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Superior Supererogation: Why Credit Default Swaps Are Securities Under the Investment Advisers Act of 1940

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SUPERIOR SUPEREROGATION: WHY CREDIT DEFAULT SWAPS ARE SECURITIES UNDER THE INVESTMENT ADVISERS ACT OF 1940

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INTRODUCTION

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act [H.R. 4173] ("The Act" or "Dodd-Frank").[1] The Act became effective July 22, 2010.[2] In the wake of the worst financial crisis since the Great Depression, Congress sought to reform the regulatory environment of U.S. financial markets.[3] The Act, among other things, amended the most fundamental term in all of securities law, the definition of "security."[4] However, with respect to security-based swaps, Dodd-Frank only amended the definition of "security" under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").[5] By inserting the term "security-based swap" into each statute's definition, Congress unambiguously brought credit default swaps under their regulatory regimes.[6] Yet, Congress did not amend the Investment Advisers Act of 1940 ("Advisers Act") to include the term "security-based swap," nor did it similarly amend the Investment Company Act of 1940.[7] Thus, whether a credit default swap based on an underlying debt security is itself a "security" for purposes of these latter statutes remains an open question. Accordingly, this Article explores the application of the definition of "security" in the Advisers Act to such swaps by: (1) investigating the role the definition of "security" plays in the definition of "investment adviser" and subsequent application of section 206 of the Advisers Act; (2) examining possible textual bases for concluding that credit default swaps are "securities" under the Advisers Act; and (3) arguing why clearer Congressional intent is not necessary to define a credit default swap as a "security" under the Advisers Act.

I. BACKGROUND

The Supreme Court long ago held that, under the Advisers Act, an investment adviser is a fiduciary.[8] The purpose of the Advisers Act, among other things, "was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business

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

[2] *Id.*

[3] *Id.*

[4] *Id.* §§ 761(a)(2), 768(a)(1).

[5] *Id.*

[6] *Id.*

[7] *Id.* §§ 769–770.

[8] *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194 (1963).

ethics in the securities industry."[9] In promulgating the Advisers Act, Congress found that "investment advisers could not completely perform their basic function—furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments—unless all conflicts of interest between the investment counsel and the client were removed."[10] Accordingly, the more specific purpose of the Advisers Act was to prohibit any practice that operates as a fraud or deceit upon any client or prospective client, and to eliminate conflicts of interest between the investment adviser and the client.[11] To enforce this tenet, Congress provided the U.S. Securities & Exchange Commission ("SEC," "Agency," or "Commission") with section 206 of the Advisers Act, the central antifraud provision of the statute.[12] However, section 206 is inapposite if there is no jurisdictional basis for its invocation. Accordingly, the remainder of this Article seeks to address this jurisdictional question by exploring whether a person is subject to section 206 of the Advisers Act if he or she solely renders advice regarding credit default swaps.

To charge a firm with violating section 206 of the Advisers Act, it must meet the definition of "investment adviser."[13] Section 206 states that "it shall be unlawful for any investment adviser" to engage in the transactions described in section 206(1)–(4), which establishes that being an investment adviser is a condition precedent to violating section 206.[14] An investment adviser is:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities ….[15]

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[9] *Id.* at 186.

[10] *Id.* at 187 (quoting H.R. Doc. No. 76-477, at 28 (1939) (internal quotation marks omitted)).

[11] *See id.* at 191–92.

[12] Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2012).

[13] *Id.*

[14] *Id.*

[15] 15 U.S.C. § 80b-2(a)(11) (2012). Though not relevant here, the Act makes certain exclusions from the definition of "investment adviser." In general, and subject to certain conditions, any bank, bank holding company, lawyer, accountant, engineer, teacher, broker-dealer, publisher, adviser with respect to government guaranteed securities, nationally recognized statistical rating organization, family office, or such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order, are excluded from the definition. *See id.* § 80b-2(a)(11)(A)–(H).

Accordingly, a firm would meet the definition of "investment adviser" if it: (1) was engaged in the business of advising others; (2) on securities; and (3) was compensated for such advice. Since the financial crisis of 2008,[16] the SEC has investigated firms that design and execute an investment strategy on behalf of a pooled investment vehicle, the main purpose of which is to purchase or sell credit default swaps ("CDSs").[17] In exchange for executing this investment strategy, the fund pays the firm a management fee based on total assets under management.[18] The key fact pattern at issue here is one where, besides the CDSs, the firm is not engaged in advising the fund on any other financial instrument. Under these facts, firms are receiving fee-based compensation for being engaged in the business of advising funds on selling CDSs. Thus, they have satisfied the business and compensation elements of the definition of "investment adviser." Therefore, whether such a firm meets the definition of "investment adviser" turns upon whether the CDSs in question meet the definition of "security" under section 202(a)(18) of the Advisers Act.

Whether a CDS meets the definition of "security" under the Advisers Act is a novel question of law. The term "credit default swap" does not appear in the definition of "security" under the Advisers Act:

> "Security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing.[19]

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[16] Also known as the "Great Recession." *See* Stanley Fischer, Vice Chairman, Fed. Reserve Bd., Testimony at a Conference Sponsored by the Swedish Ministry of Finance, Stockholm, Sweden, The Great Recession: Moving Ahead (Aug. 11, 2014).

[17] *See, e.g.*, *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 9493, 2013 WL 6503674 (Dec. 12, 2013); *In re* UBS Securities LLC, Exchange Act Release No. 3643, 2013 WL 3992459 (Aug. 6, 2013).

[18] SEC, *Investment Advisors: What You Need to Know Before Choosing One*, http://www.sec.gov/investor/pubs/invadvisers.htm (last visited Nov. 19, 2014).

[19] 15 U.S.C. § 80b-2(a)(18).

A CDS is a credit derivative,[20] and more specifically, it is a type of swap. Unlike some other terms commonly associated with derivatives regulated by the SEC, such as put, call, straddle, option, and privilege, the term "swap" does not appear in the Advisers Act's definition of "security," despite its inclusion in the Securities Act and the Exchange Act.[21] Moreover, federal courts have not addressed the status of CDSs as securities under the Advisers Act in any significant way. Thus, jurists must interpret the text of section 202(a)(18).

II. ANALYSIS

Certain CDSs are "securities" within the meaning of section 202(a)(18) of the Advisers Act.[22] In every case involving construction of a statute, the starting point is the language itself.[23] Accordingly, there are two theories rooted in the text of section 202(a)(18) which support defining certain CDSs as "securities." First, CDSs are the equivalent of an option, and are thus covered by the options language of the statute.[24] Alternatively, CDSs are evidences of indebtedness.[25] Both theories have their merits and are analyzed below.

A. Options Clause

Most convincingly, Congress has adopted the position that a security-based CDS is the equivalent of an option, and is therefore a security by virtue of the options language contained in section 202(a)(18) of the Advisers Act. The definition of "security" in the Advisers Act is unambiguous and contains the following "derivatives clause"[26]: "'Security' means any ... put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof) …."[27]

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[20] JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 86–87 (Vicki Been et al. eds., 6th ed. 2009).

[21] *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2012).

[22] *See* 15 U.S.C. § 80b-2(a)(18).

[23] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring).

[24] *See infra* Part II.A.

[25] *See infra* Part II.B.

[26] It does not appear that any other authority refers to this clause as the "derivatives clause" or "options clause." *See generally* An Act to Clarify the Jurisdiction of the Securities and Exchange Commission and the Definition of Security, Pub. L. No. 97-303, 96 Stat. 1409 (1982); *see also* H.R. REP. NO. 97-626(I) (1982), *reprinted in* 1982 U.S.C.C.A.N. 2780; H.R. REP. NO. 97-626(II) (1982), *reprinted in* 1982 U.S.C.C.A.N. 2792.

[27] 15 U.S.C. § 80b-2(a)(18).

Significantly, when Congress passed Dodd-Frank, it adopted the position that swaps, including CDSs, are the equivalent of options:

> In general ... the term "swap" means any agreement, contract, or transaction ... that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more ... securities ... including any agreement, contract, or transaction commonly known as ... a credit default swap.[28]

Furthermore, the Advisers Act incorporates this definition by reference in section 202(a)(29)[29] of the Advisers Act.[30] Thus, Congress believes that security-based CDSs are the equivalent of security-based options, and because it is well settled that the latter is a "security," so too is the former.

To explain further, the options clause was inserted into the federal securities laws to clarify, inter alia, the SEC's plenary jurisdiction over security-based options.[31] On this point, the Second Circuit has held that options on underlying securities are themselves securities.[32] Thus, since Dodd-Frank clarified that CDSs were a specialized type of option, a security-based CDS is a security-based option and therefore a security.

What is more, the same argument can be articulated in a slightly different way: a CDS is a derivative. As discussed above, the term option appears in what can be said to be the derivatives clause of the definition of "security." Derivatives may be traded on an exchange ("exchange traded") or negotiated between private parties ("over the counter" or "OTC").[33] Depending on the underlying asset, some derivatives meet the definition of "security." Thus, they are "covered derivatives."[34] Covered derivatives are financial instruments that derive value from the securities on which they are based.[35]

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[28] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 721(a)(21), 124 Stat. 1376 (2010); 7 U.S.C. § 1a(47) (2012); *see also* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999). *Cf.* 7 U.S.C. § 1a(47)(B)(x) (2012) (excluding security-based swaps from the definition of "swap").

[29] The Advisers Act contains a scrivener's error where a second subparagraph (29) appears after subparagraph (30) instead of being codified as subparagraph (31). *See* 15 U.S.C. § 80b-2(a)(29) (2012).

[30] *See also* 15 U.S.C. §§ 77b(a)(17), 78c(a)(69), 80a-2(54) (2012).

[31] *See* An Act to Clarify the Jurisdiction of the Securities and Exchange Commission and the Definition of Security, Pub. L. No. 97-303, 96 Stat. 1409 (1982); *see also* H.R. REP. NO. 97-626(I) (1982), *reprinted in* 1982 U.S.C.C.A.N. 2780; H.R. REP. NO. 97-626(II) (1982), *reprinted in* 1982 U.S.C.C.A.N. 2792.

[32] *See* Caiola v. Citibank, N.A., N.Y., 295 F.3d 312, 325–27 (2d Cir. 2002).

[33] COX ET AL., *supra* note 20, at 80.

[34] The term "covered derivatives" is used to identify those derivatives under the jurisdiction of the federal securities laws.

[35] *See* Use of Derivatives by Registered Investment Companies, Release No. 29776, 101 SEC Docket 3523, 2011 WL 3855065 at *2 & n.3 (2011) (concept release) ("Derivatives

The underlying asset may be a particular stock, a stock index, or a fixed-income security such as a bond.[36] Derivatives provide opportunities to speculate in the financial markets, as well as to hedge a position in the underlying asset.[37] For example, stock options are derivatives.[38] An option contract on stock is also a "security."[39] Hence, a stock option is a covered derivative.

A swap is another type of derivative.[40] It is a negotiated arrangement between two parties in which each promises to make a payment to the other, with the payments occurring at different times and determined under different formulas.[41] As mentioned above, the underlying asset of a derivative may be a fixed-income security.[42] These instruments are credit derivatives.[43] The CDS is the most common type of credit derivative.[44] Simply put, "the credit default swap is an unregulated form of insurance against default."[45] The buyer of the contract is seeking credit protection against a fixed-income security, typically a bond.[46] This protection is provided by the seller of the swap.[47] The seller is known as the long counterparty, and the buyer is known as the short counterparty.[48] The arrangement enables the buyer of a swap contract to transfer the risk of default on the bond to the seller of the swap contract.[49] Finally, the short counterparty is not required to hold the underlying referenced asset; that is, the short counterparty can take a synthetic position on the underlying asset.[50] Thus, a security-based CDS is a "security"

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may be broadly described as instruments or contracts whose value is based upon, or derived from, some other asset or metric (referred to as the 'underlier,' 'underlying,' or 'reference asset')."); *see also id.* at *6 & n.41.

[36] COX ET AL., *supra* note 20, at 80.

[37] *Id.*

[38] *Id.*; *see also* Caiola v. Citibank, N.A., N.Y., 295 F.3d 312, 324–27 (2d Cir. 2002) (holding that options and synthetic options are securities when their value is derived from an underlying security).

[39] COX ET AL., *supra* note 20, at 80.

[40] *Id.*

[41] *Id.* Swap payments are calculated on the basis of hypothetical quantities of the underlying asset referred to as "notionals." *Id.* at 81 (quoting Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 46–47 (1996)).

[42] *Id*. at 80.

[43] Release No. 29776, *supra* note 35, at *6 & n.41.

[44] COX ET AL., *supra* note 20, at 87 (recognizing that swaps were not securities with respect to registration and reporting requirements, but stating significant reforms will likely lead to redefining credit default swaps as securities under all provisions of the securities laws).

[45] *Id.* at 86.

[46] *Id.*

[47] *Id.*

[48] *Id.* at 81.

[49] *Id.* at 86.

[50] *Id.* at 81.

within the meaning of the derivatives clause because it is, at the very least, a "privilege" deriving its value from a security.

Two cogent arguments flow from the same clause in section 202(a)(18) of the Advisers Act, each leading to the same conclusion: a CDS is structured as a derivative.[51] As noted above, certain CDSs can be security-based.[52] It is well understood that when a derivative is based on an underlying security, that is, based on the value thereof, the derivative itself is a security. As stated in *Caiola v. Citibank, N.A., N.Y.*, options on underlying securities are themselves securities.[53] Further, *Caiola* stands for the broader proposition that synthetic positions based on securities are themselves securities.[54]

Even without Dodd-Frank's clarification of the swap definition, the options clause is a sufficient textual basis for defining security-based CDSs as securities because they are the economic equivalent of an option. When searching for the meaning and scope of the word "security," the emphasis should be on economic reality.[55] This conclusion is significant for two reasons. First, the Commission may be compelled to take a position on pre-Dodd-Frank conduct. Second, it applies a consistent ex ante and ex post interpretation of the options clause relative to the passage of Dodd-Frank.

More than being the economic equivalent of an option, CDSs are the economic equivalent of a put. Recall that section 202(a)(18) states that the term "security" includes "any put" based on the value of a security.[56] The holder of a put contract has the right to receive a contractually agreed upon amount as long as the underlying security's value falls below the strike price.[57] Similarly, the holder of a CDS has the right to receive the par value of the referenced debt security on the occurrence of a negative credit event.[58] Typically, such a credit event is default. Default has the obvious effect of driving a bond's value to zero. In both instances, the holder of the contract has essentially purchased protection against a decline in the value of the underlying asset. In the first instance, it is well understood that the

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[51] COX ET AL., *supra* note 20, at 86.

[52] *See infra* Part II.A.

[53] *See* 295 F.3d 312, 325–27 (2d Cir. 2002).

[54] *Id.* at 315–16 ("A synthetic transaction is typically a contractual agreement between two counterparties, usually an investor and a bank, that seeks to economically replicate the ownership and physical trading of shares and options.").

[55] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848 (1975) (quoting Tcherepnin v. Knight, 389 U.S. 332, 336 (1967)).

[56] 15 U.S.C. § 80b-2(a)(18) (2012).

[57] *Understanding Stock Options* at 6, CHICAGO BOARD OPTIONS EXCHANGE, http://www.cboe.com/learncenter/pdf/understanding.pdf (last visited Nov. 19, 2014).

[58] Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 729 (2008).

put contract is a security.[59] In the latter, the economics are no different, and it is well settled that courts will look through form to substance to find a security.[60] Furthermore, some master agreements treat separate CDS transactions as a series of annually settled contingent put options issued by the seller to the buyer, a contractual representation in harmony with the economic reality of the instrument itself.[61] Thus, a security-based CDS is a security by virtue of the derivatives clause.

At bottom, Congress found in section 721 of Dodd-Frank that CDSs are options.[62] Therefore, when CDSs are security-based, they are the economic and statutory equivalent of security-based options. Moreover, in 1982, Congress inserted the options clause in the Advisers Act, making it clear that security-based options were securities and subject to the SEC's jurisdiction.[63] Thus, security-based CDSs are securities by virtue of the derivatives clause.

B. *Evidence of Indebtedness*

Alternatively, it may be perfectly reasonable to argue that a CDS is an evidence of indebtedness. An "evidence of indebtedness" is "an obligation to pay in the future for consideration presently received," and the term is not "limited to notes or other acknowledgment of debt."[64] In a swap,[65] each party agrees to pay an amount in the future in exchange for the other party's

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[59] *See, e.g.*, *id.* at 729–32; *see generally* Caiola v. Citibank, N.A., 295 F.3d 312 (2d Cir. 2002).

[60] *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1945); Reves v. Ernst & Young, 494 U.S. 56, 63 n.2 (1990) (embracing economic reality); *Caiola*, 295 F.3d at 325–26.

[61] In practice, this author has reviewed documents between counterparties that were based on swap contracts published by the International Swap Dealers Association. These contracts represented the credit default swaps as "put options." Thus, if market participants consider security-based credit default swaps to be options, then, in the absence of clear Congressional intent, so should the courts and the SEC.

[62] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 721(a)(47), 124 Stat. 1376, 1666 (2010) § 721(a)(47).

[63] 15 U.S.C. § 80b–2(a)(18) (2012).

[64] Investment Company Act Release No. 10,666, 44 Fed. Reg. 25,128 (Apr. 27, 1979) (to be codified at 17 C.F.R. pt. 271) (discussing the status of reverse repurchase agreements, firm commitment agreements, and standby commitment agreements as "senior securities" under section 18 of the Investment Company Act. Although Release No. 10,666 limits its evidence of indebtedness conclusions to section 18, it defines the term "evidence of indebtedness" under section 2(a)(36). *See also* Use of Derivatives by Registered Investment Companies, Release No. 29776, *supra* note 35, at *20 & n.57 (Aug. 31, 2011) (to be codified at 17 C.F.R. pt. 271) (concept release).

[65] Here, the Article turns to using the broader term "swap" in lieu of "credit default swap" as a matter of doctrinal discretion and soundness.

promise to pay another amount in the future.[66] Each party's promise to pay is legally enforceable under the written agreement between the parties.[67] A swap, therefore, falls within the meaning of an evidence of indebtedness and would therefore be a "security" under the Advisers Act.[68]

Although the evidence of indebtedness theory would apply to all swaps regardless of their underlying references, it is important to note that the theory is doctrinally cabined to security-based swaps. Like options, CDSs can be security-based and nonsecurity-based. Accordingly, the analytical approach must be faithful to the jurisdictional divide between the SEC and the Commodity Futures Trading Commission (CFTC) intended by Congress.[69]

To determine whether an evidence of indebtedness is a security, it should be evaluated under the *Reves* test.[70] In 1990 the Supreme Court adopted the four-factor family resemblance test to judge whether notes are securities.[71] First, if the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments, and the buyer is interested primarily in the profit the instrument is expected to generate, the instrument is likely to be a "security."[72] Second, if the instrument is one in which there is common trading for speculation or investment, the instrument is likely to be a "security."[73] Third, if the investing public reasonably expects the instrument to be a security, the instrument is likely to be a "security."[74] Finally, if there is no other alternate regulatory regime that significantly reduces the risk of the instrument, the instrument is likely to be a "security."[75]

First, consider a security-based swap. Such a swap would be a security because: (1) the sellers use the proceeds for general business purposes and the buyers expect to profit from their purchase; (2) there is a market for investment and speculation in security-based swaps; (3) as with options, the investing

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[66] COX ET AL., *supra* note 20, at 80.

[67] *Id.*

[68] Investment Company Act Release No. 10,666, *supra* note 64, at 128–31 (saying that a swap is structurally the equivalent of two related forward contracts). Additionally, Release No. 10,666 and 29,776 were both written with respect to the Investment Company Act of 1940. Here, the analysis is being penned with respect to the Advisers Act, but would likely be just as applicable to the Investment Company Act.

[69] *See* Further Definition of Swap, Securities Act Release No. 33-9338, Exchange Act Release No. 34-67, 453, 2012 WL 2927796 (July 18, 2012); *see generally*, Dodd-Frank Wall Street Reform and Consumer Protection Act, tit. VII, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010), 15 U.S.C. § 78o (2012).

[70] *See* Aiena v. Olsen, 69 F. Supp. 2d 521, 534 (S.D.N.Y. 1999).

[71] *See* Reves v. Ernst & Young, 494 U.S. 56, 67 (1990) (interpreting the Exchange Act).

[72] *See id*. at 66–67.

[73] *See id*. at 66.

[74] *See id*. at 66–67.

[75] *See id*. at 67.

public would reasonably expect that a swap based on a security is itself a security; and (4) there is no other regulatory regime which significantly reduces the risk associated with a security-based swap.[76] Thus, a security-based swap, as evidence of indebtedness, is a security.

On the other hand, the Commission would not be able to extend its jurisdiction to nonsecurity-based swaps even though they would still be evidences of indebtedness.[77] If there is no other alternate regulatory regime that significantly reduces the risk of the instrument, the instrument is likely to be a "security."[78] Essentially, the question is whether there is a regulatory void with respect to nonsecurity-based CDSs. Courts tend to allow an agency to fill statutory voids, but where there is none, the agency may go out to the four corners of the statute and no further.[79] One of the benefits of the evidence of indebtedness analysis is that it would be applicable to all credit default swaps without regard to the referenced asset; that is, it would sweep in nonsecurity-based CDSs. Nevertheless, there is an alternative regulatory framework under the CFTC's jurisdiction to deal with all nonsecurity-based CDSs.[80] Accordingly, the broad definition of "swap" in the Commodity Exchange Act brings all nonsecurity-based swaps under the CFTC's jurisdiction.[81] Thus, the fourth *Reves* factor is a dispositive limitation on the evidence of indebtedness theory, cabining the SEC's jurisdiction to security-based swaps with respect to the Advisers Act.[82]

C. Statutory Construction

Certainly, if Congress's intent is clear, then there is no need to engage in elaborate textual analysis to determine whether a CDS is a security under the Advisers Act. If Congress stated that security-based swaps were securities by inserting "security-based swap" in the definition of "security" in the federal securities laws, then there would not be a need for scholarship on the issue. However, Congress did insert "security-based swap" in the definition of "security," but only in the Securities Act and the Exchange Act.[83]

[76] Applying the *Reves* test to security based swaps.

[77] *See* Securities Act Release No. 33-9338, *supra* note 69.

[78] *See Reves*, 494 U.S. at 67.

[79] *See* Local 705, Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 569–70 (1979).

[80] *See* 7 U.S.C. §§ 1(a)(9)–(12), (47) (2012); *see also* Commodity Futures Trade Commission, Exchange Act Release No. 33-9338 at 85 (July 18, 2012).

[81] *See* 7 U.S.C. § 1(a)(47).

[82] This analysis may be just as applicable to the Investment Company Act.

[83] *See* Securities Act of 1933, ch. 38, tit. I, § 768(a)(1), 48 Stat. 74 (codified as amended at 15 U.S.C.A. § 77b(a)(1) (West 2014)); Securities Exchange Act of 1934, ch. 404, tit. I,

Curiously, Congress chose not to insert "security-based swap" in section 202(a)(18) of the Advisers Act, nor did it insert the term in section 2(a)(36) of the Investment Company Act of 1940.[84] Some commenters may point to this fact as an intentional omission, arguing that when Congress had the chance in Dodd-Frank to amend the Advisers Act and the Investment Company Act, it chose not to because Congress did not believe security-based swaps, such as CDSs, should be "securities" under these statutes. This argument lacks an appreciation of history.

Where the meaning of a statute is in doubt, similar statutes may be construed in light of one another under the canon of statutory construction, *in pari materia*.[85] "[A]ll acts in pari materia are to be taken together, as if they were one law."[86] "Statutes are considered to be in pari materia when they relate to the same person or thing, to the same class of persons or things, or have the same purpose or object."[87] In short, statutes are considered *in pari materia* when they deal with precisely the same subject matter.[88] However, "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[89]

Generally, the federal securities statutes were enacted for the same fundamental purpose, to promote the highest standard of ethics in the securities industry.[90] Yet, certain provisions, though similar across the securities statutes, serve different purposes. The precise purpose of the definition of "security" in the Advisers Act is to determine when a person or entity meets the definition of "investment adviser," and is thereby subject to the act's jurisdiction.[91] Significantly, a unique purpose of the act was to impose a federal fiduciary duty on investment advisers.[92] Thus, the purpose of the definition

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§ 3(a)(10), 48 Stat. 881 (codified as amended at 15 U.S.C.A. § 78b(a)(10) (West 2014)) ("security" defined, in part, as a "security-based swap").

[84] *See* Investment Advisers Act of 1940, ch. 686, tit. II, § 202(a)(18), 54 Stat. 847 (codified as amended at 15 U.S.C.A. § 80b-2(a)(18) (West 2014)); Investment Company Act of 1940, ch. 686, tit. I, § 2(a)(36), 54 Stat. 789 (codified as amended at 15 U.S.C.A. § 80a-2(a)(36) (West 2014)).

[85] United States v. Stewart, 311 U.S. 60, 64 (1940); *see also* United States v. Freeman, 44 U.S. 556 (1845).

[86] *Stewart*, 311 U.S. at 64.

[87] United States v. Graham, 622 F.3d 445, 466 (6th Cir. 2010); *see also* United States v. Carr, 880 F.2d 1550, 1553 (2d Cir. 1989).

[88] *See Stewart*, 311 U.S. at 64.

[89] Chevron v. NRDC, 467 U.S. 837, 842–43 & n.9 (1984).

[90] *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

[91] *See* Advisors Act, 15 U.S.C.A. § 80a-2(a)(11) (West 2014) (requiring that a person or entity must give advice with respect to a "security" to meet the definition of "investment adviser").

[92] *See Capital Gains*, 375 U.S. at 191–92.

of "security" under the Advisers Act is to determine when the fiduciary relationship created by the act should be imposed. By contrast, the same definition in the Securities Act and the Exchange Act determines when a financial instrument and its issuer is subject to the registration, reporting, and disclosure purposes of those statutes.[93] Because their definitions serve the same purpose, the courts read the Securities Act and the Exchange Act *in pari materia*.[94] However, section 202(a)(18) is not to be read *in pari materia* with section 2(a)(1)[95] and Section 3(a)(10) because it is unambiguous on its face and serves a different purpose.[96] Therefore, section 202(a)(18) is to be interpreted in isolation from the Securities Act and the Exchange Act.

D. *Supererogation*

The doctrine of supererogation supports the conclusion that a CDS is a security under the Advisers Act. Despite being very similar to the Advisers Act's definition, the Securities Act and the Exchange Act both now contain the term "security-based swap"[97] in their definitions of "security."[98] However, it was only recently that Congress amended these statutes to expressly include security-based swaps in their definitions of "security."[99] Significantly, from

[93] *See* SEC v. W. J. Howey Co., 328 U.S. 293, 298–99 (1946) (stating purpose of Securities Act); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (stating purpose of Exchange Act).

[94] *See* Ballard & Cordell Corp. v. Zoller & Danneberg Exploration Ltd., 544 F.2d 1059, 1066 (10th Cir. 1976); Axelrod & Co. v. Kordich, Victor & Neufeld, 451 F.2d 838, 843 (2d Cir. 1971); Brown v. Gilligan, Will & Co., 287 F. Supp. 766, 775 (S.D.N.Y. 1968); *see also* Marine Bank v. Weaver, 455 U.S. 551, 561 n.11 (1982) (reserving the question whether a financial instrument can be a security under the Investment Company Act of 1940 and not under the Securities Act or Exchange Act).

[95] Notably, because section 17(a) of the Securities Act and section 206 of the Advisers Act serve the same purpose of prohibiting fraud, they have been read *in pari materia*. *See* Steadman v. SEC, 603 F.2d 1126, 1143 (5th Cir. 1979).

[96] *See* SEC v. Gruss, 859 F. Supp. 2d 653, 662 (S.D.N.Y. 2012).

[97] Title III of the Commodity Futures Modernization Act of 2000 ("CFMA"), "Legal Certainty for Swap Agreements," § 301(a) added § 206A(a)(3) to the Gramm-Leach-Bliley Act ("GLBA"), which defined a CDS as a swap agreement. Section 301 went on to add § 206B to the GLBA, which defined a security-based swap agreement as a swap agreement whose value is based on an underlying security. Section 301(b) then states that the term "security" under subsection (a) had the same meaning as in the Securities Act and the Exchange Act. Therefore, security-based CDS is a security-based swap and these terms will be used interchangeably in this memo. *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, tit.3, § 301(a)–(b), 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1-27f (2012)); *see also* Securities Act Release No. 33-9338, *supra* note 69, at 220.

[98] *See* Securities Act of 1933, ch. 38, tit. I,, § 2(a)(1) (codified as amended at 15 U.S.C.A. § 77b(a)(1) (West 2014)); Securities Exchange Act of 1934, ch. 404, tit. I, § 3(a)(10), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78(b)(a)(10) (West 2014)).

[99] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, tit. VII, Pub. L. No. 111-203, §§ 761, 768, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

2000 to 2010, Congress exempted security-based swaps from the definition of "security" under the Securities Act and the Exchange Act.[100] Nevertheless, today, a CDS referencing an underlying security such as a residential mortgage-backed security would be a security-based swap for purposes of the Securities Act and the Exchange Act.[101]

Accordingly, this gives rise to a two part inquiry: (1) whether the exemption from 2000 to 2010 should be imputed to the Advisers Act for that same time period; and (2) whether the failure of Congress to amend the Advisers Act to include the term "security-based swap" precludes CDSs from meeting the definition of "security" under the statute. As explained below, both are answered in the negative.

Importantly, Congress never intended to limit the scope of the definition of "security" under the Advisers Act.[102] Rather, Congress exempted security-based swaps, and therefore security-based CDSs, from the definition of "security" under the Securities Act and the Exchange Act when it enacted the CFMA.[103] Yet, Congress expressly preserved the SEC's antifraud enforcement authority with respect to such swaps.[104] Significantly, Congress reserved the question of whether a swap is a "security" in the savings clause of section 304 of the CFMA, stating: "[n]othing in this Act or the amendments made by this Act shall be construed as finding or implying that any swap agreement is or is not a security for any purpose under the securities laws."[105]

Subsequently, Dodd-Frank unwound the CFMA's narrow exemption and added the term "security-based swap" in the definition of "security" in the Securities Act and the Exchange Act.[106] Additionally, the SEC issued a rule under the Securities Act and the Exchange Act, which defined security-based CDSs as securities.[107] Neither the CFMA nor Dodd-Frank affected

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[100] *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, app. E, tit.3, 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1-27f); *see also id*.

[101] *See* Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust, Securities Act Release No. 33-3892 (Jan. 31, 1958) (enumerating eleven factors to consider when determining whether a mortgage note is a security).

[102] *See* Advisors Act, 15 U.S.C.A. § 80a-2(a)(18) (West 2014).

[103] *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, app.E, tit.3, 114 Stat. 2763 (providing "Legal Certainty for Swap Agreements").

[104] *See* Caiola v. Citibank, N.A., N.Y., 295 F.3d 312, 327 (2d Cir. 2002).

[105] *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 § 304, 114 Stat. 2763.

[106] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, tit. VII, Pub. L. No. 111-203, §§ 761, 768, 124 Stat. 1376, 1871 (2010).

[107] *See* Securities Act Release No. 33-9338, *supra* note 69, at 220 (July 18, 2012).

the treatment of security-based swaps under the Advisers Act.[108] Given this legislative history, traditional canons of statutory construction should be used to construe the definition of "security" under the Advisers Act.

Fundamentally, when the CFMA exempted security-based swaps from the definition of "security" under the Securities Act and the Exchange Act, while simultaneously preserving the SEC's enforcement authority over such swaps, Congress only intended to exempt security-based swaps from the disclosure purposes of those acts.[109] Further, Congress punted the question of whether a security-based CDS is a "security" in the savings clause of the CFMA, leaving the Advisers Act free to interpret a security-based CDS as a "security."[110] Subsequently, when Dodd-Frank inserted the term "security-based swap" in section 2(a)(1) and section 3(a)(10), omitting the same in section 202(a)(18), it was an act of supererogation.[111] There already existed enough language in section 2(a)(1) and section 3(a)(10) to define a security-based CDS as a "security," through the derivatives clause.[112] In *Tcherepnin*, the Supreme Court found that omissions, such as not amending the Advisers Act to include "security-based swap," have no controlling significance.[113] Thus, with respect to the Advisers Act, it was unnecessary to put back what was never taken away. By altering the treatment of security-based swaps under the CFMA and Dodd-Frank, Congress did not intend to affect when a person or entity was subject to the fiduciary duties imposed on investment advisers.[114] Therefore, as stated above, we need only look to the text of section 202(a)(18) to find support for defining a security-based CDS as a security.

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[108] *Compare* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763, *with* 124 Stat. 1376, 1871.

[109] *See Caiola*, 295 F.3d at 327.

[110] *Compare* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 *with* 124 Stat. 1376, 1871.

[111] *See* Tcherepnin v. Knight, 389 U.S. 332, 342 n.30 (1967) ("the exemption from registration for insurance policies was clearly supererogation"); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 74 n.4 (1958) (Brennan, J., concurring).

[112] *See* Securities Act of 1933, 15 U.S.C.A. § 77b(a)(1) (West 2014); Securities Exchange Act of 1934, 15 U.S.C.A § 78b(a)(10) (West 2014).

[113] *See Tcherepnin*, 389 U.S. at 344.

[114] Where Congress inserts a provision in only one of two statutes that deal with a closely related subject, courts construe the omission as deliberate. *See In re* Fed. Mogul Global Inc., 684 F.3d 355, 373 (3d Cir. 2012) (stating that Congress acts intentionally and purposely in the disparate inclusion or exclusion). Additionally, because the purpose of an amendment is to change the act being amended, courts should pause before reading statutes *in pari materia* where an amendment is involved. *See* NORMAN J. SINGER & J.D. SHAMBIE SINGER, SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 51:3 (7th ed. 2012).

CONCLUSION

Whether a security-based CDS is a "security" under the Advisers Act is a novel question of law. As demonstrated, a security-based CDS is a "security" by virtue of the "options clause" or the "evidence of indebtedness" language of section 202(a)(18) of the Advisers Act. Furthermore, by appreciating the history of the Securities Act and the Exchange Act, the Supreme Court's doctrine of supererogation neatly justifies Congress' decision to pen "security-based swap" into those statutes' definition of "security." Thus, when a firm is engaged in the business of providing advice on security-based CDSs for compensation, it meets the definition of "investment adviser" under the Advisers Act.