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## The Taxonomy of Global Securities: is the U.S. Definition of a Security too Broad?

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# The Taxonomy of Global Securities: is the U. S. Definition of a Security too Broad?

*By Frederick H. C. Mazando\**

*Abstract: This Article gives a fresh perspective on the perennial issue of the dearth of effective global securities rules. It argues that the disparate global securities definitions are a critical, but often overlooked, issue in global securities regulations. After all, the global trade in securities developed and grew exponentially in the last three decades without a securities treaty or effective global securities rules largely because there is no global consensus on what securities are or how best to regulate them. The stark differences between the U.S. Definition of a “security” and its foreign counterparts inspired this Article. Accordingly, it singles out and holistically compares the notoriously broad U.S. federal securities laws definition of a “security” with its foreign counterparts in four major global financial jurisdictions. In doing so, this Article illustrates the nature and extent of the disparate global securities definitions. Furthermore, this Article highlights areas of harmonizing global securities definitions. It concludes that the U.S. Definition is too broad, rigid, and obsolete relative to its foreign counterparts, recent global financial market developments, and trends in global securities definitions. Finally, it offers a harmonized U.S. Definition of a “security.”*

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## I. INTRODUCTION

At the height of the global financial bubble in 2007, approximately two-thirds of U.S. investors owned securities of non-U.S. companies; the U.S. gross trading activity in foreign securities alone was \$7.5 trillion; and foreign trading activity in U.S. securities exceeded \$33 trillion.<sup>1</sup> The statistical comparison of the global trade in “U.S. securities” and “foreign securities” suggests that securities are homogeneous globally when, in fact, the concept, meaning, regulatory treatment, and use of the term “securities” varies significantly between countries and, more ascetically, between the United States and other major global securities markets. Quintessential securities, such as stocks and bonds, still dominate the global trade in securities,<sup>2</sup> but the definition and regulatory treatment of these securities and myriad other financial activities differ considerably across the globe depending on how the financial sector is structured and regulated in each country.<sup>3</sup> Thus, this Article analyzes the disparate global concepts and definitions of a “security” by comparing the scope of the U.S. federal securities laws definition of a security<sup>4</sup> with its counterparts in a subjective sample of four major global and regional financial centers: the United

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<sup>1</sup> Christopher Cox, Chairman, Sec. Exch. Comm’n, International Business —An SEC Perspective, Address at the American Institute of Certified Public Accountants’ International Issues Conference (Jan. 10, 2008), *available at* <http://www.sec.gov/news/speech/2008/spch011008cc.htm>.

<sup>2</sup> See DEP’T OF THE TREASURY, FED. RESERVE BANK OF N.Y. & BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT ON FOREIGN PORTFOLIO HOLDINGS OF U.S. SECURITIES AS OF JUNE 30, 2010, 3–5 (2011).

<sup>3</sup> See COMM. ON CAPITAL MARKETS REGULATION, THE GLOBAL FINANCIAL CRISIS 211–17 (2009).

<sup>4</sup> In this Article, “federal securities laws” will refer to the four main laws the SEC administers: Securities Act of 1933, 15 U.S.C. §§ 77a to 77aa (2012); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78pp (2012); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (2012); and Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2012).

Kingdom, Australia, India, and South Africa (collectively, Selected Countries).

Securities are unique in that they developed and operate globally without global securities treaties, legally binding or coordinated global securities rules, or even global consensus on what they are or how best to regulate them globally. The global disparities in securities laws are, therefore, as old as global finance itself. Nonetheless, the global disparities in securities laws assumed greater significance during and immediately after the 2007–2008 global financial crisis, as the world grappled with the exponential growth of global finance in the last three decades and the need to regulate it.<sup>5</sup> Traditional banks and non-banking financial institutions, like hedge funds and private equity funds, operate globally, and markets for financial activities are global.<sup>6</sup> For example, the total global issuance of collateralized debt obligations (CDOs)—re-securitizations of other forms of debt—peaked in 2007 at \$179 billion.<sup>7</sup> Moreover, the recent global financial crisis originated in the U.S. subprime mortgage and other securitized debt markets, but it quickly spread globally, because U.S. financial institutions—fueled partly by foreign capital—globally issued, held, and sold toxic CDOs, Residential-Mortgage Backed Securities (RMBSs), Credit Default Swaps (CDSs), and other securitized debt.<sup>8</sup> These toxic securities that supported the U.S. housing market were purchased by “foreign countries, their central banks, and their commercial banks” as well as other investors.<sup>9</sup>

Typically, the global securities regulatory framework supervising the exponential global trade in securities of the last three decades consists of a bewildering web of “international bodies that have their own mandates”<sup>10</sup> and similarly dizzying numbers of national laws that vary significantly between countries depending on how the financial industry is structured and regulated in each country, including the concept, definition, and use of the term “security.”<sup>11</sup> For example, the U.S. Definition of a “security” is

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<sup>5</sup> See, e.g., COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 211. This Article does not discuss global finance or the recent global financial crisis except when necessary to demonstrate how the global variations in securities definitions affect global finance and its regulation.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 26.

<sup>8</sup> See *id.* at 7–23.

<sup>9</sup> JOHN R. TALBOTT, CONTAGION: THE FINANCIAL EPIDEMIC THAT IS SWEEPING THE GLOBAL ECONOMY. . . AND HOW TO PROTECT YOURSELF 105 (2009).

<sup>10</sup> Joseph J. Norton, *Banking Law Reform and Users-Consumers in Developing Economies: Creating an Accessible and Equitable Consumer Base from the “Excluded”*, 42 TEX. INT’L L.J. 789, 793 (2007).

<sup>11</sup> See generally David Zaring, *International Institutional Performance in Crisis*, 10 CHI. J. INT’L L. 475 (2010) (discussing the global financial regulatory scheme).

synonymous with “securities” in India and South Africa, “investments” in the U.K., and “financial product” in Australia.<sup>12</sup> Among other things, the absence of a global definition of “security” traditionally vitiated against effective global financial rules; it caused disputes between countries during and immediately after the recent global financial crisis; it stalled and eventually killed global efforts to create legally binding global financial rules through a global treaty, international organizations, or the harmonization of global financial laws;<sup>13</sup> and it affects global coordination between countries and international financial organizations.<sup>14</sup>

The impact of the global variations in the definition of security is aptly illustrated by the catastrophic global financial regulatory failures that precipitated the recent global financial crisis. In fact, the principal global financial regulatory failures preceding the recent global financial crisis involved the ineffective regulation of derivatives and securitized debts in the United States and abroad rather than the inadequate or ineffective regulation of the financial institutions that created them.<sup>15</sup> In particular, the United States did not effectively regulate complex financial products such as CDSs, because by definition, CDS involves features of commodities, securities, and insurance that overlapped its fragmented financial regulations.<sup>16</sup> Additionally, the Gramm-Leach-Bliley Act of 1999 excluded all security-based and non-security-based swap agreements (in other words, CDSs), from the definition of a regulated security.<sup>17</sup> Amendments to the Commodities Exchange Act in 2000 also provided a blanket exemption for CDSs in commodities regulation.<sup>18</sup>

Abroad, the U.K. and Australia also failed to regulate CDSs that were created or sold in their markets. The CDSs created by American

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<sup>12</sup> See *infra* Part II.

<sup>13</sup> See COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 211–17.

<sup>14</sup> See COMMODITIES AND FUTURES TRADING COMM’N & SEC. EXCH. COMM’N., A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION 80–88 (2009).

<sup>15</sup> See COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 34–37; Jonathan C. Lipson, *Enron Rerun: The Credit Crisis in Three Easy Pieces*, in LESSONS FROM THE FINANCIAL CRISIS 43, 45–46 (Robert W. Kolb ed., 2010).

<sup>16</sup> See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-216, FINANCIAL REGULATIONS: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 40–41 (2009); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 493, 528–29 (2009) (discussing how anti-fraud and anti-manipulation provisions of the Securities Act and Exchange Act are the only significant federal laws that applied to CDOs and CDSs).

<sup>17</sup> McCoy et al., *supra* note 16, at 528–29.

<sup>18</sup> See *id.*; Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 171 (2007) (discussing how CDSs enjoy a blanket exemption under the Commodities Exchange Act).

International Group (AIG) in its offices in London, U.K. nearly felled its U.S. and global operations.<sup>19</sup> Lehman Brothers misled Australian municipal government investors regarding the risks of CDOs it sold to them.<sup>20</sup> Both Australia and the U.K. regulate swaps and other derivatives disparately as “investments” and “financial products” respectively.<sup>21</sup> The disparate definitions and regulatory treatment of CDSs and CDOs in the United States, the U.K. and Australia inhibited the creation of similar or globally coordinated financial rules for such similar financial products that could have allowed regulators to detect and prevent issues that caused the recent global financial crisis. Instead, major U.S. and European banks—which historically are the most heavily regulated entities—failed; others were acquired, bailed out, or placed in conservatorship, or became bank holding companies because of their participation in lightly or unregulated financial products such as CDOs and CDSs.<sup>22</sup>

The variations in global securities definitions also fueled serious disputes between countries over how to manage failed global financial firms and the optimum financial regulations for the financial activities and institutions that caused the recent global financial crisis.<sup>23</sup> For example, Britain and Iceland engaged in a war of words over who should take responsibility for failed Icelandic banks doing business in the U.K.<sup>24</sup> Furthermore, the parallel bankruptcy proceedings for Lehman Brothers in the United States and the U.K. were contentious and messy.<sup>25</sup> Finally, the United States and Europe also disagreed over the regulation of credit rating agencies, securitized debt, and hedge funds, leading each country to pursue different regulations for similar financial activities and institutions.<sup>26</sup>

Although disputes over the classifications of globally traded financial products are not the only or the primary factor inhibiting coordinated global financial rules, they have, nonetheless, stalled and ultimately killed recent global efforts to harmonize global financial rules through an international treaty or global financial regulators.<sup>27</sup> In 2010, for example, France tried but failed to get G-20 world leaders to adopt the “Bretton Woods 3” treaty or a similar international financial treaty as powerful as the World Trade

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<sup>19</sup> See COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 211; McCoy et al., *supra* note 16, at 530.

<sup>20</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 16, at 41.

<sup>21</sup> See *infra* Parts II.B.2, II.C.2.

<sup>22</sup> See COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 18–27.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 216.

<sup>26</sup> *Id.* at 216–17.

<sup>27</sup> See *id.* at 213. For arguments against international financial regulations, see Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257 (2011); Dani Rodrik, *A Plan B for Global Finance*, ECONOMIST, Mar. 14, 2009, at 80.

Organization treaty.<sup>28</sup> Bretton Woods 3 would have, among other things, coordinated world financial regulations and accounting rules through international organizations such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO).<sup>29</sup> These and other international organizations provided the impetus toward global financial regulatory harmonization before the financial crisis, but they have differed significantly in how they define a security.<sup>30</sup> Ultimately, leaders of the G20 countries established the Financial Stability Board (FSB) “to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory, and other financial sector policies,” without identifying and classifying financial activities subject to such international coordination.<sup>31</sup>

Finally, the variations in global definitions of securities have hindered international coordination between nations and international organizations on securities regulation matters. Most notably, U.S. securities and commodities regulators, the U.S. Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) have separately entered into copious bilateral and multilateral enforcement cooperation agreements (MOUs), often with the same foreign regulators and global organizations, because, unlike the United States, most countries and global organizations define “security” to include futures.<sup>32</sup> Additionally, long before the current global financial crisis, other countries often complained that the United States’ multiple financial regulators prevent it from establishing a central point of contact and position at global fora, such as the Basel Committee on Banking Supervision Accords’ process for developing global capital standards.<sup>33</sup> For example, the U.S. Federal

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<sup>28</sup> See COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 213; Katrin Bennhold, *At Davos, Sarkozy Calls for Global Finance Rules*, N.Y. TIMES, Jan. 28, 2010, at B3.

<sup>29</sup> See COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 213.

<sup>30</sup> *Id.*

<sup>31</sup> Overview, FIN. STABILITY BOARD, <http://www.financialstabilityboard.org/about/mandate.htm> (last visited Mar. 3, 2012).

<sup>32</sup> See COMMODITIES AND FUTURES TRADING COMM’N & SEC. EXCH. COMM’N., *supra* note 14, at 80–88; BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK 2 (2004), available at <http://www.bis.org/publ/bcbs107.pdf>.

<sup>33</sup> See U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 16, at 47. The Basel Committee consists of the central bank governors and national bank regulators of the G-20 countries charged with “adopting international standards of prudential supervision covering such issues as capital adequacy and consolidated supervision of a bank’s cross-border operations.” KERN ALEXANDER ET AL., GLOBAL GOVERNANCE OF FINANCIAL SYSTEMS: THE INTERNATIONAL REGULATION OF SYSTEMIC RISK 35 (2006).

Reserve Board and thirty of the largest U.S. banks supported the new capital standards at the 2004 (Basel II) round of negotiations while the U.S. Federal Deposit Insurance Corporation, the U.S. Office of the Comptroller, and ninety-nine percent of all other U.S. depository institutions all opposed these same standards.<sup>34</sup>

This Article focuses on the United States and the Selected Countries because their concepts, definitions, and regulations of securities have a common English origin, yet these countries pursued quite different definitions and regulations of securities.<sup>35</sup> The statutory scope of the United States' and the Selected Countries' analogous definitions of securities fall into three broad categories: (1) securities and security-based futures used solely in the United States; (2) securities and futures in India and South Africa; and (3) securities, futures, insurance, and other instruments regulated as "investments" and "financial products" in the U.K. and Australia, respectively.<sup>36</sup> Moreover, the United States and the Selected Countries have become major global and regional securities jurisdictions and leading members of global securities standard-setting organizations like the G-20 and IOSCO over the years.<sup>37</sup> Thus, these countries shape global trade in securities and its regulation.<sup>38</sup>

The United States and the Selected Countries enacted significant financial regulatory reforms after the recent global financial crisis, but they all left their disparate definitions of "securities" largely untouched despite their vital contributions to the regulatory failures leading up to the crisis.<sup>39</sup> These countries are not alone in overlooking the variation in global definitions of a security and the regulatory issues posed by such variation. Indeed, there is virtually no academic literature on the subject. This Article, therefore, tries to fill that vacuum and initiate debate on the subject by illustrating the nature and extent of the disparate global definitions of a security. It does so through a comparative analysis of the U.S. Definition of a security and its counterparts in the Selected Countries. It finds the U.S. Definition of a security too broad, too rigid, and obsolete relative to recent securities market developments and global trends in securities definitions. Even so, this Article does not propose an ideal or universal concept or definition of a security. Doing so requires harmonizing global securities rules, which is outside the scope of this Article. Instead, this Article offers

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<sup>34</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 16, at 47 nn.72–73; Christopher Whalen, *Gunfight at the Basel II Corral*, INT'L ECON., Winter 2004, at 73, available at [http://www.rcwhalen.com/pdf/TIE\\_BASEL\\_II\\_0204.pdf](http://www.rcwhalen.com/pdf/TIE_BASEL_II_0204.pdf).

<sup>35</sup> See *infra* Part II.

<sup>36</sup> See *infra* Part II.

<sup>37</sup> See, e.g., ALEXANDER ET AL., *supra* note 33.

<sup>38</sup> *Id.*

<sup>39</sup> See *infra* Part II.

a U.S. Definition of security, harmonized with its counterparts in the Selected Countries that fits within the current U.S. federal securities regulatory framework.

This Article contributes to the field of, and literature on, U.S. and international securities and financial regulations. More specifically, it contributes to the ongoing global effort to harmonize global securities rules by introducing, identifying, and highlighting the nature, extent, and influence of the disparate global securities definitions that impair such harmonization efforts and areas of harmonizing global securities definitions. It also contributes to the perennial debate over the proper language, meaning, and scope of the U.S. Definition of security by offering a harmonized and contemporary definition of security that fits within the United States' fragmented regulatory framework.<sup>40</sup>

After this introduction, Part II analyzes the concept, definition, and regulatory treatment of a "security" for each country from both statutory and judicial perspectives, and discusses the scope of each country's definition. Part III compares the scope of the U.S. Definition with those of the Selected Countries. Part IV explores the statutory language and structure of the U.S. and the Selected Countries' Definitions of security to identify and compare the variances between them. Part V identifies and discusses the causes and nature of the variations between the U.S. and the Selected Countries' Definitions of security. This Part also draws on global trends in defining a security to propose a modernized or harmonized U.S. Definition. Part VI concludes this Article.

## II. THE U.S. AND SELECTED COUNTRIES' DEFINITIONS OF SECURITY

The modern concepts of securities and securities regulations—which England subsequently spread to its former colonies around the world, including the United States, Australia, India, and South Africa—can be traced back to 1553 and 1720, respectively.<sup>41</sup> In 1553, England established the Muscovy Company—the first major English business to be legally constituted by Royal Charter as a "joint-stock company" (as opposed to medieval shipping partnerships)—to conduct trade with Russia.<sup>42</sup> The Muscovy Company could not finance the costly Russian trade privately. So, it raised money by selling £6,000 in shares at £25 each, mainly to

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<sup>40</sup> See, e.g., William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311, 318 n.24, 324 n.52 (1984); Park McGinty, *What is a Security?*, 3 WIS. L. REV. 1033, 1035 (1993).

<sup>41</sup> See STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS 1690–1860*, at 23, 41 (1998).

<sup>42</sup> *Id.* at 23–24.

merchants, in return for a right to a portion of any profits eventually made.<sup>43</sup>

The idea of selling shares of companies to raise capital caught on quickly in England. It is estimated that by 1695, shares of over 150 foreign trade companies and other local enterprises engaged in manufacturing, insurance, mining and banking, and shares of public debt (jointly referred to as “stock” until the nineteenth century) traded publicly in the coffee houses of London.<sup>44</sup> In 1698, London broker John Castaing began to issue, “at this Office in Jonathan’s Coffee-house,” a list of stock and commodity prices called “The Course of the Exchange and other things,” which marked the earliest evidence of organized trading in marketable securities or the secondary securities markets.<sup>45</sup>

The rapid growth of share-trading, or “stockjobbing” as it was commonly called, attracted insider-trading, market-rigging incidents, deceit, and other forms of ill-practices that led the English Parliament to pass its first ever securities law in 1697.<sup>46</sup> The law to “restrain the number and ill-practice of brokers and stockjobbers” required all brokers to be licensed and to take an oath promising to act lawfully.<sup>47</sup> The birth of modern securities regulation in the United States and the Selected Countries, however, is more appropriately traced to the first stock market crash in English history, referred to as the South Sea Bubble of 1720.<sup>48</sup>

The South Sea Company at the center of the 1720 English stock market crash was chartered in 1711 with an exclusive mandate to trade with Spanish colonies in South America.<sup>49</sup> Fueled by public debt, government guarantees, and talking up its stock by spreading rumors about new ventures in the New World, the South Sea Company became the dominant joint-stock company in England in 1720.<sup>50</sup> The bubble burst when its stock started the year at £130 per share and rose to £1,050 by June before plunging to £310 in September and settling at £124 each by December 1720.<sup>51</sup> Many investors, including approximately 40,000 ordinary people

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<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 24; LARRY NEAL, THE RISE OF FINANCIAL CAPITALISM: INTERNATIONAL CAPITAL MARKETS IN THE AGE OF REASON 64 (1990).

<sup>45</sup> *Our History, LONDON STOCK EXCHANGE*, <http://www.londonstockexchange.com/about-the-exchange/company-overview/our-history/our-history.htm> (last visited Nov. 10, 2012).

<sup>46</sup> *Id.* at 39–40.

<sup>47</sup> 8 & 9 Will. 3, c. 32 (1697) (Eng.).

<sup>48</sup> BANNER, *supra* note 41, at 41–44.

<sup>49</sup> *Id.* at 42.

<sup>50</sup> *See id.* at 43–44.

<sup>51</sup> *Id.* at 44; Robert Sprague & Mary Ellen Wells, The Supreme Court as Prometheus: Breathing Life into the Corporate Supercitizen (August 2011) (unpublished manuscript), available at [http://alsb.roundtablelive.org/Resources/Documents/NP%202011%20Sprague\\_Wells.pdf](http://alsb.roundtablelive.org/Resources/Documents/NP%202011%20Sprague_Wells.pdf).

who owned shares of national debt, lost their life savings, causing a public outcry that forced the English Parliament to pass the Bubble Act of 1720.<sup>52</sup>

In addition to regulating the pervasive speculation and volatility in the securities markets in England and its North American colonies, the Bubble Act abolished joint-stock corporations in England until its repeal in 1825.<sup>53</sup> England extended the Bubble Act to its North American colonies in 1741.<sup>54</sup> In fact, the Bubble Act was the last major standalone securities statute in the United States and the Selected Countries until the twentieth century. The United States and Selected Countries enacted their first and current securities statutes in the following order: United States in 1933; U.K. in 1986; Australia in 1989; India in 1992; and South Africa in 2005.<sup>55</sup>

Despite their common origin, the U.S. and Selected Countries' definitions of security vary significantly with each other, and with the original English concept, use, and definition of "securities." First, the United States, India, and South Africa still use the term "securities" while the U.K. and Australia use "investments" and "financial products," respectively.<sup>56</sup> Second, the Selected Countries largely define "securities" as shares of a company, and until recently, each Selected Country regulated securities under their corporate laws.<sup>57</sup> Finally, not all countries define "securities" to include commodities despite the fact that England's initial definition and regulation of "securities" did not distinguish between corporate stock and commodities.<sup>58</sup> Indeed, long before the introduction of joint-stock companies in 1553, England proscribed speculation in food and grain as statutory offenses, as well as common law crimes of forestalling, engrossing, and regrating.<sup>59</sup> These countries' definitions of security are identified and discussed below in the order in which these countries enacted their current securities laws, and coincidentally, in descending order based on the size of their financial markets: United States, United Kingdom, Australia, India, and South Africa.

#### A. The United States

Although U.S. securities developed simultaneously with that of its former colonial master England, the American Revolution of 1776 marked the birth of the true U.S. securities regime.<sup>60</sup> Pressed for funds to finance

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<sup>52</sup> BANNER, *supra* note 41, at 75, 94 (citing 6 Geo. 1, c. 18 (1720) (Eng.)).

<sup>53</sup> *Id.* at 75–76.

<sup>54</sup> *Id.* at 126–27 (citing 14 Geo. 2, c. 37 (1741) (Eng.)).

<sup>55</sup> *See infra* Parts II.A–II.E.

<sup>56</sup> *See infra* Parts II.A–II.E.

<sup>57</sup> *See infra* Part IV.A.1.

<sup>58</sup> *See supra* text accompanying note 45.

<sup>59</sup> *See* BANNER, *supra* note 41, at 15.

<sup>60</sup> *See id.* at 122–31.

its war against England, the Continental Congress and state governments issued their first government bonds in 1776 to pay soldiers and military suppliers.<sup>61</sup> In addition to soldiers who were issued debt securities as salaries, Americans lent money to state and national governments, and bought shares in state and nationally chartered corporations to patriotically support the state governments in time of war.<sup>62</sup> The Continental Congress and the states chartered more than thirty companies in the 1780s.<sup>63</sup> By 1787, American merchants most familiar with the English securities markets had established sizeable stock and commodity brokerages in Boston, New York, and Philadelphia to trade in commodities, currencies, land, insurance, and stocks of corporations, partnerships, and public debt.<sup>64</sup>

The U.S. federal government ceased to be a major player in the U.S. securities markets and its regulation starting in 1794, in part, because of its successful efforts to retire federal debts.<sup>65</sup> Until 1933, Congress left it to the states to regulate securities markets, with the exception of emergency war-time taxes on securities transfers in 1798, 1862, 1914, and 1917.<sup>66</sup> By 1933, all states, except Nevada, had enacted securities statutes commonly referred to as “blue sky” laws.<sup>67</sup> Today, state and federal governments share responsibility for policing U.S. securities markets, with federal laws regulating interstate securities transactions.<sup>68</sup>

### *1. The U.S. Securities Regulatory Scheme*

The widespread financial abuses of the 1920s led to the Wall Street crash of 1929, which triggered the Great Depression and prompted Congress to enact six federal securities laws between 1933 and 1940.<sup>69</sup> Three of those securities statutes constitute the principal U.S. federal securities statutes today: (1) the Securities Act of 1933 (Securities Act), which regulates the primary securities markets; the Securities Exchange Act of 1934 (Exchange Act), which regulates the secondary securities markets; and (3) the Investment Company Act of 1940 (Investment Company Act), which regulates the pooled investment industry.<sup>70</sup> These and other federal

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<sup>61</sup> *Id.* at 129.

<sup>62</sup> *Id.* at 147.

<sup>63</sup> *Id.* at 129.

<sup>64</sup> BANNER, *supra* note 41, at 130.

<sup>65</sup> *Id.* at 192–94.

<sup>66</sup> *Id.* at 170.

<sup>67</sup> M.G. Warren, *Reflection on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 515 (1984).

<sup>68</sup> *Id.* at 497.

<sup>69</sup> See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194–95 (1976); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959–1960).

<sup>70</sup> See *supra* note 4.

securities laws are primarily supervised by the SEC, an independent agency of the U.S. federal government.

The United States also enacted the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in response to the corporate scandals of 2001–2002 and the financial crisis of 2007–2008, respectively.<sup>71</sup> The Sarbanes-Oxley Act included, among other things, regulations related to the quality of financial reporting for publicly traded corporations while the Dodd-Frank Act made significant amendments to the three principal federal securities laws, including to the definition of a security.<sup>72</sup>

Thus, the United States passed virtually all its significant federal securities laws in response to financial crises or corporate accounting scandals. Not surprisingly, U.S. federal securities laws are generally ad hoc regulations designed primarily to regain investor confidence through investor protections against fraud, to prevent a recurrence of the abuses that caused the financial crises, and to punish future wrongdoers, all of which is reflected by the broad language, meaning, and scope of the federal securities laws definition of a security.<sup>73</sup>

## 2. A Security Under the U.S. Federal Securities Laws

The United States employs a “functional” financial regulatory system that “maintains separate regulatory agencies across segregated functional lines of financial services, such as banking, insurance, securities and futures.”<sup>74</sup> Accordingly, federal securities laws apply only to an arrangement or scheme that qualifies as a security.<sup>75</sup> The four federal securities laws each define a “security” in substantially similar language.<sup>76</sup> Federal courts have ruled, for example, that despite the minor differences between the Securities Act and Exchange Act definitions of a “security,”

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<sup>71</sup> See Howell E. Jackson, *Variations in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253 (2007); Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 88 WASH. U. L. REV. 1045 (2005) (discussing the mutual funds scandals of 2003–2004 and the SEC’s response).

<sup>72</sup> See, e.g., Dodd-Frank Act §§ 761(a)(2), 768 (a)(1) (adding “security-based swap” to the Exchange Act and Securities Act, respectively).

<sup>73</sup> See *Hochfelder*, 425 U.S. at 195; Landis, *supra* note 69.

<sup>74</sup> DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 4 (2008).

<sup>75</sup> See McGinty, *supra* note 40; Williamson B.C. Chang, *Meaning, Reference, and Reification in the Definition of a Security*, 19 U.C. DAVIS L. REV. 403, 421 n.92 (1986) (“The very nature of the concept of a security is that it triggers the application of the securities acts.”).

<sup>76</sup> See 15 U.S.C. § 77b(a)(1) (2006); 15 U.S.C. § 78c(a)(10) (2006); 15 U.S.C. § 80a-2(a)(36) (2006); 15 U.S.C. § 80b-2(a)(18) (2006).

they consider them to be identical.<sup>77</sup> Thus, a court finding of a security under one of the four statutes resolves the same issue under each of the other federal securities laws.<sup>78</sup>

The Securities Act provides the first and principal definition of a “security” under the federal securities laws. Specifically, Section 2(a)(1) of the Securities Act (U.S. Definition), as amended, states that “unless the context otherwise requires” (context clause):

The term “security” means 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,<sup>79</sup> or warrant or right to subscribe to or purchase, any of the foregoing.

The U.S. Definition consists of several discrete elements. First, the U.S. Definition incorporates traditional securities such as stocks and bonds. Second, it includes relatively new and complex instruments like security-based swaps.<sup>80</sup> Third, it covers instruments popular with dubious promoters who circumvented state blue-sky laws prior to the federal securities laws such as interests in oil, gas, or mineral rights.<sup>81</sup> Fourth, it engrosses disparate terms, such as “investment contract,” that do not have established meanings or common usage in the financial industry or the law. Fifth, it provides extremely broad terms, such as “any interest or instrument commonly known as a ‘security.’” Sixth, it is contradictory insofar as the context clause effectively qualifies the U.S. Definition, exempting some

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<sup>77</sup> See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332, 338–39 (1969) (noting that, absent special circumstances, the Securities Act and the Exchange Act definitions of “security” are identical).

<sup>78</sup> See *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1975); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975).

<sup>79</sup> 15 U.S.C. § 77b(a)(1).

<sup>80</sup> See *Dodd-Frank Act*, Pub. L. No. 111-203, §§ 761(a)(2), 768 (a)(1), 124 Stat. 1376, 1755, 1800 (2010).

<sup>81</sup> See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (holding that oil and gas lease assignments tied to promises to drill oil wells qualify as “investment contracts” under the U.S. Definition).

instruments, while the inclusive term “any note, stock” immediately following the context clause plainly means all the enumerated instruments are automatically a security.<sup>82</sup> Seventh, except for security-based futures, the U.S. Definition and the federal securities laws fail to define the U.S. Definition’s important terms. Finally, neither the U.S. Definition nor the federal securities laws provide a statutory mechanism for the SEC to append new instruments to the U.S. Definition. The cumulative effect of these factors is that federal courts enjoy almost unfettered discretion to determine what qualifies as a security under the federal securities laws.<sup>83</sup>

### 3. *Proof of Security Under the Federal Securities Laws*

Establishing a security under the federal securities laws is critical in determining the classes of investments and investors that will receive the protections of the federal securities laws and the relevant federal securities statutes. A security under the Securities Act means all initial offers and sales of securities must be registered with or be exempted by the SEC, but its antifraud provisions will still apply.<sup>84</sup> A security under the Securities Exchange Act brings market intermediaries under the regulatory oversight of the SEC and self-regulatory organizations such as the Financial Industry Regulatory Authority (FINRA), requiring registration with both regulators.<sup>85</sup> A “security” under the Investment Company Act denotes that, unless exempted, a pool of securities issuing interests in the pool would be an investment company subject to its comprehensive federal regulations and investor protections.<sup>86</sup>

Nonetheless, the U.S. Definition does not dispose of the question of what a security is under the federal securities laws. Whether an instrument or scheme is a security under the U.S. Definition is a matter of fact to be determined initially by the SEC, and eventually, by the federal courts.<sup>87</sup> The federal courts, particularly the Supreme Court, have used their almost unfettered discretion in finding the existence of security to profoundly shape the meaning and scope of the U.S. Definition. The Supreme Court’s definitional case law has also evolved over the last eight decades.<sup>88</sup> In general, the Supreme Court has created three tests to establish a security

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<sup>82</sup> See Carney, *supra* note 40, at 317.

<sup>83</sup> See, e.g., McGinty, *supra* note 40, at 1039.

<sup>84</sup> See SEC STAFF, LIFE SETTLEMENTS TASK FORCE: STAFF REPORT TO THE UNITED STATES SECURITIES EXCHANGE COMMISSION 39–40 (2010).

<sup>85</sup> *Id.*

<sup>86</sup> See Araujo v. John Hancock Life Ins. Co., 206 F. Supp. 2d 377, 381–82 (E.D.N.Y. 2002) (holding that a variable life insurance policy qualifies as a security because it invests in mutual funds regulated by the SEC under the Investment Company Act).

<sup>87</sup> See United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848 (1975) (noting that the task of identifying securities falls on the SEC, and ultimately, the federal courts).

<sup>88</sup> See *id.*

under the federal securities laws. The first is the investment contract analysis, or *Howey* test, which the Court has applied to “novel, uncommon, or irregular devices” since 1943.<sup>89</sup> The second test applies to stocks. In *Landreth Timber Co. v. Landreth*, the Supreme Court created a rebuttable presumption that stock is a security.<sup>90</sup> Third, in *Reves v. Ernst & Young*, the Supreme Court adopted the “family resemblance test” to evaluate promissory notes.<sup>91</sup>

Furthermore, establishing a security under the federal securities laws for asset-backed securities, security-based swaps, and pooled investments involves a thorough review of the Dodd-Frank Act, SEC rules, and the Investment Company Act’s definition of an “investment company.”<sup>92</sup> The U.S. Definition does not cover all forms of swaps. It also excludes all forms of asset-backed securities and pooled investments even though they are securities under the federal securities laws.<sup>93</sup> SEC rules define asset-backed securities for the purposes of the federal securities laws, while a pooled investment fund must be an “investment company” under the Investment Company Act by owning or issuing securities.<sup>94</sup> The discussion of each of these tests and legal analysis follows.

#### i. Investment Contract Analysis

The term “investment contract” is not defined anywhere in the federal securities laws. The term, nonetheless, preoccupied the Supreme Court during the first forty years of the Securities Act’s existence, partly because of the rise in “veiled and devious” schemes that involved the unbundling of investment elements and repackaging them as a combination of real or personal property along with some other economic arrangement, such as oil drilling or service contracts on real property.<sup>95</sup> The first of such cases, *Joiner*, held that the term “investment contract” is broad enough to cover veiled and devious or “novel, uncommon or irregular devices whatever they appear to be . . . if it be proved as a matter of fact that they were widely offered or dealt under terms or courses of dealing which established their character in commerce as ‘investment contracts.’”<sup>96</sup> Nonetheless, it was the *SEC v. W.J. Howey Co.* court that defined the term and created the famous

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<sup>89</sup> *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

<sup>90</sup> 471 U.S. 681 (1985) (reviewing 100% ownership interest in company sold through common stock).

<sup>91</sup> 494 U.S. 56 (1990) (reviewing notes in farmer cooperative).

<sup>92</sup> *See infra* Parts II.A.3.iv–vi.

<sup>93</sup> *See infra* Parts II.A.3.iv–vi.

<sup>94</sup> *See infra* Parts II.A.3.iv–vi.

<sup>95</sup> *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 345–47 (1943).

<sup>96</sup> *Id.* at 352.

“*Howey* test” still used today.<sup>97</sup>

*Howey* involved the classical case of unbundling and repackaging of citrus groves with service contracts common with fraudulent securities sponsors of that time.<sup>98</sup> The issue in *Howey* was whether such packaging of citrus groves and service contracts amounted to an investment contract, and therefore, a security under the Securities Act. The Supreme Court found the investment scheme qualified as an investment contract, and therefore, a security under an analysis now known as the “*Howey* test.” The *Howey* test defines an “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.”<sup>99</sup> The *Howey* test, therefore, consists of four factors that must be proved on a case-by-case basis before an instrument is found to be an investment contract under the U.S. Definition.<sup>100</sup>

The first factor of the *Howey* test is the “investment of money” requirement. It requires the investor to commit assets in a manner that exposes her to financial loss or to give up specific consideration in return for a separable financial interest with characteristics of a security, and the investor—not somebody else, such as an employer—to make the investment.<sup>101</sup> The second factor is “expectation of profits.” It requires that profits derive from capital appreciation of the initial investment or from participation in earnings resulting from the use of the investors’ funds.<sup>102</sup> The third factor is that “profits arise solely from the efforts of others.” The Supreme Court modified this requirement in *United Housing Foundation, Inc. v. Forman* to provide that the expectation of profits must be derived from the entrepreneurial or managerial efforts of others so that the profits no longer need to come solely from the efforts of others.<sup>103</sup> Federal courts generally apply a functional rather than literal test for this requirement. In general, courts inquire into the motive of the purchaser of an investment

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<sup>97</sup> 328 U.S. 293 (1946).

<sup>98</sup> *Id.*

<sup>99</sup> *Id.* at 298–99.

<sup>100</sup> *Id.*

<sup>101</sup> *See, e.g.*, SEC v. Rubera, 350 F.3d 1084 (9th Cir. 2003); SEC v. SG Ltd., 265 F.3d 42 (1st Cir. 2001); Salazar v. Sandia Corp., 656 F.2d 578 (10th Cir. 1981).

<sup>102</sup> *See, e.g.*, SEC v. Edwards, 540 U.S. 389 (2004) (holding that an investment offering a fixed rate of return qualified as an investment contract); SEC v. Infinity Group Co., 212 F.3d 180 (3d Cir. 2000) (holding that a fixed or variable interest rate met the expectation of profits requirement).

<sup>103</sup> *See, e.g.*, *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851–54 (1975); *Romney v. Richard Prows, Inc.*, 289 F. Supp. 313 (D. Utah 1968) (discussing profits contemplated not solely or principally from the efforts of others); *Darwin v. Jess Hickey Oil Corp.*, 153 F. Supp. 667 (N.D. Tex. 1957) (holding that where investor retained control, there is no investment contract).

instrument by asking whether the investment was motivated by the prospect of a profit on the investment rather than a desire to use or consume the item purchased, and whether the purchaser has significantly participated in the management of the partnership in which it has invested such that it has more than minimal control over the investment's performance.<sup>104</sup> The expectation of profits may also be met where the investor contributed risk-capital by subjecting her money to the risk of an enterprise over which he or she exercises no managerial control.<sup>105</sup> The applicability of the risk-capital test is in doubt after the Supreme Court decision in *Reves*, with some courts still applying the test while others have abandoned it completely.<sup>106</sup>

The final element of the *Howey* test requires the investment of money in a "common enterprise." The term "common enterprise" refers to investments "in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties."<sup>107</sup> Generally, federal courts have established three judicial tests for determining what constitutes a "common enterprise": horizontal commonality; broad vertical commonality; and narrow (strict) vertical commonality.<sup>108</sup> Horizontal commonality involves the pooling of assets from multiple investors in a way that all the investors share in the profits and risks of the project.<sup>109</sup> Broad vertical commonality denotes that the success or failure of the pooled investments depends primarily on the expertise or efforts of the investment promoter.<sup>110</sup> Under the narrow vertical commonality approach, there must be some interdependence or mutuality of interest in the success of the investor and the investment promoter.<sup>111</sup> What constitutes a "common enterprise" depends entirely on the federal circuit courts. In some jurisdictions, a showing of either vertical

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<sup>104</sup> *Infinity*, 212 F.3d 180.

<sup>105</sup> See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974); *SEC v. Glenn W. Turner Enterprises, Inc.*, 348 F. Supp. 766 (D. Or. 1972) *aff'd*, 474 F.2d 476 (9th Cir. 1973).

<sup>106</sup> For a case declining to follow the risk-capital test, see *LTV Fed. Credit Union v. UMIC Gov't Sec., Inc.*, 523 F. Supp. 819 (N.D. Tex. 1981), *aff'd*, 704 F.2d 199 (5th Cir. 1983). For cases applying the risk-capital test, see *First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co.*, 919 F.2d 510 (9th Cir. 1990); *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059 (10th Cir. 1976).

<sup>107</sup> *Koscot*, 497 F.2d at 478.

<sup>108</sup> See *SEC v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125 (9th Cir. 1991) (accepting vertical commonality test); *Westchester Corp. v. Peat, Marwick, Mitchell & Co.*, 626 F.2d 1212 (5th Cir. 1980); *Brodv. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978) (accepting narrow vertical commonality test); *SEC v. Kirkland*, 521 F. Supp. 2d 1281 (M.D. Fla. 2007) (applying the horizontal test).

<sup>109</sup> See *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001); *Infinity*, 212 F.3d 180.

<sup>110</sup> See *Reynolds Enterprises*, 952 F.2d 1125 (finding vertical commonality for a scheme sharing 30% of the profits with investors and the remaining 70% going to the promoter).

<sup>111</sup> See *Hocking v. Dubois*, 885 F.2d 1449 (9th Cir. 1989).

commonality or horizontal commonality may satisfy the common enterprise element.<sup>112</sup> Other jurisdictions require a showing of horizontal commonality while others require vertical commonality.<sup>113</sup>

## ii. Stocks

A “stock” is nearly synonymous with the term “security,” and therefore, is included in all federal securities laws definitions of a security.<sup>114</sup> Nonetheless, that has not foreclosed judicial interpretation of the term. The issue in the leading case of *Landreth* was whether a sale of business transaction in which the previous owner of the corporation agreed to stay on and manage the daily affairs of his previous corporation involved the sale of a security.<sup>115</sup> The court held that the transaction was a security, noting that traditional stock “represents to many people, both trained and untrained in business matters, the paradigm of security.”<sup>116</sup> Thus, it created a presumption that common stock qualifies as a security.<sup>117</sup> Instruments labeled “stock” must, nonetheless, possess the usual characteristics of stock, which include the right to receive dividends contingent upon an apportionment of profits, negotiability, the ability to be pledged or hypothecated, the granting of voting rights to the number of shares owned and the capacity to appreciate in value.<sup>118</sup> If an instrument labeled “stock” is without the traditional features of stock, courts must look to the economic substance of the transaction to determine whether the stock is a “security” within the meaning of the federal securities laws.<sup>119</sup>

## iii. Notes and Evidence of Indebtedness

A “note” and “evidence of indebtedness” are two substantially similar debt instruments included in the U.S. Definition.<sup>120</sup> The Supreme Court in

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<sup>112</sup> See, e.g., *SEC v. Alpha Telcom, Inc.*, 187 F. Supp. 2d 1250 (D. Or. 2002), *aff'd*, 350 F.3d 1084 (9th Cir. 2003); *Great Lakes Chem. Corp. v. Monsanto Co.*, 96 F. Supp. 2d 376 (D. Del. 2000).

<sup>113</sup> See, e.g., *SEC v. Banner Fund Intern.*, 211 F.3d 602 (D.C. Cir. 2000) (horizontal commonality only); *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195 (11th Cir. 1999) (vertical commonality only); *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989).

<sup>114</sup> See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 693–94 (1985); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 850 (1975); LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 212 (1983) (“[S]tock . . . is so quintessentially a security as to forestall further analysis.”).

<sup>115</sup> *Landreth*, 471 U.S. at 688–93.

<sup>116</sup> *Id.* at 693.

<sup>117</sup> *Id.*

<sup>118</sup> *Id.* at 686; *Forman*, 421 U.S. at 851; *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1969).

<sup>119</sup> *Landreth*, 471 U.S. at 688–90.

<sup>120</sup> *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954) (holding promissory notes constituted “evidence of indebtedness”).

*Reves*, nonetheless, was faced with the question of whether demand notes issued by a cooperative constituted the type of “notes” that qualify as “securities.” In reaching its decision, the Court adopted the “family resemblance test” to determine whether an instrument labeled “note” or “promissory note” constitutes a security.<sup>121</sup> The “family resemblance test” provides that a “note is presumed to be a ‘security,’ and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of the seven enumerated categories of instrument.”<sup>122</sup> The seven enumerated notes that are excluded from the U.S. Definition include: notes delivered in consumer financing, notes secured by a mortgage on a home, short-term notes secured by a lien on a small business or some of its assets, a notice evidencing a “character” loan to a bank customer, short term notes secured by an assignment of accounts receivable, notes that formalize an open-account debt incurred in the ordinary course of business, and notes evidencing loans issued by commercial bank for current operation.<sup>123</sup>

The *Reves* court adopted a four-pronged formula to determine whether an instrument is sufficiently similar to one of the seven excluded notes and, if not, whether another category should be added to the list.<sup>124</sup> The first prong looks at the motivation of the parties in entering the agreement.<sup>125</sup> Notes sold for business purposes are securities while notes issued to finance minor assets or consumer goods are not securities.<sup>126</sup> The second prong looks at the “plan of distribution” to determine if the instrument is for “common trading for speculation or investment.”<sup>127</sup> Selling notes to a broad segment of the public suffices. In general, federal courts find that notes widely distributed to the public qualify as securities.<sup>128</sup> The third prong looks at the reasonable expectation of the parties.<sup>129</sup> The fourth prong asks whether there is another regulatory regime that renders the application of the Securities Act moot.<sup>130</sup> All four prongs must be satisfied in order for a note to be excluded from the U.S. Definition.<sup>131</sup>

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<sup>121</sup> *Reves v. Ernst & Young*, 494 U.S. 56, 60–67 (1990).

<sup>122</sup> *Id.* at 67.

<sup>123</sup> *Id.* at 65 (quoting *Exch. Nat’l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d. Cir. 1976); *Chem. Bank v. Arthur Anderson & Co.*, 726 F.2d 930, 939 (2d. Cir. 1984)), *cert. denied*, 469 U.S. 884 (1984).

<sup>124</sup> *Reves*, 494 U.S. at 66–67.

<sup>125</sup> *Id.* at 66.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *See, e.g.*, 69 AM. JUR. 2D *Securities Regulation—Federal* § 32 (2012).

<sup>129</sup> *Id.* at 66–67.

<sup>130</sup> *Id.* at 67.

<sup>131</sup> *See, e.g.*, *McNabb v. SEC*, 298 F.3d 1126, 1132–33 (9th Cir.2002); *Robyn Meredith, Inc. v. Levy*, 440 F. Supp. 2d 378, 384 (D.N.J. 2006).

#### iv. Swaps

Up until the Dodd-Frank Act, swaps developed and operated in the United States “unseen and unregulated.”<sup>132</sup> Title VII of the Dodd-Frank Act, fittingly entitled the “Wall Street Transparency and Accountability Act of 2010,” regulates U.S. swaps and their markets for the first time ever. It places swaps into three broad categories: (1) “swaps” regulated by the CFTC; (2) “security-based swaps” regulated by the SEC; and (3) “mixed swaps” regulated jointly by the CFTC and SEC depending on the nature of the underlying financial instrument.<sup>133</sup>

In 1974, Congress amended the Commodity Exchange Act of 1936 and allocated exclusive jurisdiction over derivatives to the CFTC and security-based derivatives to the SEC.<sup>134</sup> The Dodd-Frank Act divides jurisdiction over swaps between the CFTC and the SEC along the traditional futures and securities structure set up in 1974, and defines “swaps,” “security-based swaps,” and “mixed swaps.”<sup>135</sup> It also mandates that these terms are further defined jointly by the CFTC, SEC, and Board of Governors of the Federal Reserve System.<sup>136</sup> These financial regulators noted that a “swap,” as defined in the Commodity Exchange Act, includes a “security-based swap” if certain statutory exceptions and characteristics are excluded.<sup>137</sup> These regulators also determined that the same Commodity Exchange Act definition of a “swap” establishes the scope of agreements, contracts, and transactions that could be “security-based swaps.”<sup>138</sup> Put differently, these regulators found no difference between swaps and security-based swaps even though the Dodd-Frank Act purports to provide a separate definition for each. This leaves a lot of uncertainty over what

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<sup>132</sup> *The Role of Derivatives in the Financial Crisis: Hearing on the Causes of the Current Financial and Economic Crisis in the U.S. Before the Fin Crisis Inquiry Comm’n*, 111th Cong. (2010) (opening remarks of Phil Angelides, Chairman, Fin. Crisis Inquiry Comm’n), available at <http://fcic.law.stanford.edu/hearings/testimony/the-role-of-derivatives-in-the-financial-crisis>.

<sup>133</sup> Dodd-Frank Act, Pub. L. No. 111-203, § 721 (a)(21), 124 Stat. 1376, 1666 (2010) (adding Commodity Exchange Act § 1a(47)’s definition of swap); Dodd-Frank Act § 761(a)(6) (adding Exchange Act § 3(a)(68)’s definition of security-based swap); Dodd-Frank Act § 721(a) (adding mixed swap to Commodity Exchange Act § 1a(47)(D)); Dodd-Frank Act § 761(a) (adding mixed swap to Exchange Act § 3(a)(68)(D)).

<sup>134</sup> See THE PRESIDENT’S WORKING GRP. ON FIN. MKTS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT (1999) [hereinafter OTC REPORT].

<sup>135</sup> See Dodd-Frank Act § 712(d)(1).

<sup>136</sup> *Id.*

<sup>137</sup> See 15 U.S.C. § 78c(a)(68) (2012); 7 U.S.C. § 1a (2012); Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 30,596, 30,606 (May 23, 2012).

<sup>138</sup> See 77 Fed. Reg. at 30616.

security-based swaps are, and provides federal courts with another opportunity to determine what types of swaps are covered by the U.S. Definition.

#### v. Pooled Investments

The Investment Company Act has regulated U.S. mutual funds since 1940, but the U.S. Definition has never included mutual funds or other pools of private capital such as hedge funds, venture capital funds, and private equity funds.<sup>139</sup> The Dodd-Frank Act also excluded them from the U.S. Definition even as it extended federal securities laws to cover previously unregulated or exempt private funds like hedge funds.<sup>140</sup>

Instead, the Investment Company Act defines and regulates mutual funds and other private funds as an “investment company.”<sup>141</sup> It also defines an “investment company” as an issuer of and an investor in securities.<sup>142</sup> Whether or not an entity is issuing securities under the Investment Company Act is determined under the *Howey* test.<sup>143</sup> Thus, private funds that invest in non-securities such as currencies, commodities, insurance and gold can avoid federal securities laws by showing that they are not issuing or investing in securities.<sup>144</sup> Such funds would include offshore funds that routinely buy pools of non-variable life settlements not qualifying as securities in the United States.<sup>145</sup>

Furthermore, the Dodd-Frank Act exempted venture capital funds from the definition of an “investment company,” and hence, a security under the U.S. Definition.<sup>146</sup> In sum, establishing an “investment company,” and hence, a security under the federal securities laws, involves determining the

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<sup>139</sup> See, e.g., John Thompson, *Corporate Governance and Collective Investment Instruments*, in OECD: INSURANCE AND PRIVATE PENSIONS COMPENDIUM FOR EMERGING ECONOMIES bk. 2, pt. 1:4, at 11–13 (2001), available at <http://www.oecd.org/dataoecd/6/49/1815904.pdf>.

<sup>140</sup> See Dodd-Frank Act §§ 402(a), 619; 15 U.S.C. § 80b-2(a)(29) (2012); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act, 17 C.F.R. pt. 275 (2011).

<sup>141</sup> See 15 U.S.C. §§ 80b-2 (a)(29), 80a-3(a)(1)(A).

<sup>142</sup> See *id.* § 80a-3(a)(1)(A); *Prudential Insurance Co. v. SEC*, 326 F.2d 383 (3d Cir. 1964) (establishing the *Prudential* test for evaluating the existence of a separate issuer within an operating company); *Comdisco, Inc.*, SEC, No-Action Letter (Oct. 25, 2000), available at <http://www.sec.gov/divisions/investment/noaction/2000/comdisco102500.pdf> (applying the *Prudential* test for “issuer”).

<sup>143</sup> See TAMAR FRANKEL & CLIFFORD E. KIRSCH, *INVESTMENT MANAGEMENT REGULATION* 93 (3d ed. 2005).

<sup>144</sup> See, e.g., SEC STAFF, *IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS: STAFF REPORT TO THE UNITED STATES SECURITIES EXCHANGE COMMISSION* 3–4 (2003).

<sup>145</sup> See, e.g., SEC STAFF, *supra* note 84, at 5.

<sup>146</sup> 17 C.F.R. pt. 275.

structure, ownership, investment strategies, and the instruments that private pools of capital invest in or issue..

vi. Asset-Backed Securities

The modern Asset-Backed Securities or securitization market started in the United States in the 1970s with the securitization of residential mortgages.<sup>147</sup> It grew rapidly in the mid-1980s onward to include the securitization of other types of assets, such as credit card receivables, auto loans, and student loans, reaching more than \$7 trillion of mortgage-backed securities and nearly \$2.5 trillion of asset-backed securities by the end of 2007.<sup>148</sup> The U.S. securitization market developed largely unregulated so as to cause the recent financial crisis, in part, because an “asset-backed security” by itself is not an enumerated security under the U.S. Definition.<sup>149</sup> In fact, the U.S. Definition generally includes financial instruments that qualify as an “asset-backed security.”<sup>150</sup> Accordingly, federal securities regulations of asset-backed securities have thus far been centered on defining and setting up separate disclosure rules for asset-backed securities rather than appending them to the U.S. Definition.<sup>151</sup>

The SEC first defined an “asset-backed security” in 1992 as a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets.<sup>152</sup> In 2004, it adopted the 1992 definition and added leases to it.<sup>153</sup> Both the 1992 and 2004 definitions applied to the Securities Act, Regulation AB, which made rules and forms for the registration, disclosure, and reporting requirements for asset-backed securities under the Securities Act and the Exchange Act.<sup>154</sup>

The Dodd-Frank Act amended the Exchange Act to provide the first statutory, and the third overall, definition of “asset-backed securities,” which applies to representations and warranties in asset-backed securities

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<sup>147</sup> See Asset-Backed Securities, 70 Fed. Reg. 1506, 1508 (Jan. 7, 2005).

<sup>148</sup> *Id.*; Asset-Backed Securities, 75 Fed. Reg. 23,328 (May 3, 2010).

<sup>149</sup> See, e.g., Gary B. Gorton & Andrew Metrick, *Regulating the Shadow Banking System* (2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1676947>.

<sup>150</sup> See Asset-Backed Securities, 17 C.F.R. pt. 229.1101(c), 70 Fed. Reg. at 1506, 1600 (Jan. 7, 2005).

<sup>151</sup> See *id.*; 15 U.S.C. § 78c(a)(77) (2012); Dodd-Frank Act, Pub. L. No. 111-203, § 943, 124 Stat. 1376, 1897 (2010); Asset-Backed Securities, 75 Fed. Reg. at 23,328; Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, 57 Fed. Reg. 48,970 (Oct. 22, 1992); Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 7 C.F.R. pts. 229, 232, 240, 249 (2011).

<sup>152</sup> See Asset-Backed Securities, 70 Fed. Reg. at 1511.

<sup>153</sup> *Id.* at 1512.

<sup>154</sup> See *id.* at 1511-12; Asset-Backed Securities, 75 Fed. Reg. at 23,328; Asset-Backed Securities, 57 Fed. Reg. at 48,970.

offerings.<sup>155</sup> The Exchange Act-ABS, as SEC rules call it, defines an “asset-backed security” as “a fixed-income or other security collateralized by” a self-liquidating financial asset, including a collateralized mortgage obligation, a collateralized debt obligation, a collateralized bond obligation, a collateralized debt obligation of asset-backed securities, and a collateralized debt obligation of collateralized debt obligations.<sup>156</sup> The Exchange Act-ABS is broader than the asset-backed security definition in Regulation AB because it includes all the instruments in the 1992 and 2004 asset-backed securities definitions.<sup>157</sup> Moreover, it applies to securities normally sold in transactions exempt from registration under the Securities Act such as CDOs, securities issued or guaranteed by government sponsored entities like Fannie Mae and Freddie Mac, and municipal securities.<sup>158</sup> In fact, the SEC interprets the Exchange Act-ABS to include all asset-backed securities, regardless of whether they are sold in Securities Act registered transactions, if the original transaction has a covenant to repurchase or replace an asset.<sup>159</sup> Thus, the definition of “asset-backed securities,” like that of an “investment company,” is *sine qua non* for establishing a security in asset-backed securities under the federal securities laws.

#### 4. Exempt and Excluded Securities

The Securities Act provides the primary, albeit limited, exemptions from its registration and prospectus requirements, but its antifraud provisions will still apply to the exempted securities.<sup>160</sup> Section 3 of the Securities Act provides for exempted securities while Section 4 provides for exempted transactions. Additionally, the SEC may exempt any security if the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.<sup>161</sup>

Regardless of whose hands they fall into and the frequency of sale, exempted securities never have to be registered under the Securities Act.<sup>162</sup> Among other securities, the Securities Act exempts securities issued by governments and banks; short-term commercial paper; securities issued by religious, educational, charitable, and other such organizations; interests in a railroad equipment trust; and certain certificates issued by a receiver or

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<sup>155</sup> See 15 U.S.C. § 78c(a)(77); Dodd-Frank Act § 943.

<sup>156</sup> See 15 U.S.C. § 78c(a)(79).

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> See generally LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES REGULATION 177–205 (6th ed. 2006); 15 U.S.C. § 77ddd(a).

<sup>161</sup> 15 U.S.C. § 77ddd(c)–(e).

<sup>162</sup> See SODERQUIST & GABALDON, *supra* note 160.

trustee.<sup>163</sup>

Unlike exempted securities, the Securities Act excepts exempted transactions from its registration requirements for only one specific transaction. Accordingly, a buyer of an exempted transaction who intends to resell must find another transaction exemption, otherwise the securities must be registered.<sup>164</sup> Major transaction exemptions under the Securities Act include the following: (a) securities exchanged with existing security holders, (b) securities issued under a plan of exchange approved by a court of law, (c) securities issued by governmental authorities, (d) securities issued in private placement, and (e) securities issued in an intrastate transaction.<sup>165</sup>

The judicial expansion of the scope of the U.S. Definition under *Howey* in the 1960s and 1970s precipitated waves of securities class action litigation.<sup>166</sup> The Supreme Court responded by carving out limited exclusions to investment contracts, stocks, and promissory notes.<sup>167</sup> As previously discussed, *Forman* and *Landreth* exclude stock without the usual characteristics of common stock.<sup>168</sup> *Teamsters v. Daniel* and *Weaver* provide a general exclusion for securities regulated by other federal laws or federal, state, or foreign authorities.<sup>169</sup> As discussed, *Reves*' "family resemblance test" excludes seven types of notes and any additional notes with strong resemblance to the seven excluded notes.<sup>170</sup> Federal courts have also invoked the context clause to exempt or exclude numerous securities from the federal securities laws.<sup>171</sup>

### 5. The Scope of the U.S. Definition

The U.S. Definition is notorious for its over-inclusiveness.<sup>172</sup> Its over-

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<sup>163</sup> 15 U.S.C. § 77c(a)(2)–(6).

<sup>164</sup> See SODERQUIST & GABALDON, *supra* note 160.

<sup>165</sup> 15 U.S.C. §§ 77c(a)(11), 77d(2).

<sup>166</sup> See McGinty, *supra* note 40, at 1054.

<sup>167</sup> *Id.*

<sup>168</sup> *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975) (discussing stock that conveyed only right to rent unit in building); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686–87 (1985); see also *supra* discussion Part II.A.3.ii.

<sup>169</sup> *Marine Bank v. Weaver*, 455 U.S. 551, 557–59 n.7 (1975); *Teamsters v. Daniel*, 439 U.S. 551, 569–70 (1979) (holding compulsory, non-contributory employee pension plan under ERISA excluded).

<sup>170</sup> *Reves v. Ernst & Young*, 494 U.S. 56, 66–67 (1990); see also *supra* discussion Part II.A.3.iii.

<sup>171</sup> See generally THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.20 (4th ed. 2002); HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *Securities and Federal Corporate Law*, in *SECURITIES LAW SERIES* § 3:18 (Donald C. Pinkleton et al. eds., Thomson & West Group 2008); *Weaver*, 455 U.S. at 551 (excluding unique profit-sharing agreement because it was not tradable publicly, although *Howey* test was satisfied).

<sup>172</sup> See McGinty, *supra* note 40.

inclusiveness derives mainly from its overly broad statutory language and an even more inclusive interpretation of its broad terms by the federal courts.<sup>173</sup> Other federal securities laws also contribute to its broad scope. In particular, the Investment Company Act and SEC rules' definitions of "asset-backed securities" and an "investment company" extend its scope to cover mutual funds and other private funds and hybrids instruments, such as CDOs, that often include features of futures, securities, and insurance, and hence, are not securities *per se*.<sup>174</sup>

The U.S. Definition is drafted broadly using terms like "any note, stock . . . bond," which plainly mean that federal securities laws apply to every enumerated instrument, including mundane arrangements like IOUs given between friends.<sup>175</sup> It also includes broad and unusual terms such as "any interest or instrument known as a 'security,'" "investment contracts" and "profit-sharing agreements."<sup>176</sup> Additionally, terms like "any note, stock . . . bond" are preceded by the context clause.<sup>177</sup> This creates confusion regarding the U.S. Definition's exact meaning and scope. The term "any" suggests that all enumerated instruments are automatically securities, but the precedent context clause qualifies these broadly inclusive terms and even excludes certain instruments that bear the enumerated terms.<sup>178</sup> Except for security-based futures, federal securities laws do not define these disparate terms or articulate the relevant economic or legal criteria for distinguishing "securities" from "non-securities."<sup>179</sup> Instead, the task of identifying and defining securities falls on the SEC and, ultimately, the federal courts.<sup>180</sup>

Despite interpreting the U.S. Definition almost twelve times since 1943 and shaping up its meaning and scope, the Supreme Court, like the federal securities laws, has failed to determine its unequivocal meaning and scope.<sup>181</sup> The Court has also failed to produce a clear legal test to evaluate the U.S. Definition that is consistent with the purposes of the federal securities laws.<sup>182</sup> In fact, the Court has developed disparate tests for investment contracts, notes, and stocks that fail to clarify each term's exact meaning or scope.<sup>183</sup> The Court even conceded in *Landreth* that "its cases

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<sup>173</sup> *Id.* at 1035–37.

<sup>174</sup> *See supra* text accompanying notes 139–159.

<sup>175</sup> McGinty, *supra* note 40, at 1037–38.

<sup>176</sup> *Id.* at 1038.

<sup>177</sup> *Id.*

<sup>178</sup> *Id.* at 1039.

<sup>179</sup> *See, e.g., supra* note 137 and accompanying text.

<sup>180</sup> *See United Housing Foundation v. Forman*, 421 U.S. 837, 848 (1975).

<sup>181</sup> McGinty, *supra* note 40, at 1036.

<sup>182</sup> *Id.*

<sup>183</sup> *Id.* at 1037.

ha[d] not been entirely clear on the proper method of analysis for determining when an instrument is a ‘security.’”<sup>184</sup>

Nonetheless, a series of truly remarkable Supreme Court statements on the U.S. Definition help crystalize its broad view of the scope of the U.S. Definition. Starting with its first securities case, *Joiner*, the Court equated “investment contracts” with the broadest term in the entire U.S. Definition—“any interest or instrument commonly known as a security”—and applied the two terms to potentially infinite “novel, uncommon or irregular” financial arrangements and instruments.<sup>185</sup>

In *Howey*, the Court’s second definitional case, the Court made three overly broad remarks, the first being that the term “investment contracts” was capable of adaptation to meet “the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”<sup>186</sup> Second, the Court remarked that the term “in general, any interest or instrument known as a ‘security’” does not limit the scope of the U.S. Definition to those securities that precede it, such as stocks and bonds, because an instrument need not be of the type commonly known as a security to constitute a security under the federal securities laws.<sup>187</sup> Finally, the Court instructed federal courts to look behind the name of the instrument, because when searching for the meaning and scope of “security” under the federal securities laws, form should be disregarded for substance and the emphasis should be on economic reality.<sup>188</sup>

In *Weaver*, the Court said the U.S. Definition is “quite broad” and designed to include “the many types of instruments that in our commercial world fall within the ordinary concept of a security.”<sup>189</sup> It further suggested in *Reves* and *Edwards* that federal courts may disregard the statutory language and appeal to the purposes of the federal securities laws when construing the U.S. Definition, because Congress’ purpose in enacting the securities laws was to “regulate investments, in whatever form they are made and by whatever name they are called.”<sup>190</sup> So, Congress enacted a broad definition of a “security” sufficient to “encompass virtually any instrument that might be sold as an investment.”<sup>191</sup> Finally, *Edwards*, the Court’s most recent definitional case, urged courts to construe “investment contracts” broadly.<sup>192</sup>

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<sup>184</sup> *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 688 (1985).

<sup>185</sup> *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

<sup>186</sup> *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946).

<sup>187</sup> *Id.* at 297.

<sup>188</sup> *Id.* at 298; *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975).

<sup>189</sup> *Marine Bank v. Weaver*, 455 U.S. 551, 555–56 (1975).

<sup>190</sup> *See, e.g., Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

<sup>191</sup> *Id.*

<sup>192</sup> *SEC v. Edwards*, 540 U.S. 389 (2004).

Consistent with this overly broad construction of the U.S. Definition, federal courts have found securities in financial arrangements and instruments that even the most initiated reader of the federal securities statutes or accomplished securities practitioners would identify or associate with a security. These instruments include a franchise, an orange grove, a condominium, real estate lots, gold and silver bullion, diamonds, beavers, chinchillas, minks, and a myriad of other financial activities usually qualifying as “investment contracts.”<sup>193</sup> Federal courts have also found securities in futures and insurance contracts where securities were also involved, even though federal securities laws are not supposed to apply to futures and insurance contracts.<sup>194</sup> Finally, federal courts apply the *Howey* test to determine the existence of an “investment company,” and hence a security under the Investment Company Act, even though the U.S. Definition excludes pooled funds.<sup>195</sup>

In theory, federal securities laws apply only to instruments or schemes that are securities. However, the language, meaning, and scope of the U.S. Definition is so elastic that it actually captures countless traditional securities, unique instruments, pooled investments, futures, and insurance contracts. As a result, the scope of the U.S. Definition stands in stark contrast to similar global definitions. It can be argued that the U.S. Definition is the only global definition that does not dispose of the elemental issue of what qualifies as a security under the federal laws that seek to regulate the securities market. In this sense, the U.S. Definition is largely superfluous. In essence, the U.S. Definition functions as a method of providing statutory authority and legitimacy for the SEC and the federal courts to determine what constitutes a “security” under the federal securities laws on a case-by-case basis.

## B. The United Kingdom

The development of securities regulation in the United Kingdom has charted a very unusual course. The Bubble Act of 1720 provided extensive securities regulations until its repeal in 1825.<sup>196</sup> It was followed by a period of deregulation characterized by the passage of the Joint Stock Companies

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<sup>193</sup> See BLOOMENTHAL & WOLFF, *supra* note 171, § 4:1; 69 AM. JUR. 2D *Securities Regulation—Federal*, §§ 33, 59 (2012).

<sup>194</sup> See *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 544–45 (7th Cir. 1989) (holding index participations are both futures and securities); *Roth v. Am. Family Mut. Ins. Co.*, 567 F.3d 884, 886 (7th Cir. 2009) (holding that variable universal life insurance policies constituted both securities and insurance contracts); SEC STAFF, *supra* note 84, at 23–24; *SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 742, 745 (11th Cir. 2005) (holding that non-variable life settlement contracts are “investment contracts” and therefore qualify as securities).

<sup>195</sup> *Araujo v. John Hancock Life Ins. Co.*, 206 F. Supp. 2d 377, 381–82 (E.D.N.Y. 2002).

<sup>196</sup> See *supra* text accompanying notes 52, 53.

Act in 1844, which allowed U.K. companies to incorporate and register without specific Parliamentary legislation for the first time ever.<sup>197</sup> The U.K. securities markets remained self-regulated until the “Big Bang” in 1986.<sup>198</sup>

The “Big Bang” refers to the comprehensive deregulation of the U.K. financial markets under the Financial Services Act 1986.<sup>199</sup> Among other things, the Financial Services Act 1986 opened up membership of the London Stock Exchange to foreigners, and effectively removed its supervision of the securities markets by placing the now abolished Securities Investment Board in a supervisory role.<sup>200</sup> In 2001, the Financial Services Authority (FSA) established under the Financial Services and Markets Act 2000 (FSMA) replaced the Securities Investment Board, and the FSMA replaced the previously governing statute, the Financial Services Act.<sup>201</sup> The FSA is an independent, non-governmental body financed by the financial services industry.<sup>202</sup> In 2013, the FSA will be replaced by two new regulatory bodies: the Prudential Regulation Authority and the Financial Conduct Authority.<sup>203</sup> The former agency will regulate all deposit-taking institutions, insurers, and investment banks while the latter will regulate retail and wholesale banking, investments, securities, and insurance markets under the amended FSMA.<sup>204</sup> Thus, the U.K. will be transitioning from a single or universal regulator model to a “twin-peaks” model.

U.K. securities regulations have also been shaped by the U.K.’s membership in the European Economic Community (now the European Union (EU)), which the U.K. joined in 1973.<sup>205</sup> As part of its EU treaty obligations, the U.K. is required to incorporate European legislation into its laws and to recognize the jurisdiction of the European Court of Justice (ECJ) in matters of EU law.<sup>206</sup> EU financial legislation has created a parallel securities regulatory scheme for U.K. securities, whereby the FSA

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<sup>197</sup> See An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies, 1844, 7 & 8 Vict., c. 110 (U.K.).

<sup>198</sup> Scott S. Miller, *Regulating Financial Services in the United Kingdom:—An American Perspective*, 44 BUS. LAW. 323, 324–25 (1989).

<sup>199</sup> *Id.* at 325.

<sup>200</sup> See *id.* at 323–25; Patrick M. Creaven, *Inside Outside Leave Me Alone: Domestic and EC-Motivated Reform in the UK Securities Industry*, 60 FORDHAM L. REV. 285, 289–91 (1992).

<sup>201</sup> Financial Services and Markets Act (FSMA), 2000, c. 8, § 1 (U.K.).

<sup>202</sup> *Id.* § 2.

<sup>203</sup> FIN. SERVS. AUTH., THE FINANCIAL CONDUCT AUTHORITY: APPROACH TO REGULATION 5 (2011), available at [http://www.fsa.gov.uk/pubs/events/fca\\_approach.pdf](http://www.fsa.gov.uk/pubs/events/fca_approach.pdf).

<sup>204</sup> *Id.*

<sup>205</sup> See Creaven, *supra* note 200, at 299.

<sup>206</sup> See *id.* at 300; FSMA § 37 (U.K.).

must recognize financial schemes approved in and provided by other EU Member States, while the full array of domestic U.K. securities laws still applies to such schemes promoted in the U.K.<sup>207</sup>

EU financial legislation is increasingly supplanting U.K. securities laws. For example, the FSA estimates that seventy percent of the U.K.'s financial services regulatory policy is driven by EU initiatives.<sup>208</sup> EU financial directives set minimum standards or principles providing Member States discretion to interpret or enforce the standards and principles.<sup>209</sup> In the U.K., the FSA is the agency designated competent under the EU single market and financial directives to implement all EU financial services legislation, which it does through the FSMA, FSA rules, and Treasury regulations.<sup>210</sup>

The FSMA is the primary piece of legislation regulating virtually all aspects of securities markets in the U.K.<sup>211</sup> The FSMA is supplemented by rules and guidance made in the FSA Handbook and secondary legislation, including the Financial Services and Markets Act (Regulated Activities) Order 2001 (RAO) and the Public Offerings of Securities Regulations 1995 (POS Regulations).<sup>212</sup> The RAO provides for the specific activities in which firms must receive FSA permission (known as a Part IV Permission) to operate. The POS Regulations regulate initial offers of securities to the public. The FSMA is complemented by the Companies Act 2006, which governs both private and public companies incorporated or residing in the U.K., and the Criminal Justice Act 1993, under which violations of the FSMA and other statutes are criminally prosecuted.<sup>213</sup>

### 1. *The FSMA Definition of Securities as Investments*

The U.K. retains the original eighteenth century English concept, use, and definition of securities as “stock” or shares of companies and public debt.<sup>214</sup> The FSMA defines “securities” as “[s]hares or stock in the share capital of a company.”<sup>215</sup> The term “securities” is, nonetheless, enumerated

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<sup>207</sup> Alistair Alcock, *Securities Regulation in England and the United Kingdom*, in 8 INTERNATIONAL SECURITIES REGULATION § UK:6 (Robert C. Rosen et al. eds., 2012).

<sup>208</sup> *International and EU, U.K. FIN. SERVS. AUTH.*, <http://www.fsa.gov.uk/about/what/international> (last visited Nov. 30, 2012).

<sup>209</sup> Alcock, *supra* note 207.

<sup>210</sup> *Id.* § UK:13.

<sup>211</sup> *Id.* § UK:8.

<sup>212</sup> *Id.* §§ UK:8, UK:10, UK:28; Financial Services and Market Act (Regulated Activities) Order, 2001, S.I. 2001/544 (U.K.); Public Offerings of Securities Regulations, 1995, S.I. 1995/1537 (U.K.).

<sup>213</sup> Companies Act, 2006, c. 46 (U.K.); Criminal Justice Act, 1993, c. 36 (U.K.).

<sup>214</sup> *See supra* text accompanying notes 44, 58.

<sup>215</sup> *See* Financial Services and Markets Act (FSMA), 2000, c. 8, § 22(2), sch. 2 art. 11 (U.K.).

in the FSMA's definition of "investments" that, for all intents and purposes, is synonymous with the U.S. Definition and concept of a "security." Defining "investment," and hence a "security," in the U.K. is a two-part process that requires a thorough examination of the FSMA. The first part of this analysis is to determine whether an activity is a "regulated activity."<sup>216</sup> The FSMA sets out two conditions required for an activity to qualify as a regulated activity. First, the activity must be carried on in or be linked to the U.K. (the geographical test) "by way of business" (the business test).<sup>217</sup> Whether or not an activity is carried on by way of business is a question of fact determined by several non-conclusive factors, including: the "degree of continuity, the existence of a commercial element, the scale of the activity and the proportion which the activity bears to other activities carried on by the same person but which are not regulated [and] [t]he nature of the particular regulated activity that is carried on."<sup>218</sup> The second "regulated activity" requirement is that the activity must relate to an investment of a specified kind, or if the activity is specified as a class of activity and category of investment for the purposes of the FSMA, the activity must be carried on in relation to property of any kind.<sup>219</sup> The FSMA defines "specified" as "specified in an order made by the Treasury."<sup>220</sup>

The purpose of establishing a regulated activity under the FSMA is to determine what is and is not regulated by the FSA and the specific activities covered by the "General Prohibition."<sup>221</sup> The General Prohibition bars entities or individuals from operating or purporting to operate a regulated activity in the U.K. without prior FSA authorization or exemption, referred to as "Part IV Permission."<sup>222</sup> The FSMA specifies the "regulated activities" subject to the General Prohibition as: dealing in investments; arranging deals in investments; deposit taking; safekeeping and administration of assets; managing investments; investment advice; establishing collective investment schemes; using computer-based systems for giving investment instructions; and activities of reclaim funds.<sup>223</sup>

If an activity is a regulated activity, the second and final step in defining "investment" is to determine whether the activity is specified in the

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<sup>216</sup> *Id.* § 22(2).

<sup>217</sup> *See id.* §§ 19, 22(1)(a)–22(2), 418; FIN. SERVS. AUTH., THE PERIMETER GUIDANCE MANUAL § 2.3 (2012), available at <http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/hb-releases/rel121/rel121perg.pdf>.

<sup>218</sup> *Id.* at § 2.3.3.

<sup>219</sup> FSMA §§ 22(1)(a), 22(1)(b) (U.K.).

<sup>220</sup> *Id.* § 22(5).

<sup>221</sup> *Id.* § 19.

<sup>222</sup> *Id.* §§ 40–55.

<sup>223</sup> *Id.* § 22(2), sch. 2 arts. 2–9A.

classes of activity and categories of investment in Part II of Schedule 2 to the FSMA, which includes: securities; instruments creating or acknowledging indebtedness; government and public securities; instruments giving entitlement to investments; certificates representing securities; units in collective investment schemes; options; futures; contracts for differences; contracts of insurance; participation in Lloyd's syndicates; deposits; loans secured on land; or rights in investments.<sup>224</sup>

The FSMA also provides a general and uninformative definition of "investment": "any asset, right or interest."<sup>225</sup> The FSMA permits the Treasury to issue orders appending or exempting any regulated activity, investment, or both.<sup>226</sup> Thus, an "investment" and hence a "security" in the U.K. includes the specified investments and any activity the Treasury may specify as an investment under the FSMA.

Each of the enumerated classes of activity and categories of investment is comprehensively defined in the FSMA and its secondary legislation. For example, the FSMA enumerates and defines "contracts for differences," which are prohibited in all but a few countries, including the U.K. and South Africa, as any contract "the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in— (i) the value or price of property of any description; or (ii) an index or other factor designated for that purpose in the contract."<sup>227</sup>

The main distinguishing feature of "investments" under the FSMA is that it covers broad classes and categories of similar instruments rather than the individual instruments, such as stocks and bonds. For example, it groups together debentures, debenture stock, loan stock, bonds, certificates of deposit, and any other instruments creating or acknowledging a present or future indebtedness under the generic category as "instruments creating or acknowledging indebtedness."<sup>228</sup>

## *2. Pooled Investments as Units in Collective Investment Schemes*

Collective investment schemes in the U.K. have been regulated almost exclusively under EU legislation since the Undertaking for Collective Investment in Transferable Securities (UCITS) Directive (or EEA's harmonized funds directive), as amended, became part of U.K. corporate and securities laws in 1985.<sup>229</sup> Subsequently, the regulation of collective

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<sup>224</sup> FSMA sch. 2 arts. 11–24 (U.K.).

<sup>225</sup> *Id.* § 22(4).

<sup>226</sup> *Id.* § 22(5), sch. 2 art. 25.

<sup>227</sup> *Id.* sch. 2 art. 19(b).

<sup>228</sup> *Id.* sch. 2 art. 12.

<sup>229</sup> FIN. SERVS. AUTH., THE COLLECTIVE INVESTMENT SCHEME INFORMATION GUIDE § 1.1.2(2) (2006), available at <http://www.fsa.gov.uk/pubs/foi/collguide.pdf>; Council Directive 85/611, 1985 O.J. (L 375) 3 (EC).

investment schemes in the U.K. has consisted of three broad levels of regulation that can be arranged, in descending order, as EU regulation, the U.K. Government or U.K. legislation, and FSA regulation.<sup>230</sup> EU legislation takes the form of UCITS Directives. U.K. legislation is comprised of the FSMA and its secondary legislation on collective investment schemes.<sup>231</sup> The FSA is the designated competent authority under the EU single market directives for collective investment schemes and the regulatory agency for the FSMA, which empowers it to make rules and regulations for collective investment schemes.<sup>232</sup>

The UCITS Directive covers “transferable securities,” which it defines as shares in companies, and other securities equivalent to shares in companies, bonds and other forms of securitized debt, and any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange.<sup>233</sup> One of the primary purposes of the UCITS Directive was to facilitate the cross-border movement of investment funds to retail investors across the EEA.<sup>234</sup> EU “passporting” laws permit schemes established under the UCITS to apply to any open-ended collective investment vehicle that is established, authorized, and promoted to the public in any EEA Member State.<sup>235</sup> Conversely, non-UCITS funds do not enjoy passport rights because they are established and operated pursuant to national laws, and hence, they have different investment and borrowing powers from UCITS.<sup>236</sup> For instance, the UCITS does not apply to collective investment schemes in real property, commodities, private equity funds, hedge funds, and structured funds constituted in any EEA Member State primarily because these schemes borrow for investment purposes, which the UCITS strictly prohibits.<sup>237</sup>

In 2004, the EU introduced a non-UCITS Directive to regulate schemes falling outside the UCITS Directive.<sup>238</sup> Non-UCITS schemes are authorized and regulated at the national level by Member States, and can be promoted throughout the EEA.<sup>239</sup> Thus, at the EU level, the UCITS and non-UCITS Directives require the U.K. to recognize and regulate UCITS

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<sup>230</sup> FIN. SERVS. AUTH., *supra* note 229, § 1.1.2(1); Council Directive 85/611, arts. 3–18, 1985 O.J. (L 375) 3 (EC) (as amended by Council Directive 88/220, arts. 1–2, 1988 O.J. (L 100) 31 (EC) & Council Directive 95/26, arts. 7–13, 1995 O.J. (L 168) 26 (EC)).

<sup>231</sup> See FSMA §§ 235–238 (U.K.).

<sup>232</sup> *Id.*

<sup>233</sup> 1985 O.J. (L 375) 3.

<sup>234</sup> See Creaven, *supra* note 200, at 299.

<sup>235</sup> See Council Directive 04/39, art. 1, 2004 O.J. (L 145) 1.

<sup>236</sup> See FIN. SERVS. AUTH., COLLECTIVE INVESTMENT SCHEMES § 5 (2012), available at <http://media.fsahandbook.info/pdf/COLL.pdf>.

<sup>237</sup> *Id.*

<sup>238</sup> 2004 O.J. (L 145) 1.

<sup>239</sup> *Id.*

retail schemes and non-UCITS retail schemes established domestically or in other EEA Member States and non-EEA countries.

The FSMA classifies and regulates most forms of pooled investments as collective investment schemes. Establishing, operating, or winding up a collective investment scheme is a regulated activity, and hence, subject to the General Prohibition.<sup>240</sup> Units in collective investment schemes are investments under the FSMA.<sup>241</sup> Such units can be shares in or securities of an Open-Ended Investment Company or any right to participate in a collective investment scheme.<sup>242</sup>

The FSMA defines a “collective investment scheme” as:

[A]ny arrangement with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.<sup>243</sup>

The FSMA also states that “[t]he arrangements should be such that the persons who are to participate (participants) do not have day-to-day control over the management of the property whether or not they have the right to be consulted or to give directions.”<sup>244</sup> The FSMA also requires that arrangements possess one or both of the following two characteristics: “(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; (b) the property is managed as a whole by or on behalf of the operator of the scheme.”<sup>245</sup> Thus, the test for a collective investment scheme under the FSMA, before any consideration of exclusions, is three-fold: first, it must constitute an arrangement; second, the participants must not have day-to-day control over the management of the property that is the subject of the scheme; and third, at least one of the following conditions must be met: (a) the pooling of the contributions of participants and profits or income; (b) the management of the property as a whole must be satisfied.<sup>246</sup>

The England and Wales Court of Appeals, the U.K.’s second highest court, determined the scope of the statutory definition of a collective

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<sup>240</sup> FSA v. Fradley, [2005] EWCA (Civ) 1183, [5]–[6] (Eng.).

<sup>241</sup> *Id.*

<sup>242</sup> Financial Services and Markets Act (FSMA), 2000, c. 8, sch. 2 arts. 16(1)–(2) (U.K.).

<sup>243</sup> *See id.* § 235(1); Sky Land Consultants PLC, [2010] EWHC (Ch) 399, [8] (Eng.).

<sup>244</sup> FSMA § 235(2) (U.K.).

<sup>245</sup> *Id.* § 235(3).

<sup>246</sup> *Sky Land Consultants*, EWHC (Ch) 399, [10].

investment scheme as a case of first instance in *FSA v Fradley*.<sup>247</sup> In fact, there are only two definitional cases of a collective investment scheme since the Financial Services Act introduced it in 1986.<sup>248</sup> *Fradley* found the definition of collective investment scheme to be broad because “it is drafted at a high level of generality and it uses words, such as ‘arrangements’ and ‘property of any description,’” which have broad definitions.<sup>249</sup> The *Fradley* court said no formality is required to constitute “arrangements,” and in some contexts, communications may amount to arrangements even if they are not legally binding.<sup>250</sup> The more recent case of *Sky Land Consultants PLC* added that “arrangements” is generally considered as having a wider ambit than agreement or contract.<sup>251</sup>

Furthermore, *Fradley* said the term “property of any description” could include amounts of money paid by persons joining the scheme, and that there is no requirement for those monies to be invested in some investment.<sup>252</sup> Betting winnings in *Fradley*, for example, was considered “profits” under Section 235(1) of the FSMA, although the betting schemes were illegal under Section 18 of the Gaming Act 1845.<sup>253</sup> *Fradley* also defined an “operator” as two or more operators acting as operators of a single scheme.<sup>254</sup> Consequently, the singular in the statute includes the plural so that it is proper to refer to a single set of arrangements as a single scheme.<sup>255</sup> Finally, under *Fradley*, a scheme is a collective investment scheme even if some, but not all, of the participants have transferred day-to-day control of the management of their funds to the operators of the scheme.<sup>256</sup> The fact that some participants have relinquished day-to-day control to the operators of the scheme suffices to qualify the scheme as a collective investment scheme.<sup>257</sup>

### 3. *Exempt Securities and Public Offerings*

The FSMA does not specifically exempt or exclude any class or category of investment. Instead, it empowers the Treasury, by order, to exempt any regulated activity or investment.<sup>258</sup> The FSMA does, however,

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<sup>247</sup> *FSA v. Fradley*, [2005] EWCA (Civ) 1183 (Eng.).

<sup>248</sup> *Sky Land Consultants*, EWHC (Ch) 399, [11].

<sup>249</sup> *Fradley*, EWCA (Civ) 1183, [32].

<sup>250</sup> *Id.* at [33]; *see also* *In Re Duckwari PLC*, [1999] ch. 253, [260] (Eng.).

<sup>251</sup> *Sky Land Consultants PLC*, [2010] EWHC (Ch) 399, [16] (Eng.).

<sup>252</sup> *Fradley*, EWCA (Civ) 1183, [33].

<sup>253</sup> *Id.*

<sup>254</sup> *FSA v. Fradley*, [2005] EWCA (Civ) 1183, [37] (Eng.).

<sup>255</sup> *Id.*

<sup>256</sup> *See id.* at [46]; *Russell-Cooke Trust Co v. Elliott*, [2002] All E.R. (D) 197 (Eng.).

<sup>257</sup> *Elliot*, All E.R. (D) 197, [20].

<sup>258</sup> Financial Services and Markets Act (FSMA), 2000, c. 8, § 22(5), sch. 2 art. 25 (U.K.).

permit the Treasury or the FSA to exempt individual types of investments from specific statutory or regulatory requirements.<sup>259</sup> RAO excludes franchises and several schemes from the FSMA definition and regulation of collective investment schemes.<sup>260</sup> Additionally, the Treasury has exempted collective investment schemes organized and operating as single property schemes from the restrictions on promotion.<sup>261</sup>

The FSA, acting as the competent authority for securities listing, is referred to as the U.K. Listing Authority (UKLA).<sup>262</sup> In that capacity, the UKLA maintains the UKLA Official and Issuer Lists, makes Listing Rules, and can exempt certain issuers from the obligations to publish listing particulars in specific situations so that the issuer publishes an “exempt listing document” instead of the listing particulars.<sup>263</sup> Collective investment schemes sponsored and operated by State and local authorities are exempt from publishing the listing particulars, but they must publish an “equivalent offering document.”<sup>264</sup>

Further exemptions are available for securities offers. These exemptions include: offers to qualified investors only; offers to fewer than 150 persons, other than qualified investors, per EEA State; minimum individual acquisitions of at least €50,000; offers denominated in amounts of at least €50,000; and offers not exceeding €100,000.<sup>265</sup> Finally, the FSMA exempt disclosures that are: contrary to public interest; seriously detrimental to the issuer or unnecessary for intended purchasers; so trivial so as not to influence the appraisal of the financial position and prospects of the issuer from disclosure; or prohibited from disclosure by a certificate issued by the Secretary of State or the Treasury.<sup>266</sup>

#### 4. *The Scope of the U.K. Definition of Investments*

The scope of specified investments under the FSMA covers a broad range of financial products and services. In general, “investments” include virtually all modern forms and areas of investment: securities, insurance, futures, and collective investment schemes.<sup>267</sup> Despite its seemingly

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<sup>259</sup> *Id.* § 235(5).

<sup>260</sup> Financial Services and Market Act (Regulated Activities) Order, 2001, S.I. 2001/544, arts. 66–72 (U.K.).

<sup>261</sup> FSMA § 239 (U.K.).

<sup>262</sup> *Id.* § 72(1).

<sup>263</sup> *Id.* §§ 72(1), 74, 82.

<sup>264</sup> FIN. SERVS. AUTH., THE LISTING RULES § 5.26 (2003), available at [http://www.fsa.gov.uk/pubs/other/listing\\_rules.pdf](http://www.fsa.gov.uk/pubs/other/listing_rules.pdf); Council Directive 89/298, arts. 2 2.(a)–(b), 1989 O.J. (L 124) 2 (EC); Council Directive 01/34, art. 23(5), 2001 O.J. (L 184) 15 (EC).

<sup>265</sup> FSMA § 86(1) (U.K.).

<sup>266</sup> *Id.* § 82.

<sup>267</sup> *Id.* § 22(2).

endless scope, the FSMA actually limits the instruments that constitute investments in at least three ways. First, the FSMA applies only to enumerated regulated activities and specified investments.<sup>268</sup> Second, the FSMA and its secondary legislation comprehensively define all the enumerated regulated activities and classes and categories of investments, such as deposit taking and contracts for difference.<sup>269</sup> Finally, the FSMA authorizes the Treasury to add or remove regulated activities and investments from the statutory lists.<sup>270</sup>

This authorization and the FSMA's exhaustive definition of material enumerated terms are essential; they deprive the courts of the opportunity to read into the statutory language new regulated activities or investments. These limits also ensure that the Treasury and FSA are the only governmental actors adding new financial activity to the lists of regulated activity and investments. Hence, the scope of "investments" may be broad, but the list of instruments it covers is finite and clearly defined.

### C. The Commonwealth of Australia

When the U.K. Parliament granted Australia independence on January 1, 1901, it created a unique constitutional arrangement that has impacted the development and regulation of Australia's securities markets.<sup>271</sup> The resulting arrangement is a combination of a constitutional monarch, where the reigning British monarchy also serves as the Australian monarchy and its Head of State, and a "federal" system of government consisting of six states and other Commonwealth Territories.<sup>272</sup>

The language of the constitution frequently causes jurisdictional conflicts between the Commonwealth and the states. Unlike the U.S. Constitution, which rejects the exercise of federal jurisdiction by the states, the Australian Constitution embraces the doctrine of concurrent jurisdiction.<sup>273</sup> For instance, the High Court of Australia, the highest court of the land, invalidated parts of the Commonwealth Corporations Act of 1989 for violating the cross-vesting provisions of the constitution.<sup>274</sup> To overcome these jurisdictional conflicts, the Commonwealth, the states, and the Northern Territory promulgated cross-vesting legislation.<sup>275</sup> Legislative

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<sup>268</sup> *Id.* §§ 19, 22.

<sup>269</sup> *Id.* sch. 2 arts. 11–24.

<sup>270</sup> FSMA § 22(5), sch. 2 art. 25 (U.K.).

<sup>271</sup> Commonwealth of Australia Act, (Imp.) 1900, 63 & 64 Vict., c. 12, § 9 (U.K.).

<sup>272</sup> *Id.*

<sup>273</sup> See Hebert A. Johnson, *Historical and Constitutional Perspectives on Cross-Vesting of Court Jurisdiction*, 19 MELB. U. L. REV. 45, 51 n.32 (1993).

<sup>274</sup> *N.S.W. v Commonwealth (The Incorporation Case)* [1990] 169 CLR 482 (Austl.); *Gould v Brown* [1998] 193 CLR 346 (Austl.).

<sup>275</sup> *Jurisdiction of Courts (Cross-vesting) Act 1987* (Cth) (Austl.).

cross-vesting allows either the states or the federal government to enact legislation that will apply and be implemented by all parties.<sup>276</sup> In fact, the principal Australian securities laws—the Corporations Act of 2001 (Corporations Act), which came into force on July 15, 2001, and the Australian Securities and Investment Acts of 2001 (ASIC Act)—are cross-vesting legislations in which the states have referred specific powers over corporate and securities legislation to the Commonwealth.<sup>277</sup>

The Corporations Act is a voluminous statute that regulates corporations and the non-banking financial markets.<sup>278</sup> The Act contains several definitions of a “security” and “securities” spread across its ten chapters in varying forms, depending on the corporate or financial activity the respective chapter is designed to regulate. Nonetheless, these disparate definitions are aggregated, defined, and regulated as “financial products” in the context of financial market and services regulation.<sup>279</sup>

The ASIC Act created the Australian Securities and Investments Commission (ASIC), Australia’s corporate, markets, and financial services regulator.<sup>280</sup> In its capacity as the financial services regulator, ASIC supervises businesses that typically deal in superannuation, managed funds, and shares, as well as company securities, derivatives, and insurance.<sup>281</sup>

### *1. Corporations Act Definitions of Securities and Financial Products*

Australia, like the U.K., retains the original English concept of securities as shares or stock of companies, and corporate or public debt.<sup>282</sup> The Corporations Act definitions of “securities” reflect this traditional view of securities and its unique posture as the only statute that combines corporate and securities regulations.

The Corporations Act first defines “securities” in general as: “(a) debentures, stocks or bonds issued or proposed to be issued by a government; or (b) shares in, or debentures of, a body; or (c) interests in a managed investment scheme; or (d) units of such shares.”<sup>283</sup> It then provides at least four specific definitions of securities:<sup>284</sup> (1) securities of a

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<sup>276</sup> See *id.*; Gould, 193 CLR 346.

<sup>277</sup> See *Jurisdiction of Courts (Cross-vesting) Act* (Austl.); *Corporations Act 2001* (Cth) s 5 (Austl.).

<sup>278</sup> *Corporations Act* s 5 (Austl.).

<sup>279</sup> *Id.* ss 764A(1)(a), 763A. The term “financial product” is synonymous with “securities” in the United States and “investments” in the U.K.

<sup>280</sup> *Australian Securities and Investments Act 2001* (Cth) (Austl.).

<sup>281</sup> *Id.*

<sup>282</sup> *Corporations Act* s 92 (Austl.).

<sup>283</sup> *Id.* s 92(1).

<sup>284</sup> *Id.*

“body,”<sup>285</sup> (2) securities for corporate acquisitions and takeovers,<sup>286</sup> (3) securities for listed securities, and (4) the financial markets and services regulation.<sup>287</sup> The salient difference between these definitions of “securities” is that the first three apply largely to corporations and similar bodies while the fourth applies to the financial markets and services regulation as a “financial product.”<sup>288</sup> In addition, the Corporations Act excludes derivatives as an “excluded security.”<sup>289</sup> An “excluded security” means shares, debentures, or interests in a managed investment scheme composed by a right to participate in a retirement village scheme.<sup>290</sup>

The second definition of securities in Section 92 of the Corporations Act tracks the same language and exclusions as the general definition.<sup>291</sup> The only difference is that this definition applies exclusively to a “body.”<sup>292</sup> The term “body” is defined as “a body corporate or an unincorporated body and includes, for example, a society or association,” but does not include a state or territory.<sup>293</sup> A “body corporate” refers to a “body corporate that is being wound up or has been dissolved” or a registrable (unincorporated entity or foreign company) body.<sup>294</sup> The purpose of this body-specific definition of securities is to avoid jurisdictional conflicts between federal corporation legislation and state and territory laws, because they have concurrent jurisdiction over the Corporations Act.<sup>295</sup> In fact, there is no concurrent jurisdiction if there is a direct inconsistency between the Corporations Act and the laws of a state or territory.<sup>296</sup> Additionally, the Corporations Act regulates the registration, operations, and winding up of corporate and non-corporate bodies, such as managed investment schemes, covered by this definition.<sup>297</sup>

The third definition of securities applies to the rights of securities

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<sup>285</sup> *Id.* s 92(2).

<sup>286</sup> *Id.* s 92(3).

<sup>287</sup> *Id.* ss 92(4), 761A.

<sup>288</sup> *Stratford Sun Ltd. v OM Holdings Ltd., In the Matter of OM Holdings Limited (No 5)* [2011] FCA 1275, [39] (Austl.) (“For the purposes of Ch. 7 [market regulation], therefore, a ‘security’ is a ‘financial product’ . . .”).

<sup>289</sup> *Corporations Act* ss 92(1)(f)–(g) (Austl.).

<sup>290</sup> *Id.* s 9; *Stratford Sun Ltd.* FCA 1275, [39] (“The shares in OMH are not ‘excluded securities . . .’ Excluded securities relate to retirement villages.”); *ASIC v IP Prod. Mgmt. Grp. Pty. Ltd.* [2002] VSC 255, [23] (Austl.) (explaining that music schemes to manufacture and distribute music CDs and share profits are not futures contracts or excluded securities, and therefore, are covered under Section 92(1)(e)).

<sup>291</sup> *Corporations Act* s 92(2) (Austl.).

<sup>292</sup> *Id.*

<sup>293</sup> *Id.* s 9.

<sup>294</sup> *Id.*

<sup>295</sup> *See id.* s 5E.

<sup>296</sup> *Corporations Act* s 5E(4) (Austl.).

<sup>297</sup> *Id.* ss 582–588.

holders as well as to the acquisition of control and takeover of interests in listed companies, unlisted companies with more than fifty members, listed bodies that are not companies, and listed managed investment schemes.<sup>298</sup> “Securities” in this context is defined as: “(a) shares in a body; (b) debentures of a body; (c) interests in a registered managed investment schemes; (d) legal or equitable rights or interests in: (i) shares; (ii) debentures; or (iii) interests in a registered managed investment scheme; or (e) options to acquire (whether by way of issue or transfer) a security,” but excludes a derivative other than an option to acquire a security by way of transfer and a market traded option.<sup>299</sup>

The fourth and final definition is that of a “security” that, through a complex series of interlocking sections, applies to the Corporations Act fundraising rules<sup>300</sup> and market regulation as a “financial product.”<sup>301</sup> This definition provides that a “security” means:

(a) a share in a body; or (b) a debenture of a body; or (c) a legal or equitable right or interest in a security covered by paragraph (a) or (b); or (d) an option to acquire, by way of issue, a security covered by paragraph (a), (b) or (c); or (e) a right (whether existing or future and whether contingent or not) to acquire, by way of issue, the following under a rights issue: (i) a security covered by paragraph (a), (b), (c) or (d); (ii) an interest or right covered by paragraph 764A(1)(b) or (ba); but does not include an excluded security. In Part 7.11, it also includes a managed investment product.<sup>302</sup>

*Fin. Indus. Complaints Serv. Ltd. v Deakin Fin. Servs. Pty. Ltd.* aptly summarizes how “financial product” is defined under the Corporations Act.<sup>303</sup> The court held that a “financial product” is defined by reference to a general definition, some specific inclusions, and specific exclusions.<sup>304</sup> It added that a product may be included under either the general or specific inclusions, but that the specific exclusions have overriding force.<sup>305</sup>

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<sup>298</sup> *Id.* ss 111AC, 602(a)(i), 603–604, 671A; *Att’y-Gen. (Cth.) v Alinta* [2008] 233 CLR 542, [51], [55] (Austl.); *ASIC v. Pegasus Leveraged Options Grp.* [2002] 41 ACSR 561, [23], [61] (Austl.).

<sup>299</sup> *Corporations Act* s 92(3) (Austl.).

<sup>300</sup> *Thompson v ASIC* [2002] 117 FCR 159, [15]–[16] (Austl.).

<sup>301</sup> *Corporations Act* ss 92 (4), 700, 761A, 764A(1)(a); *Stratford Sun Ltd. V OM Holdings Ltd.; In the Matter of OM Holdings Ltd. (No 5)* [2011] FCA 1275, [39] (Austl.); *ASIC v. Emu Brewery Mezzanine Ltd.* [2004] 52 ACSR 168, [73], [75] (Austl.) (holding that the Section 761A definition of securities excludes notes and managed investment schemes).

<sup>302</sup> *Corporations Act* s 761A (Austl.).

<sup>303</sup> [2006] FCA 1805, [54] (Austl.); *see also Corporations Act* ss 9, 761A, 763A, 764A, 765A (Austl.).

<sup>304</sup> *Deakin Fin. Serv.*, FCA 1805, [54] (Austl.).

<sup>305</sup> *Id.*; *see also Corporations Act* s 762A (Austl.).

The general definition of a “financial product” is “a facility through which, or through the acquisition of which, a person does one or more of the following: (a) makes a financial investment . . .; (b) manages financial risk . . .; or (c) makes non-cash payments . . . .”<sup>306</sup> The specific inclusions that complete the “Australian Definition” are enumerated “specific things that are financial products.”<sup>307</sup> They include:

(a) a security; (b) an interest in, a legal or equitable right or interest, or an option to acquire an interest or right in a registered scheme; (ba) an interest in, a legal or equitable right or interest, or an option to acquire an interest or right in managed investment scheme that is not a registered scheme; (c) a derivative; (d) a contract of insurance that is not a life policy, or a sinking fund policy; (e) a life policy, or a sinking fund policy, within the meaning of the Life Insurance Act 1995, that is a contract of insurance; (f) a life policy, or a sinking fund policy, within the meaning of the Life Insurance Act 1995, that is not a contract of insurance; (g) a superannuation interest; (h) an RSA (retirement savings account); (ha) an FHSA (short for first home saver account); (j) a debenture, stock, or bond issued or proposed to be issued by a government; (k) a foreign exchange contract that is not: (i) a derivative; or (ii) a contract to exchange one currency (whether Australian or not) for another that is to be settled immediately; (ka) an Australian carbon credit unit; (kb) an eligible international emissions unit; (l) a margin lending facility; (m) anything declared by the regulations to be a financial product for the purposes of this section.<sup>308</sup>

The specific exclusions include an equally long list of excluded financial products, such as an excluded security, health insurance policies, and anything ASIC declares not to be a financial product.<sup>309</sup>

Finally, the definition of a “financial product” is the statutory mechanism under which the Corporations Act and ASIC Act cover new financial instruments.<sup>310</sup> It was added specifically for that purpose by the Financial Services Reform Act 2001, which broadened the range of products that are securities and futures in Australia.<sup>311</sup>

## *2. Interest in Managed Investment Schemes*

The Corporations Act regulates non-superannuation funds—non-retirement pension and other pooled investment schemes—as managed

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<sup>306</sup> *Corporations Act* s 763A (Austl.).

<sup>307</sup> *Id.* s 764A.

<sup>308</sup> *Id.*

<sup>309</sup> *Id.* ss 765A(1), 765A(2); *ASIC v Narain* [2008] 247 ALR 659, [38]–[40] (Austl.).

<sup>310</sup> *Corporations Act* s 765(1)(m) (Austl.); *Narain*, 247 ALR [85] (Austl.).

<sup>311</sup> *Narain*, 247 ALR [85] (Austl.).

investment schemes.<sup>312</sup> Under the Corporations Act, an interest in a managed investment scheme is a security and a financial product.<sup>313</sup> The expression “interest in a managed investment scheme” is defined as “a right to benefits produced by the scheme (whether the right is actual, prospective, or contingent, and whether it is enforceable or not).”<sup>314</sup> A “managed investment scheme” is defined as a scheme with the following features:

- (i) people contribute money or money’s worth as consideration to acquire rights (interests) to benefits produced by the scheme (whether the rights are actual, prospective, or contingent and whether they are enforceable or not);
- (ii) any of the contributions are to be pooled, or used in a common enterprise, to produce financial benefits, or benefits consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);
- (iii) the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions).<sup>315</sup>

The first requirement for a scheme to constitute a managed investment scheme under the Corporations Act is that “people contribute money or money’s worth as consideration to acquire rights to benefits,” and such benefits are produced by the scheme.<sup>316</sup> To “contribute,” according to the courts, involves giving, paying, supplying money’s worth, or generally giving for a common purpose.<sup>317</sup> The benefits produced by the scheme need not be just some gain or profit. Rather, a “benefit” broadly includes schemes that produce outcomes that benefit its members, such as recreational or lifestyle schemes.<sup>318</sup> For instance, *Brookfield Multiplex Ltd v International Litigation Funding Partners* found a litigation agreement

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<sup>312</sup> See, e.g., *Brookfield Multiplex Ltd. v Int’l Litig. Funding Partners Pte. Ltd.* [2009] 180 FCR 11, [16], [21]–[22] (Austl.).

<sup>313</sup> *Corporations Act* ss 92(1)(c), 92(2)(c), 92(3)(c), 92(4), 761A(e)(ii), 764A(1)(b)–(ba) (Austl.); *Austl. Sec. & Inv. Comm’n v. West* [2008] SASC 111 (Austl.) (“[B]y section 764A(1)(ba) an interest in a managed investment scheme that is not registered, but which is required to be registered by section 601ED(1), constitutes a financial product . . .”).

<sup>314</sup> *Corporations Act* s 9 (Austl.); *ASIC v Enter. Solutions Pty. Ltd.* [2000] 35 ACSR 620, [6] (Austl.) (“The rights which the investors acquire when they pay money in are rights to have a scheme operate in accordance with the agreements they have made and to be paid monies due.”).

<sup>315</sup> *Corporations Act* s 9(a) (Austl.).

<sup>316</sup> *Id.* s 9(a)(i); *Enter. Solutions Pty. Ltd.* 35 ACSR 620, [12]–[13] (Austl.).

<sup>317</sup> See *Enter. Solutions Pty. Ltd.* 35 ACSR 620, [12]; *Burton v Arcus* [2006] 32 WAR 366, [55]–[57] (Austl.); *Crocombe v Pine Forests of Austl. Pty. Ltd.* [2005] 219 ALR 692, [52]–[53] (Austl.).

<sup>318</sup> *Brookfield Multiplex Ltd. v Int’l Litig. Funding Partners Pte. Ltd.* [2009] 180 FCR 11, [79]–[81] (Austl.).

constituted a benefit, where people contributed money for legal services, costs orders, and security for costs to prosecute claims against Multiplex for damages or compensation for investment losses incurred during the construction of Wembley Stadium in London, U.K., without outgoings in the event of failure.<sup>319</sup>

The second requirement to establish a managed investment scheme has three facets: “that any of the contributions are pooled, or used in a common enterprise; to produce financial benefits or benefits consisting of rights or interests in property; and for the scheme members.”<sup>320</sup> The pooling of contributions is not limited to funds or physical pooling of assets. Knowing where resources are located and that the resources are available to the members fulfills the pooling condition.<sup>321</sup> A scheme is a common enterprise if shared or belongs to “more than one as a result of joint action or agreement.”<sup>322</sup> The third and final feature of a managed investment scheme is the “day-to-day control.”<sup>323</sup> The “day-to-day control” means control-in-fact, rather than control as a legal right.<sup>324</sup> Day-to-day control entails that members as a whole participate in making the routine, ordinary, everyday business decisions over the management of a scheme, and that the members are bound by the decisions made.<sup>325</sup>

Clearly, the scope of the Corporations Act definition of a “managed investment scheme” is broad. It covers many schemes that do not require registration or regulation under the Corporations Act.<sup>326</sup> To limit this broad scope, the Corporations Act provides thirteen categories of exclusions to the definition of a managed investment scheme, and authorizes ASIC to exclude any additional schemes.<sup>327</sup> The categories of exclusions include certain partnerships, body corporates, superannuation funds, franchises, statutory funds, barter schemes, retirement villages, and cooperatives.<sup>328</sup>

A scheme that fulfills all three elements of the definition of a managed investment scheme is a statutory managed investment scheme that must be constituted, registered, and conducted as prescribed in Chapter 5C; otherwise it is predisposed to be wound up.<sup>329</sup> Conversely, any scheme that falls short of any of these three requirements does not qualify as a managed

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<sup>319</sup> *Id.* at [81], [160].

<sup>320</sup> *Id.* at [83].

<sup>321</sup> *Id.* at [90]–[93].

<sup>322</sup> *Id.* at [98].

<sup>323</sup> *Corporations Act 2001* (Cth) s 9(a)(iii) (Austl.).

<sup>324</sup> *See, e.g., Burton* 32 WAR 366, [81]–[83].

<sup>325</sup> *Id.* at [80].

<sup>326</sup> *Brookfield Multiplex Ltd. v Int’l Litig. Funding Partners Pte. Ltd.*, [2009] 180 FCR 11, [26] (Austl.).

<sup>327</sup> *Id.*; *Corporations Act* s 9 (Austl.).

<sup>328</sup> *Corporations Act* s 9 (Austl.).

<sup>329</sup> *Id.* at [84]; *ASIC v Fuelbanc Austl. Ltd.* [2007] FCA 960, [26], [30] (Austl.).

investment scheme, and cannot be subjected to a winding up order.<sup>330</sup> The Corporations Act authorizes ASIC, the person operating the scheme, or a member of the managed investment scheme constituted or operating in contravention of the Corporations Act to apply to the courts to stop and disband the scheme, including declaring insolvency.<sup>331</sup>

### 3. *Exempt Securities and Public Offerings*

The Corporations Act exempts three securities from its definitions of securities: a derivative,<sup>332</sup> an excluded security,<sup>333</sup> and a market traded option,<sup>334</sup> but derivatives are still covered as a “financial product.”<sup>335</sup> Additionally, it exempts thirteen schemes from the definition of a managed investment scheme<sup>336</sup> and numerous instruments from its comprehensive list of specific things that are not financial products.<sup>337</sup>

The Corporations Act, which does not refer to public offerings as generally understood, regulates all public offerings of securities unless a clear exemption exists.<sup>338</sup> However, it provides limited exemptions to its disclosure requirements, including small scale or personal offerings, sophisticated investors, and professional investors.<sup>339</sup> The public offerings exemptions are subject to restrictions, including the restrictions on advertising and securities hawking provisions.<sup>340</sup>

### 4. *Scope of Securities and Financial Products*

The broad scope of the definition of a “financial product” is in line with the wide range of financial industries and activities ASIC and the Corporations Act regulate. It covers securities, futures, insurance and pooled investments, pension funds, life policies, and many other instruments.<sup>341</sup> It also includes non-traditional financial activities, such as

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<sup>330</sup> *Corporations Act* s 601EE (Austl.); *Nat'l Austl. Bank Ltd. v Norman* [2009] 180 FCR 243, [181]–[183] (Austl.) (arguing that a scheme to misappropriate investors' funds is not statutory managed investment scheme).

<sup>331</sup> *Corporations Act* s 601EE (Austl.); *Nat'l Austl. Bank Ltd*, 180 FCR at [181]–[183].

<sup>332</sup> *Corporations Act* ss 92(1)(f), 92(2)(f), 92(3)(f) (Austl.).

<sup>333</sup> *Id.* ss 92(1)(g), 92(2)(g), 92(3)(g), 761A.

<sup>334</sup> *Id.* s 92(3)(g).

<sup>335</sup> *Id.* s 764A(1)(c).

<sup>336</sup> *Id.* s 9(c)–(n).

<sup>337</sup> *Id.* s 765A.

<sup>338</sup> Anthony B. Greenwood et al., *Securities Regulations in Australia*, in *INTERNATIONAL SECURITIES REGULATION* § AU:17 (Robert C. Rosen et al. eds., Thomson & West Group 2012) (providing numerous exempted securities offerings).

<sup>339</sup> *Corporations Act* s 708 (Austl.); *ASIC v Pegasus Leveraged Options Grp. Pty. Ltd.* [2002] 41 ACSR 561, [61] (Austl.).

<sup>340</sup> *Corporations Act* s 734 (Austl.).

<sup>341</sup> *Id.* s 764A.

an Australian carbon credit unit and an eligible international emissions unit.<sup>342</sup>

The broad scope of financial products did not happen by accident. The Financial System Inquiry (Willis Report) recommended this broad definition as part of the Financial Services Reform Bill, which repealed the Corporations Law Act and replaced it with the Corporations Act and ASIC Act.<sup>343</sup> The Willis Report concluded that the definition and scope of “securities” in the repealed Corporations Law Act was incomplete.<sup>344</sup> Specifically, the term “securities” did not cover transactions falling outside the strict definitions of “securities” or “futures contracts;” it had narrow definitions of “securities” and “futures contract” that required legislative amendments to permit exchanges to trade new products, and it caused uncertainty and inconsistency in the treatment of hybrid products with both security and derivatives characteristics.<sup>345</sup> In fact, the prior definition of a security and its regulatory scheme resembled the U.S. Definition of security and its fragmented regulatory framework. Thus, Australia broadened the range of products that are securities and futures to cover them as financial products.<sup>346</sup>

Despite its broad scope, the Corporations Act, like the FSMA in the U.K., limits its coverage in a clear and specific way.<sup>347</sup> First, it limits the scope of “financial product” to a specific list of enumerated securities and financial products, most of which are defined in their applicable sections and chapters, as well as in the Act’s “Dictionary.”<sup>348</sup> Second, the Corporations Act allows the ASIC to add new products through regulations, requires that schemes register before they operate, and requires all individuals and entities offering a financial product to be licensed or declared exempt.<sup>349</sup> A financial product, therefore, is limited to enumerated securities, insurance contracts, futures, pooled investments, and anything declared a financial product by the regulations.

#### D. The Republic of India

The Indian securities markets date back over 200 years. The East India Company introduced the markets to raise capital, and by the close of

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<sup>342</sup> *Id.* s 764A(1)(ka)–(kb).

<sup>343</sup> Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth) 1, 3 (Austl.).

<sup>344</sup> See Angus Corbett, *Self-Regulation, CLERP and Financial Markets: A Missed Opportunity for Innovative Regulatory Reform*, 22 U.N.S.W.L.J. 506 (1999).

<sup>345</sup> *Id.*

<sup>346</sup> *Id.*

<sup>347</sup> See Financial Services and Markets Act (FSMA), 2000, c.8, § 22(2) (U.K.); *Corporations Act* ss 763A, 76A(1)(m) (Austl.).

<sup>348</sup> See *Corporations Act* ss 9, 761A–761H (Austl.).

<sup>349</sup> *Id.* ss 76A(1)(m), 601EE, 791a.

the eighteenth century, loan securities were traded frequently in colonized India.<sup>350</sup> By the 1830s, securities transactions on loans, corporate stocks, and shares had increased markedly, particularly in the banks and cotton presses of Mumbai.<sup>351</sup>

India experienced its first financial market bubble from 1861–1865, during the American Civil War.<sup>352</sup> As the United States steadily marched toward the Civil War in the late 1850s, English cotton manufacturers, who relied on U.S. cotton, formed the Cotton Supply Organization in 1857 to find cotton supplies outside the United States.<sup>353</sup> India was a natural fit. It converted grain fields into cotton plantations, and its share of the English raw cotton market increased from thirty-one percent in 1861 to over ninety percent in 1862.<sup>354</sup> This increase in Indian cotton production created unprecedented demand for and speculation in the stocks of all companies, especially banks, financial institutions, and land reclamation projects.<sup>355</sup> It also brought deceptive practices as Indian cotton producers added dirt, stones, and water, among other deceitful techniques, to increase the weight of their cotton—which the British resented.<sup>356</sup> Once the U.S. Civil War ended, the British returned to U.S. cotton producers, leading to a crash of the Indian stock markets and a deep economic depression.<sup>357</sup>

India did not enact any major securities regulations until after it gained independence from Britain in 1947. India's new Central Government enacted the Companies Act 1956 (Companies Act) to regulate companies and its primary securities markets, and the Securities Contracts (Regulation) Act 1956 (SCR Act) to regulate its secondary securities markets.<sup>358</sup> Among other things, the SCR Act outlawed stock options, futures contracts, and other derivatives, and shut down all but seven stock exchanges.<sup>359</sup> Furthermore, it removed the powers of the self-regulatory organizations that enforced securities regulations, and assigned regulatory powers to the Ministry of Finance.<sup>360</sup> Though they were heavily amended in 1992, both

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<sup>350</sup> See Shreecant Vattiikuti, *Accelerating Towards Globalization: Indian Securities Regulation Since 1992*, 23 N.C. J. INT'L L. & COM. REG. 105, 110 (1997).

<sup>351</sup> *Id.*

<sup>352</sup> Frenise A. Logan, *India—Britain's Substitute for American Cotton, 1861-1865*, 24 J. S. HIST. 472, 473–76 (1958).

<sup>353</sup> *Id.* at 472.

<sup>354</sup> *Id.* at 476.

<sup>355</sup> Vattiikuti, *supra* note 350, at 110–11.

<sup>356</sup> Frenise A. Logan, *India's Loss of the British Cotton Market after 1865*, 31 J. S. HIST. 40, 41–42 (1965).

<sup>357</sup> *See Id.* at 49.

<sup>358</sup> Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012); Companies Act, No. 1 of 1956, INDIA CODE (2012).

<sup>359</sup> Vattiikuti, *supra* note 350, 113–14 (1997).

<sup>360</sup> *Id.* at 114.

the Companies Act and the SCR Act remain India's principal corporate and securities laws.

Between 1992 and 2004, India completely overhauled its securities regulations as part of its New Industrial Policy.<sup>361</sup> It repealed its capital control law, the Capital Issues (Control) Act 1947, and replaced it with new securities laws that, for historical and other reasons, were modeled on or copied outright from the U.K.'s securities laws.<sup>362</sup> India modernized the SCR Act and the Companies Act.<sup>363</sup> Moreover, it introduced the Securities and Exchange Board of India Act 1992 (SEBI Act) and the Depositories Act 1996.<sup>364</sup> The SEBI Act created the Securities and Exchange Board of India (SEBI), India's securities regulator.<sup>365</sup> The Depositories Act established securities depositories and regulates the transfer of securities.<sup>366</sup>

### *1. The SCR Act Definition of Securities*

India's concept, use, and regulatory treatment of "securities" are akin to the United States. Section 2(h) of the SCR Act (Indian Definition) provides India's sole definition of "securities":

(i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate; (ia) derivative; (ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes; (ic) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; (id) units or any other such instrument issued to the investors under any mutual fund scheme; (ie) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable, including mortgage debt, as the case may be; (ii) Government

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<sup>361</sup> See Rakesh Mohan, *A Decade of Reforms in Government Securities Market in India and the Road Ahead*, RES. BANK INDIA BULL., November 2004, at 1011–13, available at <http://www.rakeshmohan.com/docs/RBIBulletinNov2004-2.pdf>.

<sup>362</sup> See Dara P. Mehta, *Securities Regulations in India*, in [Binder 3] INTERNATIONAL SECURITIES REGULATION 6–7, 9–10 (Robert C. Rosen et al. eds., 1997); Vattiikuti, *supra* note 350, at 118.

<sup>363</sup> Mehta, *supra* note 362, at 9–10.

<sup>364</sup> Securities and Exchange Board of India (SEBI) Act, No. 15 of 1992 INDIA CODE (2012); Depositories Act, No. 22 of 1996, INDIA CODE (2012).

<sup>365</sup> See BLOOMENTHAL & WOLFF, *supra* note 193, § 58A:5–9; 28 INDIAN LAW INSTITUTE, ANNUAL SURVEY OF INDIAN LAW 560 (Alice Jacob ed., 1992) (explaining the creation of the SEBI).

<sup>366</sup> Depositories Act §§ 2, 9.

securities; (iia) such other instruments as may be declared by the Central Government to be securities; (iii) rights or interest in securities.<sup>367</sup>

The Indian Definition has evolved in the last twenty years.<sup>368</sup> Derivatives, units in any collective investment scheme or mutual fund scheme, security receipts, certificates, government securities, and other instruments declared by the Central Government of India to be securities, were all added in that period.<sup>369</sup> These changes, especially the addition of securitization and mortgage securities, were made in response to global financial and regulatory changes.<sup>370</sup> Nevertheless, the Central Government added units and any such instrument issued to the investors under any mutual fund scheme after the Securities Appeals Tribunal held that a mutual fund constitutes a security under the SRC Act, even though Section 2(h) did not include mutual funds at the time.<sup>371</sup>

## 2. Pooled Investments as Units in Collective Investment Schemes

Consistent with most jurisdictions around the world, India regulates pooled investments as collective investment schemes.<sup>372</sup> The Indian Definition includes two forms of collective investment schemes: “units or any other instrument issued by any collective investment scheme to the investors in such schemes;” and “units or any other such instrument issued to the investors under any mutual fund scheme.”<sup>373</sup> The SEBI Act defines a “unit” as any instrument issued under a scheme, by whatever name called, denoting the value of the subscription of a unit holder.<sup>374</sup>

The SEBI Act defines a “collective investment scheme” as:

[A]ny scheme or arrangement made or offered by any company under which: (i) the contributions, or payments made by the investors, by whatever name called, are pooled and utilized solely for the purposes of the scheme or arrangement; (ii) the contributions or payments are made to such scheme or arrangement by the investors

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<sup>367</sup> Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 2(h).

<sup>368</sup> *Id.*; SEBI Act § 30 (India); NAT'L STOCK EXCH. OF INDIA LTD, 11 INDIAN SECURITIES MARKET: A REVIEW 13–14 (2008), available at [http://www.nseindia.com/archives/us/ismr/us\\_ismr2008.htm](http://www.nseindia.com/archives/us/ismr/us_ismr2008.htm).

<sup>369</sup> See NAT'L STOCK EXCH. OF INDIA LTD, *supra* note 368, at 14.

<sup>370</sup> *Id.*

<sup>371</sup> *M/s. PCS Industries Ltd v. SEBI*, (2001), Sec. App. Tribunal (Mumbai) Appeal No. 31/2001, available at <http://www.sebi.gov.in/satorders/PCSIndustries.html>.

<sup>372</sup> See NAT'L STOCK EXCH. OF INDIA LTD, *supra* note 368, at 55.

<sup>373</sup> SCR Act §§ 2(h)(ib), 2(h)(id) (India); *M/s. PCS Industries Ltd*, Appeal No. 31/2001 (India).

<sup>374</sup> SEBI (VCFs) Regulations, 1996, Gen. S. R. & O. 850(E) Reg. 2(dd) (India).

with a view to receive profits, income, produce or property, whether movable or immovable from such scheme or arrangement; (iii) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors; (iv) the investors do not have day to day control over the management and operation of the scheme or arrangement.<sup>375</sup>

This definition of a collective investment scheme is so broad that it covers schemes the government did not intend to regulate, like time-shares and club memberships. However, the SEBI Act goes on to exclude eight of these schemes.<sup>376</sup>

The SEBI Act currently authorizes and regulates three broad categories of collective investment schemes: collective investment schemes; mutual funds; and venture capital funds.<sup>377</sup> Regardless of the similarity between collective investment schemes and mutual funds vis-à-vis the pooling of savings and issuing of securities, the SEBI Act historically differentiated them based on their investment objectives. Mutual funds invest exclusively in securities while collective investment schemes only invest in plantations, real estate, and art funds.<sup>378</sup> Since January 2006, however, SEBI has permitted gold Exchange Traded Fund schemes to invest in gold and gold related instruments.<sup>379</sup> Since May 2008, SEBI has also authorized mutual funds to invest in real estate as part of SEBI's continuous review of regulations in response to market changes.<sup>380</sup>

Under the SEBI Act, "No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital fund or collective investment scheme, including mutual funds, unless he obtains a certificate of registration from the [SEBI] in accordance with the regulations."<sup>381</sup> The SEBI Act prescribes civil and criminal sanctions for violations of its provisions or its regulations.<sup>382</sup>

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<sup>375</sup> See, e.g., Securities and Exchange Board of India (SEBI) Act, No. 15 of 1992, INDIA CODE (2012), § 11AA(2); *Varindhavan Forests Ltd. v. SEBI*, (2001), Sec. App. Tribunal (Mumbai) Appeal No. 55/2001, available at <http://web.sebi.gov.in/satorders/Varindhavan.html>.

<sup>376</sup> SEBI Act § 11AA(3) (India).

<sup>377</sup> See, e.g., NAT'L STOCK EXCH. OF INDIA LTD., *supra* note 368, at 55.

<sup>378</sup> Art Funds are essentially unauthorized collective investment schemes. See *id.* at 57; SEBI (Mutual Funds) Regulations, 1996, Gen. S. R. & O. 856 (E), Reg. 2(q) (India).

<sup>379</sup> See NAT'L STOCK EXCH. OF INDIA LTD., *supra* note 368, at 59.

<sup>380</sup> *Id.*

<sup>381</sup> Securities and Exchange Board of India (SEBI) Act, No. 15 of 1992, INDIA CODE (2012), § 12(1B).

<sup>382</sup> *Id.* §§ 11, 11AA, 12.

### 3. *Exempt Securities and Public Offerings*

These amendments, along with the exhaustive definitions of the material terms in the SCR Act and its regulations, shaped the Indian definition. The SCR Act does not provide for exclusions or exemptions from the securities laws. Instead, exemptions are available to certain issuers and securities offerings pursuant to the Guidelines issued by the SEBI. The Guidelines apply to initial public offers by new companies and existing private or closely held companies and in further issues of capital by existing companies by way of shares, debentures, and bonds with limited exemptions.<sup>383</sup> The limited exemptions from securities issues include exempt private placements, that is, issues of securities to a select group of persons not exceeding forty-nine, and which is neither a rights issue nor a public issue.<sup>384</sup> Finally, the SEBI Act provides eight broad exclusions to collective investment schemes, including registered cooperative societies, contracts of insurance governed by insurance statutes, contributions to mutual fund schemes, and pension schemes.<sup>385</sup>

### 4. *Scope of the Indian Definition of Securities*

The Indian securities laws cover securities, futures, and pooled investment schemes. The Securities Appellate Tribunal, the highest judicial body to analyze the Indian Definition thus far, determined in *M/s. Integrated Amusement Ltd v. SEBI* that the Indian Definition is not closed-ended and it covers all marketable securities.<sup>386</sup> Despite its allegedly broad language and scope, the Indian Definition, in reality, is limited because it does not allow the courts or the regulators to append or remove financial instruments. Instead, the SCR Act exclusively grants these powers to the Central Government of India.<sup>387</sup> Pursuant to these powers, the Central Government added mutual fund schemes to the Indian Definition for clarity after the *M/s. Integrated Amusement* decision, along with derivatives, collective investment schemes, venture capital funds, and securitization products.<sup>388</sup>

The Indian Definition, like the FSMA in the U.K. and the Corporations Act in Australia, is limited to the enumerated financial activities and the financial industries the SCR Act regulates. Specifically, the SCR Act extensively defines the material terms in the statute and its regulations,

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<sup>383</sup> See Mehta, *supra* note 362, at 23.

<sup>384</sup> NAT'L STOCK EXCH. OF INDIA LTD., *supra* note 368, at 34.

<sup>385</sup> See SEBI Act § 11AA(3) (India).

<sup>386</sup> *M/s. Integrated Amusement Ltd. v. SEBI*, (2001), Sec. App. Tribunal (Mumbai) Appeal No. 7/2000 (India), available at <http://www.sebi.gov.in/satorders/Integrated.html>.

<sup>387</sup> Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 2(h)(iii).

<sup>388</sup> See *supra* text accompanying note 385.

excludes the civil courts' jurisdiction over securities matters, and gives the Central Government flexibility to determine and append financial activities to the Indian Definition without going through the legislature. Accordingly, the Indian Definition only covers the specific list of enumerated securities and futures. The Indian Definition is also flexible enough to capture new financial activities, such as securitization products, in response to market and regulatory developments.

#### E. The Republic of South Africa

The beginning of the South African securities markets can be traced to the discovery of gold in 1886 and the "Gold Rush" that ensued.<sup>389</sup> London businessman Benjamin Woollan established the Johannesburg Exchange & Chambers Company primarily to raise capital for the mining and financial companies through stock trading.<sup>390</sup> This company later established the Johannesburg Stock Exchange (JSE) on November 8, 1887.<sup>391</sup> The JSE enjoyed self-regulation from its inception, and reached unprecedented levels of deregulation by 1995 through amendments to the now repealed Stock Exchanges Control Act 1 of 1985.<sup>392</sup> Today, the JSE is licensed as an exchange under the Securities Services Act, and remains Africa's premier stock exchange as well as one of the world's top ten stock exchanges.<sup>393</sup>

The JSE was the sole regulator of South Africa's financial markets until 1909, when a series of company statutes were passed to regulate South Africa's primary securities markets.<sup>394</sup> Virtually all the company laws replicated the British company laws of that time. The Companies Act of 1973, for example, lifted verbatim all its capital rules from the British Companies Act. The term "company law" was also borrowed from British law, and is used widely throughout Commonwealth countries like India.

South Africa consolidated its network of capital market legislation into the Securities Services Act in 2005. The Securities Services Act regulates South Africa's non-banking financial services industry.<sup>395</sup> It is complemented by the Collective Investment Schemes Control Act (CISCA), which regulates pooled investments, and the Companies Act,

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<sup>389</sup> *Johannesburg Stock Exchange*, FIN. MAPS OF THE WORLD, <http://finance.mapsofworld.com/stock-market/johannesburg-stock-exchange.html> (last visited Oct. 15, 2012).

<sup>390</sup> *Id.*

<sup>391</sup> *Id.*

<sup>392</sup> *History of the JSE*, JOHANNESBURG STOCK EXCHANGE, <http://www.jse.co.za/About-Us/History-Of-The-JSE.aspx> (last visited Oct. 15, 2012).

<sup>393</sup> *Overview of the JSE*, JOHANNESBURG STOCK EXCHANGE, <http://www.jse.co.za/About-Us/History-Of-The-JSE.aspx> (last visited Oct. 15, 2012).

<sup>394</sup> The Companies Act 31 of 1909 (S. Afr.) was replaced by the Companies Act 46 of 1926 (S. Afr.), which was replaced by the Companies Act 61 of 1973 (S. Afr.).

<sup>395</sup> Securities Services Act 36 of 2004 § 3 (S. Afr.).

which regulates all companies.<sup>396</sup>

The Securities Services Act and CISCA are supervised by the Financial Services Board (FSB), as established by the Financial Services Board Act.<sup>397</sup> The FSB shares securities regulatory responsibilities with the Department of Trade and Industry (DTI) and the South African Reserve Bank (SARB), the nation's central bank.<sup>398</sup> The DTI registers and supervises all companies, including public companies listed for trading in the secondary market.<sup>399</sup> The SARB oversees the underwriting of securities that are typically performed by the corporate finance departments of the banks it regulates.<sup>400</sup> Furthermore, the SARB regulates cross-border dual listings and foreign securities offerings as part of its currency exchange control responsibilities.<sup>401</sup>

On February 7, 2012, South Africa introduced the Financial Markets Bill (FMB Bill), which will repeal and replace the Securities Services Act.<sup>402</sup> The FMB Bill is intended, among other things, to align South African financial regulations with the developments in the local and international financial markets, both before and after the global financial crisis, and to address the regulatory weaknesses revealed chiefly by the International Monetary Fund in 2008.<sup>403</sup> The FMB Bill will also amend the definition of a security under the Securities Services Act.

### *1. The Securities Services Act Definition of Securities*

Despite South Africa's multiple securities laws and regulators, the sole definition of "securities" (South African Definition) is found in the Securities Services Act, which provides:

- (i) shares, stocks and depository receipts in public companies and other equivalent equities, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980);
- (ii) notes;
- (iii) derivative instruments;
- (iv) bonds;
- (v)

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<sup>396</sup> Collective Investment Schemes Control Act (CISCA) 45 of 2002 (S. Afr.); Companies Act 71 of 2008 (S. Afr.).

<sup>397</sup> Financial Services Board Act 97 of 1990 (S. Afr.); *Anglo Rand Capital House (Pty) Ltd v. FSB* 2006 (4) SA 73 (W) (S. Afr.) (confirming the FSB's broad powers).

<sup>398</sup> Int'l Monetary Fund, *South Africa: Financial System Stability Assessment, Including Report on the Observance of Standards and Codes on the Following Topic: Securities Regulation*, at 31–32, IMF Country Report No. 08/349 (2008).

<sup>399</sup> *Id.*

<sup>400</sup> *Id.*

<sup>401</sup> *Id.*

<sup>402</sup> Financial Markets Bill, 2012, Bill 35022–2012 (GN) (S. Afr.).

<sup>403</sup> S. AFR. NAT'L TREASURY, EXPLANATORY MEMORANDUM ON THE FINANCIAL MARKETS BILL, 2012, at 3 (2012), available at <http://www.fsb.co.za/finmarks/FinancialMarketsBill2012/FMB%20Explanatory%20Memorandum.pdf>.

debentures; (vi) participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, No. 45 of 2002, and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act; (vii) units or any other form of participation in a collective investment scheme licensed or registered in a foreign country; (viii) instruments based on an index; (ix) the securities contemplated in subparagraphs (i) to (viii) that are listed on an external exchange; and (x) an instrument similar to one or more of the securities contemplated in subparagraphs (i) to (ix) declared by the registrar by notice in the *Gazette* to be a security for the purposes of this Act; (xi) rights in the securities referred to in subparagraphs (i) to (x); (b) excludes- (i) money market instruments except for the purposes of Chapter IV; and (ii) any security contemplated in paragraph (a) specified by the registrar by notice in the *Gazette*.<sup>404</sup>

The South African Definition has some obvious drafting errors and coverage gaps that, surprisingly, went uncorrected and unchallenged in court until the recent review of the Securities Services Act. The error is the exclusion of money market instruments in subsection (b)(i). Apparently, the legislature intended to exclude money market securities instead, because the Securities Services Act neither defines “money market instrument,” nor applies to other financial laws that include the term.<sup>405</sup>

There are two coverage gaps in the South African Definition. The first coverage gap is the Securities Services Act’s definition of “shares, stocks and depository receipts *in public companies*,”<sup>406</sup> which suggests that the South African Definition applies to listed companies only, when in fact, Section 40 covers both listed and unlisted securities. The second coverage gap stems from the Securities Services Act’s inclusion of participatory interests in a domestic and foreign collective investment schemes.<sup>407</sup> Yet, Section (2)(a) expressly provides that “this Act does not apply to a collective investment scheme regulated by or under CISCA.” This suggests that the Securities Services Act’s definition does not apply to CISCA, which is problematic because CISCA does not define securities, nor does it reference or apply to the Securities Services Act.

The FMB Bill corrects these obvious regulatory oversights. First, it inserts “securities means listed and unlisted” in front of the Securities Services Act definition of securities to clarify that the definition also

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<sup>404</sup> Securities Services Act 36 of 2004 §§ 1(a)–(b) (S. Afr.).

<sup>405</sup> *Id.* § 3.

<sup>406</sup> *Id.* § 1(a)(i) (emphasis added).

<sup>407</sup> *Id.* §§ 1(a)(vi)–(vii).

captures unlisted securities.<sup>408</sup> Second, the FMB Bill amends money market *instruments* to mean money market *securities*.<sup>409</sup> Third, the FMB Bill excludes Section 2(a) and similar language in Section 3. Otherwise, the FMB Bill retains the Securities Services Act exemptions of Share Block Companies (a company owning and operating a retirement village), money market instruments (securities), and securities specified by the Registrar.<sup>410</sup> The Registrar has not excluded any security so far.

The Securities Services Act has another definition of securities that applies to the custody and administration of securities.<sup>411</sup> This definition includes certificated and uncertificated securities as well as money market instruments. “Certificated securities” are securities evidenced by a certificate or written instrument while “uncertificated securities” are securities not evidenced by a certificate or written instrument and are transferable by entry without a written instrument.<sup>412</sup> The FMB Bill will remove certificated securities from this definition, and replace money market instruments with money market securities consistent with its changes to the Social Services Act’s main definition of securities.<sup>413</sup>

## 2. Pooled Investments as Collective Investment Schemes

CISCA regulates the collective investment schemes industry in South Africa. Section 1 of CISCA defines a “collective investment scheme” as:

[A] scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which: (a) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and (b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis determined in the deed, but not a collective investment schemes authorized by any other Act.<sup>414</sup>

Section 1 of CISCA goes on to define a “participatory interest” as: “any interest, undivided share or share whether called a participatory interest, unit or by any other name, and whether the value of such interest, unit, undivided share or share remains constant or varies from time to time,

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<sup>408</sup> See S. AFR. NAT’L TREASURY, *supra* note 403, at 16.

<sup>409</sup> *Id.*

<sup>410</sup> Securities Services Act §§ 1(a)(i), 1(b)–(b)(x) (S. Afr.).

<sup>411</sup> *Id.* § 29.

<sup>412</sup> *Id.*

<sup>413</sup> S. AFR. NAT’L TREASURY, *supra* note 403, at 16.

<sup>414</sup> Collective Investment Schemes Control Act (CISCA) 45 of 2002 § 1 (S. Afr.).

which may be acquired by an investor in a portfolio.”

CISCA authorizes and regulates five types of collective investment schemes based on their investment objectives.<sup>415</sup> The first type is Collective Investment Schemes in Securities. The portfolio of these schemes consists only of securities.<sup>416</sup> The second category is Collective Investment Schemes in Property. The portfolio of these schemes consists of property shares or immovable property.<sup>417</sup> The third regulated investment scheme category is Collective Investment Schemes in Participation Bonds. The portfolio of these schemes consists mainly of assets in the form of participation bonds.<sup>418</sup> The fourth category is Declared Collective Investment Schemes, defined as “a collective investment scheme other than a collective investment scheme in securities, property, or participation bonds, which has been declared to be a collective investment scheme under section 63 of CISCA.”<sup>419</sup> The fifth and final category of regulated collective investment schemes are Foreign Collective Investment Schemes, which the CISCA does not define.<sup>420</sup> Instead, the Securities Services Act defines Foreign Collective Investment Schemes as “a scheme, in whatever form, carried on in a country other than the Republic” of South Africa that is promoted in South Africa.<sup>421</sup>

Managers of any of these collective investment schemes may convert them into another type of collective investment scheme subject to CISCA’s Conversion of Collective Investment Schemes regulations.<sup>422</sup> All collective investment schemes must satisfy a plethora of similar statutory requirements, including the requirement that no person may operate the scheme without registration as a manager or authorized agent, unless they are exempted by the Registrar. Additionally, the constitution of all collective investment schemes must contain prescribed information.<sup>423</sup> Failure to comply with the Registrar’s directions or contravening any CISCA provision attracts the cancellation or suspension of the offending collective investment scheme’s license, along with civil and/or criminal sanctions.<sup>424</sup>

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<sup>415</sup> CISCA §§ 39, 47, 52, 62, 65 (S. Afr.).

<sup>416</sup> *Id.* § 39.

<sup>417</sup> *Id.* § 47.

<sup>418</sup> *Id.* § 52.

<sup>419</sup> CISCA § 62 (S. Afr.).

<sup>420</sup> *Id.* § 65.

<sup>421</sup> Securities Services Act 36 of 2004 § 1 (S. Afr.).

<sup>422</sup> CISCA § 77 (S. Afr.).

<sup>423</sup> *Id.* §§ 5, 32, 97; *Yarram Trading v. ABSA 2007 (2) SA 1 (SCA)* at 570 (S. Afr.) (defining the elements of a collective investment scheme in property).

<sup>424</sup> CISCA §§ 28, 115, 116 (S. Afr.).

### 3. *Exempt Securities and Public Offerings*

The South African Definition excludes money market instruments and any instrument specified by the Registrar of Securities Services.<sup>425</sup> The Companies Act also exempts select securities offerings, including: small offers not exceeding ZAR100,000; offers to existing shareholders or debenture holders of a company; rights offers; single offers of shares to company directors, officers and their close relatives; and limited one-time offers to fifty persons or less aggregating up to ZAR100,000.<sup>426</sup>

### 4. *Scope of the South African Securities Definitions*

By design and statutory language, the South Africa Definition covers securities, derivatives, and pooled investment schemes. The Securities Services Act provides statutory definitional mechanisms similar to the U.K., Australia, and India, which limit the scope of the South Africa Definition. The Securities Services Act extensively defines enumerated terms, allows the Registrar to add or remove instruments to the South African Definition, limits the powers of the Registrar to add only similar instruments to the enumerated securities, and provides a registration and authorization regiment for managers of schemes to prevent them from offering schemes outside of the South African Definition.<sup>427</sup> This is all subject to change, however, as the true scope of the South African Definition will be tested in the near future, largely because of the increasingly severe administrative, civil, and criminal sanctions in the FMB Bill and other South African financial laws.

## III. APPRAISAL OF U.S. AND SELECTED COUNTRIES DEFINITIONS' SCOPES

Although the United States' and the Selected Countries' concepts and regulation of "securities" originated from England, their shared history is undetectable in modern times due to the fundamental differences in how they define and regulate securities. In general, the U.S. and the Selected Countries' Definitions fall into three distinct categories based on form and substance. The first category includes the U.S. Definition, which is not replicated in form or substance by any other country in the world. The second category includes the Australian and U.K. Definitions, which respectively use the terms "financial product" and "investments" instead of "securities."<sup>428</sup> The Indian and South African Definitions constitute the

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<sup>425</sup> Securities Services Act § 1(b) (S. Afr.).

<sup>426</sup> Companies Act 71 of 2008 § 96 (S. Afr.).

<sup>427</sup> See Securities Services Act § 1(x) (S. Afr.); CISCA §§ 28, 115, 116 (S. Afr.).

<sup>428</sup> *Corporations Act 2001* (Cth) s 763A (Austl.); *Financial Services and Market Act* (FSMA), 2000, c. 8, § 22(1) (U.K.).

third and final group. They both employ the term “securities” in substantially the same way as the U.S. Definition, but they differ from the U.S. Definition in statutory language and scope.<sup>429</sup>

The variations in national securities laws generate an asymmetrical comparison of the scopes of the U.S. and the Selected Countries’ Definitions. The scope of each definition can, nonetheless, be proportionately measured in two ways. The first method is to consider the financial activity the definition is designed to regulate and the range of such financial activities it actually captures. The second method is to determine what financial industries the securities laws are enacted to regulate and what they cover in practice. The U.S. Definition is broader than the Selected Countries’ Definitions on both counts. This is remarkable considering that U.S. federal securities laws, unlike its counterparts in the Selected Countries, apply only to securities and a carefully carved out narrow list of security-based futures.<sup>430</sup>

The U.S. courts’ broad construction of statutory language extends the U.S. Definition to an unknowable range of complex and ordinary business activities, such as distributorship and franchise agreements, mainly as “investment contracts.”<sup>431</sup> The U.S. Definition covers pooled investments through the definition of an “investment company” as an issuer and investor in securities under the Investment Company Act.<sup>432</sup> Furthermore, while federal securities laws exclude futures, Congress and the federal courts have failed to definitively address the fundamental issue of whether and when hybrid instruments such as options, index participations, and swaps qualify as futures, securities, or both. Instead, Congress and the federal courts have crafted various technical legal standards to include these hybrid instruments under the U.S. Definition on an ad hoc basis. For example, the Shad-Johnson Accord granted SEC jurisdiction over options on securities (including exempt securities), certificates of deposit, foreign currencies traded on a national securities exchange, and groups or indices of securities.<sup>433</sup> This Accord simultaneously gave the CFTC authority over futures contracts and options on futures contracts on exempt securities (other than municipal securities), certificates of deposit, and indices of securities that satisfy the statute’s criteria.<sup>434</sup> Additionally, the Dodd-Frank Act added security-based swaps to the U.S. Definition.<sup>435</sup> Federal courts

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<sup>429</sup> See Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 1(a); Securities Services Act § 1 (S. Afr.).

<sup>430</sup> 15 U.S.C. § 77b(a)(1) (2012).

<sup>431</sup> See *supra* text accompanying note 193.

<sup>432</sup> See 7 U.S.C. § 1a (2012); 15 U.S.C. § 80a-3(a)(1).

<sup>433</sup> OTC REPORT, *supra* note 134, at 8.

<sup>434</sup> *Id.*

<sup>435</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203,

have found securities in traded financial instruments, such as index participants, which have both future and security features.<sup>436</sup> Finally, the Securities Act exempts insurance contracts as part of the general U.S. policy placing insurance regulation at the state level because the United States does not regulate it at federal level.<sup>437</sup> Nonetheless, the U.S. Definition covers insurance products in two ways. First, stocks and bonds of insurance corporations are traditional securities under the U.S. Definition, and therefore, legitimately covered as securities. Second, the insurance exemption is not available to variable life insurance policies and variable annuities that pass through to the purchaser the investment performance of a pool of assets, which the SEC and the federal courts hold as securities.<sup>438</sup>

The U.S. Definition, therefore, covers countless instruments as “securities” and futures, insurance contracts, and pooled investments, even though its statutory language does not include these terms. That makes the scope of the U.S. Definition broader than the Indian and South African Definitions, which cover securities, futures, and pooled investments while regulating entire non-banking financial sectors.<sup>439</sup> This also means that the scope of the U.S. Definition is as broad as the U.K. and Australian Definitions, which explicitly cover securities, futures, insurance contracts, and pooled investments,<sup>440</sup> but broader than all its counterparts in the Selected Countries in terms of the infinite range of instruments it has the potential to encompass.

None of the Selected Countries’ Definitions is drafted so broadly to cover virtually countless financial activities across financial industries. The use of ordinary financial statutory language, the exhaustive definition of such statutory language, and the powers given to the regulators or the governments to add to or remove instruments from the Selected Countries’ Definitions create clear perimeters for the scopes of their definitions, set at the enumerated financial activities and similar additional instruments specified by their governments or regulators within the regulated industry. Conversely, the scope of the U.S. Definition is practically immeasurable both in terms of the financial activities and industries it reaches. This makes the U.S. Definition generally broad even by U.S. standards, and too broad

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§§ 761(a)(2), 768(a)(1), 124 Stat. 1376, 1755, 1800 (2010) (codified at 15 U.S.C. § 780).

<sup>436</sup> See *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 544 (7th Cir. 1989).

<sup>437</sup> 15 U.S.C. § 78c(a)(12)(A)(iv) (2012).

<sup>438</sup> *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 71–73 (1959) (concluding that variable annuities are securities).

<sup>439</sup> Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 2(h); Securities Services Act 36 of 2004 § 1(a) (S. Afr.).

<sup>440</sup> *Corporations Act 2001* (Cth) s 764A (Austl.); Financial Services and Market Act (FSMA), 2000, c. 8, § 22(1) (U.K.).

relative to the Selected Countries' Definitions.

#### IV. APPRAISAL OF U.S. AND SELECTED COUNTRIES' STATUTORY LANGUAGE

While no two countries have identical securities laws or definitions of a "security," the form and language of the Selected Countries' Definitions is largely the same and markedly different from how the United States defines and regulates a "security." A comparison of the language and style of the U.S. Definition with all the Selected Countries as a group is illustrative of at least four important aspects of the current state of global securities regulations. First, this comparison shows and accounts for the stark differences between the U.S. and Selected Countries' Definitions. Second, this comparison shows the limits of U.S. power and ability to lead or influence global securities regulations, particularly the definition and use of the term "security." Third, this comparison demonstrates that even though there are no effective globally coordinated securities rules, a growing number of countries are aligning their securities laws at a national level. Finally, this comparison shows the trends in global definitions and regulatory treatment of securities.

Generally, the U.S. and the Selected Countries' Definitions have two key similarities. The first is that they enumerate non-exhaustive lists of instruments consisting of a security, and leave it to their courts, legislatures, or regulators to enumerate additional instruments. The second is that they all include, in different fashions, traditional debt and equity products, like stocks and bonds, and new and exotic ones such as security-based swaps. As analyzed below, the language used to enumerate financial activities and the purpose behind such enumerations determine the meaning and scope of each country's definition.

##### A. Debt and Equity Securities

Each jurisdiction includes debt and equity instruments in its definition of securities, but what constitutes such debt and equity instruments marks the first major divergence between the U.S. and the Selected Countries' Definitions. Both the U.S. and Selected Countries' Definitions include shares or stocks, bonds, and debentures as securities.<sup>441</sup> Unlike the United States, which makes "any" of these enumerated instruments a security, the Selected Countries generally retain the original definition of "securities" as shares or stock, debentures, and debenture stock of bodies, whether incorporated or not.<sup>442</sup> Accordingly, the 100% stock sale of the company in

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<sup>441</sup> 15 U.S.C. § 77b(a)(1); *Corporations Act* ss 9, 92 (Austl.); SCR Act § 2(h)(i) (India); Securities Services Act § 1(a)(i) (S. Afr.); FSMA § 22(2), sch. 2, art. 11 (U.K.).

<sup>442</sup> See *Corporations Act* ss 9, 92 (Austl.); SCR Act § 2(h)(i) (India); Securities Services

*Landreth* would not present a definitional issue in the Selected Countries, not only because stock is quintessentially a security, but because the transaction involved the shares or stock of a company, which inherently qualifies as a security.<sup>443</sup> Similarly, the stock of the housing cooperative involved in *Forman* was clearly a security under all the Selected Countries' Definitions because the housing cooperative was a body.<sup>444</sup> The stock of housing cooperatives would benefit from the exclusion of housing, retirement villages, and cooperatives available in all the Selected Countries. Thus, the requirement from *Forman* and *Landreth* that instruments labeled as "stock" possess the usual characteristics of stock is superfluous in the Selected Countries.<sup>445</sup>

Other debt securities are provided for in varying fashions between the United States and the Selected Countries and among the Selected Countries. The U.S. and South African Definitions include "notes" as debt securities without defining the term.<sup>446</sup> Furthermore, the U.S. and U.K. Definitions include "evidence of indebtedness" and "instruments creating or acknowledging indebtedness," respectively.<sup>447</sup> In *Reves*, the United States developed the "family resemblance test" for both notes and evidence of indebtedness.<sup>448</sup> Consistent with its treatment of all enumerated investments, the FSMA defines "instruments creating or acknowledging indebtedness" as debentures, debenture stock, loan stock, bonds, certificates of deposit, and any other instruments creating or acknowledging a present or future indebtedness.<sup>449</sup> The U.S. Definition differs from the U.K. Definition in its classification of certificates of deposit, which the U.K. enumerates as a distinct security. In contrast, U.S. courts have ruled that certificates of deposit issued by any federal, state, foreign bank, or insured financial institution are not securities.<sup>450</sup> Both the term "note" and its "family resemblance test" are also superfluous for the Selected Countries, because other terms such as evidence of indebtedness, debentures, and bonds of a body serve the same or better purpose than "note" in the U.S. Definition. In fact, the "bonds of a body" requirement in Australia serves the same purpose as the U.S. "family resemblance test," which discounts

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Act §§ 1(a)(i), (iii)-(v) (S. Afr.); FSMA, § 22(2), sch. 2, art. 11 (U.K.).

<sup>443</sup> *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 688-93 (1985).

<sup>444</sup> See *Corporations Act* ss 9, 92 (Austl.); SCR Act § 2(h)(i) (India); Securities Services Act § 1(a)(i), 1(a)(iii)-(v) (S. Afr.); FSMA § 22(2), sch. 2 art. 11 (U.K.).

<sup>445</sup> *Landreth*, 471 U.S. at 686-87; *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975).

<sup>446</sup> See 15 U.S.C. § 77b(a)(1) (2012); Securities Services Act § 1(a)(ii) (S. Afr.).

<sup>447</sup> See 15 U.S.C. § 77b(a)(l); FSMA § 111(2), 115, sch. 12 (U.K.).

<sup>448</sup> *Reves v. Ernst & Young*, 494 U.S. 56, 62 (1990) (citing *Sec. Indus. Ass'n v. Bd. of Governors of Fed. Reserve Sys.*, 468 U.S. 137, 149-53 (1984)).

<sup>449</sup> See FSMA § 22(2), sch. 2 art. 12 (U.K.).

<sup>450</sup> *SEC v. Randy*, 38 F. Supp. 2d 657, 666 (N.D. Ill. 1999).

notes like IOUs exchanged between family and friends.<sup>451</sup>

### B. Novel, Hybrid and Complex Instruments

The U.S. Definition covers, and federal courts evaluate, “novel, uncommon, or irregular devices” and veiled and devious financial schemes as “investment contracts” and “any interest or instrument commonly known as a “security.”<sup>452</sup> The Supreme Court suggested in *Howey* that the investment contract analysis provides a full measure of protection to the investing public, but its ability to do so is disputed both in the United States and abroad.<sup>453</sup> The Selected Countries studied and adopted many aspects of the U.S. federal securities laws, but they discounted the investment contract analysis as a regulatory tool for evaluating new or hybrid instruments and preventing “veiled and devious” schemes.<sup>454</sup> Instead, the Selected Countries’ Definitions universally grant their governments or regulators powers to identify and add any financial activity.<sup>455</sup> Besides, the investment contracts analysis often ensnares hybrid instruments with features of securities, futures, and insurance contracts.<sup>456</sup> In this capacity, the investment contract analysis is superfluous in relation to the Selected Countries’ definitional requirements, because the Selected Countries’ Definitions already cover futures, and some cover insurance as well.<sup>457</sup>

The securities laws of the Selected Countries also regulate new and complex instruments in ways that do not require them to first qualify the instrument as a security. They generally prohibit individuals and entities from conducting any securities business without prior regulatory authorization or exemption.<sup>458</sup> No person or entity is authorized or

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<sup>451</sup> See *Corporations Act 2001* (Cth) s 9 (Austl.); *supra* text accompanying note 122.

<sup>452</sup> *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

<sup>453</sup> *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298 (1946); William J. Carney & Barbara G. Fraser, *Defining a Security: Georgia’s Struggle With the “Risk Capital” Test*, 30 EMORY L.J. 73 (1981) (arguing that the *Howey* test is irrelevant to investor protection).

<sup>454</sup> See, e.g., NEL COMM’N, FINAL REPORT OF THE COMMISSION OF INQUIRY INTO THE AFFAIRS OF THE MASTERBOND GROUP AND INVESTOR PROTECTION IN SOUTH AFRICA: CORPORATE LAW AND SECURITIES REGULATION IN SOUTH AFRICA (2001), available at <http://www.info.gov.za/view/DownloadFileAction?id=95668>.

<sup>455</sup> See *Corporations Act* ss 92(1)(c), 764A (Austl.); Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), §§ 2(h)(ib), 2(h)(id); Securities Services Act 36 of 2004 §§ 1(a)(vi)–(vii) (S. Afr.); Financial Services and Market Act (FSMA), 2000, c. 8, §22(2), sch. 2 art. 16 (U.K.).

<sup>456</sup> See *Roth v. Am. Family Mut. Ins. Co.*, 567 F.3d 884 (7th Cir. 2009); *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005); *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996), *reh’g denied*, 102 F.3d 587 (D.C. Cir. 1996).

<sup>457</sup> *Corporations Act* ss 9, 92 (Austl.); SCR Act § 2(h)(i) (India); Securities Services Act § 1(a)(i) (S. Afr.); FSMA § 22(2), sch. 2 art. 11 (U.K.).

<sup>458</sup> See *Corporations Act* ss 601EB, 601EE (Austl.); Securities and Exchange Board of India (SEBI) Act, No. 15 of 1992, INDIA CODE (2012), § 12(1B); Collective Investment

exempted unless they conduct securities activities as defined in the statutes. If the instruments are new, individuals and entities must convince the regulator or the government to declare the new instruments securities.

### C. Pooled Investments and Private Funds

The U.S. Definition covers pooled investments as securities either as an “investment contract” or an “investment company” depending on how the scheme is structured.<sup>459</sup> Federal courts generally evaluate pooled investment schemes that do not issue or invest in securities, such as land and insurance schemes, as “investment contracts.”<sup>460</sup> For example, the Court in *Howey* found an investment contract, and therefore a security under the U.S. Definition, in a scheme involving interests in a Florida citrus grove development project, coupled with a contract for cultivating, marketing, and returning the net proceeds to the investors.<sup>461</sup>

The U.S. Definition covers mutual funds and other private funds indirectly as an investment company if the mutual fund issues, owns, invests, or trades in securities. U.S. courts apply the *Howey* test to determine if a scheme is issuing or investing in securities.<sup>462</sup> Thus, under the U.S. Definition, owning, issuing, investing, or trading in securities is a condition precedent for establishing an “investment company,” and hence, a security.

The Selected Countries treat pooled investments differently.<sup>463</sup> First, the Selected Countries’ Definitions include interests or units in collective investment schemes. Second, while an investment contract is a security in the United States, the Selected Countries do not treat a collective investment scheme as a security. Rather, a collective investment scheme is equivalent to an investment company in the United States in that it is a prescribed form of investment management that must be organized and operated in accordance with the rules if it meets the statutory definition of a collective investment scheme. The sole purpose of establishing a collective investment scheme in the Selected Countries is, therefore, to register or exempt collective investment schemes that meet their statutory definitions, because any interests or units issued by such schemes are automatically

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Schemes Control Act (CISCA) 45 of 2002 §§ 5, 32, 97 (S. Afr.); FSMA, §§ 19–22, 31, 40 (U.K.).

<sup>459</sup> See 15 U.S.C. § 80a-3(a)(1)(A) (2012); 15 U.S.C. § 80b-2(a)(29) (2012).

<sup>460</sup> SEC v. W. J. Howey Co., 328 U.S. 293, 294–97, 299 (1946).

<sup>461</sup> *Id.*

<sup>462</sup> See *supra* text accompanying note 143.

<sup>463</sup> For the Selected Countries’ Definitions of “security,” see *Corporations Act* s 764A(1)(b)–(ba) (Austl.); Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 2(h)(ib); Securities Services Act 36 of 2004 § 1(a)(vi) (S. Afr.); Financial Services and Market Act (FSMA), 2000, c. 8, § 22(2), sch. 2 art. 16 (U.K.).

securities.<sup>464</sup>

In a rare case of consensus on global securities regulations, both the United States and the Selected Countries use the *Howey* test to establish an “investment company” and a “collective investment scheme,” respectively. While the *Howey* test remains judicial precedent in the United States, the Selected Countries codified it in their securities laws.<sup>465</sup> Accordingly, the Selected Countries use the investment contract analysis to establish statutory collective investment schemes, rather than an investment company and a security, which happens in the United States.

#### D. Futures, Insurance and Other Instruments

Futures, insurance, and other instruments are treated and classified differently in all the countries depending on the degree of consolidation of each country’s financial laws. The U.S. Definition is the only one that excludes futures and exempts insurance.<sup>466</sup> It covers some security futures added in the last thirty years and security-based swaps added to the U.S. Definition by the Dodd-Frank Act.<sup>467</sup> Complex financial instruments like credit default swaps that have features of securities, futures, and insurance are not reached by the U.S. Definition.<sup>468</sup>

The Selected Countries’ definitions include all forms of futures as derivatives, futures, or options.<sup>469</sup> The more consolidated Australian and U.K. Definitions include insurance contracts, pension schemes, and life insurance policies.<sup>470</sup> For example, life settlement contracts that are not securities in the United States—despite the SEC’s concerted efforts to cover them as investment contracts—may not be covered by the Indian and South African Definitions, but they are automatic investments and financial products under the U.K. and Australian Definitions, respectively.<sup>471</sup> In

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<sup>464</sup> See *Corporations Act* ss 601EB, 601EE (Austl.); Securities and Exchange Board of India (SEBI) Act, No. 15 of 1992, INDIA CODE (2012), § 12(1B); Collective Investment Schemes Control Act (CISCA) 45 of 2002, §§ 5, 32, 97 (S. Afr.); FSMA §§ 19–22, 31, 40 (U.K.).

<sup>465</sup> See *Corporations Act* s 9 (Austl.); SEBI Act § 11AA (India); CISCA § 1 (S. Afr.); FSMA § 235(1) (U.K.); FRANKEL & KIRSCH, *supra* note 143.

<sup>466</sup> 15 U.S.C. § 77b(a)(1) (2012).

<sup>467</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 761(a)(2), 768(a)(1), 124 Stat. 1376, 1755, 1800 (2010) (codified at 15 U.S.C. § 780); *supra* text accompanying note 133.

<sup>468</sup> See *supra* text accompanying note 15.

<sup>469</sup> See *Corporations Act* s 764A(1)(c) (Austl.); Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 2(h)(ia); Securities Services Act 36 of 2004 § 1(a)(iii) (S. Afr.); FSMA, § 22(2), sch. 2 arts. 16–17 (U.K.).

<sup>470</sup> See *Corporations Act* s 764A(1)(d)–(f) (Austl.); FSMA §22(2), sch. 2 arts. 19–20 (U.K.).

<sup>471</sup> SEC v. Mutual Benefits Corp., 408 F.3d 737 (11th Cir. 2005); SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996), *reh’g denied*, 102 F.3d 587 (D.C. Cir. 1996).

South Africa, life settlements would still be regulated by the FSB, which oversees insurance and pension schemes under different statutes.

Each country tends to enumerate a unique list of instruments in their definitions of securities. For example, government securities are enumerated in the statutory definitions of each country, except South Africa and the United States, which exempt them.<sup>472</sup> The U.K. Definition provides for “contracts for differences” that no other country, except South Africa, allows to be traded in its markets.<sup>473</sup> The Australian Definition includes an Australian carbon credit unit and an eligible international emissions unit.<sup>474</sup> The Indian Definition explicitly includes security receipts and certificates issued in securitization transactions or by securities depositories.<sup>475</sup> Finally, the U.S. Definition is replete with instruments that no other country replicates, such as profit-sharing agreements and investment contracts.<sup>476</sup>

#### E. Definitional Terminology

The U.S. Definition’s language differs significantly from that of all the Selected Countries in at least four respects. First, it uses terms without ordinary financial uses or established financial or legal meanings outside judicial interpretations, such as “investment contracts.”<sup>477</sup> Second, the U.S. Definition includes numerous certificates for securities, such as a “collateral-trust certificate,” “any certificate of interest or participation,” or a “temporary or interim certificate.”<sup>478</sup> Third, it includes instruments, such as an “interest or participation in any profit-sharing agreement” and a “fractional undivided interest in oil, gas, or other mineral rights,” which are typically forms of pooled investments.<sup>479</sup> Finally, the U.S. Definition slices securities options into “any put, call, straddle, option, or privilege *on any security*” in order to distinguish options on securities from options on futures outside its jurisdiction.<sup>480</sup>

None of the U.S. Definition’s counterparts in the Selected Countries use terms that are unfamiliar to the financial markets and the law.<sup>481</sup> When

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<sup>472</sup> See *Corporations Act* s 92(1) (Austl.); SCR Act § 2(h)(ii) (India); FSMA § 22(2), sch. 2 art. 13 (U.K.).

<sup>473</sup> FSMA § 22(2), sch. 2 art. 19 (U.K.).

<sup>474</sup> *Corporations Act* s 764A(1)(ka)–(kb) (Austl.).

<sup>475</sup> See SCR Act § 2(h)(ic) (India).

<sup>476</sup> 15 U.S.C. § 77b(a)(1) (2012).

<sup>477</sup> *Id.*

<sup>478</sup> *Id.*

<sup>479</sup> *Id.*

<sup>480</sup> *Id.* (emphasis added); OTC REPORT, *supra* note 134, at 8.

<sup>481</sup> *Corporations Act 2001* (Cth) s 764A(1) (Austl.); Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 2(h); Securities Services Act 36 of 2004 § 1(a) (S. Afr.); Financial Services and Market Act (FSMA), 2000, c. 8, § (22)(2), sch. 2 art. 16 (U.K.).

they do, they comprehensively define such terms. For example, the U.K. Definition includes “contracts for differences,” which is largely meaningless until the U.K. Definition defines this term as rights under any contract the “purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or an index or other factor designated for that purpose in the contract.”<sup>482</sup> The Selected Countries universally collate securities certificates under the generic terms “certificates representing securities.”<sup>483</sup> Fractional and participatory interests in any scheme are covered in the Selected Countries under the rubric “participatory interests” or “units in collective investment schemes.”<sup>484</sup> Finally, the Selected Countries do not distinguish between options on securities and options on futures because, unlike the U.S. Definition, both futures and securities are covered under the Selected Countries’ definitions.<sup>485</sup>

#### F. The Judiciary and Securities Definitions

The broad language of the U.S. Definition and its use of unfamiliar terms—that neither it nor the federal securities laws define—hand the task to the SEC, and ultimately the federal courts, to decide which of the myriad financial transactions in today’s globalized financial markets can be regulated by the federal securities laws.<sup>486</sup> In fact, only security-based futures in the U.S. Definition—including a “security future,” “narrow-based security index,” “security futures product,” and “security-based swap”—are extensively defined in the federal and securities laws.<sup>487</sup> Historically, Congress added security-based futures to the U.S. Definition either (1) after extensive litigation over whether such products are futures, securities, or both, or (2) to provide greater legal certainty and foreclose product and jurisdictional disputes between the CFTC and SEC over such products.<sup>488</sup> Consequently, the U.S. Definition does not dispose of the threshold issue of whether an instrument or scheme is a security. That is determined almost exclusively by the federal courts, which has, in turn, shaped the scope of the

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<sup>482</sup> FSMA sch. 2 art. 19 (U.K.).

<sup>483</sup> See SCR Act §§ 2(h)(ic), 2(h)(id) (India); Securities Services Act § 1(a)(x) (S. Afr.); FSMA sch. 2 art. 15 (U.K.).

<sup>484</sup> See *Corporations Act* s 764A (1)(b)–(ba) (Austl.); SCR Act § 2(h)(ib) (India); Securities Services Act § 1(a)(vi) (S. Afr.); FSMA § 22(2), sch. 2 art. 16 (U.K.).

<sup>485</sup> *Corporations Act* s 764A (Austl.); SCR Act § 2(h) (India); Securities Services Act § 1(a) (S. Afr.); FSMA § 22(2) (U.K.).

<sup>486</sup> See *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 847–48 (1975).

<sup>487</sup> See *supra* text accompanying note 137.

<sup>488</sup> See, e.g., *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 544 (7th Cir. 1989) (holding that since index participations are both futures and securities, they are to be regulated by the CFTC); U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 16.

U.S. Definition.<sup>489</sup>

The Selected Countries' definitions and securities laws curtail their respective courts' jurisdiction in three significant ways.<sup>490</sup> First, each Selected Countries' definition uses modern and straightforward terms with established financial and legal meanings. Second, each Selected Countries' definition, securities laws, rules, and regulations extensively define and explain the definitions' material terms, complete with real life examples, questions, and even answers in some cases.<sup>491</sup> Finally, the Selected Countries' definitions authorize their governments or regulators to add or remove any financial instrument from their securities definitions.<sup>492</sup> Consequently, major court battles over the Selected Countries' definitions are rare and largely unnecessary. In fact, most of these rare definitional cases in the Selected Countries have involved the general issue of whether a scheme is a statutory "collective investment scheme," rather than the issue of whether the participatory interests in such collective investment schemes are securities, which must be determined on a case-by-case basis.<sup>493</sup>

#### V. HARMONIZING THE U.S. DEFINITION

Securities, unlike other financial activities, have developed and now operate internationally without global securities treaties, legally binding global securities rules, or even a global consensus on what they are or how best to regulate them. To the extent that it exists, the global securities regulatory framework consists of varying national laws and a web of "international bodies that have their own mandates, jurisdiction and powers."<sup>494</sup> National securities laws are generally either fragmented or consolidated. Fragmented securities laws typically prescribe detailed rules for banking, futures, securities, and insurance goods and services, while regulating these industries separately.<sup>495</sup> Fragmented securities regulations

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<sup>489</sup> See Lewis D. Lowenfels & Alan R. Bromberg, *What Is A Security Under Federal Securities Laws?*, 56 ALB. L. REV. 473, 488–49 (1993) (discussing the meaning of "security" under the federal securities laws).

<sup>490</sup> See *Corporations Act* ss 9, 92, 763A (Austl.); SCR Act § 2 (India); Securities Services Act § 1 (S. Afr.); FSMA § (22)(2), sch. 2 pts. I & II (U.K.).

<sup>491</sup> *Corporations Act* ss 9, 92, 763A (Austl.); SCR Act § 2 (India); SSA § 1 (S. Afr.); FSMA § (22)(2), sch. 2 pts. I & II (U.K.).

<sup>492</sup> See *Corporations Act* s 764A(1)(m) (Austl.); SCR Act § 2(h)(iia) (India); Securities Services Act § 1(b)(ii) (S. Afr.); FSMA, § 22(2) (U.K.).

<sup>493</sup> See, e.g., *National Austrl. Bank Ltd. v Norman* [2009] 74 ACSR [181]–[183] (Austl.); *M/s. PCS Industries Ltd. v. SEBI*, (2001), Sec. App. Tribunal (Mumbai) Appeal No. 31/2001 (India), available at <http://www.sebi.gov.in/satorders/Integrated.html>; *FSA v. Fradley* [2005] EWCA (Civ) 1183, [7] (Eng.).

<sup>494</sup> Norton, *supra* note 10, at 793.

<sup>495</sup> See Elizabeth F. Brown, *The Tyranny of the Multitude is a Multiplied Tyranny: Is the United States Financial Regulatory Structure Undermining U.S. Competitiveness?* 2 BROOK. J. CORP. FIN. & COM. L. 369, 372, 378 (2008).

are increasingly vanishing globally, except in the United States and a few holdout countries.<sup>496</sup> South Africa and India have fragmented securities rules as well, but they, along with the U.K., are moving toward the semi-consolidated or twin-peaks model already in place in Australia.<sup>497</sup>

The degree of consolidation of each country's financial laws seems to account for most, if not all, the variations in scope and statutory language of the U.S. and Selected Countries' definitions of a security.<sup>498</sup> U.S. federal securities laws apply to securities, and the U.S. Definition only covers securities and security-based products, even though its broad statutory definition permits coverage of insurance and futures products.<sup>499</sup> India and South Africa—whose securities laws are fairly fragmented, but regulate the non-banking financial industry—include futures and securities in their definitions of a security.<sup>500</sup> Australia and the U.K.—the two Selected Countries with the most consolidated financial laws—include insurance, futures, and securities in their definitions.<sup>501</sup>

The origins and purposes of the financial laws also provide a less obvious but significant source of variation in the U.S. and the Selected Countries' definitions. Major U.S. financial laws are generally remedial and punitive laws enacted in response to financial crises.<sup>502</sup> That helps to explain why the U.S. Definition is rules-based and prescriptive of the instruments that are securities. This structure allows financial market participants to tailor their conduct in a way that avoids the severe civil and criminal penalties the federal securities laws prescribe.<sup>503</sup> Moreover, the successive financial crises have influenced the language and scope of the U.S. Definition. Actually, Congress deliberately designed the initial U.S. Definition broad enough to include fraudulent schemes of the 1920s and 1930s.<sup>504</sup> The Dodd-Frank Act added security-based swaps only after they

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<sup>496</sup> *Id.* at 371-72.

<sup>497</sup> See John H. Walsh, *Institution-Based Financial Regulation: A Third Paradigm*, 49 HARV. INT'L L.J. 381 (2008) (proposing institution-based financial regulation as an alternative to rules and principles-based regulation).

<sup>498</sup> See generally Cristie L. Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, 55 MCGILL L.J. 257, 262-63 (2010).

<sup>499</sup> See, e.g., H.R. REP. NO. 106-434, at 157 (1999) (Conf. Rep.).

<sup>500</sup> See Securities Contracts (Regulation) Act (SCR Act), No. 42 of 1956, INDIA CODE (2012), § 2(h)(ia); SSA § 1(a)(iii) (S. Afr.).

<sup>501</sup> See *Corporations Act 2001* (Cth) s 763A (Austl.); Financial Services and Market Act (FSMA), 2000, c. 8, § 22(1) (U.K.).

<sup>502</sup> See H.R. REP. NO. 73-85, at 1-5 (1933).

<sup>503</sup> See Andrew J. Donohue, Dir., SEC Div. of Inv. Mgmt, *Regulating Hedge Funds and Other Private Investor Pools*, Address at the Fordham Journal of Corporate and Financial Law's 3rd Annual Symposium on the Regulation of Investor Funds (Feb. 19, 2010), available at <http://www.sec.gov/news/speech/2010/spch021910ajd.htm>.

<sup>504</sup> See, e.g., JOSEPH C. LONG, *Blue Sky Law*, in SECURITIES LAW SERIES § 1:19 (Thomson & West Group 1999); Lowenfels & Bromberg, *supra* note, at 488 (noting that the Securities

created and exploited regulatory gaps that caused the recent global financial crisis.<sup>505</sup> Conversely, the Selected Countries' enacted their securities laws to modernize or harmonize them with other bodies, such as the EU, and to create a competitive regulatory and investment climate for the domestic and foreign capital.<sup>506</sup> Thus, their definitions of securities are generally aligned with global market and regulatory developments in their language, meaning, and scope.

#### A. Effects of U.S. Definition on Global Securities Rules

There are five principal ways in which the U.S. Definition has affected global securities rules. While the question of whether catastrophic financial regulatory failures in the United States caused the recent global financial crisis is settled, the critical role played by the U.S. Definition in precipitating the regulatory failures is often overlooked.<sup>507</sup> In reality, the crux of those financial regulatory failures was the failure of U.S. regulators to detect and effectively respond to the issues caused by credit default swap and other securitized debts that were not covered by the U.S. Definition.<sup>508</sup> Given that global financial markets are now characterized by a proliferation of complex and unique instrument such as credit default swaps, the first and principal impact of the U.S. Definition on U.S. and global financial rules is its inability to cover new, complex, and hybrid instruments—such as combinations of securities and futures, insurance, and other securities—that are, by definition, ordinarily outside its jurisdiction.<sup>509</sup> In fact, even if federal securities laws covered futures and insurance, the fact that credit default swaps were novel, unique, and uncommon instruments before the recent financial crisis meant that the SEC and the federal courts had to determine on a case-by-case basis whether and which of the myriad of securitized assets were “investment contracts” under the U.S. Definition.<sup>510</sup> That creates legal uncertainty, as well as regulatory and coverage gaps for new instruments until the federal courts rule either way. As the variable life

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Act definition of “security” was modeled on earlier definitions in state blue-sky laws).

<sup>505</sup> See generally Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix it*, 2009 U. ILL. L. REV. 1359 (2009) (discussing how unregulated security-based swaps factored into the global financial crisis).

<sup>506</sup> See, e.g., Creaven, *supra* note 200, at 299; Gail Pearson, *Risk and the Consumer in Australian Financial Services Reform*, 28 SYDNEY L. REV. 99 (2006); Heidi M. Schooner & Michael Taylor, *United Kingdom and States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 TEX. INT'L L.J. 317, 340–41 (2003).

<sup>507</sup> See, e.g., Lipson, *supra* note 15, at 43.

<sup>508</sup> *Id.* at 45–46.

<sup>509</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 16, at 40, 48; McCoy et al., *supra* note 16, at 526–32.

<sup>510</sup> See, e.g., *S.E.C. v. W.J. Howey Co.*, 328 U.S. 298–99 (1946).

settlements cases show, the split between the District of Columbia and 11th federal circuits on whether variable life settlements are investment contracts, and therefore securities, created additional legal uncertainties for users and regulators of these instruments.<sup>511</sup> The U.S. Definition is, therefore, both inefficient and ineffective in its coverage of new and complex instruments.

The second effect of the U.S. Definition on global financial rules is its overly broad scope that, through judicial construction, SEC rules and other federal securities laws capture asset-backed securities, futures, insurance, and private funds, despite federal securities laws not applying to insurance and futures.<sup>512</sup> The SEC lacks both the expertise and mandate to supervise and develop effective regulations for non-securities. The spectacular failure of the alternative disclosure rules for asset-backed securities under SEC Regulation AB aptly demonstrates this point.<sup>513</sup> At an elementary level, the SEC structured Regulation AB for disclosure based on operating businesses using asset-backed securities instead of the instruments themselves.<sup>514</sup> Accordingly, the Regulation focused on how traditional corporate accounting required no due diligence by users or underwriters to ensure the securitized assets in a pool were adequately documented, and did not require agencies rating asset-backed securities to reveal important data on asset pools.<sup>515</sup> U.S. financial institutions exploited these ineffective alternative disclosure rules to create the toxic asset-backed securities responsible for the recent global financial crisis.<sup>516</sup>

The third consequence of the broad reach of the U.S. Definition to global securities rules is that it traditionally created the product coverage and regulatory gaps that contributed significantly to the recent financial crisis.<sup>517</sup> In particular, the perennial jurisdictional disputes between the CFTC and SEC prevented both agencies from developing effective rules for instruments with features of securities and futures long before the introduction of modern complex products like credit default swaps.<sup>518</sup> Those product coverage and regulatory gaps allowed U.S. financial institutions to create and sell toxic securitized assets globally with minimal or no oversight from U.S. federal financial regulators.<sup>519</sup>

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<sup>511</sup> *Roth v. Am. Family Mut. Ins. Co.*, 567 F.3d 884 (7th Cir. 2009); *SEC v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005); *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996).

<sup>512</sup> See Mendales, *supra* note 505, at 23–24, 34–37.

<sup>513</sup> See *id.*

<sup>514</sup> See *id.* at 36.

<sup>515</sup> See *id.* at 36–37.

<sup>516</sup> See COMM. ON CAPITAL MARKETS REGULATION, *supra* note 3, at 211.

<sup>517</sup> See *supra* text accompanying notes 15, 16.

<sup>518</sup> See OTC REPORT, *supra* note 134.

<sup>519</sup> See, e.g., Austin Murphy, *An Analysis of the Financial Crisis of 2008: Causes and*

The fourth principal effect the U.S. Definition has had on global securities regulation is that it has inhibited SEC efforts to export U.S. securities rules to other countries.<sup>520</sup> Since World War II, the United States has surreptitiously used its dominant capital markets and cooperative initiatives between the SEC with its foreign counterparts to globally promote and export its standards and securities rules.<sup>521</sup> Nevertheless, no country has thus far adopted the U.S. Definition or its fragmented regulatory scheme. If these trends in global securities definitions reflect U.S. efforts to shape them, then it clearly failed both before and after the recent global financial crisis as evidenced by the Selected Countries, which all undertook major securities regulatory reforms in the last thirty years, but universally snubbed the U.S. Definition.<sup>522</sup>

Finally, the U.S. Definition impacts the United States' international coordination with its foreign counterparts and international organizations on securities, because virtually every other country includes securities and futures in their definitions of a security.<sup>523</sup> The U.S. Definition covers, either explicitly or through judicial precedent, security-based futures, swaps, or insurance contracts.<sup>524</sup> The concept of "security-based" anything is unheard of globally, and a stretch even in the United States. For example, Congress, federal financial regulators, and the courts have found no practical differences between security-based swaps and swaps or options on securities and options on futures.<sup>525</sup> There are no global rules on "security-based futures," and the SEC has not concluded a single international agreement with its foreign counterparts or international organizations regarding security-based futures or insurance contracts. Such products are, therefore, subjected to different rules in the United States than in the Selected Countries, whose definitions include both securities and future. It is, therefore, unsurprising that the global financial regulatory failures preceding the recent financial crisis involved the ineffective differential regulation of securitized debts between the United States and other countries, rather than different rules for banks and other financial institutions that created and sold them globally.<sup>526</sup>

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*Solutions 2–3* (Nov. 4, 2008) (unpublished manuscript), <http://ssrn.com/abstract=1295344>.

<sup>520</sup> See Chris Brummer, *Post-American Securities Regulation*, 98 CALIF. L. REV. 327, 333–44 (2010).

<sup>521</sup> *Id.* at 336.

<sup>522</sup> See *supra* text accompanying notes 203–204, 277–279, 362, 403.

<sup>523</sup> See COMMODITIES AND FUTURES TRADING COMM'N & SEC. EXCH. COMM'N., *supra* note 14, at 79–89.

<sup>524</sup> See *supra* text accompanying notes 80, 179, 194.

<sup>525</sup> See *supra* text accompanying notes 194; see, e.g., *Chicago Mercantile Exch. v. SEC*, 883 F.2d 537, 544 (7th Cir. 1989).

<sup>526</sup> See *supra* text accompanying note 15.

### B. Impetus for Harmonizing the U.S. Definition

The U.S. Definition is remarkably resilient. It has outlived all the financial crises and emerged from the ensuing financial regulatory reforms largely the same as it has been since 1933.<sup>527</sup> Many factors account for the U.S. Definition's resilience, the most obvious being that the federal securities laws have also remained largely unchanged over this same period.<sup>528</sup> Furthermore, the SEC seems to prefer the status quo and historically defers to the federal courts to adjudicate all questions concerning the legal definitions of futures and securities.<sup>529</sup> Without having changed the fragmented U.S. financial regulatory scheme, a U.S. Definition overhaul has never gained traction over the years. Even though Congress did not consolidate or modernize the U.S. Definition during its recent financial reforms, it did not eliminate the possibility of reform, which may still occur depending on how four possible financial regulatory and market developments play out.

The first potentially significant development relates to whether Congress revisits the Treasury Department's 2008 proposal to merge and consolidate the fragmented financial regulatory system, especially the merger of the SEC and CFTC, which escaped the recent financial overhaul mainly because it never gained political traction in Congress.<sup>530</sup> The United States currently employs a "functional" regulatory system, although some argue that it actually uses a hybrid system combining both "functional" and "institutional" regulatory schemes.<sup>531</sup> The U.S. Treasury Department proposed a consolidated "three-peak" model, consistent with most major financial markets that would consist of three regulators: a market stability regulator, a prudential regulator, and a business conduct regulator.<sup>532</sup> Securities regulations would fall under the business conduct regulator comprising, among others, the merged CFTC and SEC.<sup>533</sup>

A consolidated U.S. financial regulatory regime would put the United States on par with other major global centers, such as the U.K. and Australia. A semi-consolidation of the SEC and the CFTC would only mean that the new U.S. Definition would include futures and securities,

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<sup>527</sup> See, e.g., Lybecker, *supra* note 71.

<sup>528</sup> *C.f.* Norton, *supra* note 10, at 793.

<sup>529</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-410, FINANCIAL REGULATION: CLEARER GOALS AND REPORTING REQUIREMENTS COULD ENHANCE EFFORTS BY CFTC & SEC TO HARMONIZE THEIR REGULATORY APPROACHES 18 (2010).

<sup>530</sup> See DEP'T OF THE TREASURY, *supra* note 74, at 11–12, 115–18; Ronald D. Orol, *CFTC & SEC Merger Not Top Priority for Treasury, Obama*, MARKETWATCH (June 5, 2009, 4:34 PM), <http://www.marketwatch.com/story/cftc-and-sec-merger-not-top-priority-for-treasury>.

<sup>531</sup> See, e.g., DEP'T OF THE TREASURY, *supra* note 74, at 138–41; Schooner & Taylor, *supra* note 506, at 328 (arguing that the United States is a hybrid system).

<sup>532</sup> See, e.g., DEP'T OF THE TREASURY, *supra* note 74, at 143–83.

<sup>533</sup> *Id.*

similar to India and South Africa. A full consolidation similar to that of the U.K. would require regulation of insurance at the federal level for the first time ever. The ensuing U.S. Definition would, therefore, include futures, securities, and insurance. A full or partial consolidation of U.S. federal financial laws would also include pooled investments as units or participatory interests in an investment company or collective investment scheme.

The second possible development relates to whether Congress adopts principles-based rules instead of the rules-based approach it employs pursuant to the federal securities laws.<sup>534</sup> The adoption of principles-based securities regulations in the United States started in earnest with the Sarbanes-Oxley Act and the Dodd-Frank Act.<sup>535</sup> The Dodd-Frank Act contains numerous principled-based rules, such as Section 619, which permits federal banking agencies, the SEC, and the CFTC to promulgate rules adding new private funds similar to hedge funds and private funds. A principles-based U.S. Definition would enable the SEC to significantly alter its language to conform it to U.S. and global financial and regulatory practices, as it has already done to its definitions of asset-backed securities and venture capital funds under the Dodd-Frank Act.<sup>536</sup>

Third is the possible establishment of a legally binding international financial regulatory scheme through a treaty, international organizations, or the harmonization of global financial laws.<sup>537</sup> Although global efforts to harmonize global financial regulations have stalled, the contemporary patchwork of national financial regulations is simply unsustainable in today's globalized financial markets. Most of these national financial regulations, including those of the United States, are comparable to, consistent with, or higher than international standards, such as IOSCO's principles for securities regulations. But differences in legal systems and the discretion countries have to choose what to include in their national regulations often negate a more consistent alignment of global financial regulations based on global standards. For example, because of the variations in global securities laws, the SEC staff now strongly recommends negotiating MOUs only with foreign regulators empowered to provide assistance beyond that required by the IOSCO standards.<sup>538</sup> The SEC

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<sup>534</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 529 at 7.

<sup>535</sup> See, e.g., John C. Coffee Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 342–44 (2004) (arguing that Sections 302 and 906 of the Sarbanes-Oxley Act are principles-based rules for financial disclosure).

<sup>536</sup> See *supra* text accompanying note 146, 155.

<sup>537</sup> See David Sanger & Mark Landler, *In Europe, Obama Faces Calls for Rules on Finances*, N.Y. TIMES (Apr. 2, 2009), at A1, available at [http://www.nytimes.com/2009/04/02/world/europe/02prexy.html?\\_r=0&pagewanted=print](http://www.nytimes.com/2009/04/02/world/europe/02prexy.html?_r=0&pagewanted=print).

<sup>538</sup> See *International Enforcement Assistance*, U.S. SEC. & EXCH. COMM'N, [http://www.sec.gov/about/offices/oia/oia\\_crossborder.shtml](http://www.sec.gov/about/offices/oia/oia_crossborder.shtml) (last visited Mar. 18, 2012).

requires that the foreign regulator's authority has the power to gather internet service providers' phone and other records other than bank, broker, and beneficial owner information on behalf of the SEC, or the power to compel testimony.<sup>539</sup> A binding global financial regulatory regime would include a harmonized "security" definition the United States would be obligated to adopt.

Finally, the technology that facilitated the recent rapid growth of global finance and the creation of complex instruments that traverse traditional regulatory boundaries will continue to develop faster than financial laws can adjust.<sup>540</sup> The main issue with new and complex technologically-advanced financial products is always how to identify them sufficiently in legal terms to enable specific regulation. Already, the United States struggles to define and regulate complex instruments driven partly by technology such as CDSs.<sup>541</sup> Technology is also linking global financial markets, changing the financial intermediation system as we know it, and putting pressure on national regulators.<sup>542</sup> Eventually, technology will develop to the extent that the national securities regulations, including the laws and regulations establishing the U.S. Definition, will become superfluous.

### C. Proposed Harmonized U.S. Definition

Although the Selected Countries vary in their definitions and use of the term "securities," the overwhelming trend is that they all use modern and flexible language to define securities. Thus, the Selected Countries' definitions provide a representative sample of global trends in the definitions of a security. They are also instructive on how a harmonized U.S. Definition should appear.

Nonetheless, a harmonized U.S. Definition must acknowledge the fundamental variations in securities regulations between the United States and the Selected Countries, particularly the degree of consolidation of financial regulations. Short of another catastrophic financial crisis caused by financial regulatory failures, the United States will not regulate insurance at the federal level, nor will it consolidate its financial regulations any time soon. Thus, the harmonized U.S. Definition proposed below excludes futures and insurance products except security-based futures and insurance, which the U.S. Definition already covers expressly or pursuant to federal court opinions:

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<sup>539</sup> *Id.*

<sup>540</sup> *See, e.g.,* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 *TEX. L. REV.* 1255, 1273–79 (2002) (detailing some of these technological changes).

<sup>541</sup> *See, e.g.,* McCoy et al., *supra* note 16, at 501–09.

<sup>542</sup> *See, e.g.,* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 16.

In this Act, “security” means: (a) shares, scrips, stocks, bonds, debentures, or other marketable securities of a like nature in or of a corporate body or an unincorporated body; (b) security-based futures instruments; (c) security-based insurance instruments; (d) instruments based on an index; (e) a certificate or receipt or instrument (by whatever name called) representing securities; (f) such other instruments similar to one or more instruments covered by subparagraphs (a) to (f) that the SEC, may, by rule, determine to be a security; (g) units or any other form of instruments covered by subparagraphs (a) to (f) issued by any investment company in such company; (h) a legal or equitable right or interest in a security covered by subparagraphs (a) to (g); (i) a right (whether existing or future and whether contingent or not) to acquire a security covered by subparagraphs (a) to (h).

The harmonized U.S. Definition proposed here addresses the major criticisms of the appropriate language, meaning, and scope of the U.S. Definition. First, it replaces the context clause that precedes the U.S. Definition with “[I]n this Act, ‘security’ means . . . .” Federal courts have invoked the context clause to provide unprecedented elasticity to the U.S. Definition.<sup>543</sup> The context clause’s proper language, meaning, and scope has also been debated by prominent academics and judges like Professor Loss and Justice Jackson, who argue that the context clause, viewed in light of legislative history, suggests that the relevant “context” should be that of the surrounding factual circumstances, instead of the surrounding statutory language that the federal courts usually apply.<sup>544</sup> Second, the harmonized U.S. Definition excludes the catch-all phrase beginning “*any* notes, stock” that would cover instruments most do not think of as security, such as IOUs issued between friends, if not for the limits prescribed by the Supreme Court’s “family resemblance test.”<sup>545</sup> Instead, the harmonized U.S. Definition makes it clear that only the stock, bonds, and other instruments of entities or bodies constitute securities without requiring courts to make a case-by-case determination. Third, the harmonized U.S. Definition replaces inclusive and unusual terms, such as “investment contract,” with contemporary terminology, such as “marketable instruments.” Fourth, the harmonized U.S. Definition omits “note,” making it consistent with most other countries’ definitions, which also exclude “note” from their definitions of securities. Besides, the term “note” is largely superfluous, since investment notes are adequately covered in the harmonized U.S. Definition by “debentures” and other debt instruments.

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<sup>543</sup> See Loss, *supra* note 114.

<sup>544</sup> See, e.g., *id.* at 261 n.13.

<sup>545</sup> See *supra* text accompanying note 175; *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990).

Fifth, the harmonized U.S. Definition consolidates similar instruments in the U.S. Definition under generic terms. It consolidates all certificate and receipt-based instruments under the generic term “certificates, receipts or instruments representing securities.” It also covers other certificate and receipt-based instruments such as a “right to subscribe to or purchase any of the foregoing” as “rights or interests in securities.” Additionally, the definition consolidates security futures, security-based swaps, and other security-based future instruments under the general category of “security-based futures.” Similarly, it groups together the various instruments found on indexes and stock exchanges, and covers them simply as “instruments based on an index.” Further, it introduces security-based insurance instruments as “security-based insurance instruments.” The federal courts already include security-based insurance products in the U.S. Definition by holding that they qualify as “investment contracts” and fall outside the insurance exemption in Section 3(a)(8) of the Securities Act.<sup>546</sup> Thus, “security-based insurance instruments” would fill the gap left by the exclusion of the term “investment contracts,” under which insurance contracts are currently evaluated.

Sixth, the harmonized U.S. Definition modernizes the coverage of U.S. pooled investments by introducing the term “units or any other [interest in an instrument] issued by any investment company in such company.” Finally and most fundamentally, it turns the rules-based U.S. Definition into a principles-based securities definition by defining instruments in general terms and allowing the SEC to declare any instrument as a security. These features would significantly curtail the jurisdiction of the federal courts to determine securities under the federal securities laws, and eliminate the inclusive and controversial term “investment contracts” currently used to evaluate new and unique instruments.

Giving authority to the SEC to add new products to the U.S. Definition has implications that go beyond the scope of the U.S. Definition. As the securities market regulator, the SEC has intimate knowledge of and unparalleled expertise in the financial markets, and can easily summon the financial industry to help determine whether an instrument is a security, when to add it to the definition of security, when to introduce its inclusion to the financial markets, and what to name the new instrument. That would provide legal certainty over whether some new or complex instrument is covered by the U.S. Definition. It would also ensure speedy and timely introduction and regulation of new instruments in the securities markets, as opposed to the current laborious process in which the SEC has to ask Congress or the federal courts to include instruments to the U.S. Definition.

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<sup>546</sup> Roth v. Am. Family Mut. Ins. Co., 567 F.3d 884 (7th Cir. 2009); SEC v. Mutual Benefits, 408 F.3d 737 (11th Cir. 2005); SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996).

For example, the SEC staff identified life settlements as a security in 2007, and recommended that Congress add these instruments to the U.S. Definition in July 2010, but that request is still pending.<sup>547</sup> The harmonized U.S. Definition hastens this process by equipping the SEC with statutory authority to add new products without first obtaining Congressional or judicial approval.

Like the material terms in the Selected Countries' definition, the true meaning and scope of the harmonized U.S. Definition would be determined by exhaustive definitions of the material terms in the statute and rules similar to U.S. federal financial laws' treatment of security-based futures. Similar definitions of the material terms in the harmonized U.S. Definition based on U.S. and global financial industry usage and federal court precedents will be necessary to compliment this principles-based definition.

#### D. Investment Contracts as Investment Company

The harmonized U.S. Definition breaks with the longstanding U.S. tradition of excluding pooled investments in general while regulating some pooled investments as "investment contracts" and others as "investment company." The harmonized U.S. Definition instead follows international trends by regulating all pooled investments as units or interests in an investment company. Yet, it is carefully designed to exclude pooled investments in futures, insurance, pension, or retirement schemes that fall outside the jurisdiction of the federal securities laws by insisting that the units or interests concerned involve securities or similar instruments. It also retains the term "investment company" instead of adopting the globally interchangeable terms "collective investment schemes," "managed funds" and "mutual funds."

A collective investment scheme is actually one of the few securities expressly defined by IOSCO. IOSCO defines a collective investment scheme as "an open-ended collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments," excluding schemes investing in property/real estate, mortgages, or venture capital.<sup>548</sup> Most countries, including the Selected Countries, refined and expanded the IOSCO definition to include collective investment schemes in certain stocks, bonds, and instruments that IOSCO expressly excluded, such as property, real estate, mortgages, and venture capital funds.<sup>549</sup>

Remarkably, the Selected Countries' statutory definitions of

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<sup>547</sup> See SEC STAFF, *supra* note 84, at 39–43.

<sup>548</sup> INT'L ORG. SEC. COMM'N, TECHNICAL COMM., PRINCIPLES FOR THE SUPERVISION OF OPERATORS OF COLLECTIVE INVESTMENT SCHEMES n.1 (1997).

<sup>549</sup> *Id.*

“collective investment scheme” are based on the *Howey* test.<sup>550</sup> If the United States were to follow the rest of the world and regulate all forms of pooled investments as collective investment schemes, and make units in such collective investment schemes securities, the *Howey* test or any of the Selected Countries’ definitions of a collective investment scheme would suffice as the new definition of “investment company.” The regulation of instruments and activities that currently fall under the definition of “investment company” would require significant changes to the Investment Company Act that are outside the scope of this Article; suffice to say, schemes similar to those in *Joiner* and *Howey* would be subject to similar regulatory treatment as mutual funds and other private funds under the harmonized U.S. Definition.

## VI. CONCLUSION

The differences in global securities laws and the lack of a model global definition of a security make the comparison of the definitions and scope of the U.S. Definition with the Selected Countries’ definitions asymmetrical. This Article, nonetheless, shows that the scope of the U.S. Definition is indeed too broad relative to Selected Countries’ definitions in two ways. First, consistent with the broad statutory language and the overly inclusive construction given to it by the federal courts, the scope of the U.S. Definition is virtually limitless regarding the range of “securities” it reaches. Second, by judicial construction, the U.S. Definition covers security-based futures and insurance products that are exempted or excluded from the federal securities laws, as well as numerous non-traditional instruments that are not enumerated in the U.S. Definition if in fact they involve securities such as franchise agreements. None of the Selected Countries’ definitions is drafted so broadly, and they certainly do not cover financial activities outside futures and securities in the case of India and South Africa, and futures, insurance, and securities in the case of Australia and the U.K. Yet, the U.S. Definition is remarkably too rigid and obsolete relative to market developments and global trends in securities definitions. Thus, this Article suggests a harmonized U.S. Definition that addresses the longstanding criticism over the proper language, meaning, and scope of the U.S. Definition. This harmonized definition aligns the U.S. Definition with global financial market developments and trends in global securities definitions without altering its fragmented financial regulatory scheme.

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<sup>550</sup> *Corporations Act 2001* (Cth) s 9 (Austl.); Securities and Exchange Board of India (SEBI) Act, No. 15 of 1992, INDIA CODE (2012), § 11AA; Collective Investment Schemes Control Act (CISCA) 45 of 2002 § 1 (S. Afr.); Financial Services and Market Act (FSMA), 2000, § 235(1) (U.K.).