *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003).

61 The court also rejected the argument that an LLC membership interest constituted stock. *See supra* Note 29.

62 *Robinson v. Glynn*, 349 F.3d 166, 170–71 (4th Cir. 2003).

63 *SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007).

64 The Eleventh Circuit characterized registered limited liability partnerships as a "hybrid between general and limited partnerships." *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 756 (11th Cir. 2007).

65 *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 765–66 (11th Cir. 2007) (applying a test set forth in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), to determine when partnership interests are investment contracts); *see also United States v. Wetherald*, 636 F.3d 1315, 1326 (11th Cir. 2011) (relying on *Williamson v. Tucker* to hold that partnership interests were securities where investors in those interests had no industry experience, were not asked to vote on important decisions, sat on partnership committees that "were largely symbolic," had a "minimal" time commitment, "did not control disbursement of funds," were not consulted in filing a petition for bankruptcy and "had no say in the operations of the company").

66 *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008).

67 *United States v. Leonard*, 529 F.3d 83, 90–91 (2d Cir. 2008) (citing *SEC v. Merchant Capital, LLC*, 483 F.3d

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747 (11th Cir. 2007); *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003); and *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981)). *Accord Affco Investments 2001 LLC v. Proskauer Rose L.L.P.*, 625 F.3d 185, 191 (5th Cir. 2010) (holding that LLC interests were securities because the investors who held them were "passive" and "depended—both in reality and according to their investment contracts—upon the efforts of others for their profits").

68 *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996), *reh'g denied*, 102 F.3d 587 (D.C. Cir. 1996), *on remand*, 986 F. Supp. 644 (D.D.C. 1997).

69 Viatical settlement contracts are investment contracts in which the investor purchases an interest in the life insurance policy of a terminally ill individual, usually at a discount. Upon the death of the insured, the investor receives the proceeds of the insurance less certain costs and expenses. Viatical settlements first became increasingly common in the context of the AIDS epidemic.

70 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 538 (D.C. Cir. 1996); *see also Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144 (3d Cir. 1997) (holding an interest in a highly structured securitization transaction not to be a security under the *Howey* test because the investor retained "pervasive control" over the investment).

71 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 539–40 (D.C. Cir. 1996).

72 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996).

73 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543–44 (D.C. Cir. 1996).

74 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 548 (D.C. Cir. 1996).

75 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 549 (D.C. Cir. 1996). Significantly, the Eleventh Circuit and at least three federal district courts have declined to follow *Life Partners* and have held that viatical settlements are securities. *SEC v. Mutual Benefits*, 408 F.3d 737, 744. In *SEC v. Tyler*, No. A3:02-CV-0282-P, 2002 WL 32538418 (N.D. Tex. Feb. 21, 2002), the District Court for the Northern District of Texas distinguished *Life Partners* and held that the viatical settlements sold by the defendants were securities, based on the post-purchase efforts of the defendants to provide liquidity and despite the fact that many of the elderly purchasers were in fact unaware that they were buying viatical settlements or that the value of their investment derived in part from the defendants' post-purchase functions. Later, the District Court for the Northern District of Ohio observed in *Wuliger v. Christie*, 310 F. Supp. 2d 897 (N.D. Ohio 2004), that state courts in Arizona, Colorado, Indiana, Michigan and Ohio that had considered viatical settlements under their state securities laws had either rejected or distinguished *Life Partners*. The court found the reasoning in *Life Partners* unpersuasive, on the ground that "it is not the date of the viator's death which establishes the success of the investment but the selection by the promoter of the policy into which the investor's money is placed, based upon its expertise in assessing the viator's life expectancy and other variables, which drives the success of the investment." *Wuliger v. Christie*, 310 F. Supp. 2d 897, 907 (N.D. Ohio 2004). Accordingly, the court held the last prong of the *Howey* test to be satisfied. In 2013, the District Court for the Northern District of Illinois acknowledged recent challenges to the *Life Partners* holding and chose to adopt the Eleventh Circuit's reasoning in *Mutual Benefits*, holding that life settlements should be considered securities under federal and Illinois securities laws. *See Giger v. Ahmann*, Fed. Sec. L. Rep. (CCH) ¶ 97,773 (N.D. Ill. 2013). In 2015, the Texas Supreme Court held that viatical settlements do constitute securities under Texas securities laws, abrogating a prior decision by a Texas appellate court that had followed *Life Partners*. *See Life Partners, Inc. v. Arnold*, 464 S.W.3d 660 (Tex. 2015); *Griffitts v. Life Partners, Inc.*, No. 10-01-00271-CV, 2004 Tex. App. LEXIS 4844, 2004 WL 1178418 (Tex. Ct. App. May 26, 2004).

76 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335 (D.C. Cir. 2009).

77 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 337, 341 (D.C. Cir. 2009).

78 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 341 (D.C. Cir. 2009); *see also Shirley v. JED Capital, LLC*, 724 F. Supp. 2d 904, 911–12 (N.D. Ill. 2010) (finding that LLC interests held by a 20% equity holder constituted an investment contract because another equity holder owned two-thirds of the LLC and served as its manager with veto power over any change in manager).

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79 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 341 (D.C. Cir. 2009).

80 *SEC v. Edwards*, 540 U.S. 389 (2004).

81 *But see* CFTC Order Exempting the Trading and Clearing of Certain Products Related to SPDR ® Gold Trust Shares, 73 Fed. Reg. 31,981 (June 5, 2008), and CFTC Exemptive Order for SPDR ® Gold Futures Contracts, Comm. Fut. L. Rep. (CCH) ¶ 30,863 (June 5, 2008) (implicitly questioning whether certain exchange-traded funds owning commodity interests satisfy the "efforts of others" prong of the *Howey* investment contract criteria).

82 In a loan participation, a single bank makes a loan and assigns interests in the loan to other financial institutions. However, there is no direct contractual relationship between the borrower and the other institutions. A syndication has a similar structure, but each institution is a direct lender with respect to its portion of the loan. Commercial banks sell loan participations, arrange syndicated loans and use various other loan derivative products (*e.g.*, the fractional assignment of pieces of loans) to diversify risk, improve liquidity or comply with capital requirements and lending limits.

83 *See, e.g.*, *Union Planters National Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174 (6th Cir. 1981), *cert. denied*, 454 U.S. 1124 (1981) ("*Union Planters*"). *Compare Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144 (3d Cir. 1997) (holding that a securitization transaction did not constitute an investment contract because the investor had significant powers to control the business enterprise).

84 *See, e.g.*, *McVay v. W. Plains Service Corp.*, 823 F.2d 1395 (10th Cir. 1987).

85 *SEC v. Edwards*, 540 U.S. 389 (2004).

86 *Compare Union National Bank of Little Rock v. Farmers Bank*, 786 F.2d 881 (8th Cir. 1986) (holding that a fixed rate, short-term commercial note is not a security in part because there was no expectation of profit or capital appreciation) with *Southwest Investments I v. Midland Energy Co.*, 596 F. Supp. 219 (E.D. Mo. 1984) (holding that a contingent rate of return is expectation of profit under the *Howey* test).

Farmers Bank and similar cases turn on the underlying loan's being a normal commercial lending transaction. Therefore, loan participations not involving a normal commercial lending transaction (because, for example, the borrower is not creditworthy, there is inadequate collateral, returns on the loan are contingent on the borrower's profits, the loan participation trades at a steep discount (indicating that the "lender" probably seeks profits through increase in the resale value of the participation rather than from payment of interest on the loan)) or, where the lender is not institutional, may be investment contracts under *Howey*.

Even prior to *SEC v. Edwards*, 540 U.S. 389 (2004), plaintiffs could have argued that cases holding that a fixed rate of return fail to pass the investment contract test are no longer valid in light of the Supreme Court's statement in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 (1990), that "profit" includes a "valuable return on an investment" and specifically includes interest. In *Reves*, the court had noted that it was appropriate for "profit" to be defined differently depending on whether an instrument is being analyzed as a "note" or an "investment contract." In *Edwards*, however, the Court rejected this prior statement. *See supra* Note 59 and accompanying text.

87 *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993) ("*Banco Espanol*").

88 Brief of the SEC, *Amicus Curiae*, *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993).

89 *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 55–56 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993).

90 *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 55 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993). The lower court opinion, 763 F. Supp. 36 (S.D.N.Y. 1991), which the Second Circuit affirmed, had also ruled that the participations were not investment contracts under the *Howey* test. The Second Circuit did not consider the investment contract analysis.

91 Brief of the SEC at 3, *Amicus Curiae, Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d

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51 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993).

92 Some commercial paper is exempt from the registration requirements of the Securities Act pursuant to § 3(a)(3) thereof, and sales of other commercial paper may be structured to be exempt from registration in reliance on the exemptions provided by § 4(2) of the Securities Act or Rule 144A thereunder. *See* § 3.05[3]. However, notwithstanding these exemptions from registration, commercial paper is a security under the Securities Act, and issuers and sellers of commercial paper are subject to the fraud provisions of the Securities Act. If loan participations sold under programs like Security Pacific's were treated as securities, the sales could also be structured to be exempt from registration under the Securities Act.

93 Since the mid-1980s, banks have been selling "loan notes" similar to those sold by Security Pacific in an effort to compete with short-term commercial paper that was being offered by investment banks at a lower cost than traditional bank financing.

94 In *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808 (2d Cir. 1994), *cert. denied*, 513 U.S. 963 (1994), the Second Circuit applied the *Reves* test to mortgage participations that were sold to certain "unsophisticated investors" by way of a discretionary account. The court held that the instruments were securities, noting that (i) although it may have been a close question as to whether the sellers' motivation was accurately characterized as investment rather than commercial, the buyers' motivation was clearly investment-related, (ii) the broad-based, unrestricted nature of the sales of the instruments distinguished this case from *Banco Espanol* and supported a finding that the instruments were subject to the federal securities laws, (iii) the buyers could reasonably expect that the instruments were securities, particularly in light of their instructions to the broker for their discretionary account to make conservative, low-risk investments, most of which consisted of investment-grade bonds, and (iv) there were no other factors that reduced the risks inherent in the instruments, such as independent regulation or collateral. *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808, 812–15 (2d Cir. 1994).

95 In fact, the court in *Banco Espanol* recognized that some loan participations may be securities, stating explicitly that "even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities." *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 56 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993) (citing *Gary Plastic*).

96 *See, e.g., Realtek Industries, Inc. v. Nomura Securities*, 939 F. Supp. 572 (N.D. Ohio 1996) (holding that, because the parties expressly intended to repackage mortgage loans and issue certificates to the general public, such certificates constituted securities).

97 For a general discussion of the treatment of loan participations under the U.S. securities laws, *see* Lee C. Buchheit, *When Is a Loan Not a Loan?*, 9 INT'L FIN. L. REV. 29 (1990).

98 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DRIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.17[6][c].

98.1 For a discussion of banking laws that may be applicable to certain financial instruments issued or entered into by banks, such as deposits, *see* Robert L. Tortoriello, Derek M. Bush and Hugh C. Conroy, Jr., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. West 2017).

98.2 For a more detailed discussion of swaps and security-based swaps, *see* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.15[b].

98.3 CEA § 1a(9). Prior to 1974, the term "commodity" included only specified agricultural products. Futures contracts and commodity options involving goods other than the agricultural products specified in the CEA were not regulated under the statute. As the markets for other "goods" (including derivative financial products) developed, exchanges came to trade regulated and unregulated futures contracts side by side. The 1974 Amendments amended the definition of the term "commodity" to include, in addition to specified agricultural products, all other "goods and articles … and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in" in order to bring all futures contracts under the CEA's statutory and administrative framework. *See* CEA § 1a(9). The 1974 Amendments also included a specific provision, proposed by the Department of the Treasury, to exclude from the CEA's

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otherwise expanded jurisdiction transactions in foreign currencies and specified financial instruments—as long as those transactions were not transactions involving "the sale thereof for future delivery conducted on a board of trade."

98.4 Futures Trading Act of 1982, Pub. L. No. 97-444, tit. 1, 96 Stat. 2294 (1983). The accord is named for the then-chairmen of the SEC and CFTC.

98.5 For these purposes the term "exempt securities" means certain securities exempted under § 3 of the Securities Act or § 3(a)(12) of the Exchange Act but does not include, among other securities, municipal securities.

98.6 *See* former CEA §§ 2(a)(1)(A)(i), 2(a)(1)(B)(ii) and (iv) and 4c(f) (as amended by the CFMA, current CEA §§ 2(a)(1)(A), 2(a)(1)(C)(ii) and (iv) and 4c(f)).

98.7 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.09[1].

98.8 The Shad-Johnson Accord excluded from regulation under the CEA any "put, call, or other option on one or more securities … including any group or index of such securities, or any interest therein or based on the value thereof." *See* former CEA § 2(a)(1)(B)(i) (now CEA § 2(a)(1)(C)(i)). *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.09 for more information.

98.9 CEA §§ 4c(f) and 4m(2).

98.10 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[4][c] for more detailed discussion of hybrid instruments.

98.11 In 1987, the CFTC published for comment an advance notice of proposed rule-making in which it asserted jurisdiction over virtually all hybrid instruments, with only limited exclusions or exemptions for hybrid instruments having "*de minimis*" or "incidental" futures or commodity option features.

98.12 Pub. L. No.106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000).

98.13 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

98.14 Title VII of the Dodd-Frank Act also expanded the "security" definition in § 2(a)(1) of the Securities Act and § 3(a)(10) of the Exchange Act to cover security-based swaps.

98.15 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.15[1][a].

98.16 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5][c].

98.17 Under the CFMA, an agreement, contract or transaction between eligible contract participants that provided for the purchase or sale of one or more securities based on the occurrence of a *bona fide* contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract or transaction was excluded from the definition of "security." This exclusion was generally regarded as covering credit default swaps. The Dodd-Frank Act repealed this exclusion, instead subjecting such an agreement, contract or transaction to regulation as a swap or security-based swap.

98.18 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.15.

98.19 *See, e.g.*, § 3(a)(10) of the Exchange Act.

98.20 CEA § 2(a)(1)(C)(i).

98.21 CEA § 1a(47)(B)(iii).

98.22 *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1274 (S.D. Ohio 1996).

98.23 The *P&G* court also analyzed a second swap—referred to as the "DM swap"—which, although documented as a "floating-for-floating" interest rate swap, effectively provided for BT to pay to P&G, for

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four years, 1% on a notional amount of approximately DM 160 million in exchange for the right to receive a "spread" after one year, if the prevailing level of German four-year interest rates (actually, the "DM four-year swap rate") ever traded outside a defined range during the one-year period. This spread would be the fixed rate periodically payable, under a four-year fixed-for-floating interest rate swap, in exchange for the right to receive a floating rate payment based on the DM four-year swap rate.

98.24 The *P&G* court also considered whether the "5s/30s swap" and the "DM swap" were investment contracts under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("*Howey*"). The court ruled that the instruments did not satisfy the *Howey* test because "what is missing is the element of a 'common enterprise.'" *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1278 (S.D. Ohio 1996). In addition, the court observed, the value of both swaps depended upon market forces, not the entrepreneurial activities of BT. In reaching this conclusion, the court rejected P&G's arguments that P&G and BT had a course of dealing treating the swap agreements as securities and that the P&G swap agreements should be viewed in the context of all of BT's derivatives business.

Notably, the "investment contract" test has been used in lower courts to analyze interest rate futures, which are contracts to buy or sell government securities and which can serve the same general functions as rate protection transactions. In *P&C Investment Club v. Becker*, 520 F. Supp. 120 (E.D. Pa. 1981), the court found that the interest rate futures were not securities because their return was completely dependent on interest rate movements and did not depend on the efforts of others in a common enterprise. *But see Fisher v. Dean Witter Reynolds, Inc.*, 526 F. Supp. 558, 560 (E.D. Pa. 1981) (an interest-rate futures contract is a security, as it is a contract for the sale of the underlying security). *See also SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1390–91 (9th Cir. 1986) (sale of gold coins did not involve profits "'solely' from the efforts of others" because "profits to the coin buyer depended upon the fluctuations of the gold market"). *But see SEC v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1341 (9th Cir. 1994) (profits from interest-rate sensitive scheme attributable to promoter's efforts, rather than market movements).

For a more detailed discussion of the *Howey* "investment contract" test, *see* § 12.02[2][d].

In addition, the P&G court analyzed whether the swap agreements should be regarded as notes under *Reves*' "family resemblance test." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990), *reh'g denied*, 494 U.S. 1092 (1990) ("*Reves*"). The court found that the swap agreements, unlike traditional notes, did not involve any payment or repayment of principal. The court opined that, on balance, the swap agreements were entered into more for commercial than investment purposes, were customized for P&G and not readily tradable, and the public and, more specifically, P&G did not have a reasonable expectation that the swap agreements were securities. Though the court conceded that there may be no other regulatory scheme designed to protect counterparties to swap agreements, nonetheless, the absence of such a scheme alone was not sufficient to bring the swap agreements within the definition of a note. *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1278 (S.D. Ohio 1996). Because the swap agreements were not notes for purposes of the securities laws, the court also held that the swap agreements were not evidences of indebtedness. *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1280 (S.D. Ohio 1996).

The conclusion that swaps more generally should not be treated as notes for purposes of the securities laws would seem to be correct for a number of other reasons. Historically, the major terms of each transaction have been individually negotiated in accordance with the business needs of the parties, making it unlikely that a transaction will have equivalent value to nonparties, and these transactions have not been amenable to trading. Moreover, trading of these instruments is commonly restricted by contractual provisions that require that both parties consent to any termination or assignment of the instrument. While what is sometimes referred to as a "secondary market" in swaps and rate protection transactions has developed, this is not a market in which these instruments are traded; rather, it is a source of quotations and other information for parties seeking to enter into new transactions. A party seeking to exit an existing transaction generally would not transfer or assign such transaction, but instead would terminate the transaction at a negotiated price. When an assignment of an existing transaction does

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occur, it is generally the product of negotiations between the parties. If a party wishes to get out of a transaction without seeking the consent of its counterparty, or in circumstances where such consent is not forthcoming, the party may enter into a new transaction that offsets its economic position in the original transaction. In light of these characteristics, it is clear that the so-called "secondary market" in swaps and rate protection transactions does not constitute a secondary trading market as that term is commonly understood in the context of securities trading. Although the amendments to the CEA by the CFMA permitting greater standardization, and electronic trading, of swap agreements led to the development of markets through which new swap agreements may be entered into, that development should not affect the conclusion that swaps should not generally be treated as notes for purposes of the securities laws. Moreover, the Dodd-Frank Act excluded "notes" subject to the Acts from the definition of "swap," thereby clearly expressing congressional intent that notes be distinguished from swaps. *See* CEA § 1a(47)(B)(vii).

For a more detailed discussion of the *Reves* "family resemblance" test, *see* § 12.02[2][d].

98.25 *See Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1281 (S.D. Ohio 1996). Although the definition of security includes "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (*including any interest therein or based on the value thereof*)…." (emphasis added), § 2(a)(1) of the Securities Act; § 3(a)(10) of the Exchange Act, the court concluded that the underscored parenthetical modified only the phrase "group or index of securities," and not the terms "security" or "any option." The court went on expressly to limit its holdings to the particular leveraged derivative instruments at issue in the case, observing that "[s]ome of these derivative instruments, because of their structure, may be securities." *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1283 (S.D. Ohio 1996); *see infra* Note 29.

98.26 SEC Release No. 33-7124 (Dec. 22, 1994).

98.27 SEC Release No. 33-7124, Fed. Sec. L. Rep. (CCH) ¶85,477, p. 86,112 n.6 (Dec. 22, 1994).

98.28 In addition to the numerous other transactions entered into between Gibson Greetings and BT Securities over a period of several years, BT wrote a cash-settled call option based on the yield of a particular 30-year Treasury security. The option was exercisable at maturity and would expire if the yield on the 30-year Treasury security dropped below a designated level. SEC Release No. 33-7124 (Dec. 22, 1994). It is apparent from the SEC's characterization of this transaction that because the yield on a given security is based on its price, the SEC regards an option based on the yield of a specified debt security as an option "on any security … or group or index of securities (including any interest therein or based on the value thereof)." § 2(a)(1) of the Securities Act.

98.29 The court in *Proctor & Gamble* might have based its holding that the P&G swap was not a security on the specific characteristics of the swap (*i.e.*, the fact that the option was an embedded, nonseverable component of a bilateral executory agreement). The court's articulated reasoning, however, is unsatisfactory in a number of respects. First, the court offered no predicate analysis of the statutory text justifying reference to the legislative history of the provision. In connection with its discussion of the provision's legislative history, the court also neglected to consider whether its holding was consistent with the jurisdictional framework established under the CFTC-SEC jurisdictional accord of which the relevant statutory text formed a part and ignored relevant text in parallel provisions of the CEA. Finally, the court's discussion of the statutory term "option" was largely conclusory.

98.30 *Caiola v. Citibank*, 295 F.3d 312 (2d Cir. 2002); *see also* § 11.11[2].

98.31 *Caiola v. Citibank*, 137 F. Supp. 2d 362 (S.D.N.Y. 2001), *rev'd*, 295 F.3d 312 (2d Cir. 2002).

98.32 Caiola also claimed that the provisions of the CFMA that amended § 10(b) of the Exchange Act to reach swap agreements should be applied retroactively even if the arrangements were not securities themselves. However, the Second Circuit declined to address the question of retroactivity as it found that Caiola failed to properly raise the issue in the district court. *See Caiola v. Citibank*, 295 F.3d 312, 327 (2d Cir. 2002).

98.33 *See Caiola v. Citibank*, 295 F.3d 312, 326 (2d Cir. 2002). The court noted that an option on an index of securities, which is defined as a security under § 3(a)(10), is settled by cash since physical delivery is not

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possible. The court continued that "there is no basis for reading into the term 'option' as used in the phrase [in § 3(a)(10)] 'option … on any security' a limitation requiring a particular method of settlement—a limitation that clearly does not apply to 'option' as used in the phrase 'option … on any … index of securities.'" *Caiola v. Citibank*, 295 F.3d 312, 327 (2d Cir. 2002). There are several other instances where the SEC has taken the position that options whose value is derivatively based on the value of a security or group of securities—even at multiple levels of abstraction—are securities. For example, the SEC has noted that it would treat options on the S&P 500 Dividend Index as securities. *See* CBOE Rule Change, SEC Tracker Daily, SR-CBOE-2009-022 (Dec. 10, 2009). In another release, the SEC has stated that it would treat options based on the occurrence of credit events in the debt securities of one or more issuers as securities: "the credit default options proposed by CBOE are securities because they are options based on the value of a security or securities and because they are options on an interest in, or based on the value of an interest in, a security or securities." *See* Order Granting Approval of a Proposed Rule Change to List and Trade Credit Default Basket Options, as Modified by Amendment No. 3, and Designating Credit Default Basket Options as Standardized Options under Rule 9b-1 of the Securities Exchange Act of 1934, SEC Release No. 34-56275 (Aug. 17, 2007). Lastly, we note that the SEC has treated options on volatility indices based on the value of securities as securities. *See* Order Granting Approval to the Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to Options on Certain CBOE Volatility Indexes, SEC Release No. 34-49563 (Apr. 14, 2004). In this order, the SEC does not explicitly state that such options are securities under § 3(a)(10) of the Exchange Act; however, the context of the order and the SEC's statement that "the CEA does not apply to the volatility index options CBOE proposes to list and trade" make it clear that the SEC believes they are. Order Granting Approval to the Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to Options on Certain CBOE Volatility Indexes, SEC Release No. 34-49563 (Apr. 14, 2004).

98.34 A collar has option-like characteristics in that, for example, one party's exposure to loss has been limited in the context of a decline in the price of the stock to the strike price of the put option. A collar has swap-like or futures-like features in that each party has contingent exposure to loss and contingent opportunity for gain. As the exercise prices of the two options converge, the instrument becomes more similar economically to an equity swap or futures contract.

98.35 An example of a deep-in-the-money option is an option in which Party A has the right to purchase from Party B in three months for $25 per share a stock that has a current market value of $100 per share. Such an agreement has option-like characteristics in that, for example, Party A's exposure to loss has been limited to its premium, Party A has no additional exposure to loss resulting from a decline in the price of the stock below $25, and Party A is not contractually obligated to purchase the stock. The agreement may be characterized as having swap-like or futures-like features in that each party has contingent exposure to loss and contingent opportunity for gain. Party A may be said to have prepaid its contingent future loss through the payment of the intrinsic value component (the "in-the-money"—as opposed to the "time value"—component) of the option premium.

98.36 This discussion is not intended to address situations in which similar economic results are obtained by the execution of two or more independent option transactions. An analysis of the circumstances in which multiple contemporaneous option transactions would be integrated for regulatory purposes would necessarily be fact-dependent. *Cf. In re Thrifty Oil Co.*, 212 B.R. 147 (Bankr. S.D. Cal. 1997) (declining to integrate related contemporaneous interest rate swap and loan transactions).

98.37 *See, e.g.*, Title VII Product Definitions Final Rule, 77 Fed. Reg. 48,208, 48,260 (Aug. 13, 2012) (explaining that the name or label used by the parties to refer to a transaction is not determinative of whether it is a swap or security-based swap); *In re Wright*, CFTC Docket No. 97-02 (Oct. 25, 2010) ("[T]he Commission applies a 'facts and circumstances' test rather than a bright-line test focused on the contract's terms.").

98.38 *See, e.g.*, *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (evaluating whether a particular instrument was a security); *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989); *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982) (evaluating whether particular transactions constituted

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futures contracts); *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 547 (7th Cir. 1989) ("Words are useful only to the extent they distinguish some things from others; symbols that comprise everything mean nothing").

98.39 *See, e.g.*, *Progressive Corp. v. United States*, 970 F.2d 188, 193–94 (6th Cir. 1992) (call option should be treated for tax purposes as the equivalent of a contractual obligation to sell where it is so deep-in-the-money that exercise is "virtually guaranteed"); IRS Revenue Ruling 82-150, 1982-2 C.B. 110 (taxpayer who purchased a call option with strike price equal to 30% of the fair market value of the underlying stock treated as the owner of the stock); *In re Berge*, 32 B.R. 370, 372 (Bankr. W.D. Wis. 1983) (equipment lease with an option to purchase was not a true lease where the purchase option was for a price so nominal that, at the time the lease was entered into, exercise of the option was "virtually certain" as a matter of rational business judgment); *Gordon & Co. v. Board of Governors of the Federal Reserve System*, 317 F. Supp. 1045 (D. Mass. 1970) (declining, based on improbability of success on the merits, to enjoin an interpretation of the Board that a 30-day call option on a stock with a strike price of 70% of the stock's market value constituted an extension of credit because the likelihood that the option would be exercised would render the transaction more akin to a present sale of the stock with a 30% down payment and an extension of credit for the remaining 70% of the purchase price).

98.40 CFTC Interpretative Letter No. 94-32, Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994); *see also* CFTC Interpretative Letter No. 94-93, Comm. Fut. L. Rep. (CCH) ¶26,249 (July 27, 1994) (status of financial Instruments indexed to individual stocks) (financial instruments economically equivalent to options on individual stocks—§ 2(a)(1)(B)(v)).

98.41 CFTC Interpretative Letter No. 94-32 (status of financial instruments indexed to individual stocks), Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994).

98.42 This is an amount, calculated on the basis of the historical price performance of the stock over the preceding one-year period, equal to the maximum deviation from the forward value of the stock over a one-year period that is likely to be exceeded only with a probability of roughly 32%. By way of example, given a mean forward stock price of $25 and an annualized standard deviation of 20% (or $5.00), there would be a 68% probability, at the end of one year, that the value of the stock would fall within the range bounded on the lower side by $20 ($25 minus $5) and on the higher side by $30 ($25 plus $5). Conversely, there would be a roughly 16% likelihood that the price of the stock would fall above, and a 16% likelihood that the price of the stock would fall below, the specified range. This translates, in the case of an individual option, to a probability of non-exercise roughly equal to 16%. If one were to employ the framework for analysis suggested by decisions such as those cited in *supra* Note 39, a compelling argument can be made that an option having a 16% probability of nonexercise (such as the options proposed in the no-action request) is not virtually certain of exercise and, accordingly, should be respected as an option.

98.43 CFTC Interpretative Letter No. 94-32, Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994), at 41,344.

98.44 CFTC Interpretative Letter No. 94-32, Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994), at 41,346 (citing *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989), and observing that the one-way indexing characteristic of an option derives from its having a strike price that is out-of-the-money).

98.45 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.14. Certain swaps based on loans are also security-based swaps under the Dodd-Frank Act. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.17[3].

98.46 § 3(a)(68) of the Exchange Act.

98.47 § 3(a)(10) of the Exchange Act.

98.48 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.01.

98.49 CEA § 2(a)(1)(A).

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99 For example, the Supreme Court implied in *Howey* that the land and service contract transactions might not have been considered to involve securities if the investors had lived near the citrus groves and had expertise and equipment to manage the groves sufficient to lessen their reliance on defendants.

100 Analyzing the instruments under *Reves*, the court noted that the transaction was fundamentally commercial in nature in that the repackaged loans were effectively the seller's inventory rather than an investment whose outcome was tied to the profitability of the seller. In addition, the instruments were sold to a very specialized and sophisticated secondary market and the existence of collateral was a risk-reducing factor leading the court to hold that the instruments were not notes. *Resolution Trust Corp. v. Stone*, 998 F.2d 1534, 1528–29 (10th Cir. 1993). The court also found that the instruments were not investment contracts under the *Howey* test because investors received specified interest payments rather than dividends tied to the profitability of the seller. *Resolution Trust Corp. v. Stone*, 998 F.2d 1534, 1540–41 (10th Cir. 1993).

101 Several structures have been used to repackage mortgage loans. For example, the resulting instrument may evidence an equity-type interest in the pool of loans (such as mortgage pass-through certificates) entitling the holder to a proportional share of payments on the underlying loans. In other structures (for example, collateralized mortgage obligations), the instrument is characterized as a debt obligation that is collateralized by the underlying mortgage loans. *But see Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993) (holding that car loans, repackaged with enhancements such as a buy-back guarantee and insurance, and sold on the secondary market, were not securities).

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