Reinventing A Security: Arguments For A Public Interest Definition

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In February 1992, the American Stock Exchange sought Securities and Exchange Commission\(^1\) approval to introduce Standard & Poor's Depositary Receipts (SPDR's), a new investment vehicle designed to allow individuals to invest easily in the benchmark Standard & Poor's 500 Composite Stock Price Index (S&P 500).\(^2\) Currently, investors can buy stock in each of the 500 companies,\(^3\) invest in mutual funds that hold S&P 500 stocks, buy options on the S&P 500, or buy S&P 500 futures.

Each of these alternatives has its drawbacks. To buy a properly weighted portfolio of all S&P 500 stocks costs millions of dollars, not including commissions. It is also difficult to purchase or dispose of stock in 500 companies contemporaneously. Mutual funds charge fees, either on the purchase or sale of shares or periodically. Options do not pay the dividends declared on the underlying stock during the option period and expire, at the longest, in three months. Futures have the same limitations as options and, by definition, derive their value not simply from the underlying S&P 500 index but from traders' expectations of the value of the index at expiration.

Although the mechanics of SPDR's are complex, the idea behind them is simple.\(^4\) After the October 1987 equity markets crash, investors have
shown increasing interest in vehicles that replicate the markets’ performance. The wonder is not that the American Stock Exchange introduced SPDRs but that it took them so long to do so. It was not for lack of trying.

Three years before SPDRs, in 1989 Judge Easterbrook faced a dilemma. After SEC approval, the American Stock Exchange and other exchanges had introduced Index Participations (IPs), a new investment vehicle designed to allow individuals to invest easily in the S&P 500. Because IPs resembled stock but also resembled a futures contract, a futures exchange brought suit to stop trading in IPs on the ground that only the Commodity Futures Trading Commission (CFTC) has jurisdiction over futures contracts. The United States Court of Appeals for the Seventh Circuit’s task, Judge Easterbrook wrote, was to “decide whether tetrahedrons belong in square or round holes.” After fourteen pages of analysis, he sided with the futures exchange and CFTC. SPDRs are the exchanges’ response to Judge Easterbrook. They are the next tetrahedrons.

Although the question whether IPs were securities may have been evanescent, their reincarnation as SPDRs shows that coverage is easily the most enduring and recurring fundamental question in securities regulation. To what instruments do the securities laws apply? Since the October 1987 crash new investment vehicles have proliferated. Over the next decade many more instruments worth many trillions of dollars will be brought to market. All of them present the question whether the securities laws apply.

5. Order Approving Proposed Rule Changes Relating to the Listing and Trading of Index Participations, Exchange Act Release No. 26,709, 54 Fed. Reg. 15,280, at 15,290 n.96 (1989) [hereinafter Index Participation Rule Change]. An IP was a contract of indefinite duration that obligated the seller (called the short) to pay to the buyer (called the long) at the long’s option the value of an index of securities such as the S&P 500. The short’s obligation to pay could only be enforced once (at which point the contract ended) and only enforced on one of a series of periodic cash-out dates, usually quarterly. Each quarter, until the contract ended, the short paid the approximate value of the dividends paid by the stocks in the index over the preceding quarter. IPs were fully negotiable and a clearinghouse was interposed between the shorts and longs so that obligations ran between the short and the clearinghouse and between the clearinghouse and the long. Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 539-40 (7th Cir. 1989), cert. denied, 110 S. Ct. 3214 (1990).

6. Chicago Mercantile Exch., 883 F.2d at 540.

7. Id. at 539.

8. For an analysis of SPDRs under both the traditional and public interest analyses, see infra text accompanying note 169.


11. In 1991 alone, the total dollar volume of securitized loans, only one kind of new vehicle, was estimated at $299,000,000,000. Richard L. Stern & Jason Zweig, Bank Reform Wall Street Style, FORBES, Mar. 30, 1992, at 62.
The most salient consequences of coverage are registration and antifraud protection. If an instrument is covered by the securities laws, it must be registered with the SEC unless an exemption can be found. Issuers are subject to severe civil liabilities for failing to register vehicles that, in retrospect, are determined to be securities. If an offering of a new instrument must be registered, the cost can easily run to $350,000 or more. Moreover, if an instrument is a security, the antifraud protections attach, even if it is exempt from registration. Those provisions impose liability upon a purchaser or seller who knowingly or recklessly commits fraud in connection with the purchase or sale of a security.

The statutory starting places for the definition of "security," section 2(1) of the Securities Act of 1933 and section 3(a)(10) of the Securities Exchange Act of 1934, with minor variations begin by enumerating myriad paradigms. They then move to more tenuous variations, and finally culminate with the inclusion of "in general, any interest or instrument commonly known as a 'security.'"

The short answer to the question "What is a security?" is a law professor's dream: a security is anything that ought to be one. The Supreme Court has consistently reaffirmed that Congress's intention was to extend coverage to any "investment." The touchstone, said the Court, is whether investors need protection through the disclosure requirements of the Securities Act or through the antifraud provisions of the Exchange Act. The most theoretical scholar to examine the question sees the definition of security as comprising both specific, reified paradigms such as stock, and instruments possessing attributes that Congress believed belonged to "securities."

This traditional approach to securities laws coverage has been criticized as unpredictable. A more important problem is that coverage turns entirely

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16. E.g., note, stock, treasury stock, bond, and debenture.
17. E.g., collateral-trust certificate, preorganization certificate or subscription, transferable share, and investment contract.
19. Professor Chang has defined the problem of defining a security as "self-referencing." Williamson B.C. Chang, Meaning, Reference, and Reification in the Definition of a Security, 19 U.C. Davis L. Rev. 403, 421-22 n.92 (1986). He states his conception of the problem as "[t]he very nature of the concept of a security is that it triggers the application of the securities acts. In other words, we know what the securities acts are by knowing what securities are." Id. at 415. Chang describes the problem as a lack of "fair warning" and predictability which allows judges to consider the merits of the case before the act is applied. Id.
22. Chang, supra note 19, at 415.
on the private needs of private investors rather than on the public needs of the national securities markets. The current analysis does not consider the American capital formation and secondary trading markets or those markets' ability to compete with foreign markets. As the number and variety of new investment vehicles increases over the next few years, the problem of deciding which are covered by the securities laws will become more acute. In other words, the current answer to the question "What is a security?" is too narrow because it excludes some instruments that should be securities.

Continuing to ignore that national interest will exacerbate the indeterminacy of securities coverage analysis because the new, sophisticated investment vehicles are not easily amenable to the traditional analysis. Unless securities coverage is tied to protecting the national markets, those markets and the American economy will be at risk.

An economic concern with the financial markets is only one reason to change the analysis of securities coverage. Since the October 1987 crash, federal regulators have focused on rationalizing the markets' regulation. Moreover, protecting the larger public interest in the financial markets was part of Congress's intention at least as early as 1934 and as late as 1987. Further, in terms of theoretical harmony, a consideration of the markets would not displace the traditional analysis. Instead, it would provide a useful supplement to that approach.

I. THE CURRENT APPROACH

The current approach to securities laws coverage derives from about a dozen Supreme Court cases. Some involved the relatively concrete "stock" and "notes" and the more plastic "investment contract." Other Supreme Court cases considered not the inclusive aspect of the definition, but the statutory exclusions for contracts of insurance and short term notes as well as exclusion based on coverage by another regulatory scheme. Throughout these cases the Court's decisions have been anchored to the need to protect the purchasers of the vehicles.

The Court held that if an instrument is stock under general corporate law principles it is always covered by the securities laws. Stock is always


covered, the Court said, because Congress implicitly found that purchasers of stock almost always expect the securities laws to apply. That expectation creates the need to protect purchasers generally through the disclosure and antifraud provisions of the securities laws even if a particular purchaser does not need or even expect the securities laws’ protection.

A note is presumed to be a security but certain notes that are not "investments" and other notes that bear a sufficient "family resemblance" to them are excluded. The three "family resemblance" criteria are, said the Court, the same as those used to decide whether any instrument is a security. They all focus on the private interests of the purchasers. First, does the buyer desire profit and does the seller intend to use the proceeds in a traditional capital investment sense? Second, is the instrument unique to the parties or is it capable of being offered to others? Third, do the potential purchasers reasonably expect the securities laws to apply?

Instruments that do not fall into one of the more concrete categories like stock or notes have usually been subjected to the Howey test for investment contracts. Like the tests for stock and notes, the investment

31. Id. at 687; Reves, 110 S. Ct. at 952; United Hous. Found., Inc. v. Forman, 421 U.S. 834, 850 (1975).
32. Landreth, 471 U.S. at 687-88.
33. Id. at 696; Reves, 110 S. Ct. at 949; Gould v. Ruefenacht, 471 U.S. 701, 706 (1985); Forman, 421 U.S. at 850. In Reves, the Court effectively clarified its holding in Landreth. It confirmed that "the public perception of common stock as the paradigm of a security suggests that stock, in whatever context it is sold, should be treated as within the ambit of the [Securities] Acts." Reves, 110 S. Ct. at 949.
35. Reves, 110 S. Ct. at 951. The Reves Court spoke of a fourth criterion, the existence of another regulatory scheme. Id. Another scheme of regulation would significantly reduce "the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." Id. at 952.
36. Id. at 951-52.
37. Id. at 952. This criterion essentially duplicates "the common enterprise prong" of the Howey Test. James D. Gordon III, Interplanetary Intelligence about Promissory Notes as Securities, 69 Tex. L. Rev. 383, 395 (1990). The Court addressed this criterion directly in finding an agreement between two private parties regarding a loan guarantee was not intended to be traded publicly and, therefore, was not a security under the Act. Marine Bank v. Weaver, 445 U.S. 551, 560 (1982). There, the Court distinguished Howey based on the number of potential investors. Id.
contract analysis looks to the need for purchaser protection.\textsuperscript{40} Under \textit{Howey}, an instrument is a security if it is ‘(1) an investment; (2) in a common enterprise;\textsuperscript{41} (3) with a reasonable expectation of profits;\textsuperscript{42} (4) to be derived from the entrepreneurial or managerial efforts of others.’\textsuperscript{43}

Some securities have nevertheless been excluded from coverage. In those cases the Court, again, looked to the need for investor protection. Three cases involved statutory exceptions for certain kinds of instruments. In the first case,\textsuperscript{44} the Court held that the instrument was not a contract of insurance and, without elaboration, stated that the instrument was within the definition of a security.\textsuperscript{45} The Court’s discussion of the insurance exception did not turn on public policy notions.\textsuperscript{46} The instrument in \textit{SEC v. United Benefit Life Insurance Co.},\textsuperscript{47} the second case, was held to be an investment contract under \textit{Joiner} and \textit{Howey} and not a contract of insurance.\textsuperscript{48} Justice Harlan’s opinion explicitly rested upon notions of the need for investor protection.\textsuperscript{49}

In \textit{Reves v. Ernst & Young},\textsuperscript{50} the third exclusion case, the respondent relied upon the so-called commercial paper exemption.\textsuperscript{51} The majority found that the statutory language was ambiguous at least as to demand notes,

\begin{itemize}
\item \textsuperscript{40} \textit{Howey}, 328 U.S. at 298. The \textit{Howey} test has been held to contain the thread for all of the Court’s securities coverage analysis. \textit{Forman}, 421 U.S. at 852.
\item \textsuperscript{41} This is the origin of the requirement that the instrument not be unique to the parties. This prong was the basis of \textit{Weaver}’s holding that because the separate contracts were not offered at large they were not securities. \textit{Weaver}, 455 U.S. at 560.
\item \textsuperscript{42} \textit{Forman}, 421 U.S. at 852-59.
\item \textsuperscript{43} \textit{Reves v. Ernst & Young}, 110 S. Ct. 945, 950 (1990) (citing Arthur Young & Co. v. Reves, 856 F.2d 52, 54 (8th Cir. 1988), rev’d on other grounds \textit{Reves v. Ernst & Young}, 110 S. Ct. 945 (1990)).
\item \textsuperscript{44} \textit{SEC v. Variable Annuity Life Ins. Co.}, 359 U.S. 65 (1959).
\item \textsuperscript{45} \textit{Id.} at 71.
\item \textsuperscript{46} The concurring opinion of Justice Brennan rested upon traditional investor protection arguments. \textit{Id.} at 76-91. Justice Brennan’s concurring opinion is held tantamount to the majority opinion. \textit{SEC v. United Benefit Life Ins. Co.}, 387 U.S. 202, 210 (1967). Compare, though, the typically supple dissent of Justice Harlan (speaking for himself and three others) arguing that the origin of the exception for contracts of insurance was based upon a later discarded view that regulation of insurance was beyond the power of Congress under the Commerce Clause. \textit{Variable Annuity Life}, 359 U.S. at 99 (Harlan, J., dissenting).
\item \textsuperscript{47} 387 U.S. 202 (1967).
\item \textsuperscript{48} \textit{SEC v. United Benefit Life Ins. Co.}, 387 U.S. 202, 211 (1967).
\item \textsuperscript{49} “It seems eminently fair that a purchaser ... be afforded the same advantages of disclosure [under the Securities Acts] which inure to a mutual fund purchaser.” \textit{Id.}; cf. \textit{Associates in Adolescent Psychiatry, S.C. v. Home Life Ins. Co.}, 941 F.2d 561 (7th Cir. 1991), in which Judge Easterbrook held an annuity to be a contract of insurance under both \textit{Variable Annuity Life Ins. Co.} and \textit{United Benefit Life Ins. Co.} and an investment under \textit{Howey}. Judge Easterbrook’s decision not to subject the annuity to the regulation of the securities laws turned on the amount of risk the purchaser held. \textit{Id.} at 565-68. No part of his opinion turned on the public interest.
\item \textsuperscript{50} 110 S. Ct. 945 (1990).
\item \textsuperscript{51} \textit{Reves v. Ernst & Young}, 110 S. Ct. 945, 953 (1990).
\end{itemize}
which were involved in that case. The Court resolved the ambiguity in favor of coverage on the ground that investor protection required coverage because the instrument could have a maturity longer than nine months. The Court suggested that the result might have been different had the parties intended that the notes mature within nine months. In dictum, the Court strongly suggested that the appropriate resolution of the ambiguity was that Congress intended the exemption to apply only to commercial paper sold only to sophisticated investors.

Finally, a few other cases raised an argument that securities should be exempt because another regulatory system exists. The Court first suggested, then held, that where another regulatory system sufficiently reduces an instrument's risk such that purchasers do not need the protection of the securities laws, those laws do not apply. For example, coverage under the Employee Retirement Income Security Act (ERISA) or the Federal Deposit Insurance Act (FDIA) vitiates the need for securities coverage.

II. THE CURRENT ANALYSIS AND NEW VEHICLES

The most common objection to the current analysis for securities coverage is that it is indeterminate. As we have seen, the Court uses three

52. Id. at 955.
53. Id.
54. Id.
55. Id. at 954. The Chief Justice argued in dissent that the statute is not ambiguous as to demand notes. Id. at 957-60 (Rehnquist, C.J., concurring in part and dissenting in part). He did not make any public policy arguments about the purpose of the statutory exemption or securities laws coverage generally. Id. Compare Justice Stevens' concurrence on the commercial paper argument ground and the Chief Justice's response to Justice Stevens. Id. at 955-60 (Stevens, J., concurring).
60. "The existence of [ERISA] ... severely undercut[s] all arguments for extending the Securities Acts to non-contributory, compulsory pension plans. ... Not only is the extension of the Securities Acts by the court below unsupported by the language and history of those Acts, but in light of ERISA it serves no general purpose." Daniel, 439 U.S. at 569-70. Similarly, in Weaver, the Court found that "[i]t is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws." Weaver, 455 U.S. at 559; cf. Reves, 110 S. Ct. at 953 (noting that comprehensive regulatory schemes in Weaver and Daniel were essentially risk reducing factors that suggested instruments were not securities); SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 210 (1967) (quoting SEC v. Variable Annuity Life Ins. Co., 359 U.S. at 75 (Brennan, J., concurring) as stating that presence of state regulation schemes for insurance made federal regulation of insurance instruments 'even less relevant').
different methods to determine whether an instrument is a security. Further, the Court has sometimes approached the coverage question by asking whether an instrument is something other than a security. It uses yet another criterion to decide whether a security should not be covered by the securities laws when a competing regulatory scheme exists. The point is not that there is a welter of tests but that the Court has given little guidance as to which test or tests should apply to a particular instrument.

For example, as early as Variable Annuity Life Ins. Co. and United Benefit the Court itself seemed uncertain whether to start its analysis by deciding if the instrument was a security or by deciding if it was something else. In another example, the Forman case generated great confusion because it was unclear whether the Howey test always applied, whether it did not apply to more concrete instruments like stock, or whether it was always available as an alternative. In the end, the Landreth Court had to "clarify" the Court's reasoning in that area. In yet a third instance, as recently as 1990 the Court was forced to deal with the widespread confusion over which test to apply to notes. Four circuits used an "investment versus commercial" test, three circuits essentially used the Howey test, and one circuit used the "family resemblance" test.

This indeterminacy in choosing one test over another is compounded by the indeterminacy within each test. Howey is obviously intended to be open in its application and, therefore, purposefully indeterminate, but even the tests for stock and notes are unpredictable. The Court in Forman and Landreth wrestled with the question of which qualities define the paradigm of stock and it deliberately finessed the question of instruments containing some but not all of those qualities. Likewise the Reves Court had trouble

61. See, e.g., Reves v. Ernst & Young, 110 S. Ct. 945 (1990) (positing that notes may be securities under family resemblance test); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (holding that stock, by its nature, is security); SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (establishing test for investment contracts).

62. E.g., SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 68 (1958) (asserting that analysis begins with question of whether respondents were issuing insurance contracts); United Benefit Life, 387 U.S. at 211 (finding that instrument was not within insurance exemption prior to holding it was security).


64. See Variable Annuity Life, 359 U.S. at 68 (noting that "[t]he common question to the exemption provisions of the Securities Act and the Investment Company Act and to § 2(b) of the McCarran-Ferguson Act is whether respondents are issuing contracts of insurance"); cf. id. at 74 n.4 (Brennan, J., concurring) (asserting that instrument would clearly be security were it not for insurance exemption); id. at 95-96 (Harlan, J., dissenting) (asserting that instrument contains elements of both securities and insurance contracts); see also SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 211 (1967) (holding that instrument was not insurance contract and that it was security).

65. The First, Fifth, Seventh, and Tenth Circuits used the "investment versus commercial" test, the Eighth, Ninth, and District of Columbia Circuits used essentially the Howey test, and the Second Circuit used the "family resemblance" test. Reves, 110 S. Ct. at 950.

deciding what effect a state’s characterization of a note should have on the federal definition of a security.67

The problems of this indeterminacy become particularly acute with new investment vehicles because they are specifically designed to be mutations of traditional vehicles. In an active securities market, sophisticated investors are constantly seeking new investment vehicles68 that either offer (1) new qualities,69 (2) “pure” qualities,70 (3) or new combinations of qualities.71

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67. Reves, 110 S. Ct. at 954; id. at 958 note * (Rehnquist, C.J., concurring in part and dissenting in part); cf. Tcherepnin v. Knight, 389 U.S. 332, 337-38 (1967) (holding that state law creating instrument defines its characteristics but that federal law must govern whether the instrument is security).

68. Investors can sometimes replicate the vehicles they want through trading strategies, regardless of whether the vehicle they want actually exists. See infra note 97. Advances in technology have also played a part in the development of new vehicles. Stern & Zweig, supra note 11, at 62.


70. For example, investors’ desire to invest in one but not both of an equity’s appreciation methods (i.e. either principal appreciation or dividend declaration) led to the development of trusts offering essentially those qualities (Americus Trusts) and to the unsuccessful Unbundled Stock Units. See Sixth Annual Review of Developments in Business Financing, 45 Bus. LAW. 441, 446 (1989) [hereinafter Sixth Annual Review] (describing Unbundled Stock Units); Floyd Norris, Americus Trust Becoming Extinct, N.Y. TIMES, Feb. 13, 1992, at D12 (discussing demise of Americus Trust because of adverse tax consequences for trusts formed after 1987); Karen Slater, Investors May be Ready for ‘Prime’ Time, WALL ST. J., May 3, 1990, at Cl (discussing Americus Trusts). Those instruments allowed investors to focus on precisely the investment qualities they chose without being forced to invest in instruments with unwanted qualities.

71. For example, General Motors has offered two series of preference shares, called Preference Equity Redemption Cumulative Stock (PERCS), that offer an enhanced dividend...

Finally, the Chicago Board of Trade announced that it would introduce a futures contract that would allow insurance companies to reduce the risk of reinsurance. See Eric N. Berg, New Futures Contract On Insurance Planned, N.Y. TIMES, May 17, 1990, at A6.

72. Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 544 (7th Cir. 1989), cert. denied, 110 S. Ct. 3214 (1990). In an example of how spanning feeds on itself, one recent development involves creating a new vehicle that offers "pure" qualities formerly found in a new vehicle that offered new combinations of qualities! Salomon Brothers and First Boston Corporation developed a Super-LYON based on the new LYONS described in supra note 71. Super-LYONS separate the zero coupon aspect of LYONS from their convertibility rights and allow the purchaser to sell either aspect separately. See Laura Jereski, Super-LYONS, FORBES, June 8, 1992, at 44. For examples of strategies using spanning, see Stanley W. Angrist, How to Make Much of Midsized Stocks—Options, Futures Hedge S&P Index, WALL ST. J., Mar. 25, 1992, at C1; Jonathan Clements, Here Are Four Strategies for Building The Right Mutual Fund Portfolio for You, WALL ST. J., Mar. 18, 1992, at C1.

73. See, e.g., Stern & Zweig, supra note 11, at 62 (listing seven different kinds of securitized loans); Taylor, supra note 10, at C1 (listing 12 new vehicles introduced in 1991).
contingent value rights combine elements of equity interest, like stock, with an element of futurity, like a futures contract. Reinsurance futures could be exempted from coverage as contracts of insurance or could be stock or futures. Finally, sulfur dioxide allowances might be stock or futures or might be exempted from securities coverage because they are regulated by the Environmental Protection Agency.

The impossibility of predicting accurately which, if any, of those instruments would be held to be a security has inhibited the development and marketing of new vehicles because the criteria for coverage are unrelated to the needs of all market participants and of the markets in the aggregate. Coverage depends instead upon the potential purchasers' needs. The current analysis forces developers of new instruments either to tailor the vehicles around the contours of the analysis or to market new instruments abroad. Taking the first alternative can dilute a new vehicle's effectiveness because it requires including or withholding qualities that the developer believes would be optimal. The contrast between IP's and market

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75. Salwen, supra note 74, at A5A (quoting SEC Commissioner Mary Shapiro as saying that "[t]here are a lot of questions raised about how to [oversee] each market, about jurisdiction and about customer protection").

76. The American Stock Exchange SPDR's were designed to solve the regulatory problems of IP's. Steiner, supra note 2, at C1.

77. See, e.g., Kurt Eichenwald, Chicago Futures Going Worldwide, N.Y. TIMES, June 24, 1992, at D6 (citing practice of foreign competitors marketing new instruments abroad and taking market share away from domestic exchanges); Salwen, supra note 74, at A5A (SEC Commissioner Mary "Shapiro said she is eager to approve new products to allow U.S. exchanges and our firms to be able to compete. 'Some of these products already are trading in Europe, and with the proper surveillance in place, they ought to be able to trade in the U.S.,' she said").

78. See Torres, supra note 74, at C1, C9 (quoting influential securities lawyer as saying that "products are being tinkered with to be pigeon-holed in the law. The public isn't getting more protection, and the product isn't getting sounder"). The vice chairman of a major Chicago bank stated that "[t]he biggest problem is when you try to invent something new and
baskets throws the problems of following this course into relief. Market baskets were developed to avoid any question that the securities laws might not apply to them; they have been unsuccessful in part because of the inclusion of qualities that made them clearly subject to the securities laws.\textsuperscript{79} Whether SPDR's will suffer the same fate remains to be seen. The second avenue, foreign marketing, has already been used and may be used more frequently, with potentially devastating consequences for the American capital markets.\textsuperscript{80}

This stifling of new products at home and their increased marketing abroad works to the detriment of the American economy, its capital markets,\textsuperscript{81} and the investors, issuers, intermediaries, and regulators, that participate in those markets. Home mortgages are one example of how new investment vehicles affect the real economy. In 1974 home buyers had difficulty obtaining mortgages because banks found more profitable uses for loan money. In 1991, when a recession and falling home prices should likewise have made banks reluctant to lend to home buyers, mortgages were plentiful. The difference was, at least in part, caused by the development in the interim of mortgage-backed securities. By 1991 banks could package their home mortgages into pools and sell securities based on those pools. That ability to package loans, and thus reduce risk, made banks more willing to lend.\textsuperscript{82}

Inhibiting new investment vehicles reduces the American trading markets' liquidity because investors are less eager to trade when spanning possibilities are reduced. Since Red October,\textsuperscript{83} spanning has increased in

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\textsuperscript{79} Power, supra note 74, at C19; cf. Steiner, supra note 2, at C1.

\textsuperscript{80} See Eichenwald, supra note 77, at D6 (noting that because of foreign marketing efforts, Chicago's share of worldwide futures market has fallen to 50% from earlier level of almost 100%); Diana B. Henques, In World Markets, Loose Regulation, N.Y. TIMES, July 23, 1991, at D1 (asserting that "[t]he pace of this trend is startling: The net purchases of foreign stocks and bonds by American investors tripled from 1988 to 1990, and market researchers expect those sharp gains to continue"); Salwen, supra note 74, at A5A (quoting SEC Commissioner Mary Shapiro as saying that many new products under SEC review are already trading abroad); Torres, supra note 74, at C9 (noting that "[s]ome derivative traders say they are increasingly frustrated by uneven U.S. regulations and may decide to move their business abroad. 'I would be willing to bet that in two years most of our competitors in equity derivatives will move to London' because of tight U.S. regulations" quoting a banker with a large French bank); Craig Torres, Liquidity Drought Worsens the Plight Of Profit-Thirsty Stock Market Players, WALL ST. J., Nov. 19, 1990, At C1 [hereinafter Torres, Liquidity Drought].

\textsuperscript{81} Both the trading market and the capital formation market.

\textsuperscript{82} Stern & Zweig, supra note 11, at 62; see also Suzanne Woolley & Stan Crock, 'You Can Securitize Virtually Everything,' Bus. Wk., July 20, 1992, at 78 (suggesting that purpose of proposed SEC rules to ease securitization of small business loans is to facilitate making of such loans).

\textsuperscript{83} The October 1987 crash produced such large losses—red ink—that it is sometimes called Red October.
response to the realization that the various trading markets for equities and derivatives are effectively one market. Dramatic proof of this link came in April 1992 when the flood that halted trading in the Chicago futures and options markets resulted in reduced volume and price movement in the stock markets. On the New York Stock Exchange, the day's volume was the second lowest of the year and, after the Chicago markets closed, the Dow Jones Industrial Average traded within a narrow five point range.

This changed perception of those markets led to the development of new vehicles that take advantage of that unity through making the market more efficient. This efficiency comes about when the new products either reduce costs or act as price discovery mechanisms. The markets then become more attractive to traders who, in turn, increase the markets' liquidity. This added liquidity is the single attribute that most determines the health of the trading markets, and one that has been declining since the October 1987 crash. Such new instruments as SPDRs, IPs, market baskets, Americus Trusts, reinsurance futures, credit-card backed debt instruments, and others have been developed and introduced since the crash. These products' success will maximize the liquidity of the American markets, easing the largest problem facing those markets. It seems likely that the need for such new instruments will continue.

84. A derivative is an instrument whose price is a function of the price of another instrument. ALLAN H. PESSIN & JOSEPH A. ROSS, STILL MORE WORDS OF WALL STREET 70 (1990). The derivative market has recently been estimated at over $10,000,000,000,000. Steven Lipin & William Power, "Derivatives" Draw Warnings From Regulators, WALL ST. J., Mar. 25, 1992, at C1.

85. Randall Smith et al., Flood in Chicago Waters Down Trading on Wall Street, WALL ST. J., Apr. 14, 1992, at C1; see, e.g., Angrist, supra note 72, at C1 (describing investment strategies that use equities and derivatives).

86. Transaction costs may be lower for one product rather than another as with stock index futures and stocks. Purchasing an index future is a single transaction and is significantly cheaper than buying up to 500 stocks which may make up the index. U.S. GAO, Financial Markets: Preliminary Observations on the October 1987 Crash, at 30 n.6 (Jan. 1988) [hereinafter Financial Markets]; see also James Sterngold, Steps to Aid Big Trades Weighed, N.Y. TIMES, June 10, 1988, at D1.

Lower transaction costs, in turn, is one reason why investors may prefer to trade one vehicle rather than the other; the first vehicle will set the price for the second. For example, partly because the futures markets have lower transactions costs (and partly because the vehicle traded embodies the investors' views of near term future prices in stocks) stock index futures are the price discovery mechanism for the stock market. Financial Markets, supra, at 30 n.6.

87. Eric A. Chiappinelli, Red October: Its Origins, Consequences, and the Need to Revive the National Market System, 18 SEC. REG. L.J. 144, 146 n.5 (1990). Increasing liquidity makes the trading markets more efficient and less volatile and lowers transactions costs for all participants. Id. For a discussion of the interrelationship between efficiency and liquidity, see id. at 155.


89. See, e.g., Torres, Liquidity Drought, supra note 80, at C1; Market Regulation Director Remarks on Future Structural Issues, Fed. Sec. L. Rep. (CCH), No. 1334, at 9 (1989) [hereinafter Market Regulation Director Remarks]; Chiappinelli, supra note 87, at 155-57.
A related lesson of Red October is that the world's trading markets are also strongly linked. Investors and others have increased their global participation since 1987. The global investment markets have assumed increased importance as well because the capital committed to the American markets has shrunk as a result of the 1987 crash. A part of that capital has simply moved to markets outside the United States.

A major goal for United States regulators and for market participants is to attract capital from abroad and to retain American capital in American trading markets. New products such as Nikkei warrants, TOPIX futures and options, deposit notes, and FT-SE warrants are designed to appeal to this global market, either by allowing Americans to invest domestically in vehicles that have returns based on foreign events, or by drawing foreign capital to America.

Not only do American trading markets benefit from spanning, but the capital formation market does as well. New investment methods increase the options of corporations seeking capital. Those options increase the number of issuers that can make use of the capital markets. These new

93. Sixth Annual Review, supra note 70, at 446.
products, to be successful, must also satisfy investor needs. If they do so, more investors will be willing to commit greater capital to the capital formation market, which in turn will increase the total liquidity of the market and increase the number of issuers that may resort to that market. This increased liquidity and increased options for financing serves to lower the total cost of capital, which helps the real economy by encouraging capital formation. Thus, this increased capital formation and decreased costs are directly related to total economic productivity and gross national product.96

The trading and capital formation markets are not the only beneficiaries of spanning. New investment vehicles help investors, issuers, intermediaries, and regulators, and each of those groups has supported new instruments.

Investors use new vehicles to develop trading strategies that have the potential for additional profits.97 Also, new vehicles may allow investors to assume or shed risk.98 Finally, investors may use new vehicles as price

96. See, e.g., Torres, GM, on the Back of EDS Unit, supra note 71, at C2 (reporting that GM doubled size, to $1,500,000,000, of PERC offering based on its Class E common stock). The Class E stock itself entitles the holder only to the dividend stream from GM's EDS unit. Id. GM has raised $3,300,000,000 from such new vehicles. "Not one penny of the capital raised in the [EDS PERC] offering will go directly to EDS to help the company grow. All of the funds go to hard-pressed parent General Motors, which is trying to shore up its balance sheet. "This latest preference share is just further evidence of the struggle GM is going through now, and their need for cash and capital," says Terence Quinn, senior technology analyst at Kidder Peabody.") Id.; Friedman & Light, supra note 71, at 66 (noting that corporations issuing Liquid Yield Option Notes can raise money from the public at below market rates and also defer the interest payments for years); Berg, supra note 71, at D6; Mitchell, supra note 69, at Cl; BRADY REPORT, supra note 90, at Study VII and Study VIII.

97. Sophisticated investors now resort to a kind of self-help called analytics. Analytics are complex computed developed trading strategies whose function is to replicate an investment vehicle. Craig Torres, Mathematicians Race to Develop New Kinds of Trading Instruments, WALL ST. J., Oct. 18, 1991, at Cl. Similarly, in the early 1980s savings and loan associations used the new mortgage backed securities (and often more esoteric variations such as interest only or principal only rights called IO and PO strips) in conjunction with other instruments to profit from a trading strategy called risk-controlled arbitrage. See LEWIS, supra note 69, at 83-102; Donnelly, 'Scenario Analysis,' supra note 69, at Cl; Charles McCoy, Many Big S&L Losses Turn Out to Be Due To a Financial Gamble, WALL ST. J., Aug. 9, 1991, at Al; see also Angrist, supra note 72, at Cl; Clements, supra note 72, at Cl.

98. Sometimes they do both at the same time. For example, banks pool their loans and sell securities in the pools to reduce their risk. They then buy securities based on the loan pools securitized by other banks. It was reported that in the first six months of 1991 banks bought back over 25% of the loans they securitized. Stern & Zweig, supra note 11, at 62; see also Angrist, supra note 71, at Cl (rights allow investors to reduce the risk of common stock); Chiappinelli, supra note 87, at 158 n.48 and sources cited; Donnelly, CMO's May Promise, supra note 69, at Cl; Donnelly, 'Scenario Analysis', supra note 69, at Cl; Donnelly, Small Investors', supra note 69, at Cl; Slater, supra note 70, at Cl (noting that new instruments allow investors to accept more or less of risk of common stocks); Leah N. Spiro, Money Machine, Bus. Wx., June 10, 1991, at 80, 83-84; Jeffrey Taylor, CBOT Puts Insurance Futures on Hold, WALL ST. J., Sept. 4, 1991, at Cl; Woolley & Crock, supra note 82, at 78 (attributing investors' preference for asset-backed securities to risk reduction and increased liquidity).
discovery surrogates for other vehicles.  

Issuers may want to create new investment products to transfer risk or raise capital.  

Mortgage backed securities were developed not only to satisfy investors, but to permit savings and loans to lay off part of the risk of their loan portfolios and to raise money to loan out.  

A corporation needing externally generated capital must consider many factors in selecting the appropriate vehicle for raising that capital. The first factor is the total amount of capital needed. Second is the time for which that capital will be required: short term, medium term, and permanent or very long term needs. If the need is short term, a corporation's choice of vehicle may depend in part upon whether that need is predictable and cyclical or unpredictable and extraordinary. Corporations, of course, seek to raise capital as cheaply as possible. The cost must be measured not only by the interest or dividend that will be paid but by the other attributes of the vehicle that may make it more or less desirable to purchasers. That desire may directly affect the interest rate or dividend but even without such an affect, those attributes are a "cost" that must be borne. These attributes include such things as the source, priority, surety, and frequency of repayment, and the rights of holders to participate in management. Corporations must also consider the needs of potential purchasers, which may include new, pure, or hybrid qualities as discussed above.  

Certainly of prime importance to a potential investor is the ease or difficulty with which the vehicle can be sold; the existence of a secondary trading market.  

Financial intermediaries such as exchanges and broker-dealers may also seek to develop new products for proprietary reasons. A new product may cost a million dollars to develop and market, but the brokerage commissions and other fees can return enormous profits.  

Financial intermediaries such as exchanges and broker-dealers may also seek to develop new products for proprietary reasons. A new product may cost a million dollars to develop and market, but the brokerage commissions and other fees can return enormous profits.


100. See, e.g., Berg, supra note 71, at D6; Friedman & Light, supra note 71, at 66; Stern & Zweig, supra note 11, at 62; Torres, GM, on the Back of EDS Unit, supra note 71, at C2.

101. See Lewis, supra note 69, at 83-102; Stern & Zweig, supra note 11, at 62; Woolley & Crock, supra note 82, at 78.

102. The needs may include the tax consequences of the investment, as well. See, e.g., Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 322-23 (4th ed. 1991); Button, supra note 71, at 89.


104. Taylor, supra note 98, at C1.


106. See, e.g., Anders, supra note 94, at C1 (noting that because most new products cost $1 million or less, 1 in 10 success ratio can be profitable); Stanley W. Angrist, In Search of the 'Hot' Futures Contract, WALL ST. J., Apr. 8, 1991, at C1; Friedman & Light, supra note 71, at 66 (observing that for brokerage houses, LYONS mean large fees); Woolley & Crock, supra note 82, at 78; see also Berg, supra note 71, at D6 (citing competition, spokesman for Chicago Board of Trade declined to give details of new product).
develop successful new investment vehicles is so intense, and the cost so expensive, that the developers go to great lengths to protect whatever proprietary rights they may have. For example, the ill-fated unbundled stock units were developed by a brokerage house. IP's and SPDR's were developed by the exchanges and were opposed by the futures exchanges largely because of a perception that they would capture some of the demand for stock index futures. Those intermediaries are also among the largest investors; they desire new products for the same reasons as other investors.

Finally, at least some new products are developed at the instigation of regulators to protect the domestic markets from inefficiency and from foreign competition. In the aftermath of the October 1987 market crash, regulators worked to develop market baskets. Regulatory requirements may also give an incentive to issuers to use new vehicles. For example, banks issue securities based on pools of their loans in part to assuage regulatory concerns.

III. A Public Interest Definition

The current calculus for determining the scope of the securities laws is not bad, as far as it goes. It is in fact quite useful in protecting people who invest their money. The current tests, however, fail to consider either the public needs of the American capital markets or to recognize that those markets are being hurt by that failure. What is needed is an expanded calculus that explicitly includes consideration of the capital formation and

107. See Raghavan, supra note 74, at C1.
108. Anders, supra note 94, at C1; Eichenwald, supra note 77, at D6 (noting that, because instruments are not patentable, Chicago exchanges began Globex as way to protect market share against foreign appropriation of instruments); William Power & Milo Geyelin, Ideas for New Financial Products Must Be Novel to Gain Protection, WALL ST. J., Oct. 4, 1991, at B8; Torres, supra note 94, at C1; see also Berg, supra note 71, at D6 (citing competition, spokesman for the Chicago Board of trade declined to give details of new product); cf. Index Participation Rule Change, supra note 5, at 15,284 (addressing proprietary concerns between competing exchanges).
109. The proprietary concerns of the Philadelphia Exchange (Phlx) in the development of their IP (designated CIP) were so strong that they contended their development secured a vested property right protected by copyright. Index Participation Rule Change, supra note 5, at 15,284. The American Stock Exchange product, the Phlx contended, infringed on that right. Id. For other examples of the competitive concerns of the exchanges, see Berg, supra note 71, at D6 (noting that CBOT spokesman declined to give details about reinsurance futures citing competition with other exchanges); Power & Geyelin, supra note 108, at B3.
110. E.g., Spiro, supra note 98, at 80; Torres, supra note 97, at C1.
111. See, e.g., Sterngold, supra note 86, at D1 (noting that David Ruder, then SEC Chairman, had "encouraged the stock exchange to create a cash index vehicle to be traded on the floor a way of making the market more efficient"); Woolley & Crock, supra note 82, at 78 (noting that SEC has proposed rules making it easier to securitize small business-backed loans to ease small business credit crunch).
113. Stern & Zweig, supra note 11, at 62.
secondary trading markets (both in isolation and vis-à-vis foreign markets), and issues of market regulation.\footnote{114}

The prior discussion suggests that an instrument ought to be within the definition of a security if it aids capital formation by increasing liquidity or lowering costs,\footnote{115} or improves the trading markets by adding liquidity, aiding price discovery, or reducing transaction costs.\footnote{116} However, another set of public concerns has yet to be considered. More rational or more effective market regulation has a beneficial effect on the trading markets.\footnote{117} A new instrument should be subject to the securities laws when doing so would achieve such regulatory benefits as uniformity\footnote{118} or market consolidation, market integrity, or market participant oversight.\footnote{119}

\footnote{114} The literature on the definition of a security is quite large; literature on narrower aspects of that question is enormous. Useful sources for the most valuable articles are Hazen, \textit{supra} note 23, at 24 n.19; 2 Loss & Seligman, \textit{supra} note 23, at 920 n.120.

At least one scholar has proposed a test that takes account in some way of the national securities markets. Professor FitzGibbon, writing on the cusp of the explosion of new instruments that began in the early 1980's, recognized that Congress was concerned with the financial markets when it adopted the Securities Acts. FitzGibbon, \textit{supra} note 23, at 912-16. He also recognized the possibility that many new instruments would be introduced. \textit{Id.} at 933.

His proposal, though, would limit the definition of security essentially to instruments that effect the production of goods and services. That definition would exclude some (perhaps all) derivative instruments and certainly would exclude instruments based, for example, on indexes of stocks. \textit{Id.} at 919-21. Professor FitzGibbon would also require that the purchaser intend that gain come primarily from the production of those goods and services, again eliminating some instruments that, under my analysis might be securities. \textit{Id.} at 921-25. Perhaps most centrally, Professor FitzGibbon's analysis is incomplete because it is rooted not only in notions of Congressional intent (rather than concern with the national economy as a matter of current public policy apart from Congress's purpose in the 1930s) but in the goal of investor protection. \textit{Id.} at 926-28 (observing that definition of security tied to that of open market, which turns basically on participation of individual investors needing protection).

\footnote{115} \textit{See supra} note 96 and accompanying text.

\footnote{116} \textit{See supra} text accompanying notes 81-95. As noted above, an instrument adds to liquidity when it keeps capital in the United States or draws foreign capital to domestic markets. \textit{See}, \textit{e.g.}, Richard E. Rustin, \textit{'Early Bird' NASDAQ Plan Hits a Snag}, \textit{WALL ST. J.}, Aug. 23, 1990, at C1; Stout & Duke, \textit{supra} note 95, at C1 (noting that new rule 144A aimed at increasing liquidity in U.S. capital markets and opening those markets to foreign companies); Craig Torres, \textit{Big Board Facing Serious Erosion as Market for Stocks, Chief Warns}, \textit{WALL ST. J.}, Mar. 13, 1991, at C1 (warning by NYSE Chairman Donaldson about effects of foreign products on future success of exchange).


\footnote{118} Uniformity of regulation may be defeated in two ways. Two or more instruments may be related but are not covered under the same regulatory scheme; they may be covered under different schemes or one may be unregulated entirely. Second, a single instrument may be subject to coverage under two regulatory schemes, as the IP was.

\footnote{119} "Market participants" includes registered broker-dealers and futures commission merchants (FCMs) whether acting for their own accounts or as agents. The term also includes professional traders such as risk arbitrageurs and institutional investors who may or may not be registered broker-dealers or FCMs.
Two dangers arise when two or more instruments are functionally related but not subject to the same regulatory scheme. One problem is that some instruments may trade while others do not. The relation between the instruments then becomes dysfunctional. For example, stock index futures are regulated by the CFTC and trade in great numbers. Market baskets, which were designed to compliment stock index futures by allowing investors to purchase up to five hundred stocks in a single transaction, were regulated by the SEC, virtually never traded, and were finally suspended in late 1991.120

The second problem is that the ancillary rules governing the instruments will be different which may also impede the relation between the instruments. For example, stock index options, which are securities, are in many ways functional equivalents to stock index futures, which are not securities. Traders in stock index options are required to comply with the margin requirements established for securities trading, and such requirements are far more onerous than the margin requirements for stock index futures traders.121 Among the reforms to come out of the October 1987 market crash was the move to unify the trading markets and to centralize their regulation.122 A new instrument's similarity to other instruments should affect the question of coverage for regulatory reasons as well as economic ones.

When an instrument may be covered under both the securities laws and another regulatory scheme there is the danger that both regulators will assert authority over the instrument or that the other scheme will not be as beneficial as the securities laws. Litigation, as with the IP, will be necessary to allocate each new instrument between the competing regulators;123 this is

120. Eichenwald, supra note 74, at C4; Power, supra note 74, at C21.
122. Dean Foust, The SEC's Dick Breeden: A Superpol Building a Superpower, Bus. Wk., Apr. 2, 1990, at 43; Scott McMurray, Merc May Cede Some Oversight on Indexes to SEC, WALL ST. J., Feb. 15, 1990, at C1; Kevin G. Salwen, SEC May Receive Boost in Meeting on Index Futures, WALL ST. J., Mar. 27, 1990, at C18; Kevin G. Salwen, Plan to Shift Oversight of Index Futures to SEC is Unveiled by Administration, WALL ST. J., June 6, 1990, at C23; Kevin G. Salwen, SEC's Schapiro Urges a Merger of Agency, CFTC, WALL ST. J., Mar. 21, 1990, at C1. Effecting this change has been seen as making a public policy choice between expanding the powers of one of the current regulators or creating a new agency. The likelihood of regulatory unification has varied from time to time since the crash. Salwen, supra note 9, at C6. Regardless of the outcome of the unification dispute, the need for an expanded test for securities laws coverage will remain. Even if a single regulatory agency governs all the markets, courts must still determine whether new products are covered by the securities laws.
123. See, e.g., Torres, supra note 74, at C9 ("Adds S. Waite Rawls III, vice chairman at Continental Bank in Chicago: 'The biggest problem is when you try to invent something new and fit it into the jigsaw of current [U.S.] regulation. One guy will argue that it fits one place; one argues it fits another. Both fear that if tested in court, they will be wrong. The uncertainty is a big problem").
a relatively short term exercise, but not one without significant expense and uncertainty.

There may be instances, however, where the benefits of the other regulatory scheme outweigh the cost of exclusion from the securities laws. The facts of *Weaver* and *Daniel*, though not the opinions, are potential examples. In each case, the reduction in the instrument’s risk could have been found to outweigh the dysfunction from excluding the instruments from coverage. The calculus for securities coverage should include both these public interests in assessing whether an instrument should be governed by the securities laws or by another system.

Increasing market integrity is a second public regulatory concern. One danger in not extending securities coverage is that the antimanipulation rules will not apply. For example, a leading broker-dealer manipulated a portion of the $2.2 trillion market in government securities by cornering several auctions, including purchasing ninety-four percent of a $12.26 billion offering of two year Treasury notes. The manipulation, which ironically would have served to reduce in the short term the cost to the government, prompted calls for regulation of the essentially unregulated secondary government trading market.

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124. The opinions did focus on the reduction in risk, but used that reduction only to consider whether the holders needed the securities laws’ protection. The opinions did not consider risk reduction vis-à-vis market impairment.

125. This was suggested by commentators after Red October by comparing the CFTC to the SEC or the Federal Reserve Board. See, e.g., Chiappinelli, supra note 87, at 172; Scott McMurray, *Stotler Collapse Indicates Futures Funds' Growth Has Outpaced Their Regulation, Analysis Say*, Wall St. J., Aug. 27, 1990, at C12; cf. Kenneth H. Bacon & Kevin G. Salwen, *Summer of Financial Scandals Raises Questions About the Ability of Regulators to Police Markets*, Wall St. J., Aug. 28, 1991, at A10 (discussing series of scandals in June, July, and August 1991 led many to question competence of regulators); Henriques, supra note 80, at D1 (regulation usually lax or nonexistent in many countries); *The SEC Chairman Moves Quickly to Capitalize on the Salomon Scandal*, Wall St. J., Sept. 13, 1991, at A1 (observing that SEC Chairman Richard Breeden emphasizes SEC regulatory skills and lack of skills in Treasury Department and Federal Reserve System).


A third aspect of market regulation is oversight of market participants’ financial integrity. Coverage should depend in part on the financial risk to which the investors, market participants, and clearing and settling participants will be exposed. Coverage can monitor such risk and limit participants from accepting excessive risk. This consideration may be particularly important when the participants involved in a new instrument are also dealing with covered instruments, so as to present the risk that a portion of the participant’s capital will be monitored and another portion will not.129

Again a recent example is instructive. Among the new trading vehicles is an interest rate swap often used by institutions such as banks to hedge or protect against unanticipated changes in interest rates or currency exchange rates.130 Swaps can be used alone or in conjunction with strategies such as risk-controlled arbitrage;131 the total swaps market is estimated at five trillion dollars.132 Swaps are essentially unregulated and, under current accounting practices, are not reflected on the balance sheets of banks. Recently, as the Bank of New England’s financial problems worsened because of a deteriorating real estate loan portfolio, the bank found itself with another, potentially as serious, problem. The bank, which had thirty billion dollars worth of assets, also had thirty-six billion dollars worth of swaps and found that other traders were becoming increasingly reluctant to trade with it because of its precarious financial position. Fortunately, the bank was able to stave off disaster from the swaps (though not from the bad loans; the bank was seized by banking regulators in early 1991) but regulators were unable to control the size of the bank’s swaps exposure and trading activities. The next swaps debacle may be far worse.133

give regulators more muscle over the secondary, or resale, market in government securities, by requiring the SEC to oversee dissemination of price and volume information. ‘The government market has been a largely unregulated gap in the securities markets,’ Mr. Breeden said”; cf. John Connor, Fed Bank Probes Possible “Squeezes” in Treasury Issues, WALL ST. J., Mar. 23 1992, at C10 (observing another possible manipulation in Treasury securities market, long after Salomon scandal).


130. See William Glasgall & Bill Javetski, Swap Fever: Big Money, Big Risks, BUS. WK., June 1, 1992, at 102 (describing mechanics of swaps).

131. See Risk Isn’t Always Controlled, supra note 97, at A4.


133. See JOHN W. BACHMANN ET AL., REPORT OF THE BACHMANN TASK FORCE ON CLEARNANCE AND SETTLEMENT REFORM IN U.S. SECURITIES MARKETS 11 (1992); Lipin & Power, supra note 84, at C1 (noting influential regulator is warning market participants about risk to entire world financial system from large loss by single participant in trading derivatives, especially swaps); Glasgall & Javetski, supra note 130, at 103; Michael Siconolfi, Merrill Sets Up Unit to Cash In On Derivatives, WALL ST. J., Nov. 12, 1991, at C21 (noting that major brokerage house established separate unit to trade derivatives, especially swaps. The unit will have higher credit rating than brokerage house itself, which will result in greater trading power
IV. Other Goals

So far, the argument for expanding the definition of a security has rested upon economic or regulatory benefits. These are the more socially compelling reasons for changing the analysis but they are not the only ones. The public interest test is entirely consonant with the traditional touchstones of congressional intention and prior case law. Protecting the public interest in the national markets would help give effect to Congress's full intention in enacting the securities acts and several amendments. Further, a public interest test would be intellectually compatible with the traditional approach to securities coverage and would provide, in some cases, a greater measure of predictability.

As a matter of congressional intent, the expanded calculus for securities coverage would give more complete effect to Congress's goals. The Securities Act was directed at regulating the process of distributing securities to the public. The primary concern was with disclosure and the protection of individual investors was the aim.134

In 1934, though, Congress turned its attention to the secondary trading markets, and the New York Stock Exchange in particular.135 Congress recognized that a larger public interest, apart from individual investors, called for passage of the 1934 Act and, more directly, that recognition informed the definition of "security."136

That notion of a link between the national interest in the securities markets and the definition of a security was more explicit and direct in congressional amendments in 1975, 1982, and 1986.137 The Securities Acts...
Amendments of 1975\textsuperscript{138} represent Congress's decision to implement a National Market System. Based on an SEC proposal, the National Market System was intended to improve the quality of the nation's equity markets essentially by maximizing the markets' liquidity.\textsuperscript{139} The legislative history of the Securities Acts Amendments of 1975 is replete with concerns about the national interest in the health of the securities markets. From the preamble of the statute itself,\textsuperscript{140} through the House and Senate reports,\textsuperscript{141} to remarks on the floor,\textsuperscript{142} the concern was obviously with protecting the markets from harm.


139. Chiappinelli, supra note 87, at 165.
142. "The final version of this bill is designed to reduce barriers to securities markets,
Congress again specifically infused a national interest in the definition of security in the 1982 Amendments to the Securities Acts. The 1982 Amendments enacted an informal accord between the SEC and the CFTC over their respective jurisdictions. As with the 1975 Amendments, the legislative history of the 1982 Amendments contain many expressions of Congress's intention to protect the national markets and to do so through the scope of the definition of "security."

Lastly, in 1986 Congress became concerned with a number of intermediary failures in the market for federal government securities and enacted the Government Securities Act of 1986 to bring at least a portion of that market under greater regulation. As with the earlier amendments, Congress was acting to protect the public interest in the integrity of the financial markets through the governor of the statutory definition of "security."

Not only would Congressional intention be aided by the public interest test, but that test would be entirely consonant with the current analysis because it would be supplemental. Indeed, the Supreme Court has occasionally made reference to these larger national concerns, but has never used them as a basis for analysis. For example, the *Landreth* Court might have looked to the capital formation function of stock as a basis for its holding. In *Daniel* the Court could have compared the regulatory efficacy of the SEC and the Department of Labor, which oversees ERISA, in deciding whether the presence of another regulatory scheme should exempt the interests in *Daniel* from the securities laws.

permit the dissemination of market information and establish the basis for the development of a national securities market system." 121 CONG. REC. 10,732 (1975) (remarks of Sen. Brooke).


144. H.R. REP. No. 626, 97th Cong., 2d Sess. (1982) ("These laws were aimed at protecting public investors, assuring market integrity and, most important, restoring investor confidence in order to attract needed funds back into the U. S. capital markets. These goals were, and remain, of paramount concern to Congress").


146. The 1986 Amendments again changed the exemptions under 3(a)(12) to add additional descriptions to the exemptions for government securities. Citing dealer failure as a concern, these amendments attempted to regulate those dealing in formerly exempted securities. H.R. REP. No. 258, 99th Cong., 1st Sess. 46 (1985).

147. The five cases where the court has used support from the public interest are: SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Tcherepnin v. Knight, 389 U.S. 332 (1967); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985); and Reves v. Ernst & Young, 110 S. Ct. 945 (1990). *Joiner* and *Howey* were unsuitable for the public interest test because the instruments offered in those cases were unique to the issuers (though the buyers were not unique); SEC v. Howey, 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943); see FitzGibbon, *supra* note 23, at 912-16 (recognizing that congress was concerned with financial markets when it adopted Securities Acts).
V. AN OBJECT LESSON

The story of IP's and SPDR's provides an opportunity to consider the limitations of the traditional coverage analysis and to assess the new analysis. In the IP case, Judge Easterbrook began by finding that IP's could be considered securities under the statutory language that includes "any . . . privilege on any . . . index of securities (including any interest . . . based on the value thereof)" and "in general, any instrument commonly known as a "security" . . . ." He rejected the argument that IP's are "stock" because they do not represent an equity interest in anything. Similarly, he found that an IP is not a 'certificate of interest or participation in . . . any of the foregoing' because it represents a value based on something but not in something.

He also found that IP's could be futures because they require the short to pay a value to be fixed at a date in the future and may be settled by entering into offsetting obligations. Judge Easterbrook conceded that IP's do not possess every characteristic of traditional futures contracts, such as indefinite duration and bilateralism. He concluded that IP's have characteristics of both securities and futures, noting that they were designed to do so.

After a brief excursus into administrative law, Judge Easterbrook decided that administrative principles of deference do not provide a solution to this quandary because both the SEC and the CFTC are arguably entitled to deference on the scope of a statute they administer. Following the hierarchy set out in the Exchange Act and the Commodity Exchange Act (CEA), Judge Easterbrook concluded that if an instrument is a future, the CFTC's jurisdiction is exclusive.

Finally, Judge Easterbrook declined to look to the purposes of the Exchange Act or the CEA in deciding whether IP's are covered by the securities laws. First, he concluded that both Acts define their coverage by the attributes of the instruments rather than the persons involved. He then noted that although the Supreme Court has sometimes looked at legislative purpose in securities coverage cases, doing so in this case did not support securities coverage. Rather, he posited an IP based upon a

149. Id.
150. Id.
151. Id. at 545-46.
152. Id.
153. Id. at 546.
154. The Commodities Futures Trading Commission participated in the case only as amicus curie, id. at 539, perhaps raising an issue of whether the court had a second agency to defer to.
155. Id.
156. Id. at 549 (citing Landreth). This is certainly a narrow reading of Landreth and one that was repudiated in Reves, if not by Landreth itself.
157. Id.
commodities index rather than a stock index. In such an instance, the CFTC
should be the regulator; by extension, the CFTC should regulate IPs.\textsuperscript{158}

In looking at Judge Easterbrook's opinion under the traditional analysis,
the point is not so much that he is wrong (although he may be),\textsuperscript{159} but that
the current analysis, even skillfully applied, is inadequate to provide a
relatively determinate result.

Some IP purchasers would have been unsophisticated individuals. Others
would have been sophisticated individuals; still others institutional investors.
A part of the SEC's concern in approving IPs was that they would have
been marketed to individual investors.\textsuperscript{160} The Commission took pains to
ensure that such investors would have been protected.\textsuperscript{161} Under the tradi-
tional analysis, IP purchasers would have been investors in securities who
expected the securities laws to apply and therefore needed the protection of
those laws.

The traditional analysis also does nothing to resolve the question of
securities laws coverage in the face of a competing regulatory scheme. The
Court in \textit{Weaver} simply noted the federal insurance aspect of certificates
deposit and held that the securities laws did not apply, even though
securities were involved. \textit{Daniel} relied on ERISA as an alternative ground
for holding that the instrument was not a security. The \textit{Reves} case (decided
after \textit{Chicago Mercantile Exchange}) characterized the test as being whether
the other regulatory scheme reduces the risk of the instrument such that
securities law protection is unnecessary. Both the FDIC and ERISA provi-
sions reduce risk. The CEA and the CFTC would have done nothing to
reduce the risk of IPs; they would have provided an alternative regulatory
body, if desired. In sum, considering investor protection simply does not
help much in deciding whether IPs should have been covered by the securities
laws. It does not help at all in deciding whether the securities laws should
have applied in the face of the CEA.

Applying the public interest test to IPs yields a more rational analysis
and may result in a finding that the securities laws should govern. First,
IPS would have helped the trading markets financially by adding to liquidity,
allowing for risk allocation, and reducing volatility.\textsuperscript{162} This test supports

\textsuperscript{158} \textit{Id.} at 549-50.

\textsuperscript{159} First, Judge Easterbrook glosses over other categories in the definition of security
that might fit IPs, such as receipt for the interests, certificate of deposit for a security, and
investment contract. \textit{Index Participation Rule Change, supra} note 5, at 15,285 n.47. Second,
the Commission made a strong case that an instrument that lacks futurity is not a future. \textit{Id.}
at 15,286-89. Third, Judge Easterbrook may be misreading the statutes in holding that if IPs
are partially futures they are futures for purposes of the Commodity Exchange Act and
therefore subject to the exclusive jurisdiction of the CFTC. Perhaps Congress meant the
categories to be mutually exclusive. In other words, perhaps the question is not whether IPs
are partly futures, but whether they are more future than security. \textit{See also supra} note 156.

\textsuperscript{160} So called "retail" investors. \textit{See Index Participation Rule Change, supra} note 5, at
15,286-89.

\textsuperscript{161} \textit{Id.} at 15,292.

\textsuperscript{162} \textit{Id.} at 15,290.
coverage. Second, capital formation would not have been fostered because no capital would have passed to an issuer to be used for production of goods and services. As Judge Easterbrook notes, IPs are not interests in anything. This test, then, militates against securities coverage.

Third, instruments similar to IPs were and are being traded abroad. American markets have lost capital by not offering IPs. Judge Easterbrook admitted as much but held that consideration irrelevant under the traditional coverage analysis. Regulation would have ensured that IPs were offered and would thus have helped to attract and retain capital in the American markets.

Market regulation reasons also support securities coverage for IPs. Without coverage they would either have been unregulated or regulated by the CFTC. Because IPs were in many ways functionally equivalent to stock index futures (regulated by the CFTC), the danger of disparate regulation existed. Looking first to whether the CFTC or the SEC would have been the better regulator, virtually all commentators agree that the SEC is better. Second, unlike ERISA or the FDIA, the CEA does not reduce the risk of instruments under its regulation. The presence of the CFTC, then, would not have reduced the risks that the securities laws were designed to prevent.

Considering the question of market integrity, securities coverage of IPs would have fostered antimanipulation goals. Market participants could not have taken advantage of a lack of regulation to manipulate IPs by, for example, frontrunning customer orders. As the regulatory scandals involving the futures markets attest, the CFTC is not superior to the SEC in maintaining market integrity.

Turning to the question of the financial oversight of market participants, the SEC, in its release approving IPs spelled out the controls it would have

163. See Kevin G. Salwen & William Power, After-Hours Big Board Trading: How It Will Work, WALL ST. J., May 22, 1991, at C1, C19 ("Basket trades [at least 15 stocks] are a main reason the Big Board is getting into this after-hours game. . . . Large investors often take their trades to London, where they can trade cheaply and with more anonymity than in New York. But the Big Board wants their business back, so it has set aside a session just for them").

164. Chiappinelli, supra note 87, at 172. In 1989, a federal undercover investigation of widespread trading fraud led to 48 indictments on the two largest exchanges regulated by the CFTC. The indictments led critics to "wonder just what the watchdog was watching." Kevin G. Salwen, SEC Seeking Hostile Takeover of CFTC's Power to Regulate Financial Markets, Is Favored to Win, WALL ST. J., Apr. 20, 1990, at A16; see also Foust, supra note 122, at 43 (referring to "notoriously lax CFTC"); McMurray, supra note 122, at C1 (pointing out that CFTC is "widely viewed as less stringent than SEC"); Salwen & McMurray, supra note 121, at C1 (noting that Chicago exchanges have long been perceived as being weaker in policing than are stock exchanges).


166. A broker-dealer frontruns when he or she trades in advance of, and with knowledge of, an impending customer order that is expected to change the market price.

167. Salwen, supra note 164, at A16.
placed upon IPs and traders to ensure that neither the market participants trading IPs nor the clearing and settlement participants exposed themselves to excessive or unmonitored financial risk. Because most, if not all, of the traders and intermediaries of IPs would have been registered broker-dealers already subject to SEC oversight, this criterion suggests that securities coverage be extended to IPs as well.

Applying the traditional analysis to SPDRs is straightforward. Although the statute does not expressly define interests in trusts as securities, a SPDR is surely a “certificate of interest or participation in” a security. Section 2(2) of the Securities Act provides further evidence by defining “person” to include a trust only where the interests in the trust are evidenced by a security. SPDRs probably also fall within the definition of an investment contract under Howey. Unlike IPs, SPDRs have no element of futurity because the purchase or sale is completed in the present and the buyer and seller have no further obligations to one another. SPDRs are, then, surely not subject to being labeled futures. Because SPDRs are to be sold to individual investors, and no other regulatory scheme would reduce the risk of SPDRs, the protection of investors would require that they be covered by the securities acts.

The public interest definition of a security would apply to SPDRs as it did to IPs except that the CEA does not provide an alternative regulator to balance against the regulation by the SEC. Under this test, the American markets would obviously benefit from regulating SPDRs as securities.

Comparing IPs and SPDRs under both analyses points out the problems with the traditional test for securities coverage that were illustrated in Chicago Mercantile Exchange. A vehicle that allows individuals to invest easily in the S&P 500 index should have been available in 1989. The costs incurred because of the delay can be described in several ways. First are the transactional costs of the American Stock Exchange and others in developing and defending IPs and SPDRs; costs that could have been greatly reduced. Second is the administrative and judicial time spent in analyzing IPs and, presumably, SPDRs. Third, investors, market participants, and intermediaries have been damaged by the delay in introducing either IPs or SPDRs; all these groups lost profits by being unable to trade in the new instruments. Fourth, the American trading markets were less efficient than they otherwise would have been because investors were denied an easy way to invest in the S&P 500. Finally, those markets were harmed because the functional equivalent of IPs has been traded abroad. All these costs would have been avoided or reduced had the public interest definition been applied to IPs in 1989.

168. Index Participation Rule Change, supra note 5, at 15,292-93.
169. 2 Loss & Seligman, supra note 23, at 1060-64.
170. That is, they are an investment in a common enterprise with a reasonable expectation of profit to be derived from the entrepreneurial or managerial efforts of others. See supra notes 40-42 and accompanying text.
As this exercise in analysis shows, two fundamental dangers exist in ignoring the public interest when determining the scope of securities laws coverage. First, and more importantly, ignoring the public interest leaves the capital markets at risk. That risk is both financial and regulatory. Further, the ability of American capital markets to attract and retain capital against increasing competition from foreign markets is undercut by ignoring the public interest when determining securities coverage. Second, the traditional calculus is not useful in predicting whether coverage will be imposed and it effects only part of Congress's intention in enacting the securities laws.

VI. CONCLUSION

The traditional analysis of securities laws coverage is simply inadequate when applied to many new investment vehicles. The IP and SPDR story is an example of the problems created by continuing to hew to the existing criteria. Courts need to consider the larger, national implications of securities coverage. The implications involve improving the capital markets, American competitiveness in world financial markets, and market regulation. Ignoring these concerns can only make the question of coverage more indeterminate and can only hurt the American securities markets and in the end the American economy as a whole.