

**PRIVATE RIGHT OF ACTION IN TRANSACTIONS WITH CROSS-BORDER SECURITY-BASED SWAPS**

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*Abstract*

*In 2010, in Morrison v. National Australia Bank, the Supreme Court significantly restricted the private right of action in cases of transnational fraud by announcing a bright-line transactional test. Application of the Morrison bright-line test to security-based swaps, however, proved to be difficult. Moreover, the new regulatory regime of derivatives introduced by the Dodd-Frank Act complicated the issue by expanding the reach of the United States' securities laws to areas that are traditionally considered extraterritorial.*

*This note examines how the Morrison transactional test applies to antifraud claims in connection with transactions involving security-based swaps and argues that the Morrison test failed to accomplish the goals the Supreme Court sought to achieve. The note concludes that even without the bright-line transactional test, federal courts possess sufficient tools to close access to the private right of action for investors whose transactions have only tenuous connections with the U.S. securities markets as well as to protect foreign sovereign interests from unjustified interference. The note suggests that in disputes arising from transactions with security based swaps, the Morrison transactional test should be replaced with a test that relies on a regulatory framework developed by the Dodd-Frank Act.*

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## I. Introduction

Section 10(b) of the Securities Exchange Act of 1934<sup>2</sup> (Exchange Act) purports to prevent “manipulative and deceptive activities that can occur in connection with the purchase or sale of a security.”<sup>3</sup> The Exchange Act, however, does not specify if there is a private right of action under its section 10(b) or whether the Act applies extraterritorially.<sup>4</sup>

Notwithstanding the Exchange Act’s silence on these matters, federal courts recognized an implied private right of action under section 10(b)<sup>5</sup> and developed conduct and effects tests to determine whether a transaction with foreign elements entitles an investor to bring antifraud claims in federal courts.<sup>6</sup> In 2010, however, in *Morrison v. National Australia Bank*, the Supreme Court significantly restricted the private right of action in cases of transnational fraud by announcing a bright-line transactional test requiring courts to hear the 10(b) claims only if the underlying

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<sup>2</sup> Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2012) (“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality or interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary and appropriate in the public interest or for the protection of investors.”).

<sup>3</sup> SEC. & EXCH. COMM’N, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 1 (2012), <http://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf> [<https://perma.cc/9BU9-354W>] [hereinafter STUDY ON THE PRIVATE RIGHT OF ACTION].

<sup>4</sup> *See id.* at 10 (“[T]he Exchange Act did not explicitly define the circumstances under which Section 10(b) applied to securities frauds that took place in whole or in part outside the United States.”); Justin Marocco, Note, *When Will It Finally End: The Effectiveness of the Rule 10b-5 Private Action as a Fraud-Deterrence Mechanism Post-Janus*, 73 LA. L. REV. 633, 633 (2013) (“Neither Section 10(b) nor Rule 10b-5 contains language providing for a private cause of action under the rule. Instead, federal courts have implied it.”).

<sup>5</sup> *See Superintendent of Ins. of State of N. Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971).

<sup>6</sup> *See infra* Part II.B (discussing conduct and effects tests).

transaction involves securities listed on American stock exchanges, or “the purchase or sale of any other security in the United States.”<sup>7</sup> Although many praised the *Morrison* test for its clarity, the Second Circuit’s opinion in *Parkcentral Global HUB Ltd. v. Porsche Auto Holdings SE* showed that applying *Morrison* to cross-border security-based swaps (SBS) raises numerous concerns.<sup>8</sup> Moreover, the new regulatory regime of derivatives introduced by the Dodd-Frank Act complicated the issue by expanding the reach of the United States’ securities laws to the areas that traditionally are considered extraterritorial.<sup>9</sup>

This note examines how the *Morrison* test applies to antifraud claims arising from transactions with cross-border SBS and argues that the *Morrison* test failed to accomplish clarity and predictability sought by the Supreme Court. The note concludes that even without a bright-line transactional test, federal courts possess sufficient tools to restrict access to the 10(b) remedy for investors whose transactions have only tenuous connections with the U.S. securities markets and to protect the foreign nations’ regulatory interests from undue interference. The note suggests that in disputes arising from transactions with SBS, the *Morrison* rule should be replaced with a test that builds upon the post-Dodd-Frank regulatory regime. The new test would improve upon the existing standard by replacing the ambiguous “place of transaction” with more specific criteria developed for the registration of entities active on the derivatives markets and the SBS execution. A test based on objective criteria such as SBS parties’ status (e.g. registration in the United States as a swap dealer) or the SBS execution on the organized platforms with participation of a clearing house, would notify parties to such SBS about the geography of potential litigation long before an SBS-related dispute arises.

Part I of this note explains security-based swaps, their major difference from conventional securities, as well as the recent changes

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<sup>7</sup> *Morrison v. Nat’l Austl. Bank*, 561 U.S. 247, 272 (2010) (“Section 10(b) reaches the use of manipulative device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.”).

<sup>8</sup> *Parkcentral Global HUB Ltd. v. Porsche Auto Holdings SE*, 763 F.3d 198 (2d Cir. 2014).

<sup>9</sup> See *infra* Part I.B; see also John C. Coffee, Jr., *Extraterritorial Financial Regulation: Why E.T. Can’t Come Home*, 99 CORNELL L. REV. 1259, 1274-75 (2014).

in their regulatory framework. Part II analyzes a notion of prescriptive jurisdiction and discusses its development in connection with cross-border securities. In particular, this part examines the conduct and effects tests developed by federal courts to determine the extraterritorial reach of securities laws as well as the *Morrison* bright-line test introduced by the Supreme Court. Part III examines the Second Circuit's opinion in *ParkCentral* where the court grappled with the application of the *Morrison* test to a transaction involving SBS and discusses the implications of *Morrison* in relation to antifraud claims arising from the purchase or sale of SBS. Part IV proposes a modified test built on the new regulatory framework of the security-based swaps.

## II. *Security-Based Swaps*

### A. General

A security-based swap or equity swap (SBS) is “a bilateral, privately negotiated derivative contract in which a protection buyer makes periodic payments to a protection seller, in return for a contingent payment if a predefined event occurs in a reference security or group of securities.”<sup>10</sup> Parties to such contracts bet on future prices of the underlying securities and the flow of payments under these contracts depends on whether a party was successful in its prediction.<sup>11</sup> SBS may be traded on stock exchanges<sup>12</sup> or over-the-counter through a network of dealers (the OTC market).<sup>13</sup>

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<sup>10</sup> Barry Le Vine, Note, *Derivative Market's Black Sheep: Regulation of Non-Cleared Security-Based Swaps Under Dodd-Frank*, 31 NW. J. INT'L L. & BUS. 699, 709 (2011).

<sup>11</sup> See Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 6 (2011) (“Financial derivatives . . . are bets between parties that one will pay the other a sum determined by what happens in the future to some underlying financial phenomenon, such as an asset price, interest rate, currency exchange ratio, or credit rating.”); see also Po-Ting Peng, Note, *Deciding the Applicable Law in Private Antifraud Claims Arising From Cross-Broder Security-Based Swaps*, 24 MINN. J. INT'L L 131, 132 (2015) (“A swap is a contract in which counterparties exchange payments over a specified time period when the amounts of payments are determined by the difference in prices of two financial instruments.”); Alisha Patterson, Case Comment, *Section 10(b) Liability Note Applicable to Domestic Securities-Based Swap Agreements on Foreign Securities—Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198 (2d Cir. 2014), 38 SUFFOLK TRANSNAT'L L. REV. 233, 234 n.4

SBS is a security and subject to the antifraud provisions of the Exchange Act.<sup>14</sup> The Dodd-Frank Act defines SBS as a swap

based on—(i) an index that is a narrow-based security index, including any interest therein or on the value thereof; (ii) a single security or loan, including any interest therein or on the value thereof; or (iii) the occurrence, nonoccurrence or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index; provided that such event directly affects the financial statements, financial condition or financial obligations of the issuer.<sup>15</sup>

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(2015) (citing William K. Sjostrom, *The AIG Bailout*, 66 WASH & LEE L. REV. 943, 984-85 (2009)).

<sup>12</sup> See Christian Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction, and Dodd-Frank: The Implications of US Global OTC Derivative Regulation*, 14 NEV. L.J. 542, 547 (2014) (“The exchange-traded derivatives industry is a mature and active financial market.”).

<sup>13</sup> See Reed T. Schuster, *Sacrificing Functionality for Transparency? The Regulation of Swap Agreements in the Wake of Financial Crisis*, 62 SYRACUSE L. REV. 385, 391 (2012) (“Despite its arguable shortcomings in the way of confidentiality, the OTC derivatives market has flourished over the years.”); see also Le Vine, *supra* note 10, at 709 (explaining the structure of the OTC security-based swap market).

<sup>14</sup> Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 34-63,236, 75 Fed. Reg. 68,560, 68,561 (Nov. 8, 2010) (“Security-based swaps, as securities, will be subject to the general antifraud and anti-manipulation provisions of the federal securities laws . . . once the relevant provisions of the Dodd-Frank Act take effect.”).

<sup>15</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) § 761(a)(6), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 78c (2012)); see also SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, SEC ANTI-FRAUD RULE UNDER TITLE VII OF DODD-FRANK 1 (2010), [http://www.skadden.com/newsletters/SEC\\_Anti-fraud\\_Rule\\_Under\\_Title\\_VII\\_of\\_Dodd-Frank.pdf](http://www.skadden.com/newsletters/SEC_Anti-fraud_Rule_Under_Title_VII_of_Dodd-Frank.pdf) [<https://perma.cc/3GZ9-ENF3>] (“Dodd-Frank . . . adds security-based swaps to the definitions of ‘security’ in the Securities Act and the Exchange Act and, for purposes of both acts, provides that the terms ‘purchase’ or ‘sale’ include the execution, termination, assignment, exchange, transfer or extinguishment of rights in respect of security-based swaps.”).

A security-based swap, unlike most other securities, is an executory contract requiring parties to “bear[] the counterparty credit risk and market risk until the transaction is terminated.”<sup>16</sup> The Securities Exchange Commission (SEC) illustrates the concept of a security-based swap with an example of a total return swap.

A total return swap . . . is a security-based swap [that] may, obligate one of the parties (i.e., the total return payer) to transfer the total economic performance (e.g., income from interest and fees, gains or losses from market movements, and credit losses) of a reference asset (e.g., a debt security) (the “reference underlying”), in exchange for a specified or fixed or floating cash flow (including payments for any principal losses on the reference asset) from the other party (i.e., the total return receiver).<sup>17</sup>

The Second Circuit explains in connection with a total return swap that

[t]he party that receives the stock-based return is styled the “long” party. The party that receives the interest-based return is styled the “short” party. These contracts do not transfer title to the underlying assets or require that either party actually own them. Rather, in a total-return equity swap, the long party periodically pays the short party a sum calculated by applying an agreed-upon interest rate to an agreed-upon notional amount of principal, as if the long party had borrowed that amount of money from the short party. Meanwhile, the short party periodically pays the long party a sum equivalent to the return to a shareholder in a specified company—the increased

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<sup>16</sup> Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 34-69,490, 78 Fed. Reg. 30,968, 30,980 (May 23, 2013); *see* SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, *supra* note 15, at 3.

<sup>17</sup> Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 34-63236, 75 Fed. Reg. 68,560, 68,562 (Nov. 8, 2010).

value of the shares, if any, plus income from the shares—as if the long party owned actual shares in that company.<sup>18</sup>

A dispute decided in *Parkcentral Global HUB Ltd. v. Porsche Auto. Holdings SE* arose from a security-based swap as well.<sup>19</sup> Although the *Parkcentral* opinion refers to a “securities-based swap agreement,” under the Dodd-Frank Act the agreement implicated in this case falls within the definition of a “security-based swap” as a swap based on a single security.<sup>20</sup> The plaintiffs in *ParkCentral*, hedge funds, entered into swap agreements with New-York based Deutsche Bank and Morgan Stanley referencing shares of a German car manufacturer, Volkswagen (VW), traded only on the European stock exchanges.<sup>21</sup> Under the terms of the swap agreements the hedge funds were betting on the decrease in prices of VW shares and therefore were essentially mirroring a short position in such securities.<sup>22</sup>

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<sup>18</sup> *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 654 F.3d 276, 279-80 (2d Cir. 2011). The transaction giving rise to a dispute in *Caiola v. Citibank, N.A.* provides one more example of a security-based swap. 295 F.3d 312 (2d Cir. 2002); *see also* Thomas J. Molony, *Still Floating: Security-Based Swap Agreements After Dodd-Frank*, 42 SETON HALL L. REV. 953, 994 (2012). The swap in this case consisted of agreements between Louis Caiola and Citibank under which Caiola owed to Citibank “‘interest’ on a notional amount representing the price of a specified number of shares of Philip Morris stock, plus the amount of any losses resulting from decreases in the price of the stock.” Molony, *supra*, at 974. In exchange, Citibank promised to pay “the amount of any dividends paid on the Philip Morris shares, plus the amount of any gains resulting from increases in the price of the stock.” *Id.* In sum, the parties’ payment obligations depended on the fluctuations of the Philips Morris’ shares. *Id.* at 975.

<sup>19</sup> *Parkcentral Global HUB Ltd. v. Porsche Auto. Holdings SE*, 763 F.3d 198, 201 (2d Cir. 2014) (“[T]he securities transactions upon which the plaintiffs brought suit were so-called ‘securities-based swap agreements’ relating to the stock of Volkswagen AG . . . the amount of gain and loss in the transactions depended on prices of VW stock recorded on foreign exchanges.”).

<sup>20</sup> Exchange Act § 3(a), 15 U.S.C. § 78c (2012); *see also* Molony, *supra* note 18, at 977 (emphasizing that the transaction in *ParkCentral* was analogous to that considered in *Caiola* and likely to fall within the definition of a security-based swap under the Dodd-Frank Act).

<sup>21</sup> *Parkcentral*, 763 F.3d at 207.

<sup>22</sup> *Id.* at 205.

Credit-default swaps are SBS that drew the attention of global financial markets during the recent financial crisis.<sup>23</sup> In a credit default swap, a buyer of a swap based on “a particular corporate or mortgage-backed bond” agrees to make regular payments of fixed amount to the swap seller.<sup>24</sup> If there is a default on a bond underlying the credit-default swap, the seller will pay to the swap buyer “(usually the face value of the security) and take possession of it.”<sup>25</sup> In other words, a credit-default swap protects its buyer from the risk of default under the underlying security.<sup>26</sup>

Given the derivative nature of SBS, potential fraud involving such instruments, unlike fraud involving conventional securities, can occur in two different variations: (i) fraud in connection with the underlying security, and (ii) fraud in connection with the SBS itself.<sup>27</sup> The first type of fraud may involve actions aimed at manipulation of the value of the referenced shares while the second may relate to “misconduct that affects the market value of the [SBS] for purposes of posting collateral or making payments or deliveries under such [SBS].”<sup>28</sup>

### **B. Regulatory Framework of the Dodd-Frank Act**

Until recently, SBS remained largely unregulated.<sup>29</sup> In 2010, in response to concerns about a “domino effect” triggered by the

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<sup>23</sup> PAUL H. SCHULTZ, PERSPECTIVES ON DODD-FRANK AND FINANCE 159 (2014).

<sup>24</sup> Stout, *supra* note 11, at 6.

<sup>25</sup> SCHULTZ, *supra* note 23, at 159; *see also* Stout, *supra* note 11, at 6.

<sup>26</sup> *See* Stout, *supra* note 11, at 7.

<sup>27</sup> *See* Susan I. Gault-Brown et al., *SEC Proposes Anti-Fraud and Anti-Manipulation Rule for Security-Based Swaps under Section 763(g) of the Dodd-Frank Act*, K&L GATES (Nov. 9, 2010), <http://www.klgates.com/sec-proposes-anti-fraud-and-anti-manipulation-rule-for-security-based-swaps-under-section-763g-of-the-dodd-frank-act-11-29-2010/>

[<https://perma.cc/5V9T-QATU>] (distinguishing “fraud, manipulation, and deception involving a security-based swap itself” and “fraud, manipulation, or deception in connection with a securities-based swap agreement that involves the ‘reference underlying’ . . . on which the swap is based”); *see also* Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 34-63,236, 75 Fed. Reg. 68,560, 68,562 (Nov. 8, 2010).

<sup>28</sup> Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, 75 Fed. Reg. at 68,562.

<sup>29</sup> Peng, *supra* note 11, at 134.

default of major swap participants,<sup>30</sup> Congress adopted a comprehensive regulatory framework for the OTC swap markets.<sup>31</sup>

The Dodd-Frank Act requires central clearing for SBS,<sup>32</sup> meaning that an over-the-counter SBS will be replaced with two swaps: one between a party to the swap and the clearinghouse and an identical swap between a second party and the same clearinghouse.<sup>33</sup> The clearing process eliminates risks related to the solvency of the parties to SBS, because in the case of one party's default, the clearinghouse will make the payment due to the other party.<sup>34</sup>

SBS subject to clearing requirements will no longer be traded over the counter.<sup>35</sup> Transactions involving SBS will be executed through a swap execution facility (SEF), "a trading platform that provides pretrade bid and ask prices and an execution mechanism."<sup>36</sup> Not all SBS, however, will be subject to clearing.<sup>37</sup>

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<sup>30</sup> See Ilya Beylin, *A Reassessment of a Clearing Mandate*, HARV. L. SCH. FORUM ON CORP. GOV. FIN. REG. (Aug. 18, 2015), <http://corpgov.law.harvard.edu/2015/08/18/a-reassessment-of-the-clearing-mandate/> [<https://perma.cc/LS3U-L3NH>] ("Clearinghouses can stop domino effects from emerging between swap market participants as they prevent the failure of one swap party and associated defaults on its swaps from causing losses to its counterparties."); see also SCHULTZ, *supra* note 23, at 163 (explaining financial risks posed by the AIG's potential failure in the absence of a collateral securing performance of parties under swap agreements).

<sup>31</sup> See *Derivatives*, SEC. & EXCH. COMM'N, <https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml> [<https://perma.cc/H7CQ-7P5H>]; see also Stout, *supra* note 10, at 33-36 (discussing the Dodd-Frank regulatory framework in connection with derivatives).

<sup>32</sup> Exchange Act § 3c, 15 U.S.C. § 78c-3(a)(1) (2012) ("It shall be unlawful for any person to engage in [SBS] unless that person submits such [SBS] for clearing to a clearing agency that is registered under this Act or a clearing agency that is exempt from registration under this Act if [SBS] is required to be cleared.").

<sup>33</sup> Beylin, *supra* note 30.

<sup>34</sup> *Id.*; see also SCHULTZ, *supra* note 23, at 160 ("Traders do not need to worry about whether their counterparties will remain solvent. The clearinghouse takes place of their counterparties.").

<sup>35</sup> Exchange Act § 3c; see also SCHULTZ, *supra* note 23, at 160.

<sup>36</sup> Schultz, *supra* note 23, at 160. In July 2015, SEC brought first action to enforce the SBS regulation of the Dodd-Frank Act against "a web-based exchange that allowed its members to buy and sell contracts in the form of 'fantasy stock' based on the value of private companies in advance of expected liquidity events, such as initial public offerings, mergers or dissolutions." Annette L. Nazareth, *SEC and CFTC Turn to Swaps and*

Bespoke SBS, including the instruments used by parties to hedge their own commercial risk, will be exempt from such requirements, leaving the parties to such SBS to comply with capital and margin rules.<sup>38</sup>

The Dodd-Frank Act also created a comprehensive compliance regime for major players on the swap markets, major swap market participants (MSMPs) and swap dealers (SDs).<sup>39</sup> MSMPs and SDs are required to register with the SEC and comply with numerous requirements concerning “capital, margin, and segregation and business conduct standards.”<sup>40</sup> A swap dealer is defined through its activities.<sup>41</sup> Among other things, swap dealers usually hold themselves out as dealers in swaps, act as market makers in swaps, or regularly enter into swaps for its own account.<sup>42</sup> Swap dealers “design complex instruments offering various combinations of financial risk and return, and market them to clients

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*Security-Based Swaps Enforcement*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (July 15, 2015), <http://corpgov.law.harvard.edu/2015/07/05/sec-and-cftc-turn-to-swaps-and-security-based-swaps-enforcement/> [<https://perma.cc/RAF6-XCUK>]. According to the SEC, these contracts were SBS referencing events relating to a single issuer (a start-up company). *Id.*

<sup>37</sup> See Saule Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63, 69, 78 (2012); see also Adam J. Levitin, *Response: The Tenuous Case for Derivatives Clearinghouses*, 101 GEO. L.J. 445, 466 (2013) (explaining that the SEC has the authority to exclude certain swaps from the clearing requirement); Stout, *supra* note 11, at 34; SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, *DERIVATIVES 2*, [http://www.skadden.com/newsletters/FSR\\_Derivatives.pdf](http://www.skadden.com/newsletters/FSR_Derivatives.pdf) [<https://perma.cc/VGF2-6BMX>].

<sup>38</sup> *OTC Derivatives Resource Center*, SIFMA, <http://www.sifma.org/issues/regulatory-reform/otc-derivatives/overview/> [<https://perma.cc/VSA9-FM5A>]; see also SULLIVAN & CROMWELL LLP, *SECURITY-BASED SWAPS: CAPITAL, MARGIN AND SEGREGATION REQUIREMENTS 9* (2012), [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_Proposed\\_Rules\\_on\\_Capital\\_Requirements\\_Margin\\_for\\_Security\\_Based\\_SDs\\_and\\_MSPs.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Proposed_Rules_on_Capital_Requirements_Margin_for_Security_Based_SDs_and_MSPs.pdf) [<https://perma.cc/C7D5-66LB>] (explaining that the Dodd-Frank Act authorized the SEC to develop margin and capital requirements for uncleared SBS).

<sup>39</sup> *The Regulatory Regime for Security-Based Swaps*, SEC. & EXCH. COMM’N, <http://www.sec.gov/swaps-chart/swaps-chart.pdf> [<https://perma.cc/8RWD-PTM4>].

<sup>40</sup> *Id.*

<sup>41</sup> See 17 C.F.R. § 240.3a71-1 (2016).

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

by taking either side of the transaction . . . build large portfolios of positions in various instruments and hedge their risks by entering into trades with other clients or, more commonly, other dealers.”<sup>43</sup>

In contrast, MSMP targets “systemic risks associated with a person’s Swap positions and so looks principally at the size of a person’s positions.”<sup>44</sup>

Exercising its rulemaking authority under the Dodd-Frank Act, the SEC clarified that non-U.S. swap dealers will be subject to registration in the United States “on the basis of a threshold amount of U.S.-facing activity[.]”<sup>45</sup> which comprises dealing with U.S. persons and with entities having “rights of recourse against a U.S. person that is controlling, controlled or under common control with the affiliate of the non-U.S. person[.]” as well as all dealing activity of a non-U.S. person acting as a conduit affiliate of a U.S. person.<sup>46</sup> Entities involved only in a “de minimis” amount of dealing transactions, however, are exempt from the registration requirements.<sup>47</sup>

A SBS transaction between two non-U.S. entities involving only certain preparatory activities in the United States are not excluded from the reach of the new regulatory regime. In particular, the SEC opines that “dealing activity carried out by a non-U.S. person through a branch, office, affiliate, or agent acting on its behalf in the United States may raise concerns . . . even if a significant proportion—or all—of those transactions involve non-U.S.-person

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<sup>43</sup> Omarova, *supra* note 37, at 72.

<sup>44</sup> SHERMAN STERLING LLP, SWAP DEALER, MAJOR SWAP PARTICIPANT AND ELIGIBLE CONTRACT PARTICIPANT: SEC AND CFTC ADOPT ENTITY DEFINITION RULES 9 (2012), [http://www.shearman.com/~/media/files/newsinsights/publications/2012/07/swap-dealer-major-swap-participant-and-eligible-\\_/files/view-full-memo-swap-dealer-major-swap-participant\\_/fileattachment/swapdealermajorswapparticipantandcftcadoptentity\\_.pdf](http://www.shearman.com/~/media/files/newsinsights/publications/2012/07/swap-dealer-major-swap-participant-and-eligible-_/files/view-full-memo-swap-dealer-major-swap-participant_/fileattachment/swapdealermajorswapparticipantandcftcadoptentity_.pdf) [<https://perma.cc/F8EV-KEQN>]; see 17 C.F.R. § 240.3a67-1 (2015).

<sup>45</sup> Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make A Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1335-36 (2014).

<sup>46</sup> 17 C.F.R. § 240.3a71-3 (2016).

<sup>47</sup> Security-Based Swap Transactions Connected with a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed By Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, Exchange Act Release No. 34-77104, 81 Fed. Reg. 8,598, 8,612 (Feb. 19, 2016).

counterparties.”<sup>48</sup> Relying on this premise, the SEC requires a non-U.S. person to count towards its de minimis threshold: “[SBS] transactions connected with such person’s security-based swap dealing activity that are arranged, negotiated, or executed by personnel of such non-U.S. person located in a U.S. branch or office, or by personnel of an agent of such non-U.S. person located in a U.S. branch or office.”<sup>49</sup> A non-U.S. dealer will have to count such transactions towards the threshold amount triggering its duty to register as an SD under the Dodd-Frank Act.<sup>50</sup>

This brief overview illustrates that the new legal framework intends to regulate SBS-related activities of non-U.S. entities, as well as SBS transactions with foreign elements. In particular, section 722 of the Dodd-Frank Act emphasizes that the new SBS regime of the Commodity Exchange Act applies extraterritorially if SBS-related activities “have a direct and significant connection with activities in, or effect on, the commerce of the United States.”<sup>51</sup> Moreover, the same section provides that the provisions of the Dodd-Frank Act added to the Exchange Act govern a foreign SBS-related conduct if a “person transacts such [SBS-related] business in contravention of . . . rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent the evasion of any provision of this title that was added by the [Dodd-Frank Act].”<sup>52</sup>

This intent to regulate extraterritorial SBS-activity is also evidenced by section 929P(b)(2) of the Dodd-Frank Act which expressly states the U.S. federal courts possess subject matter jurisdiction to actions

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<sup>48</sup> Security-Based Swap Transactions Connected with a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed By Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. at 8,600.

<sup>49</sup> 17 C.F.R. § 240.3a71-3 (2016).

<sup>50</sup> SULLIVAN & CROMWELL LLP, CROSS-BORDER SECURITY-BASES SWAPS 3 (2016),

[https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_Cross\\_Border\\_Security\\_Based\\_Swaps\\_02\\_17\\_2016.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Cross_Border_Security_Based_Swaps_02_17_2016.pdf) [<https://perma.cc/9ZD8-SGPF>].

<sup>51</sup> Dodd-Frank Act § 722(d), Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see also* Stout, *supra* note 11, at 35.

<sup>52</sup> Dodd-Frank Act § 722(d). Some commentators opine that section 722 of the Dodd-Frank Act “contains explicit reference to the extraterritorial application.” Coffee, *supra* note 9, at 1261.

brought or instituted by the [SEC] or the United States alleging a violation of the [securities] antifraud provisions . . . involving—(1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.<sup>53</sup>

### **III. Extraterritorial Reach of Securities Regulation**

#### **A. Taxonomy: Prescriptive Jurisdiction**

The U.S. securities laws do not specify whether they apply extraterritorially, namely “beyond . . . territorial limits.”<sup>54</sup> Enacting the Securities Act and the Exchange Act in the early 1930s, Congress intended to regulate U.S. capital markets and disputes related to these statutes were primarily domestic.<sup>55</sup> After the Second World War, however, the United States’ capital markets inevitably became a part of the globalized economy.<sup>56</sup> Moreover, in recent decades the world

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<sup>53</sup> Exchange Act § 27(b), 15 U.S.C. § 78aa (2012) (emphasis added).

<sup>54</sup> Anthony J. Colangelo, *What Is Extraterritorial Jurisdiction?*, 99 CORNELL L. REV. 1303, 1312 (2014) (quoting BLACK’S LAW DICTIONARY 929 (9th ed. 2009)).

<sup>55</sup> *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir. 1975) (“The Congress . . . in the midst of the depression could hardly have been expected to foresee the development of offshore funds thirty years later.”); Daniel S. Kahn, *The Collapsing Jurisdictional Boundaries of the Antifraud Provisions of the U.S. Securities Laws: the Supreme Court and Congress Ready to Redress Forty Years of Ambiguity*, 6 N.Y.U.J.L. & BUS. 365, 369 (2010) (explaining that Congress adopting the Securities Act of 1933 and the Exchange Act could not have anticipated the future globalization of the American economy).

<sup>56</sup> See Larry Cramer, *Vestiges of Beale: Extraterritorial Application of American Law*, 1991 SUP. CT. REV. 179, 182 (1991) (“Cases with foreign elements may once have been marginal, but events since World War II have deeply entangled the United States in the world’s political and market economies.”).

financial markets became even more interconnected,<sup>57</sup> and, in particular, in the area of derivatives.<sup>58</sup> In light of these structural changes, it was less than clear whether the U.S. securities laws apply extraterritorially, namely to occurrences or activities taking place abroad or involving foreign elements.<sup>59</sup> Before discussing the difficulties of extraterritorial jurisdiction in the area of securities regulation, we have to define the contours of prescriptive jurisdiction.

Traditionally, the power of a sovereign state to regulate activities with foreign elements comprises: (i) prescriptive jurisdiction, (ii) adjudicative jurisdiction, and (iii) enforcement jurisdiction.<sup>60</sup> Prescriptive jurisdiction is the power “to make and apply law to persons or things” and associate it with a state’s legislative activities, while adjudicative jurisdiction is “the power to

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<sup>57</sup> See Frederick H. C. Mazando, *The Taxonomy of Global Securities: Is the U.S. Definition of a Security too Broad?*, 33 NW. J. INT’L & BUS. 121, 126 (2012) (discussing the CDSs created by the American International Group (AIG) in its offices in London that nearly destroyed its U.S. and global operations); see also Genevieve Beyea, *Morrison v. National Australia Bank and the Future of Extraterritorial Application of the U.S. Securities Laws*, 72 OHIO ST. L.J. 537, 539 (2011) (emphasizing the increasing integration of world financial markets and the attendant escalation of transnational securities); Robert W. Hillman, *Cross-Border Investment, Conflict of Law, and the Privatization of Securities Law*, 55 LAW & CONTEMP. PROBS. 331, 331 (1992) (“[E]ven an inexperienced investor may own . . . shares in a multitude of mutual funds that invest in a specific country’s stock market, such as the Asia Pacific, Austria, Brazil, Chile, Germany, Mexico, India, Irish, Italy, Jakarta Growth, Korea. . .”).

<sup>58</sup> Le Vine, *supra* note 10, at 709 (addressing the growth of the SBS market). In connection with the derivatives market in general, see Johnson, *supra* note 12, at 550 (“The OTC derivatives market has experienced nothing short of explosive growth since the early 1980s. The total notional amount outstanding as of the end of 2012 (the most recent data) for OTC derivatives was estimated by the BIS to be approximately \$633 trillion. The gross market value of these trades was estimated at \$24.7 trillion with the gross credit exposure calculated to be \$3.6 trillion.”). For the discussion of global over-the-counter swaps, see RAFFAELE SCALCIONE, *THE DERIVATIVES REVOLUTION* 37 (2011).

<sup>59</sup> Colangelo, *supra* note 54, at 1305 (“Must every aspect of a claim be foreign for the exercise of prescriptive jurisdiction to qualify as extraterritorial, or is it enough that some aspect of a claim takes place abroad? If it is the latter, which aspect of the claim?”).

<sup>60</sup> *Id.* at 1310.

subject persons or things to judicial process.”<sup>61</sup> The Restatement (Third) of Foreign Relations Law, among factors that justify a state’s prescriptive jurisdiction, lists activities involving that state’s nationals, as well as conduct taking place or causing substantial effects within that state’s territory.<sup>62</sup>

Personal and subject matter jurisdiction are examples of adjudicative jurisdiction.<sup>63</sup> Enforcement jurisdiction is defined as a “power to induce or compel compliance or to punish non-compliance with the law.”<sup>64</sup> The dividing lines between these types are not cast in iron and, of course, there is some cross-pollination among them.<sup>65</sup>

Imprecise contours of those definitions caused significant confusion in legal literature and jurisprudence.<sup>66</sup> Disagreements of Justice Souter, writing for the majority, with Justice Scalia, dissenting, in *Hartford Fire Insurance Co. v. California*<sup>67</sup> are illustrative. While Justice Souter opined that the application of the Sherman Antitrust Act to conduct abroad was a question of the adjudicative (subject matter) jurisdiction, Justice Scalia emphasized that the authority of a state to make its law applicable to persons or activities differed from the power to adjudicate.<sup>68</sup>

For some time this confusion persisted in the securities regulation field. Prior to the Supreme Court’s decision in *Morrison*, many courts concluded that the issue of whether a federal court should apply U.S. securities laws to a private lawsuit arising from activities with a foreign element was an issue of federal subject

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<sup>61</sup> *Id.* at 1310-11.

<sup>62</sup> RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 402 (AM. LAW INST. 1987); see Eleanor M. Fox, *Modernization of Effects Jurisdiction: From Hands-Off to Hands Linked*, 42 INT’L L. POLITICS 159, 162 (2009) (“The Restatement . . . begins its treatment of jurisdiction to prescribe with a basic concept . . . that a nation has jurisdiction to prescribe where it has a legitimate stake in the matter, such as nationality, conduct on the territory (these being well recognized and uncontroverted bases for jurisdiction), or substantial effects in the territory.”).

<sup>63</sup> Colangelo, *supra* note 54, at 1311.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.* at 1311; Larry Kramer, *Extraterritorial Application of American Law After the Insurance Antitrust Case: A Reply to Professors Lowenfeld and Trimble*, 89 AM. J. INT’L L. 750, 750 n.3 (1995).

<sup>66</sup> Kramer, *supra* note 65, at 750; see also Colangelo, *supra* note 54, at 1335.

<sup>67</sup> 509 U.S. 764, 798-99 (1993).

<sup>68</sup> *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 798 (1993); Colangelo, *supra* note 54, at 1336.

matter jurisdiction.<sup>69</sup> However, *Morrison* made it clear that the application of the U.S. securities laws to transactions with foreign elements is a matter of a prescriptive jurisdiction rather than adjudicative.<sup>70</sup> Justice Scalia, writing for the majority in *Morrison*, emphasized that “to ask what conduct § 10(b) reaches is to ask what conduct § 10(b) prohibits, which is a merits question.”<sup>71</sup> The opinion stresses that federal courts possess jurisdiction to determine if section 10(b) of the Exchange Act can be relied on by the plaintiff in a securities fraud case.<sup>72</sup>

Federal courts traditionally consider securities regulation as a subset of public law<sup>73</sup> and view this field through the prism of “domestic territoriality,” meaning that countries possess prescriptive

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<sup>69</sup> *Morrison v. Nat’l Australia Bank Ltd.*, 561 U.S. 247, 253-54 (2010) (“[W]e must correct a threshold error in the Second Circuit’s analysis. It considered the extraterritorial reach of § 10(b) to raise a question of subject-matter jurisdiction . . .”).

<sup>70</sup> Colangelo, *supra* note 54, at 1336 (“Even where the plaintiff, the defendant, and the transaction were foreign . . . judicial subject-matter jurisdiction existed under the [Exchange Act’s] jurisdictional provisions.”).

<sup>71</sup> *Morrison*, 561 U.S. at 254; *see also* U.S. S.E.C. v. Chicago Convention Ctr., LLC, 961 F. Supp. 2d 905, 909 (N.D. Ill. 2013) (“The Supreme Court specifically noted that the ‘district court had jurisdiction under 15 U.S.C. § 78aa to adjudicate the question whether § 10(b) applies to [the defendants] conduct.’”).

<sup>72</sup> *Morrison*, 561 U.S. at 254. Section 27 of the Exchange Acts provides that “[t]he district courts of the United States . . . shall have exclusive jurisdiction of violations of this title [the Exchange Act of 1934] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title [the Exchange Act of 1934] or the rules and regulations thereunder. Exchange Act § 27, 15 U.S.C. § 78aa (2012); *see also* Beyea, *supra* note 57, at 547 (“The location of fraudulent conduct therefore does not affect this conferral of jurisdiction.”).

<sup>73</sup> William S. Dodge, *Breaking the Public Law Taboo*, 43 HARV. INT’L L.J. 161, 185 (2002) (“It is generally assumed that courts should neither entertain suits under foreign antitrust and securities laws nor enforce judgments rendered under those laws even when the plaintiff is a private party.”); Hillman, *supra* note 57, at 341 (“Adherence to the public/private law distinction explains why the *Third Restatement of Foreign Relations*, rather than the *Second Restatement of Conflicts*, covers extraterritorial issues arising in securities and antitrust cases, and effectively negates the use of a choice of law analysis.”).

jurisdiction over the actions occurring within their territories.<sup>74</sup> When addressing a public law issue with foreign elements, courts do not determine if foreign or domestic public laws should apply, but whether they have the authority to resolve an issue “having significant foreign elements” under the laws of the forum.<sup>75</sup> Thus, having determined that an issue is not domestic and lies within the realm of public law, courts will refrain from applying foreign public laws in such a dispute.<sup>76</sup> In contrast, if the same court considers a contractual dispute with an international element, the court could apply the law of its own jurisdiction or the laws of another state and decide the case on the merits.<sup>77</sup>

Characterizing the issue of extraterritorial reach of the U.S. securities laws as the domain of prescriptive jurisdiction leads to two important conclusions. First, unlike in the case involving adjudicatory (subject matter) jurisdiction, a court cannot raise the extraterritoriality issue *sua sponte*.<sup>78</sup> Furthermore, a court’s finding

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<sup>74</sup> Chris Brummer, *Territoriality as a Regulatory Technique: Notes from the Financial Crisis*, 79 U. CIN. L. REV. 499, 503 (2010); see also Hillman, *supra* note 57, at 341 (“[T]he *Third Restatement of Foreign Relations*, rather than the *Second Restatement of Conflicts*, covers extraterritorial issues arising in securities and antitrust cases, and effectively negates the use of a choice of law analysis.”).

<sup>75</sup> Hillman, *supra* note 57, at 340.

<sup>76</sup> See Dodge, *supra* note 73, at 161. One may argue that the securities regulation implicates both public and private enforcement and therefore private lawsuits under the Exchange Act should be treated as usual tort claims and subject to conflict-of-laws provisions. See, e.g., Hillman, *supra* note 57, at 351 (“[C]ourts should have choice-of-law flexibility in private cross-border securities transactions.”); Dodge, *supra* note 73, at 193 (“[E]ven if . . . the [Exchange Act] creates public rights, the public law taboo does not bar enforcement of those rights by a private plaintiff.”). For example, some commentators note that in disputes brought by investors under rule 10(b)-5 “the litigation postures and styling of the cases suggest they are private law cases: one private party is suing another private party for relief.” Colangelo, *supra* note 54, at 1349. Another school of thought suggests that these suits involve “private enforcement of a public regulatory law” and therefore go beyond the boundaries of tort law and cannot be treated as a domain of private law. *Id.* (“Yet the laws at issue suggest something different is going on.”).

<sup>77</sup> RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 186 (AM. LAW INST. 1971); see Dodge, *supra* note 73, at 161 (“It is common to find judges applying foreign tort law to decide a case, or enforcing a foreign judgment for breach of contract.”).

<sup>78</sup> Colangelo, *supra* note 54, at 1344.

that the U.S. securities laws do not apply to a plaintiff's claim signifies a defendant's victory because upon this finding the court dismisses the claims without engaging in a conflict-of laws analysis typical for contractual or tort cases.<sup>79</sup>

### B. Conduct and Effects Tests Prior to Morrison

Prior to *Morrison*, federal courts and, in particular, the Second Circuit, had developed two tests for determining whether securities disputes fall within the scope of the U.S. "jurisdiction to prescribe".<sup>80</sup> Under the effects test, an activity involving securities was considered domestic if "the wrongful conduct had a substantial effect in the United States or upon United States citizens."<sup>81</sup> The conduct test examines if "the wrongful conduct occurred in the United States."<sup>82</sup>

*Schoenbaum v. Firstbrook* illustrates the effects test by requiring plaintiffs to show "harm to specific interests within the United States,"<sup>83</sup> for example, by proving damages sustained by the American investors "as a result of the foreign conduct."<sup>84</sup> The conduct test, in turn, focused on the conduct that caused the harm in question and did not take into account the place of the transaction.<sup>85</sup> For example, the Second Circuit in *Leasco Date Processing*

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<sup>79</sup> *Id.* at 1351 n.253; Hillman, *supra* note 57, at 345 ("The judicial assignment . . . is the all-or-nothing task of determining whether to apply U.S. law or to dismiss the case."); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 186 (AM. LAW INST. 1971) ("Issues in contract are determined by the law chosen by the parties in accordance with the rule of § 187 and otherwise by the law selected in accordance with the rule of § 188.").

<sup>80</sup> *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247, 257 (2010); Beyea, *supra* note 57, at 542.

<sup>81</sup> *Morrison*, 561 U.S. at 257.

<sup>82</sup> *Id.*

<sup>83</sup> Beyea, *supra* note 57, at 543; *see Schoenbaum*, 405 F.2d at 208 ("[T]he district court has subject matter jurisdiction over violations of [the Exchange Act] although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve stock registered and listed on a national securities exchange, and are detrimental to the interests of American investors.").

<sup>84</sup> Beyea, *supra* note 57, at 543.

<sup>85</sup> *Id.* ("The conduct test looks at whether some conduct that was material to the fraud directly caused the harm in question, regardless of the location of the investors or the markets where the stock was sold.").

*Equipment Corp. v. Maxwell*<sup>86</sup> found that section 10(b) applies to the claim of an American company contending that it was induced to buy securities in the United Kingdom because “some of the deceptive conduct had occurred in the United States.”<sup>87</sup>

Other federal circuits did not embrace the Second Circuit’s approach fully, and applied tests similar to the conduct and effects analysis.<sup>88</sup> Nonetheless, all variations of the conduct/ effects inquiry required the adjudicator to engage in lengthy fact-intensive proceedings at early stages of the dispute.<sup>89</sup> This lack of clarity and consistency of application of the conduct and effects tests raised numerous concerns, mainly among foreign companies who claimed that these tests subjected to the U.S. antifraud provisions companies with only tenuous connections to the United States.<sup>90</sup>

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<sup>86</sup> 468 F.2d 1326 (1972).

<sup>87</sup> *Morrison*, 561 U.S. at 256-57; see also *Leasco Date Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1337 (1972) (“We likewise cannot see any sound reason for believing that, in a case like that just put, Congress would have wished protection to be withdrawn merely because the fraudulent promoter of the Saskatchewan mining security took the buyer’s check back to Canada and mailed the certificate from there. In the somewhat different yet closely related context of choice of law, the mechanical test that, in determining the *locus delicti*, ‘The place of wrong is in the state where the last event necessary to make an actor liable for an alleged tort takes place’ . . .”).

<sup>88</sup> *Id.* at 259 (“While applying the same fundamental methodology of balancing interests and arriving at what seemed the best policy, they produced a proliferation of vaguely related variations on the ‘conduct’ and ‘effects’ test.”); Kahn, *supra* note 55, at 375 (describing approaches developed in the Third, Eighth and Ninth Circuits).

<sup>89</sup> Marco Ventrizzo, *Like Moths to a Flame? International Securities Litigation After Morrison: Correcting the Supreme Court’s “Transactional Test,”* 52 VA. J. INT’L L. 405, 407, 421 (2012) (emphasizing that the pre-*Morrison* standards “require[d] a fact intensive, case-by-case analysis” and that that inconsistent judicial decisions frequently “stretch[ed] the coverage of the securities law to disputes in which the United States had little interest.”); see also Richard W. Painter, *The Dodd-Frank Extraterritorial Jurisdiction Provision: Was it Effective, Needed or Sufficient?*, 1 HARV. BUS. L. REV. 195, 213 (2011) (emphasizing the lack of predictability of a pre-*Morrison* legal framework).

<sup>90</sup> Steven Davidoff Solomon, *Securities Law Ruling Creates Unintended Problems*, N.Y. TIMES (June 1, 2012, 12:55 PM), <http://dealbook.nytimes.com/2012/06/01/securities-law-ruling-created-more-problems-than-it-solved/> [<https://perma.cc/XY8E-EVA5>].

### C. *Morrison* Transactional Test

In *Morrison* the Supreme Court overruled the conduct and effects tests developed by the Second Circuit and articulated the extraterritoriality framework refined in subsequent opinions.<sup>91</sup> In *Morrison*, Australian plaintiffs, who purchased shares of an Australian bank on the Australian stock exchange, brought claims in the federal district court for the Southern District of New York alleging that they were misled by the bank's management statements concerning the performance of the bank's U.S. subsidiary.<sup>92</sup> The Supreme Court agreed with the lower court's decisions to dismiss the plaintiffs' claims upon finding that section 10(b) of the Exchange Act does not apply extraterritorially, in particular, to transactions with securities traded outside the United States.<sup>93</sup>

The Supreme Court began its analysis by announcing the presumption against the extraterritorial application of the laws, meaning that if a statute does not clearly indicate that it has extraterritorial reach, it does not have one.<sup>94</sup> This presumption presupposes a two-step analysis of the extraterritoriality issues. The first step requires a court to ask if "the presumption against extraterritoriality has been rebutted—that is, whether the statute gives a clear, affirmative indication that it applies extraterritorially."<sup>95</sup> If the presumption stands, the court must decide

whether the case involves a domestic application of the statute . . . by looking to the statute's "focus." If the conduct relevant to the statute's focus occurred

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<sup>91</sup> *Id.* ("[T]he Supreme Court took a sledgehammer to decades of case law on the application of United States securities laws abroad."); *see, e.g.*, *RJR Nabisco, Inc. v. European Cmty.*, 136 S. Ct. 2090 (2016); *Kiobel v. Royal Dutch Petroleum Co.*, 133 S. Ct. 1659 (2013).

<sup>92</sup> Richard Painter et al., *When Courts and Congress Don't Say What They Mean: Initial Reactions to Morrison v. National Australia Bank and to the Extraterritorial Jurisdiction Provisions of the Dodd-Frank Act*, 20 MINN. J. INT'L L. 1, 5 (2011).

<sup>93</sup> *Morrison v. Nat'l Australia Bank Ltd.*, 561 U.S. 247, 265 (2010); *see also* Painter et al., *supra* note 92, at 5.

<sup>94</sup> *RJR Nabisco, Inc. v. European Cmty.*, 136 S. Ct. 2090, 2100 (2016) (quoting *Morrison*, 561 U.S. at 255) ("Absent clearly expressed congressional intent to the contrary, federal laws will be construed to have only domestic application."); *see also* Colangelo, *supra* note 54, at 1340-41; Painter et al., *supra* note 92, at 5.

<sup>95</sup> *RJR Nabisco, Inc.*, 136 S. Ct. at 2101.

in the United States, then the case involves a permissible domestic application even if other conduct occurred abroad; but if the conduct relevant to the focus occurred in a foreign country, then the case involves an impermissible extraterritorial application regardless of any other conduct that occurred in U.S. territory.<sup>96</sup>

In *Morrison*, the Supreme Court determined that the language of section 10(b) of the Exchange Act did not rebut the presumption of the extraterritoriality.<sup>97</sup>

In connection with a factor that qualifies securities-related activities as domestic, the Supreme Court stated that the focus of “the Exchange Act is not upon the place where the deception originated, but upon purchases and sales of securities in the United States,” and replaced the conduct and effects analysis with a bright-line transactional test.<sup>98</sup> This test allows a plaintiff to pursue the section 10(b) claims in the U.S. federal courts if (i) the purchase or sale of the security was done in the United States, or (ii) when the transaction involves securities listed on domestic exchanges.<sup>99</sup> Provided one of these conditions is satisfied, *Morrison* requires courts to consider such a transaction domestic even if it involves certain foreign elements.<sup>100</sup>

The Supreme Court justified the replacement of the conduct and effects tests with a bright-line transactional one by the former’s

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<sup>96</sup> *Id.* at 2101.

<sup>97</sup> *Morrison*, 561 U.S. at 265 (“[T]here is no affirmative indication in the Exchange Act that § 10(b) applies extraterritorially, and we therefore conclude that it does not.”); *see also RJR Nabisco, Inc.*, 136 S. Ct. at 2100.

<sup>98</sup> Painter et al., *supra* note 92, at 5.

<sup>99</sup> *Morrison*, 561 U.S. at 266 (“Section 10(b) does not punish deceptive conduct, but only deceptive conduct “in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered.”).

<sup>100</sup> Colangelo, *supra* note 54, at 1342. The federal court clarified that “read as a whole, the *Morrison* opinions indicate that the [Supreme] Court considered that under its new test § 10(b) would not extend to foreign securities trades executed on foreign exchanges even if purchased or sold by American investors, and even if some aspects of the transaction occurred in the United States . . . .” *Cornwell v. Credit Suisse Grp.*, 729 F.Supp.2d 620, 624 (S.D.N.Y. 2010); *see also Arco Capital Corp. v. Deutsche Bank AG*, 949 F. Supp. 2d 532, 541 (S.D.N.Y. 2013).

lack of predictability and consistency in application.<sup>101</sup> The court also clarified that by limiting the extraterritorial effect of the U.S. securities laws, it sought to avoid regulatory competition with other countries who also have an interest in regulating fraud committed in their jurisdictions.<sup>102</sup> Moreover, commentators note that one of the reasons for *Morrison*'s ruling was a fear of "a chilling effect on valuable economic activity in the United States" that could have been caused by foreign issuers moving their businesses abroad in light of the risks of costly litigation in federal courts.<sup>103</sup>

#### **D. Development of the Transactional Test After *Morrison***

In practice, *Morrison*'s bright-line transactional test proved to be much more complicated than the Supreme Court envisaged.<sup>104</sup> In *Absolute Activist Value Master Fund Ltd. v. Ficeto*,<sup>105</sup> a court grappled with the issue of whether Cayman Islands investors' transactions with "securities issued by U.S. companies brokered through a U.S. broker-dealer" fall within the scope of section 10(b) of the Exchange Act.<sup>106</sup> The Second Circuit held that an over-the-counter transaction was domestic for the purposes of the *Morrison*

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<sup>101</sup> *Morrison*, 561 U.S. at 258 ("[T]hese tests were not easy to administer."); see Beyea, *supra* note 57, at 554.

<sup>102</sup> *Morrison*, 561 U.S. at 269; see also Beyea, *supra* note 57, at 555 ("Too broad an extraterritorial application of the U.S. antifraud rules can result in jurisdictional conflict with other countries seeking to regulate the same transaction.").

<sup>103</sup> See Beyea, *supra* note 57, at 554; see also *Morrison*, 561 U.S. at 270 ("[S]ome fear that [the United States] has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."); see also STUDY ON THE PRIVATE RIGHT OF ACTION, *supra* note 3, at iii (summarizing arguments of the defendants and amici curiae in the *Morrison* case).

<sup>104</sup> *In re Optimal U. S. Litig.*, 865 F. Supp. 2d 451, 453 (S.D.N.Y. 2012) (highlighting that the second prong of *Morrison*, the purchase or sale of security, presented many questions). For post-*Morrison* developments, see STUDY ON THE PRIVATE RIGHT OF ACTION, *supra* note 3.

<sup>105</sup> 677 F.3d 60 (2d Cir. 2012).

<sup>106</sup> Jacob True, Note, *What Counts as a Domestic Transaction Anymore: The Second Circuit and Other Lower Courts' Struggles in Interpreting the Supreme Court's Intent in Morrison v. Australia National Bank When Dealing with Derivative Securities Transactions*, 10 HASTINGS BUS. L.J. 513, 527 (2014).

test “if irrevocable liability is incurred or title passes within the United States.”<sup>107</sup> The irrevocable liability is incurred within the United States if a “purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security.”<sup>108</sup> Furthermore, the Second Circuit clarified that the presence of a broker in the United States is not conclusive of the place of the transaction.<sup>109</sup>

*Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd*<sup>110</sup> also illustrates the difficulties of the *Morrison* transactional test. The court in that case held that the parties did not assume irrevocable liability in New York even though the buyer transferred the money to a bank in New York.<sup>111</sup> The court found that the provisions of the parties’ agreement, under which the buyer reserved the right to reject an application, even if the buyer’s money had been wired to New York, to be critical.<sup>112</sup> According to the court, the transaction was not completed until the seller accepted the buyer’s application, which occurred not in New York, but in the seller’s Cayman Islands offices.<sup>113</sup>

In light of the difficulties related to the determination of of a place where parties to a transaction incurred irrevocable liability, some commentators opine that the test as interpreted by the Second Circuit is more of “an ‘elusive,’ contextual standard than . . . a bright-line rule.”<sup>114</sup>

Application of the *Morrison* test to unconventional securities also remains difficult. In *City of Pontiac Policemen’s and Firemen’s*

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<sup>107</sup> *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).

<sup>108</sup> *Id.* at 68.

<sup>109</sup> *Id.* (“[T]he location of the broker alone does not necessarily demonstrate where a contract was executed.”).

<sup>110</sup> *Cascade Fund, LLP v. Absolute Capital Mgmt. Holdings Ltd.*, No. 08-CV-01381-MSK-CBS, 2011 WL 1211511, at \*1 (D. Colo. Mar. 31, 2011).

<sup>111</sup> *Id.* at \*7 (“That leaves the final fact urged by Cascade: that the funds to complete the transaction were wired (at least initially) to New York. This assertion does not amount to a conclusion that the transaction was completed in New York . . .”).

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*; see also *Securities Regulation—Securities Exchange Act—Second Circuit Holds that Transactions in Unlisted Securities Are Domestic if Irrevocable Liability is Incurred or if Title Passes Within the United States*, Case Comment, 126 HARV. L. REV. 1430, 1437 (2013).

<sup>114</sup> Case Comment, *supra* note 113, at 1435.

*Retirement System v. UBS AG*,<sup>115</sup> the Second Circuit applied the *Morrison* test to transactions with shares traded abroad but cross-listed on American stock exchanges.<sup>116</sup> The court considered the cross-listing in the United States irrelevant, concluding that the focus of the *Morrison* ruling is “the location of the securities transaction, rather than the location of an exchange on which the security may be dually listed.”<sup>117</sup> Having established that the purchase of securities in question was made outside the United States, the court refused to apply section 10(b) of the Exchange Act.<sup>118</sup>

American Depository Receipts (ADRs) also posed a problem for the *Morrison* test application. In *In re Royal Bank of Scotland Group PLC Securities Litigation*, “the court rejected plaintiffs’ arguments that the defendants’ ADRs, traded on the NYSE, were ‘listed’ securities under *Morrison* and therefore triggered § 10(b) application.”<sup>119</sup>

Moreover, the Dodd-Frank Act, enacted less than a month after *Morrison*, complicated the issue of extraterritoriality even further by providing that actions brought by the SEC and DOJ arising from the violations of the U.S. securities laws “involving (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States” fall within the federal jurisdiction.<sup>120</sup> Commentators point to the ambiguity of the statutory language and stress that “the language . . . referenced the federal court’s subject matter jurisdiction rather than the issue on the merits of section 10(b).”<sup>121</sup> Accordingly, they conclude that Dodd-Frank

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<sup>115</sup> *City of Pontiac Policemen’s & Firemen’s Ret. Sys. v. UBS AG*, 752 F.3d 173 (2d Cir. 2014).

<sup>116</sup> *Second Circuit Extends Supreme Court Ruling on Extraterritorial Unavailability of Exchange Act Claims*, SIMPSON THACHER LLP (May 27, 2014), [http://www.stblaw.com/docs/default-source/memos/firm-memo\\_05\\_23\\_14.pdf?sfvrsn=10](http://www.stblaw.com/docs/default-source/memos/firm-memo_05_23_14.pdf?sfvrsn=10) [https://perma.cc/3E8X-FPQA].

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

<sup>118</sup> *Id.*

<sup>119</sup> Debbie Mavis Placid, *A Look at the Effects of Morrison v. National Australia Bank on American Depository Receipts and Section 10(B) Liability* 15, SETON HALL LAW E-REPOSITORY (2013), [http://scholarship.shu.edu/cgi/viewcontent.cgi?article=1369&context=student\\_scholarship](http://scholarship.shu.edu/cgi/viewcontent.cgi?article=1369&context=student_scholarship) [https://perma.cc/W48Y-F6YU].

<sup>120</sup> Exchange Act § 27, 15 U.S.C. § 78aa (2012).

<sup>121</sup> True, *supra* note 106, at 526.

Act did not intend to restore the conduct and effects tests and meant to address only subject matter jurisdiction.<sup>122</sup> Nonetheless, the majority of commentators seem to agree that although the legislature did not use the most elegant language in the Dodd-Frank Act, it in fact intended to overcome the *Morrison* ruling with respect to the actions brought by the SEC and DOJ.<sup>123</sup> In particular, the SEC emphasizes that “[s]ection 929P(b)(2) provided the necessary affirmative indication of extraterritoriality for Section 10(b) action involving transnational frauds brought by the [SEC] and DOJ.”<sup>124</sup>

In sum, the *Morrison* bright-line transactional test proved to be as complex and fact-intensive as the conduct and effects tests it criticized, and the “potential for arbitrariness” remained, since it is tied to a location of a transaction “in a world where physical location is becoming increasingly illusory.”<sup>125</sup>

#### ***IV. Applying the Morrison Transactional Test to SBS***

The transactional test as sharpened by the Second Circuit after *Morrison* does not fit cases involving SBS with ease. For example, strict application of the *Absolute Activist* irrevocable liability test to transactions with SBS “could lead to absurd results with foreigners flying into the United States to purchase derivatives on foreign securities to create jurisdiction.”<sup>126</sup> This test may open the door to further forum shopping since parties to a privately negotiated SBS can easily execute it outside the United States and avoid

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<sup>122</sup> Painter et al., *supra* note 92, at 19 (“Some . . . may argue that they do not affect the Court’s holdings in *Morrison* as to what transactions fall within Section 10(b) because these provisions merely give federal courts jurisdiction that the *Morrison* opinion recognized courts already have. Because the Dodd-Frank Act language does not speak to the merits, *e.g.* the substantive reach of Section 10(b), Congress has not changed the Court’s holding with respect to actions brought by the SEC or the United States.”).

<sup>123</sup> See STUDY ON THE PRIVATE RIGHT OF ACTION, *supra* note 3, at 6-7 n.5 (quoting 156 Cong. Rec. H5237 (daily ed. June 30, 2010) (statement of Rep. Kanjorski, author of section 929P(b)); see also Painter et al., *supra* note 92, at 19 (“Such a literal reading of the Dodd-Frank Act clearly does not reflect the intent of Congress.”).

<sup>124</sup> STUDY ON THE PRIVATE RIGHT OF ACTION, *supra* note 3, at i.

<sup>125</sup> Case Comment, *supra* note 113, at 1437.

<sup>126</sup> Davidoff Solomon, *supra* note 90.

application of the U.S. antifraud laws, at least with respect to the private actions.<sup>127</sup>

Moreover, commentators argue that the *Absolute Activist* test does not take into account the nature of SBS.<sup>128</sup> They note that “no title or ownership passes in swap transactions [and thus] . . . the ‘irrevocable liability’ test would not apply easily to swaps because . . . it would ignore the location of the transactions that determine the swaps’ economics.”<sup>129</sup>

#### **A. Parkcentral Global HUB Ltd. v. Porsche Auto Holdings SE**

The Second Circuit’s decision in *ParkCentral* illustrates the difficulties of the *Morrison* test’s application to SBS.<sup>130</sup> The case concerned an over-the-counter swap executed in the United States, but referencing German securities, shares issued by Volkswagen (VW), and traded only in Germany.<sup>131</sup> The plaintiffs, hedge funds, “held short positions” in SBS, meaning that “SBS would generate gains for plaintiffs as the price of Volkswagen’s shares fell and generate losses as the price of Volkswagen’s shares rose.”<sup>132</sup> The plaintiffs alleged that Porsche Automobil Holding SE (“Porsche”), a German company that was not a party to the swap agreements in question, made fraudulent statements about its intentions with respect to the stock of VW.<sup>133</sup> In particular, by 2007 Porsche accumulated 31% of VW’s stock.<sup>134</sup> When asked about the purpose of these acquisitions, however, Porsche allegedly misrepresented its purpose by stating that it bought VW stock to prevent a hostile takeover of the company.<sup>135</sup> Porsche revealed its true intentions later—it, in fact,

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<sup>127</sup> Problems of forum-shopping arising from the *Morrison* were emphasized by Justice Stevens in his concurring opinion. *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247, 285 (2010) (Stevens, J., concurring).

<sup>128</sup> Scott D. Musoff, *Morrison’s Bright-Line Test Is Not Always So Bright-Line*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Apr. 12, 2012), <https://www.skadden.com/insights/imorrisonis-bright-line-test-not-always-so-bright-line> [<https://perma.cc/587R-67R4>].

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

<sup>130</sup> *Parkcentral Global HUB Ltd. v. Porsche Auto Holdings SE*, 763 F.3d 198 (2d Cir. 2014).

<sup>131</sup> *Id.*

<sup>132</sup> Peng, *supra* note 11, at 136.

<sup>133</sup> *Parkcentral*, 763 F.3d at 201.

<sup>134</sup> Patterson, *supra* note 11, at 235.

<sup>135</sup> *Id.*

planned to acquire 75% of VW's shares to gain control over the issuer.<sup>136</sup>

When Porsche disclosed that it acquired 74% of VW's shares, prices of VW stock increased rapidly, thus causing losses to ParkCentral since under the SBS agreements, ParkCentral bet on the decrease in value of VW shares.<sup>137</sup> The hedge funds brought a suit against Porsche in the federal district court for the Southern District of New York. The district court, however, held that the hedge funds could not rely on section 10(b) of the Exchange Act because such an approach would "extend extraterritorial application of the Act's antifraud provision to virtually any situation in which one party to a swap agreement is located in the United States."<sup>138</sup> It explained that the "economic reality" of the swap agreements was that they replicated trades in the underlying security,<sup>139</sup> and therefore did not satisfy the *Morrison* transactional test.

The Second Circuit agreed with the result reached by the district court, although for different reasons.<sup>140</sup> It also rejected the literal reading of *Morrison* and *Absolute Activist*, concluding that "[s]ubjecting a foreign issuer to the regulatory regime of the United States for conduct outside the United States, not involving securities issued or trading in the United States . . . was too far for §10 to stretch."<sup>141</sup> It clarified that "while [*Morrison*] unmistakably made a domestic securities transaction (or transaction in a domestically listed security) necessary to a properly domestic invocation of § 10(b), such a transaction is not alone sufficient to state a properly domestic claim under the statute."<sup>142</sup>

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

<sup>137</sup> Patterson, *supra* note 11, at 238.

<sup>138</sup> *Elliott Assocs. v. Porsche Automobil Holding SE*, 759 F. Supp. 2d 469 (S.D.N.Y. 2010).

<sup>139</sup> Patterson, *supra* note 11, at 238.

<sup>140</sup> *Parkcentral Global HUB Ltd. v. Porsche Auto Holdings SE*, 763 F.3d 198 (2d Cir. 2014).

<sup>141</sup> Fred T. Isquith, *Readying For A New First Monday*, LAW360 (Sept. 16, 2014, 9:07 AM), <http://www.law360.com/articles/577246/readying-for-a-new-first-monday> [<https://perma.cc/PGE6-ZA8V>].

<sup>142</sup> *Parkcentral*, 763 F.3d at 215; *see also* PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, RECENT SECOND CIRCUIT DECISION IN PARKCENTRAL V. PORSCHE EXTENDS MORRISON TEST BY LIMITING APPLICABILITY OF SECTION 10(B) BASED ON "FOREIGNNESS" OF CLAIMS (2014), [http://www.paulweiss.com/media/2593946/03sept14\\_alert.pdf](http://www.paulweiss.com/media/2593946/03sept14_alert.pdf) [<https://perma.cc/85U6-C74W>] ("[A]pplying §10(b) whenever a suit is predicated on a domestic transaction, 'regardless of the foreignness of the

Under *Morrison*, if the transaction with the SBS is executed within the United States, it is considered domestic.<sup>143</sup> Prior to *ParkCentral*, that would be the end of the analysis. The Second Circuit, however, requires courts to go one step further to examine whether certain factors still evidence excessive “foreignness” of the transaction.<sup>144</sup>

The Second Circuit, however, refused to list conditions that would suffice to bring an SBS transaction within the U.S. prescriptive jurisdiction, explaining that financial innovations “can come in innumerable forms of which we are unaware and which we cannot possibly foresee.”<sup>145</sup> Some commentators, therefore, note that the *ParkCentral* opinion signifies the Second Circuit’s return to unpredictability criticized by the Supreme Court in *Morrison*<sup>146</sup> and opine that the factors that the Second Circuit considered important are analogous to the conduct test rejected in *Morrison*.<sup>147</sup>

### **B. What Did the *Morrison* Transactional Test Accomplish?**

By replacing the conduct and effects tests with a bright-line transactional one, the *Morrison* court sought to address clarity and predictability concerns.<sup>148</sup> The application of the *Morrison* test, however, proved to be complicated and fact-intensive, particularly with transactions involving unconventional securities.<sup>149</sup> Moreover, the new bright-line test left open opportunities for forum-shopping and, due to its rigidity, will be bound to remain either over or under-

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facts constituting the defendant’s alleged violation,’ would undermine . . . *Morrison* by inevitably putting §10(b) in conflict with foreign securities regulations.”).

<sup>143</sup> Colangelo, *supra* note 54, at 1343 (“If the statutory focus had been a domestic element of the claim (say, fraudulent conduct in *Morrison*), there would have been, no extraterritorial application of the statute and thus no need for the presumption.”).

<sup>144</sup> *ParkCentral*, 764 F.3d at 215.

<sup>145</sup> *Id.* at 217.

<sup>146</sup> *Morrison*, 561 U.S. at 260 (“Commentators have criticized the unpredictable and inconsistent application of §10(b) to transnational cases . . . The criticisms seem to us justified.”).

<sup>147</sup> PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, *supra* note 142 (“[T]he factors cited by the Second Circuit are similar to those previously considered relevant to the ‘conduct’ element of the rejected test.”).

<sup>148</sup> See *supra* note 101 and the accompanying text.

<sup>149</sup> See *supra* Part II.D & III.A.

inclusive. In addition, even without *Morrison* there are sufficient procedural and substantive mechanisms in play ensuring that American litigation does not interfere with the regulatory interests of foreign sovereigns while protecting federal courts from cases that have only tenuous connections with the United States' financial markets.

### 1. Forum Shopping Opportunities

*Morrison*, even in light of the *Parkcentral* reading, still keeps the door open for forum shopping.<sup>150</sup> Nothing prevents parties to an OTC bilateral swap from executing the agreement outside the United States, thus, eliminating a condition necessary for the application of the U.S. securities laws to the potential fraud suits.<sup>151</sup> Such formalistic approach to dismissal of a case involving SBS contradicts the broad purpose of the Dodd-Frank Act, which according to some commentators, overruled the presumption of extraterritoriality, at least in relation to SBS.<sup>152</sup> Moreover, a federal court's finding that the Exchange Act does not apply to the claim involving the SBS does not necessarily prevent investors from bringing state tort claims against the entity allegedly involved in

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<sup>150</sup> Problems of forum-shopping arising from the *Morrison* were emphasized by Justice Stevens in his concurring opinion. *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 285 (2010) (Stevens, J., concurring).

<sup>151</sup> *Parkcentral*, 763 F.3d at 215 ("On careful consideration of *Morrison*'s words and arguments as applied to the facts of this case, we conclude that, while that case unmistakably made a domestic securities transaction (or transaction in a domestically listed security) necessary to a properly domestic invocation of § 10(b), such a transaction is not alone sufficient to state a properly domestic claim under the statute."); see also Coffee, *supra* note 9, at 1260 ("[M]ajor financial institutions are extremely mobile and can easily park their higher-risk operations abroad and beyond the regulatory reach of their home country unless extraterritorial authority is recognized.").

<sup>152</sup> Coffee, *supra* note 9, at 1261 n.6 ("[T]he Dodd-Frank repeatedly indicates that it is to apply extraterritorially."); see also Kara M. Stein, Sec. & Exch. Comm'n, Cross-Border Security-Based Swap Rules and Guidance (June 25, 2014), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370542555426#.VRCz6o54pgk> Stein [<https://perma.cc/J8B2-YVUD>] (emphasizing that the Dodd-Frank Act was adopted to overcome "a weakness of the U.S. regulatory regime: the failure to meaningfully regulate swaps trades that occur outside of the United States").

fraud in states' courts.<sup>153</sup> A more flexible approach, somewhat similar to the pre-*Morrison* conduct and effects tests, however, would enable courts to decide issues of extraterritorial application arising in the SBS disputes efficiently and avoid inconsistency between the results of *Morrison*'s literal application and the broad purposes of current cross-border SBS regulation.<sup>154</sup>

Commentators note that “there is often a trade-off between the policy goal of making domestic markets more competitive and the goal of making those markets safer and more stable in the long run.”<sup>155</sup> The background of the Dodd-Frank Act, however, shows that it was adopted in response to cross-border risks related to SBS<sup>156</sup> and therefore makes a choice in favor of safety and stability of financial markets.<sup>157</sup>

## 2. Over or Under-Inclusive Rule

Reliance on the bright-line *Morrison* test may be justified for fraud claims arising from transactions involving conventional securities, traded on organized stock exchanges. Complex financial instruments, such as over-the-counter SBS, however, may require a different approach. The modern financial industry designs newer and more complicated versions of such instruments every day.<sup>158</sup>

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<sup>153</sup> *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 273-274 (2010) (Breyer, J., concurring) (explaining that state law or other federal fraud statutes may apply); see also Katherine Florey, *State Law, U.S. Power, Foreign Disputes: Understanding the Extraterritorial Effects of State Law in the Wake of Morrison v. National Australia Bank*, 92 B.U. L. REV. 536, 548 (2012).

<sup>154</sup> See Coffee, *supra* note 9, at 1272-74 (explaining the background of Title VII of the Dodd-Frank); Kara M. Stein, *supra* note 152 (“[W]e’ve had other high-profile swaps-related issues where trading conducted abroad inflicted significant damage on US market participants . . . despite the geography, the losses were ultimately absorbed here in the United States.”).

<sup>155</sup> Omarova, *supra* note 37, at 72.

<sup>156</sup> See, e.g., Stein, *supra* note 152.

<sup>157</sup> Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 39,068, 39,151 (July 9, 2014) (“[A] key goal of Title VII of the Dodd-Frank Act is to promote the financial stability of the United States by improving accountability and transparency in the financial system.”).

<sup>158</sup> SCALCIONE, *supra* note 59, at 15 (“More complex types of derivatives are being developed at an exponential rate.”); see also Omarova, *supra* note 37,

Moreover, until recently such instruments remained largely unregulated in both the United States and the European Union.<sup>159</sup> The innovative character of these instruments explains why legislators should tread cautiously in developing an extraterritoriality standard that would take into account all potential variations of fraud involving SBS. Moreover, given that the SEC has not yet adopted all the regulations concerning the SBS as mandated by the Dodd-Frank Act, thus rendering the legal framework concerning these instruments incomplete,<sup>160</sup> federal courts should possess some flexibility in determining whether private SBS fraud claims are sufficiently domestic.<sup>161</sup>

Furthermore, although many traditionally view specific rules as the guarantee of “the restraint of official arbitrariness and certainty,”<sup>162</sup> given the complexity of the SBS as well the novelty of the regulatory regime, a bright-line test for extraterritoriality inevitably becomes either over-inclusive or under-inclusive.<sup>163</sup>

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at 70 (“Complex financial instruments are difficult to understand and value, because their risks are not easily measured and controlled. This is attributable to the potential complexity of the specific reference assets.”).

<sup>159</sup> See Mary Jo White, *Statement at Open Meeting Concerning Rules Regarding Security-Based Swap Data Repositories and Regulation SBSR*, SEC. & EXCH. COMM’N (Jan. 14, 2015), [http://www.sec.gov/news/statement/2015-spch011415mjw.html#.VRH-j\\_nF-AU](http://www.sec.gov/news/statement/2015-spch011415mjw.html#.VRH-j_nF-AU) [<https://perma.cc/2KMR-N4ZG>] (“For decades, the over-the-counter derivatives market was unregulated and operated behind closed doors.”); see also Stein, *supra* note 152 (“One of the greatest challenges to implementing a security-based swaps regime is that we haven’t overseen this market in the past.”).

<sup>160</sup> See *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC. & EXCH. COMM’N, <https://www.sec.gov/spotlight/dodd-frank.shtml#> [<https://perma.cc/VGP6-H7WL>].

<sup>161</sup> It is illustrative that at least with respect to actions initiated by the SEC, the Dodd-Frank Act overruled *Morrison* and reinstated the conduct and effects tests. STUDY ON THE PRIVATE RIGHT OF ACTION, *supra* note 3, at 6 n.5 (“With respect to [the SEC] and DOJ actions under Section 10(b), Dodd-Frank Act Section 929P(b)(2) codified the pre-Morrison view . . .”).

<sup>162</sup> Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1687, 1688 (1976).

<sup>163</sup> Joshua L. Boehm, Note, *Private Securities Fraud Litigation after Morrison v. National Australia Bank: Reconsidering a Reliance-Based Approach to Extraterritoriality*, 53 HARV. INT’L L. REV. 502, 514 (2012) (“It has frequently proven difficult for courts to maintain fidelity to Morrison’s bright-line approach without coming to a result that is over- or

### 3. Procedural Safeguards

A bright-line extraterritoriality test for securities-fraud claims is often justified by the need to create a barrier to the flood of foreign litigation in the U.S. federal courts.<sup>164</sup> It remains questionable, however, whether the *Morrison* test was necessary to protect federal courts from these lawsuits.

A private right of action against a person engaged in securities fraud does not dispense with the procedural requirements of federal litigation—that is, personal jurisdiction.<sup>165</sup> The Supreme Court always stressed that personal jurisdiction was not a mere formality and that it was predicated on the Due Process Clause “protect[ing] an individual’s right to be deprived of life, liberty, or property only by the exercise of lawful power; this is no less true with respect to the power of a sovereign to resolve disputes through judicial process than with respect to the power of a sovereign to prescribe rules of conduct for those within its sphere.”<sup>166</sup>

According to the Supreme Court’s opinion in *Daimler AG v. Bauman*,<sup>167</sup> a court may exercise general jurisdiction over foreign corporations only when their affiliations with the state make corporations essentially at home in a forum state (that is, the corporation is incorporated in the forum state or has its principal place of business there). *Daimler* precludes federal courts from hearing cases against foreign entities (that are not at home in that

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under-inclusive with regard to Sec. 10(b).”); *see also* Omarova, *supra* note 37, at 70.

<sup>164</sup> *See Morrison*, 561 U.S. at 270 (“[S]ome fear that [the United States] has become the Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets.”).

<sup>165</sup> *Int’l Shoe Co. v. Wash.*, 326 U.S. 310 (1945) (“[D]ue process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice.’”); 28 U.S.C. § 1391(b) (2012) (establishing venue requirements); *see also* Ventoruzzo, *supra* note 89, at 422 (“Securities class actions based on Rule 10b-5 face several additional hurdles that a foreign plaintiff must overcome. Courts can thus apply intelligent and well-advised judicial discretion in using these rules in order to curb frivolous litigation and prevent misuse (or abuse) of American courts by foreign plaintiffs and their attorneys.”).

<sup>166</sup> *J. McIntyre Mach., Ltd. v. Nicastro*, 131 S. Ct. 2780 (2011) (plurality opinion).

<sup>167</sup> 134 S. Ct. 746 (2014).

forum) unless the cause of action arises from those entities' contacts to the forum and such contacts rise to the level of substantial minimum contacts.<sup>168</sup>

The substantial minimum contracts test of specific personal jurisdiction does not allow courts to exercise jurisdiction over defendants that did not purposefully avail themselves to the power of the forum courts.<sup>169</sup> Moreover, even if such contacts exist, the court can still conclude it unreasonable that a foreign defendant be forced to litigate in that court.<sup>170</sup> The Supreme Court emphasized that “[a] court may subject a defendant to judgment only when the defendant has sufficient contacts with the sovereign such that the maintenance of the suit does not offend ‘traditional notions of fair play and substantial justice.’”<sup>171</sup>

The doctrine of forum *non-conveniens*<sup>172</sup> creates additional safeguards for defendants who do not consider a U.S. court a proper forum for the adjudication of their securities dispute.<sup>173</sup> Therefore, the interests that *Morrison* sought to address are already protected by procedural doctrines that ensure that litigants have sufficient connections with a forum.<sup>174</sup>

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<sup>168</sup> Daimler AG v. Bauman, 134 S. Ct. 746, 754 (2014).

<sup>169</sup> Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985) (“Where forum seeks to assert specific jurisdiction over an out-of-state defendant who has not consented to suit there, fair-warning requirement is satisfied if the defendant has purposefully directed his activities at residence of the forum and the litigation results from injuries that arise out of or relate to those activities.”).

<sup>170</sup> Asahi Metal Industry Co. v. Superior Court, 480 U.S. 102 (1987).

<sup>171</sup> J. McIntyre Mach., Ltd. v. Nicastro, 131 S. Ct. 2780, 2787 (2011) (plurality opinion).

<sup>172</sup> Piper Aircraft Co. v. Reyno, 454 U.S. 235, 255 (1981) (“[T]here is ordinarily a strong presumption in favor of the plaintiff’s choice of forum, which may be overcome only when the private and public interest factors clearly point towards trial in the alternative forum.”); *see also* Ventoruzzo, *supra* note 89, at 430 (explaining how courts apply the forum non-conveniens doctrine).

<sup>173</sup> *See, e.g.*, Ventoruzzo, *supra* note 89, at 429-30 (“Consider . . . a typical foreign-cubed action based on Rule 10b-5, in which Italian investors buy shares of a Swiss corporation on the London Stock Exchange. . . . [I]t is more likely than not that the case would be dismissed on forum non conveniens grounds.”).

<sup>174</sup> Although in relation to a different statute, RICO, Justice Ginsburg also opined that procedural instruments such as “forum non conveniens” along with “due process constraints” on exercise of personal jurisdiction “provide a check against civil . . . litigation with little or no connection to the United

Furthermore, although federal courts may be an attractive forum for a large class-action litigation involving numerous investors that bought flawed standardized financial products (stock traded on the stock exchange), a case involving complicated bilateral over-the-counter swaps crafted specifically for the needs of the counterparties does not contain the same risks of abuse by the potential plaintiffs.

#### 4. International Comity

*Morrison* sought to take into account the interests of other sovereign nations in regulating securities fraud.<sup>175</sup> Even in the absence of a bright-line test, federal courts may employ a balancing test of international comity to avoid interference with another state's interests.<sup>176</sup>

The doctrine of international comity prevents American courts from encroaching on the competing jurisdiction of foreign nations. Courts define international comity as "a doctrine of prudential abstention . . . that counsels voluntary forbearance when a sovereign which has a legitimate claim to jurisdiction concludes that a second sovereign also has a legitimate claim to jurisdiction under principles of international law."<sup>177</sup> The need to balance competing regulatory interests of states frequently arises in cases involving securities law.<sup>178</sup>

This doctrine has guided the U.S. courts in deciding disputes with foreign elements for a long time even though the precise contours of the doctrine's factors are not clearly defined.<sup>179</sup> The absence of a clear definition of comity did not prevent courts from applying its teachings by balancing competing interests of sovereign

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States." *RJR Nabisco, Inc. v. European Cmty.*, 136 S. Ct. 2090, 2115 (2016) (Ginsburg, J., concurring in part and dissenting in part).

<sup>175</sup> See *supra* note 102 and the accompanying text.

<sup>176</sup> See, e.g., Diego Zambrano, *A Comity of Errors: The Rise, Fall and Return of International Comity in Transnational Discovery*, 34 BERKELEY J. INT'L L. (forthcoming 2016) (discussing the application of international comity to transnational discovery).

<sup>177</sup> *Mujica v. AirScan Inc.*, 771 F.3d 580, 598 (9th Cir. 2014) (quoting *United States v. Nippon Paper Indus. Co.*, 109 F.3d 1, 8 (1st Cir. 1997)).

<sup>178</sup> STUDY ON THE PRIVATE RIGHT OF ACTION, *supra* note 3, at 6 n.5 ("The international comity is frequently implicated in the context of transnational securities frauds.").

<sup>179</sup> See *Mujica*, 771 F.3d at 598 (quoting *JP Morgan Chase Bank v. Altos Hornos de Mexico, S.A. de C. V.*, 412 F.3d 418, 423 (2d Cir. 2005)).

states.<sup>180</sup> It is not clear why, in cases implicating SBS fraud, courts should reject a cautious approach of the balancing test in favor of a rigid rule.<sup>181</sup>

### 5. No Private Right of Action Notwithstanding the Assertion of Prescriptive Jurisdiction

The Dodd-Frank Act extends the scope of the SBS regulation to certain swaps-related activities occurring abroad, as well as to transactions involving significant foreign elements.<sup>182</sup> In particular, some foreign companies will be subject to registration and other requirements in the United States (swap dealers or major swap market participants), while some SBS, although not purchased domestically from the *Morrison* point of view, will be considered a U.S.-facing activity for the purposes of the registration of the counterparties.<sup>183</sup> Nonetheless, expansion of the territorial reach of the substantive provisions of the Exchange Act does not necessarily ensure the rebuttal of the presumption against extraterritoriality with respect to the private right of action based on those provisions.<sup>184</sup>

Accordingly, applying the *Morrison* transactional test to private antifraud claims in connection with SBS may lead to

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<sup>180</sup> *Timberlane Lumber Co. v. Bank of America, N.T. & S.A.*, 549 F.2d 597, 613 (9th Cir. 1976) (“What we prefer is an evaluation and balancing of the relevant considerations in each case . . . a ‘jurisdictional rule of reason.’”); see also RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 403 (AM. LAW INST. 1987).

<sup>181</sup> Justice Stevens in his concurring opinion in *Morrison* emphasizes the role of the federal courts in interpreting § 10(b) in connection with transnational securities frauds. *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247, 274 (2010) (Stevens, J., concurring).

<sup>182</sup> See *supra* Part I(B); Coffee, *supra* note 9, at 1261 (“In any event, both the United States and the European Union have asserted such extraterritorial authority, particularly with regard to over-the-counter (OTC) derivatives.”); see also Dodd-Frank Act § 722(d), 7 U.S.C. § 2(i) (2012). For the reasons behind this extraterritorial expansion, see Stein, *supra* note 152.

<sup>183</sup> See *supra* Part I.B.

<sup>184</sup> The Supreme Court clarified in the opinion concerning the RICO Act that “the presumption against extraterritoriality must be applied separately to both [statute’s] substantive prohibitions and its private right of action. . . . It is not enough to say that a private right of action must reach abroad because the underlying law governs conduct in foreign countries.” *RJR Nabisco, Inc. v. European Cmty.*, 136 S. Ct. 2090, 2108 (2016). See generally STUDY ON THE PRIVATE RIGHT OF ACTION, *supra* note 3.

puzzling results where the securities laws regulate the transaction and its participants (for example, SBS executed between two non U.S. entities negotiated with the use of U.S. personnel and counted towards the *de minimis* amount for purposes of registration as an SD<sup>185</sup>), but the *Morrison* test would prevent claims under section 10(b) of the Exchange Act because the parties incurred irrevocable liability overseas.<sup>186</sup> In sum, reliance on the *Morrison* test in fraud claims arising from cross-border SBS creates a situation where the legislator views certain SBS transactions as sufficiently “domestic” to regulate them, but does not consider them sufficiently connected to the United States to provide a remedy to the affected parties.

## V. *Recommendations*

The *Morrison* test did not create a clear and predictable method of determining whether transactions with SBS were domestic for purposes of section 10(b) of the Exchange Act.<sup>187</sup> In addition, reliance on this test leads to conceptually inconsistent results since parties to transactions, although regulated by the United States, will not be eligible for protections granted to other investors if their transaction is finalized overseas.<sup>188</sup> Moreover, the evils from which the *Morrison* court sought to protect the federal courts are assuaged by other procedural and substantive mechanisms.<sup>189</sup> Furthermore, notwithstanding the appeal of a concise bright-line test, given the complexity of over-the-counter financial instruments, swaps and the like, the effective one-sentence criterion for the application of the U.S. laws to the antifraud claims seems unrealistic.<sup>190</sup> Conversely, a combination of clear connecting factors with an opportunity to rebut the presumption of the U.S. laws’ application based on a flexible test addresses the above concerns.

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<sup>185</sup> See *supra* Part I.A (discussing regulation of cross-border SBS).

<sup>186</sup> See *supra* Part II.D (discussing *Activist Fund*’s irrevocable liability test).

<sup>187</sup> See *supra* notes 130-147 and the accompanying text.

<sup>188</sup> See *supra* Part I.B.

<sup>189</sup> See *supra* Part III.B.

<sup>190</sup> Andreas Lowenfeld emphasizes that “no single criterion will solve all problems. No one who has worked in conflict of laws would argue any longer for yes/no tests for choice of law such as the place of accident in a personal injury case two generations ago.” Andreas Lowenfeld, *Public Law in the International Arena: Conflict of Laws, International Law, and Some Suggestions for Their Interaction*, 163 RECUEIL DES COURS 311, 352 (1979).

The criteria developed by the Dodd-Frank Act and the SEC for subjecting entities and transactions to the U.S. regulatory regime are well-suited for serving as connecting factors. Given the significant work done for a new regulatory framework for SBS,<sup>191</sup> it is only reasonable to build a test for a private right of action for the fraud claims involving SBS on the basis of this framework, albeit with the qualifications that address the concerns and findings of *Morrison*, and most recently, *Parkcentral*.

Requirements of clearance and execution on the centralized platforms, as well as criteria developed by the SEC for purposes of registration of swap dealers and major swap market participants, can be used as connecting factors for the first step in the proposed test. These factors are defined and leave less room for interpretation than “domestic transaction” or “irrevocable liability” of the *Morrison* test.<sup>192</sup> Moreover, swap market participants subject to regulation under the Dodd-Frank Act will not be surprised by a lawsuit in American courts, since long before such a lawsuit these entities will be notified about their registration and other requirements in the United States on the basis of the same factors.

If the above connecting factors are present, presumptively a plaintiff should be entitled to the section 10(b) claim in federal courts. A defendant, however, should be able to overcome such presumption by showing that the alleged wrongdoing did not produce any substantial or foreseeable effect in the United States.<sup>193</sup> Private lawsuits arising from standardized SBS executed in the United States on the swap execution platforms or cleared through the U.S. clearing houses require a different test.<sup>194</sup> These transactions should be considered domestic, and defendants should *not* be given an opportunity to rebut this presumption.

#### **A. Nature of the Alleged Fraud: Preliminary Step**

Given the derivative nature of SBS, the application of section 10(b) of the Exchange Act to claims arising from these transactions

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<sup>191</sup> For the list of the rules adopted and proposed by the SEC, see *Derivatives*, *supra* note 31.

<sup>192</sup> See 17 C.F.R. § 240.3a71-3 (2016).

<sup>193</sup> For a discussion of a proposal based on an “effects-only” test, see Ventoruzzo, *supra* note 89, at 441.

<sup>194</sup> For a discussion of clearance requirements and swap execution facilities, see *supra* notes 32-38 and the accompanying text.

requires an understanding of the nature of the alleged violation.<sup>195</sup> This step in the analysis is crucial and should precede any discussion of whether the transaction is domestic or foreign.<sup>196</sup>

If a plaintiff brings an action against an issuer of the underlying security traded overseas or an entity other than a counterparty to an SBS contract, alleging fraud relating to a performance of such security, such claims should be viewed as arising from a transaction imitating a purchase of the underlying securities. Thus, the *Morrison* transactional test should apply. The plaintiff in this case should not be permitted to rely on the Exchange Act even if the SBS contract was executed in the United States.<sup>197</sup>

However, if the alleged fraud relates to SBS itself (for example, misrepresentation concerning the financial condition of one of the parties or “misconduct that affects the market value of the security based swap for purposes of posting collateral or making payments or deliveries under such security-based swap”<sup>198</sup>), the court should consider whether the transaction with SBS, rather than the transaction with an underlying security it tried to mirror, is domestic.<sup>199</sup> In this scenario the fact that a security referenced by

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<sup>195</sup> See *supra* Part III.A.

<sup>196</sup> *Parkcentral* illustrates potential confusion concerning the nature of the fraud claims involving swaps. In *ParkCentral*, the plaintiffs alleged fraudulent misstatements concerning the underlying reference, VW stock. *Parkcentral*, 764 F.3d at 200. Their arguments were structured as if the SBS enabled plaintiffs to purchase VW stock. *Id.* Had the plaintiffs argued that the fraud involved elements other than the referenced security, such as the financial condition of the counterparty, posted collateral, and/or terms of ongoing payments, the outcome of the case could have been different. See Wulf A. Kaal & Richard W. Painter, *The Aftermath of Morrison v. National Australia Bank and Elliot Associates v. Porsche*, 1 EUR. COMP. FINANCIAL L. REV. 77, 86 (2011).

<sup>197</sup> See *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 654 F.3d 276, 288 (2d Cir. 2011) (Winter, J., concurring) (“[C]ash-settled total-return equity swaps do not . . . render the long party a ‘beneficial owner’ of such shares . . .”).

<sup>198</sup> Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 34-63,236, 75 Fed. Reg. 68,560, 68,562 (Nov. 8, 2010).

<sup>199</sup> Kaal & Painter, *supra* note 196, at 86 (“[I]t is not clear that if the dispute had been between U.S. counterparties to a U.S. swap agreement (for example, if one lied about the ability to perform), a U.S. court would have dismissed the suit simply because the reference security was traded in Germany.”).

such SBS is not traded in the U.S. should not bear on a court's finding as to whether the U.S. securities laws apply.<sup>200</sup>

A different interpretation could lead to results that the *Morrison* court sought to avoid—allowing private antifraud claims arising from the SBS executed in the United States against the issuer of the underlying security traded abroad, where the issuer does not distribute shares in the United States—which seems to be an unjustified interference with the regulatory interests of foreign states.<sup>201</sup>

### B. SBS Subject to Clearance and Trading on the SEF

The Dodd-Frank Act requires that most SBS be cleared and purchased through organized platforms—swap execution facilities (SEFs).<sup>202</sup> Transactions with SBS on the SEFs are similar to stock trades on the organized stock exchange, and therefore a purchase of SBS through the SEF located in the United States forecloses any discussion as to the place of the transaction.<sup>203</sup> A party executing SBS on such an organized platform purchases a security in the United States and such transaction satisfies the *Morrison* transactional test. Therefore, private antifraud claims arising from a SBS cleared in the United States and executed on domestic swap execution facilities should be subject to the United States laws. Moreover, the clearance requirement presupposes that transactions involving SBS are executed in compliance with the United States regulatory regime and therefore should be considered domestic, thus falling within the prescriptive jurisdiction of the United States.<sup>204</sup>

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<sup>200</sup> *Id.*

<sup>201</sup> See Boehm, *supra* note 163, at 522.

<sup>202</sup> See *supra* Part I.B (addressing the new regulatory framework).

<sup>203</sup> See *Morrison*, 561 U.S. at 267.

<sup>204</sup> Uncleared SBS are not exempt from regulation and subject to margin requirements. One could argue that this requirement signifies that such SBS are also within the U.S. prescriptive jurisdiction and thus antifraud claims arising from them are governed by section 10(b). See Lucy McKinstry, *Regulating A Global Market: The Extraterritorial Challenge of Dodd-Frank's Margin Requirements for Uncleared OTC Derivatives & A Mutual Recognition Solution*, 51 COLUM. J. TRANSNAT'L L. 776, 797 (2013) ("Requiring margin on uncleared derivatives would serve to alleviate some of the increased risk of uncleared derivatives transactions, by quantifying and collateralizing both market and credit risks, and it therefore serves as a linchpin in derivatives reform."). The SEC, however, structured its proposal concerning margin requirements as requirements to entities, frequent

### C. Regulatory Regime of Parties to SBS

A private antifraud action arising from an SBS contract with a financial entity subject to registration pursuant to the Dodd-Frank framework should be governed by the United States laws, unless a defendant shows that the alleged wrongdoing produced no substantial and foreseeable effect in the United States.

The SEC developed compliance and registration requirements to the entities involved in cross-border transactions with SBS.<sup>205</sup> Presumptively, if an entity is subject to registration as a major swap market participant (MSMP) or a swap dealer (SD), such entities have already been found capable of affecting the U.S. capital markets.<sup>206</sup> Accordingly, a cross-border SBS transaction, one party to which is a financial entity subject to registration under the Dodd-Frank Act, should be considered domestic, thus entitling parties to such transaction to bring section 10(b) claims in federal courts. Defendants, however, should be given an opportunity to overcome this presumption by showing that the alleged wrongdoing had no substantial and foreseeable conduct in the United States.

### D. Transactions Considered for De Minimis Exception

The new regulatory framework considers certain SBS transactions sufficiently domestic to count them towards *de minimis* amounts for the purposes of registration in the United States.<sup>207</sup> In this connection, the SEC expressly states that its regulatory approach

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players on derivatives markets, SDs and MSMPs. *See Fact Sheet: Proposing Rules Governing Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants*, SEC. & EXCH. COMM'N, <https://www.sec.gov/News/Article/Detail/Article/1365171586085> [<https://perma.cc/H5TA-KLA7>]. Given that this note proposes to consider domestic transactions entered by registered SDs and MSMPs for the purposes of private rights of action, it is not necessary to distinguish margin requirements to transactions with uncleared SBS as an independent criteria. *See infra* Part IV.C.

<sup>205</sup> Application of “Security-Based Swap Dealer” and “Major Security-Based Swap Participant” Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 39,068 (July 9, 2014).

<sup>206</sup> *See* Coffee, *supra* note 151, at 1263 (explaining why “Congress opted for an extraterritorial reach for much of the Dodd-Frank Act”).

<sup>207</sup> *See* 17 C.F.R. § 240.3a71-3 (2016).

“focuses on a person’s activity, not solely on the amount of risk created by that activity.”<sup>208</sup>

Criteria developed by the SEC for consideration of the SBS transaction towards de minimis amounts could be successfully used in a test for private rights of action. In particular, SBS dealing transactions of a U.S. entity should be considered domestic if they are counted towards a threshold requiring registration with the SEC.<sup>209</sup> In the case of a foreign dealer, private 10b-5 claims should be heard by federal courts if they are (i) dealing transactions of a non-U.S. dealer with the U.S. entities; (ii) dealing transactions of a non-U.S. dealer with a non-U.S. party if such non-U.S. party has a right of recourse against a U.S. affiliate of the non-U.S. person under the terms of the SBS; and (iii) dealing transactions between non U.S. entities where a non-U.S. person acts as a conduit affiliate of a U.S. person.<sup>210</sup> Furthermore, this list should also include dealing transactions of a non-U.S.-person “when the transaction[s] are] arranged, negotiated, or executed by that person’s personnel who are located in a U.S. branch or office, or by its agent’s personnel who are located in a U.S. branch or office.”<sup>211</sup>

Given, however, the breadth of the above list of qualifying transactions, a defendant should be given an opportunity to overcome a presumption in favor of the United States “prescriptive jurisdiction” by showing that the alleged wrongdoing had no substantial or foreseeable effect in the United States.

## **VI. Conclusion**

This note examined how the *Morrison* transactional test applies to antifraud claims arising from SBS and argues that the *Morrison* test failed to accomplish the goals the Supreme Court sought to achieve. The note concludes that even without the bright-line transactional test, federal courts possess sufficient tools to close access to the section 10(b) remedy for investors whose transactions

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<sup>208</sup> Security-Based Swap Transactions Connected with a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed By Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, Exchange Act Release No. 34-77104, 81 Fed. Reg. 8,598, 8,614 (Feb. 19, 2016).

<sup>209</sup> For a discussion of transactions that are counted towards de minimis threshold, see 17 C.F.R. § 240.3a71-2 (2016).

<sup>210</sup> See 17 C.F.R. § 240.3a71-3 (2016).

<sup>211</sup> *Id.*

have only tenuous connections with the U.S. securities markets as well as to protect foreign sovereign interests from unjustified interference. The note suggests that in disputes arising from transactions with SBS, the *Morrison* transactional test should be replaced with a test relying on a regulatory framework developed by the Dodd-Frank Act in relation to SBS. This test would improve upon the existing standard by replacing the ambiguous “place of transaction” test with more straightforward criteria developed by the SEC for purposes of subjecting SBS-related entities to registration as well as clearance and trading on the organized platforms. Reliance on these criteria would provide parties early in the process of the SBS execution with information concerning the possibilities of litigation in the federal courts. Furthermore, the note suggests that in certain circumstances a new test should give defendants an opportunity to rebut the presumption regarding domestic transactions, thus adding flexibility that the current rule lacks.