Note

AT THE WATER'S HEDGE: INTERNATIONAL INSIDER-TRADING ENFORCEMENT AFTER *MORRISON*

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ABSTRACT

From copy rooms to boardrooms, many Americans have succumbed to the siren song of insider trading. As U.S. companies have gone international, so too have corporate secrets ripe for exploitation. With the growth of overseas derivatives based on U.S. stock, foreigners are able to engage in insider trading to a similar extent as Americans.

But in Morrison v. National Australia Bank*, the Supreme Court limited the reach of the statutory insider-trading prohibition to transactions taking place in U.S. territory or transactions in securities listed on U.S. exchanges. Neither condition applies to overseas insider trading using derivatives. However, courts have reasoned that when the trader's broker hedges by buying stock on a U.S. exchange, that transaction can be attributed to the trader, thus bringing the scheme within* Morrison.

This hedging theory depends on the acts of third parties—the brokers—to create insider-trading liability, thus giving arbitrary windfalls to blameworthy traders and creating both evidentiary and legal hurdles for U.S. enforcement. Because Morrison *has backed courts into this unworkable corner, it should not govern in insider-trading cases.*

There is a fix: the Dodd-Frank Wall Street Reform and Consumer Protection Act abrogated Morrison *for enforcement actions, albeit imperfectly. By abandoning the theory in favor of Dodd-Frank's pragmatic standard, courts can more nimbly and forcefully protect U.S. markets from foreign fraud.*

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INTRODUCTION

Insider trading is as close to a federal common-law offense as exists in the United States. No statute explicitly forbids trading on inside information.[1] Rather, the prohibition emerged organically; law enforcement theorized that insider trading was a species of fraud prohibited by the securities laws, and courts agreed.[2] This origin story seems as though it would invite concerns of both due process and separation of powers—people are being fined and imprisoned for conduct that Congress never explicitly made illegal. Despite notable skepticism of insider-trading doctrine in scholarship,[3] there is widespread agreement that insider trading is *malum in se*, unfair, and greedy.[4] The stereotypical inside trader is a white-collar professional.[5]

1. *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION 905 (8th ed. 2017) ("Congress has never defined with any degree of precision the nature of the insider trading prohibition.").

2. Thomas C. Newkirk & Melissa A. Robertson, U.S. SEC. & EXCH. COMM'N, Insider Trading—A U.S. Perspective, Remarks at the 16th International Symposium on Economic Crime (Sept. 19, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch221.htm [https://perma.cc/8GG8-LT47] ("While Congress gave us the mandate to protect investors and keep our markets free from fraud, it has been our jurists, albeit at the urging of the Commission and the United States Department of Justice, who have played the largest role in defining the law of insider trading.").

3. *See, e.g.*, John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 53 (arguing that issuer-sanctioned insider trading "does not cause identifiable economic harm and turns out to be permissible under both utilitarian and deontological moral theories").

4. *See* COX ET AL., *supra* note 1, at 905 ("[T]he attack against insider trading, a campaign for fair play in the stock markets, has had enduring political appeal."); Bruce W. Klaw, *Why Now Is the Time to Statutorily Ban Insider Trading Under the Equality of Access Theory*, 7 WM. & MARY BUS. L. REV. 275, 298 (2016) (arguing that insider trading is, inter alia, violative of the social contract); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 2 (1982) (noting "the strongly held intuition that insider trading is unfair"); Letters to the Editor, *Insider Trading's Cumulative Harm*, WASH. POST. (Aug. 14, 2018), https://www.washingtonpost.com/opinions/insider-tradings-cumulative-harm/2018/08/14/2cf939e0-9f1d-11e8-a3dd-2a1991f075d5_story.html?utm_term=.64650df203e0 [https://perma.cc/PE7Z-B4LL] (collecting critical reader responses to an op-ed suggesting that insider trading is a victimless crime); *cf.* Matt Levine, Opinion, *Insider Traders Made Some Easy Money on Stock Offerings*, BLOOMBERG (June 3, 2015), https://www.bloomberg.com/view/articles/2015-06-03/insider-traders-made-some-easy-money-on-stock-offerings [https://perma.cc/G7EA-WWFG] ("[P]eople think [insider trading] is illegal because it's unfair, but it is actually illegal because it is *theft* . . . . [N]onpublic financial information *belongs to someone*, and if you use information that belongs to someone else without their permission, then you are stealing it." (emphasis in original)).

5. *See* Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1329 (1999) ("Insider trading stories are wonderful drama: When they involve the rich and famous[,] . . . they tap into images of power, greed, and hubris; when they deal with the smaller traders, they conjure up images of Everyman

Thus, from a distributive perspective, inside traders elicit little sympathy.

However, there are more sophisticated—and more important—justifications for the prohibition. In a sense, these justifications are an axiomatic chain, with each proposition depending on the one before it. First, there is a national interest in robust securities markets.[6] Second, investors would be deterred from participating in securities markets if they perceived themselves to be at an information disadvantage relative to insiders.[7] Third, civil and criminal sanctions are effective at deterring insider trading and boosting investor confidence.[8]

These policy commitments appear in various permutations throughout court opinions on insider trading.[9] Even though the *legal* victim in insider trading is the individual on the other end of the trade,[10]

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with luck and far too little self-restraint."); *see also* Samuel W. Buell, *Is the White Collar Offender Privileged?*, 63 DUKE L.J. 823, 879 (2014) (noting that white-collar defendants enjoy resource advantages which may impact plea bargaining and charging decisions).

6. *What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/Article/whatwedo.html [https://perma.cc/E42R-YGAK] (stating that securities regulations produce "a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy").

7. *See, e.g.*, Arthur Levitt, Chairman, U.S. SEC. & EXCH. COMM'N, A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading, Remarks at the SEC Speaks Conference (Feb. 27, 1998), https://www.sec.gov/news/speech/speecharchive/1998/spch202.txt [https://perma.cc/QR73-HB6Z] ("[I]f there is a perception of unfairness, there'll be no investor confidence—and precious little investment.").

8. *See id.* ("Our enforcement efforts in the 1980s sent a strong signal to the investing public: People saw that dishonest dealers on Wall Street would be prosecuted, and lawbreakers would go to jail."); *cf.* Langevoort, *supra* note 5, at 1329 ("One reason why insider trading regulation takes on such prominence in contemporary securities enforcement is its seemingly unique ability to interest the public and hence operate as a vehicle for the SEC to seek both visibility and support for its mission.").

9. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658 (1997) ("[I]nvestors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."); *cf.* SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968) ("Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.").

10. *See, e.g.*, *In re* Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961) (describing Rule 10b-5 as a remedy for defrauded sellers and buyers in transactions with corporate insiders).

the *practical* victim is the market itself.[11] This is why both civil[12] and criminal[13] agencies have prioritized insider-trading enforcement—the crime has economic dimensions that transcend individual victims. That is, to protect the market broadly, enforcement must identify and punish individual actors—an approach the U.S. Securities and Exchange Commission ("SEC") and the U.S. Department of Justice ("DOJ") have embraced. Those who subscribe to the position that insider trading is wrong should logically want law enforcement's toolbox to be equal to the task.

The toolbox shrank after *Morrison v. National Australia Bank*.[14] In *Morrison*, an Australian bank unprofitably acquired a U.S. company, and several of the bank's shareholders sued under the antifraud provisions of U.S. securities laws, despite the fact that the bank's shares were not traded on any U.S. exchange.[15] In a vigorous application of a canon called the presumption against extraterritoriality, the Supreme Court held that the antifraud provisions apply only to transactions in U.S. exchange–traded securities and to other domestic securities transactions because Congress did not intend international coverage.[16] This ruling collaterally handicapped international insider-trading enforcement, which is based on the same antifraud provisions.[17]

In an increasingly global securities market, strictly limiting the reach of the securities laws is inconsistent with the economic goals served by prohibiting insider trading. Individuals seeking to victimize U.S. investors can easily do so from abroad and without the use of

11. *See* Jason M. Breslow, *Preet Bharara: Insider Trading Is "Rampant" On Wall Street*, FRONTLINE (Jan. 7, 2014), https://www.pbs.org/wgbh/frontline/article/preet-bharara-insider-trading-is-rampant-on-wall-street [https://perma.cc/3FUM-HE3D] (noting a comment by Preet Bharara, former U.S. Attorney for the Southern District of New York, that "the market is a victim, and the system is victimized" when insider trading goes undeterred).

12. Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Testimony on "Oversight of the U.S. Securities and Exchange Commission" Before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Sept. 26, 2017), https://www.sec.gov/news/testimony/testimony-clayton-2017-09-26 [https://perma.cc/KMZ2-4TN2] (noting that the Securities and Exchange Commission has "charged more than 700 defendants in civil insider trading cases since fiscal year 2010").

13. Breslow, *supra* note 11 (noting that "Bharara has led one of the government's most aggressive crackdowns on insider trading").

14. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).

15. *Id.* at 250–53.

16. *Id.* at 265–67.

17. *See infra* Part I.

exchange-traded securities.[18] With this in mind, U.S. enforcement agencies have continued to pursue defendants abroad.[19] Yet, to avoid problems under *Morrison*, the SEC has offered—and several courts have accepted[20]—a tenuous theory of liability, referred to here as the "hedging theory."

As an illustration of the hedging theory, suppose a foreigner is tipped off to an impending event that will cause the stock price of a U.S. public company to soar. Because she has no access to a U.S. brokerage account, she cannot purchase the stock of that company directly on the New York Stock Exchange ("NYSE"). Instead, she purchases a derivative from her broker that is based on that company's stock. As long as the underlying stock never changes hands, this is neither a transaction in U.S. exchange–traded securities nor does it occur in the United States. Consequently, *Morrison* places this transaction outside the scope of the U.S. securities laws.

But suppose the foreigner's broker took a short position on this trade, meaning that if the stock goes up, the broker will lose. Seeking to minimize its risk, the broker hedges by buying the U.S. stock itself. This way, the broker will neither gain nor lose too much money—if the stock price goes up, its new stock holdings will gain value and offset the loss on the derivative. If the stock price goes down, the gain on the derivative will offset the loss in its stock holdings. The decision whether and how to hedge is ultimately a business decision for the broker. Yet, under the hedging theory, a hedge by a broker creates liability for the broker's client—the putative inside trader—on the theory that the trader "caused" a transaction in a U.S. exchange–traded security, even if the foreign trader herself was not a participant in that transaction.[21] Although there are attractive policy reasons for liability in this context, the arbitrariness of the hedging theory is apparent. If her broker had

18. For example, in 2015, the SEC charged numerous defendants in an international scheme involving Russian hackers illegally obtaining earnings data from newswire sources. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges 32 Defendants in Scheme to Trade on Hacked News Releases (Aug. 11, 2015), https://www.sec.gov/news/pressrelease/2015-163.html [https://perma.cc/HP5Z-25BH]. The hackers later traded on the basis of this information using various derivatives, including the ones discussed in this Note. *Id.*; *see infra* Part II.

19. *See, e.g.*, Press Release, *supra* note 18 (charging several traders based in Ukraine).

20. *See infra* Part III.A.

21. *See* SEC v. Sabrdaran, 252 F. Supp. 3d 866, 887–88 (N.D. Cal. 2017) (upholding a judgment against a defendant in part because hedging activity by a broker rendered the insider's derivative trades "in connection with the sale or purchase of securities in the U.S. market").

decided not to hedge, the trader would have no liability.[22] Appropriately, brokers themselves have no legal exposure for this kind of hedging under U.S. securities laws because they lack scienter—that is, the intent to engage in insider trading.[23] A different theory of liability—one in which brokers' actions are not dispositive of traders' liability—would better safeguard U.S. markets.

This Note proceeds in four parts. Part I offers an account of international insider-trading jurisprudence, before and after *Morrison*. Part II demonstrates the problem that international derivative instruments pose for enforcement, using as illustrations two equity derivatives popular in Europe and Australia—contracts for difference ("CFDs") and spread bets. Part III explains and critiques the hedging theory of liability from the perspective of the defendant, the judiciary, and enforcement agencies. Part IV argues that courts should discard the hedging theory by holding that *Morrison* was abrogated for enforcement actions by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[24]

I. THE LAW OF INSIDER TRADING

Insider trading is the buying or selling of a company's securities on the basis of material nonpublic information about that company, in violation of a duty to disclose that information.[25] Although this Note focuses on the jurisdictional rather than the substantive concerns of insider trading, this Part offers a brief review of the elements of the offense and how they came to exist.

Enacted in the wake of the Great Depression, the Securities Act of 1933 ("the '33 Act")[26] and the Securities Exchange Act of 1934 ("the

22. *Cf.* SEC v. Sabrdaran, No. 14-cv-04825-JSC, 2016 WL 4791771, at *1, *3 (N.D. Cal. Sept. 14, 2016) (denying the SEC's motion for summary judgment because the absence of evidence regarding the broker's hedging put into doubt whether the defendant's conduct was "in connection with the purchase or sale of any security").

23. *See* United States v. O'Hagan, 521 U.S. 642, 665 (1997) ("To establish a criminal violation of Rule 10b-5, the Government must prove that a person 'willfully' violated the provision.").

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

25. Salman v. United States, 137 S. Ct. 420, 423 (2016) ("Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b–5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage.").

26. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2018).

'34 Act")[27] together constitute the original statutory basis for federal regulation of the securities markets. The '33 Act primarily created disclosure obligations for offerings of securities by issuers; the '34 Act primarily created structure and oversight for exchanges and other market participants.[28] In addition, the '34 Act created the SEC, which holds civil enforcement and rulemaking power.[29]

The provisions of the securities laws are legion, but two are most important for insider trading: section 10(b) of the '34 Act[30] and Rule 10b-5.[31] Section 10(b), the enabling statutory provision, prohibits the use of any "manipulative or deceptive device or contrivance," as defined by SEC rules, in connection with a purchase or sale of any security.[32] The SEC subsequently promulgated Rule 10b-5, using similarly broad language to define fraud.[33] These provisions are the foundation for civil and criminal enforcement by the SEC and DOJ, respectively.[34]

Notably, Rule 10b-5 makes no mention of insider trading. Rather, the SEC developed the theory that insider trading is fraud through the opinion of SEC Chairman William Cary in an administrative

27. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78qq (2018).

28. *See The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/about-lawsshtml.html [https://perma.cc/TQH2-PU8J] (describing the prominent features of the '33 Act and '34 Act).

29. *Id.*

30. 15 U.S.C. § 78j(b) (2018).

31. 17 C.F.R. § 240.10b-5 (2018).

32. 15 U.S.C. § 78j(b).

33. Rule 10b-5 reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

34. *See generally* CRIMINAL PROSECUTORIAL DISCRETION IN INSIDER TRADING CASES: LET'S LOOK AT THE NUMBERS, N.Y. STATE BAR ASSOC. (May 12, 2010), https://www.nysba.org/Sections/Commercial_Federal_Litigation/ComFed_Display_Tabs/Reports/CRIMINALPROSECUTORIALDISCRETIONINTHEINSIDERTRADINGCASES_pdf.html [https://perma.cc/XU86-46KU] (discussing the civil and criminal remedies available through enforcement by the SEC and DOJ, respectively).

proceeding.[35] A circuit court first endorsed that position in 1968, stating that "the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[36]

Because the language of Rule 10b-5 prohibits fraud, the theory of liability for insider trading must be based on fraud. Rule 10b-5, and particularly subsection (b),[37] largely corresponds to the common-law concept of fraud: a knowingly false statement (a misrepresentation) or the knowing failure to say something (an omission).[38] Insider trading is a fraud based on omission—the nondisclosure of the trader's material nonpublic information.[39] Yet for an omission to be fraudulent, there must be a duty to disclose the omitted information. In *Chiarella v. United States*,[40] the Supreme Court clarified that the duty to disclose is fiduciary in nature.[41] As such, insider trading is only illegal when the trader deceives someone with whom she has a fiduciary relationship.

In the "classical" variety of insider trading, a corporate insider—often an officer or board member—trades on material nonpublic information, thereby breaching a fiduciary duty to that company's shareholders.[42] For decades, this was the only type of insider trading. In 1997, the Supreme Court endorsed an alternate theory of "misappropriator" liability.[43] In a misappropriation case, someone outside the company—for example, an employee of a company's law firm—improperly obtains access to nonpublic information and uses it

35. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 910–11 (1961); *see also* Langevoort, *supra* note 5, at 1319 ("William Cary's opinion for the SEC in *In re Cady, Roberts & Co.* built the foundation on which the modern law of insider trading rests.").

36. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

37. § 240.10b-5(b) ("It shall be unlawful . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .").

38. *Fraud*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "fraud" as "[a] knowing misrepresentation or knowing concealment of a material fact made to induce another to act to his or her detriment.").

39. Chiarella v. United States, 445 U.S. 222, 232 (1980) (describing silence when under a duty to disclose as fraudulent and as the basis for insider trading).

40. Chiarella v. United States, 445 U.S. 222 (1980).

41. *Id.* at 229 ("[A] purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts.").

42. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

43. *See id.* at 659 ("The misappropriation at issue here was properly made the subject of a § 10(b) charge because it meets the statutory requirement that there be 'deceptive' conduct 'in connection with' securities transactions.").

to make trades.[44] Because this person has no fiduciary relationship to the company's stockholders, the fiduciary duty violated is that between the misappropriator and her employer, the law firm. And the breach is the misappropriator's act of obtaining and trading on the information without telling her employer.[45]

Further, an insider or misappropriator might disclose the material nonpublic information to a third party—an act that is sometimes called "tipping."[46] If the tippee trades on the basis of that information, she may face criminal liability herself.[47] The tippee inherits the duty breach of the tipper, and thus legal liability, when two conditions are met. First, the tipper must have received some sort of personal benefit for disclosing the information, even if nominal.[48] Second, the tippee must have known about the tipper's breach of duty.[49]

A. Before Morrison*: Conduct-and-Effects Test*

When the SEC or DOJ seeks to punish insider trading in the United States, jurisdiction is no different than for any other criminal or civil charge. Pursuing a foreign defendant is more complicated. First, the court must exercise personal jurisdiction over the defendant, a familiar civil-procedure inquiry. Second, because the '34 Act and the rules promulgated thereunder seek primarily to regulate the domestic securities markets,[50] the court must analyze whether a foreign defendant's conduct actually violates U.S. law. Historically, this was a question of subject-matter jurisdiction.[51] The Second Circuit pioneered the dominant approach to subject-matter jurisdiction in cases involving

44. *Id.* at 653 ("The misappropriation theory is thus designed to 'protect[] the integrity of the securities markets against abuses by outsiders to a corporation . . . .'" (alteration in original) (quoting Brief for United States at 14, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842)).

45. *Id.* at 652 ("In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.").

46. *See* Salman v. United States, 137 S. Ct. 420, 423 (2016) (noting that insiders "may not tip inside information to others for trading").

47. *See id.* (noting that "the tippee may commit securities fraud by trading in disregard of that knowledge").

48. *See id.* at 424 (inferring personal benefit when confidential information was exchanged between relatives).

49. *Id.* at 423.

50. *See infra* note 69 and accompanying text.

51. *See* Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 170–71 (2d Cir. 2008) (describing whether Congress wanted extraterritorial application as a question of subject-matter jurisdiction).

international application of the securities laws' antifraud provisions.[52] Under this approach—the conduct-and-effects test—courts determined "(1) whether the wrongful conduct occurred in the United States, and (2) whether the wrongful conduct had a substantial effect in the United States or upon United States citizens."[53]

There were several downsides to this approach to jurisdiction. First, it was naturally fact intensive.[54] This put parties and courts in the position of expending resources to litigate a threshold question that is separate from the merits of the violation. Second, and relatedly, the judicial discretion afforded by the conduct-and-effects test created uncertainty as to how it would be applied in any particular case.[55]

However, there were important benefits of the conduct-and-effects test. First, the judicial-discretion problem had a flipside. Because the conduct-and-effects test developed organically, it was adaptable enough to account for novel forms of international fraud.[56] Moreover, the flexibility of this test permitted judges to reach sensible results in cases without twisting doctrinal concepts—a problem in several post-*Morrison* cases, as discussed in Part III. Second, the breadth of activity covered by the conduct-and-effects test is consonant with the protective instincts of the Depression-era Congress responsible for the '33 and '34 Acts.[57]

52. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 257–58 (2010).

53. *Morrison*, 547 F.3d at 171.

54. In particular, the conduct-and-effects test often resulted in squabbling over the percentage of a company's stock that must be held in the United States in order to establish subject-matter jurisdiction. *See* Consol. Gold Fields PLC v. Minorco, S.A., 871 F.2d 252, 262 (2d Cir. 1989) (reversing the district court's dismissal for lack of subject-matter jurisdiction "where American residents representing 2.5% of Gold Fields' shareholders owned 5.3 million shares with a market value of about $120 million"). *But see* Plessey Co. v. Gen. Elec. Co., 628 F. Supp. 477, 488, 492 (D. Del. 1986) (dismissing for lack of subject-matter jurisdiction because of "the minimal percentage [of 1.6 percent] and relative unimportance of the shares held in America").

55. *See generally* Stephen J. Choi & Linda J. Silberman, *Transnational Litigation and Global Securities Class-Action Lawsuits*, 2009 WIS. L. REV. 465 (discussing the unpredictable nature of the conduct-and-effects test, particularly for "f-cubed" cases).

56. *See, e.g.*, SEC v. Berger, 322 F.3d 187, 192–93, 196 (2d Cir. 2003) (applying the conduct-and-effects test to find jurisdiction over a defendant who fabricated financial statements regarding an offshore investment entity), *abrogated by Morrison*, 561 U.S. at 266–67.

57. *See What We Do*, *supra* note 6 (noting that the '33 Act, passed "during the peak year of the Depression[,] . . . was designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing").

B. Morrison *Limits Section 10(b)*

In 2010, *Morrison* rejected the conduct-and-effects test. The facts of the case made application of the U.S. securities laws especially unpalatable.[58] A group of Australian shareholders of an Australian bank sued under Rule 10b-5 after the bank acquired a U.S. subsidiary in the business of servicing home loans.[59] The subsidiary allegedly manipulated financial models to inflate the company's value, and the bank was forced to write down the value of its new acquisition after the merger.[60] The bank's stock was not traded on any U.S. exchange.[61] Because the plaintiffs purchased their shares in Australia, the fraud was territorially far removed from the United States.[62]

Morrison is an example of an "f-cubed" case: a *foreign* issuer being sued by *foreign* investors based on a *foreign* transaction.[63] Importantly, every court that heard the case—the trial judge, the Second Circuit, and both the majority and the dissenters in the Supreme Court—thought the case should be dismissed.[64] The Second Circuit applied the conduct-and-effects test and concluded that the U.S.-based conduct—the manipulation of the subsidiary's financial models—did not "compris[e] the heart of the alleged fraud."[65] The Supreme Court granted certiorari not to reverse the judgment but to reverse the Second Circuit's reasoning. The Court held that whether the '34 Act applied to the bank had nothing to do with subject-matter jurisdiction because the Act provides subject-matter jurisdiction whenever there is a violation of the Act.[66] Instead, the Court applied the presumption

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58. *Cf.* O'Bannon v. Town Court Nursing Ctr., 447 U.S. 773, 804 (1980) (Blackmun, J., concurring) ("[E]asy cases make bad law.").

59. *Morrison*, 561 U.S. 247, 251–53. In addition to its role in insider-trading jurisprudence, Rule 10b-5 is an implied private right of action that serves as something of an omnibus vehicle for securities-fraud litigation. *See* COX ET AL., *supra* note 1, at 698–99 (discussing the inception and rapid growth of private 10b-5 litigation).

60. *Morrison*, 561 U.S. at 252.

61. Although the Australian bank's American Depositary Receipts (securities entitling U.S. investors to shares of foreign stock) were traded on the NYSE, the plaintiffs held common stock that was not traded on the NYSE. *Id.* at 251–52.

62. *See id.* at 252–53 ("The acts performed in the United States did not 'compris[e] the heart of the alleged fraud.'" (quoting Morrison v. Nat'l Austl. Bank Ltd., 547 F.3d 167, 175–76 (2d Cir. 2008)) (alteration in original)).

63. *Id.* at 283 n.11 (Stevens, J., concurring in the judgment).

64. *Id.* (suggesting a bright-line rule that would have preserved the conduct-and-effects test but would have categorically barred all f-cubed cases); *Morrison*, 547 F.3d at 176 (affirming the trial court's dismissal of the complaint for lack of subject-matter jurisdiction).

65. *Morrison*, 547 F.3d at 175.

66. *Morrison*, 561 U.S. at 254.

against extraterritoriality—a canon premised on the idea that Congress clearly indicates when it wants a law to apply abroad.[67] In applying this canon, the Court held that section 10(b) and thus Rule 10b-5 do not apply outside the United States.[68]

In redefining the scope of section 10(b), the Court construed the provision's focus—the U.S. securities exchanges[69]—to also be its limit, at least in the context of international frauds. Because the '34 Act concerns itself largely with exchanges, the Court dismissed the idea that Rule 10b-5 serves as a universal antifraud rule. The Court held that section 10(b) applies "only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[70] This is *Morrison*'s "transactional test," which asks where the securities transaction *occurs*, not where effects of that transaction are felt.

The Court's application of the presumption against extraterritoriality suffered from at least three deficiencies. First, the notion that the singular focus of the '34 Act is securities exchanges is difficult to square with section 10(b)'s inclusion of securities not traded on any exchange.[71] Second, the '34 Act's explicit inclusion of commerce "between any foreign country and any State" in its definition of interstate commerce was given unjustifiably cursory treatment.[72] The Court described this as "broad language" and analogized it to statutory language in another case that did not overcome the presumption against extraterritoriality.[73] However, the comparison was arguably unpersuasive because the statutory language at issue in that case was notably vaguer, using the phrase: "between a State and any place outside thereof."[74]

67. *Id.* at 265. *Morrison* was one in a series of cases representing "the Court's renewed emphasis on the presumption against extraterritoriality." David Keenan & Sabrina P. Shroff, *Taking the Presumption Against Extraterritoriality Seriously in Criminal Cases After* Morrison *and* Kiobel, 45 LOY. U. CHI. L.J. 71, 74 (2013).

68. *Morrison*, 561 U.S. at 265.

69. *Id.* at 267 (describing the focus of the '34 Act as the "primacy of the domestic exchange").

70. *Id.* at 273.

71. *See* 15 U.S.C. § 78j (2018) (prohibiting fraud "in connection with the purchase or sale of any security registered on a national securities exchange *or any security not so registered*" (emphasis added)).

72. *See* § 78c(a)(17).

73. *Morrison*, 561 U.S. at 262–63.

74. EEOC v. Arabian Am. Oil Co., 499 U.S. 244, 249 (1991) (quoting 42 U.S.C. § 2000e(g) (1988)).

Third, the Court rejected the argument that Congress intended to punish international actors who defraud Americans by means other than an exchange; however, the Court had no problem believing that the same actors and the same conduct should be reachable when accomplished via exchange. The presumption against extraterritoriality ostensibly requires an explicit grant of extraterritorial jurisdiction, but such language is *equally absent* in section 10(b) for frauds executed on exchanges.[75] The only explanation for this dissonance is that the Court treats a fraud initiated in another nation as occurring *in* the United States if the fraud takes advantage of an exchange.

Morrison's transactional test strains the traditional understanding of fraud. Rule 10b-5 punishes "manipulative or deceptive device[s] or contrivance[s]" not just civilly, but criminally.[76] A hallmark of criminal law is the concept of actus reus, which as a physical concept must necessarily occur in a particular place.[77] As such, while it may have seemed uncontroversial under the facts of *Morrison* to state that the law's "focus . . . is not upon the place where the deception originated,"[78] that proposition becomes more difficult to defend in a criminal or civil enforcement context.[79]

This Note is not principally a critique of *Morrison*; many scholars have trodden that path before.[80] Rather, *Morrison's* presupposition that transactions in exchange-traded securities effectively take place in

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75. *See* 15 U.S.C. § 78j (lacking an explicit grant of extraterritorial jurisdiction).

76. 17 C.F.R. § 240.10b–1, § 240.10b-5 (2018).

77. *Actus Reus*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "actus reus" as "[t]he wrongful deed that comprises the physical components of a crime and that generally must be coupled with mens rea to establish criminal liability; a forbidden act.").

78. *Morrison*, 561 U.S. at 266.

79. *Morrison*'s limitation on the scope of section 10(b) and Rule 10b-5 also applies to criminal enforcement actions. United States v. Vilar, 729 F.3d 62, 74–75 (2d Cir. 2013).

80. For an in-depth discussion of the *Morrison* Court's conception of where transactions take place, see Christopher Calfee, *Can't See the Forest for the Trees: Where Does a Purchase or Sale of Securities Occur?*, 2 AM. U. BUS. L. REV. 153, 158–61 (2012). *See also* Steve Thel, *Taking Section 10(b) Seriously: Criminal Enforcement of SEC Rules*, 2014 COLUM. BUS. L. REV. 1, 31 (criticizing the Court's tendency to evaluate section 10(b) and Rule 10b-5 under an identical framework and arguing that Dodd-Frank overruled *Morrison* for enforcement purposes). Thel's Dodd-Frank argument is discussed in Part IV. For additional critiques of *Morrison* from a private-litigation perspective, see, for example, Elizabeth Cosenza, *Paradise Lost: § 10(b) After* Morrison v. National Australia Bank, 11 CHI. J. INT'L L. 343, 386–87 (2011). For a discussion of *Morrison*'s implications for over-the-counter transactions and securities that are listed but not traded, see generally Raphael G. Toman, Note, *The Extraterritorial Reach of the U.S. Securities Laws and Non-Conventional Securities: Recent Developments After* Morrison *and Dodd-Frank*, 14 N.Y.U. J.L. & BUS. 657, 680–90 (2018).

the United States sets the stage for the strained logic of the hedging theory, as discussed in Part III. Indeed, there was so little reason for U.S. adjudication in *Morrison* that the Court stepped into its gatekeeper role, disposing of the case as the securities-law equivalent of ambulance chasing. Yet, the rule of law ushered in by *Morrison* is insufficiently attentive to increasingly prevalent securities frauds that are sophisticated and international in scope. In the wake of *Morrison*, lower courts have struggled to reconcile their role as faithful adherents to precedent with their duty to pragmatically apply principles of equity and justice to new types of fraud.[81]

II. FOREIGN DERIVATIVES AND U.S. MARKETS

Morrison poses no obstacle to enforcement of the securities laws for two types of transactions: those in exchange-traded securities and those occurring inside the United States. There are numerous national securities exchanges registered with the SEC under section 6 of the '34 Act, the most prominent of which are the NYSE and Nasdaq.[82] Several other exchanges are more specialized and facilitate trading in derivatives.[83]

Morrison places no geographic boundaries on section 10(b) when the securities at issue are traded on a U.S. exchange.[84] Additionally, frauds *not* involving exchanges are illegal when they occur in the territory of the United States. This is plainly within the historical core of the SEC and DOJ's enforcement role. Because *Morrison* had no effect on these broad categories of fraud, it is necessary to analyze which types of fraud do fall through *Morrison*'s cracks. This Note deals with one such scenario: foreign derivatives based on U.S. stock.

81. *See infra* Part III (discussing the difficulties of post-*Morrison* international insider-trading cases).

82. *National Securities Exchanges*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/divisionsmarketregmrexchangesshtml.html [https://perma.cc/2EK5-QGL7]. As of January 13, 2019, the NYSE and Nasdaq are the two largest stock exchanges in the world by market capitalization of listed companies, at $22.92 trillion and $10.86 trillion, respectively. *List of Stock Exchanges*, STOCKMARKETCLOCK.COM, https://www.stockmarketclock.com/exchanges [https://perma.cc/M4M9-W5V6].

83. *National Securities Exchanges*, *supra* note 82 (listing several options and futures exchanges).

84. *See* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 273 (2010) ("Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States.").

Foreigners are not forbidden from having a U.S. brokerage account or from trading in U.S. stock; in fact, one estimate suggests that foreigners own 35 percent of all U.S. corporate stock.[85] However, foreign retail investors face unique hurdles. Noncitizens must sometimes supply additional documentation to open brokerage accounts, and they also receive unfavorable tax treatment on investment income.[86] As such, foreign investors naturally look to alternatives. Certain derivatives give them access to the depth of U.S. capital markets without the substantial costs associated with a U.S. brokerage account. This Part describes two exemplary derivatives that have become popular vehicles for foreign investment, innocent and otherwise: CFDs and spread bets.

A. Derivatives in Context

The most straightforward way to participate in the securities markets is to purchase stock in a publicly traded company. This gives the investor access to a company's upside while also exposing her to the risk of a downside.[87] Owning stock also entitles the investor to vote for directors of the company and on various proposals related to corporate governance.[88]

Derivatives are securities whose value is based on something else, called the underlying asset.[89] Underlying assets can include commodities, debt obligations, currencies, and more.[90] Derivatives that use stock as the underlying asset are called equity derivatives.[91] Put simply, derivatives are contracts that entitle the investor to either cash or some right to the underlying asset at a future date. One reason

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85. Steven M. Rosenthal, *Slashing Corporate Taxes: Foreign Investors Are Surprise Winners*, TAX NOTES (Oct. 23, 2017), https://www.taxnotes.com/tax-notes/corporate-taxation/slashing-corporate-taxes-foreign-investors-are-surprise-winners/2017/10/23/1x78l#1x78l-0000033 [https://perma.cc/WB4H-2E2E].

86. *Can a Non-U.S. Citizen Trade U.S. Stocks?*, THE MOTLEY FOOL, https://www.fool.com/knowledge-center/can-a-non-us-citizen-trade-us-stocks.aspx [https://perma.cc/2NYL-23KN].

87. *See Common Stock*, INVESTOPEDIA, https://www.investopedia.com/terms/c/commonstock.asp [https://perma.cc/NC4V-UUR2] ("With common stock, if a company goes bankrupt, the common stockholders do not receive their money until the creditors and preferred shareholders have received their respective share of the leftover assets.").

88. *Id.*

89. *Derivative*, INVESTOPEDIA, https://www.investopedia.com/terms/d/derivative.asp [https://perma.cc/5T7U-8G9T].

90. *Id.*

91. *Equity Derivative*, INVESTOPEDIA, https://www.investopedia.com/terms/d/derivative.asp [https://perma.cc/5T9V-CS3F].

investors might prefer derivatives to stock is that purchasing stock requires upfront capital. With derivatives, it is possible for investors to expose themselves to the same risk, and benefit, as a large stock investment without as much expenditure.[92]

Sophisticated and institutional investors—banks, hedge funds, and the like—value this versatility, which is helpful in three of their core activities: speculation, arbitrage, and hedging.[93] Speculating means making a bet on the value of an investment—buying low and selling high, or generally investing for profit.[94] Arbitrage means simultaneously buying and selling an investment to take advantage of a temporary price difference in two different markets.[95] For example, if a particular security is trading on Exchange A at $100 and on Exchange B at $101, an arbitrageur would purchase as many shares as possible on Exchange A and resell them on Exchange B, pocketing the price difference as profit. Arbitrageurs play an important role in keeping prices consistent across different markets, even among different countries.[96]

Hedging is particularly important in the context of this Note. Hedging means taking a position opposite another investment in order to minimize the risk of price movements—in other words, going long and short at the same time.[97] For example, suppose an investor buys stock. The investor would benefit if the stock appreciates in value, but she risks losing money if the value falls. To reduce that risk, she could purchase an option to sell the shares at a certain price (a "put option"). If the value of the stock goes up, she would not exercise the put option. If the value goes down, she can exercise the option to sell the shares at the option price, which would be above the then-market price. As such, the money paid for the option is akin to insurance to minimize her potential loss.

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92. *See* COX ET AL., *supra* note 1, at 559 ("Through derivatives, parties can isolate, even customize, risk exposure and the potential for financial reward.").

93. *Id.*

94. *Id.*

95. *Id.*

96. *See id.* ("By purchasing in one market and selling in another, the arbitrageur's trading brings the two markets closer together.").

97. *Id.*

B. CFDs and Spread Bets

CFDs and spread bets are specialized, customizable derivatives.[98] They can have virtually any sort of underlying asset, such as equities, foreign currencies, and commodities.[99] The focus here is on those that use stock, making them equity derivatives. The instruments have features that make them ideal for speculating, hedging, and—as Part III illustrates—insider trading.

Both CFDs and spread bets (together, "contracts") are agreements between an investor and a broker to pay the difference in the price of a stock between the day the contract is purchased and the day it is sold.[100] Each contract has a sell price, or the price at which one could sell the contract and thus exit the position, and a buy price, or the cost to buy the contract.[101] The buy price is always higher than the sell price; the difference between them is called the spread.[102] The price of the contract mirrors the price of the underlying stock.[103] As the stock rises or falls in value, so does the contract.[104] If the price rises by an amount greater than the spread, such that the new sell price exceeds the old buy price, the contract can be sold for a profit.[105]

These contracts have a number of features that make them attractive securities. First, they are cash settled. Investors never have to take possession of the underlying shares; when the position is closed out, only cash changes hands.[106] Second, the contracts can be leveraged, meaning that the investor does not need to pay the full cash value of

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98. *See Difference Between Spread Betting & CFD Trading*, CMC MARKETS, https://www.cmcmarkets.com/en-gb/learn-spread-betting/spread-betting-vs-cfd [https://perma.cc/6XSM-R4BD] (outlining the main characteristics of and differences between CFD trading and spread betting, including tax efficiency, short selling, commission charges, and profit-loss calculations).

99. *Id.*

100. Trevir Nath, *Getting Market Leverage: CFD versus Spread Betting*, INVESTOPEDIA (May 23, 2018), https://www.investopedia.com/articles/investing/110714/getting-market-leverage-cfd-versus-spread-betting.asp [https://perma.cc/FD94-Z6HD].

101. *Id.*

102. *Id.*; *see also* Cory Mitchell, *An Introduction to CFDs*, INVESTOPEDIA (May 2, 2018), https://www.investopedia.com/articles/stocks/09/trade-a-cfd.asp [https://perma.cc/DHY6-QYV6] (introducing the major advantages of CFD trading that make it an "attractive alternative to traditional markets" but noting that "CFDs trims traders' profits through spread costs").

103. Mitchell, *supra* note 102.

104. *Id.*

105. *Id.*

106. *Contract for Differences - CFD*, INVESTOPEDIA, https://www.investopedia.com/terms/c/contractfordifferences.asp [https://perma.cc/DSJ9-SWMF].

the trading position.[107] Rather, she can put up a cash deposit called margin. Many brokers require only a 5 percent margin,[108] meaning an investor can take a $1000 position by paying only $50 in cash.

CFDs. When an investor purchases a CFD from a broker, the broker charges a commission and proceeds to purchase the actual underlying shares on a U.S. exchange.[109] This results in a 100 percent hedged transaction, meaning that the broker cannot lose money on the trade. This business model is sometimes called "direct market access" ("DMA").[110] It also involves a securities transaction in the United States, as required by *Morrison*.

Spread Bets. Unlike CFDs, spread bets are not necessarily hedged by purchasing the shares. Instead, the broker takes a position opposite the investor. This business model is sometimes called "market maker."[111] Because the broker is trading for its own account, it has discretion over whether and how to hedge. Spread bets also differ from CFDs with respect to tax treatment, and some spread bets have an expiration date, while CFDs typically do not.[112]

Both kinds of contracts are popular in Australia and Europe. London constitutes one of the biggest markets, with U.K. brokers holding roughly $4.7 billion USD in client funds invested in CFDs.[113] However, CFDs and spread bets are not available in the United States.

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107. Nath, *supra* note 100.

108. *Id.*

109. *See* Stuart Washington, *You Lose, They Win: So Whose Side Are Market Makers on?*, SYDNEY MORNING HERALD (Aug. 28, 2010, 3:00 AM), https://www.smh.com.au/business/you-lose-they-win-so-whose-side-are-market-makers-on-20100827-13vu3.html [https://perma.cc/8JVU-45AE] (noting that for DMA brokers, "every CFD sold is based on a linked trade in the underlying market"); *see also CFD Trading*, IG GROUP, https://www.ig.com/en/cfd [https://perma.cc/L45X-X3T7] (advertising a variety of CFD products and stating that "[g]enerally you only pay a commission charge for share CFDs").

110. Washington, *supra* note 109.

111. Washington, *supra* note 109. Because a market-maker CFD is highly similar to a spread bet, this Note exclusively uses the term "CFD" to refer to DMA products, and the term "spread bet" is used to refer to a contract with a market maker.

112. *See* Nath, *supra* note 100 (noting that "[s]pread bet[s] have fixed expiration dates when the bet is placed while CFD contracts have none" and that "[w]hen profits are realized for CFD trades, the investor is subject to capital gains tax while spread betting profits are tax free"); *see also Spread Betting vs CFDs*, IG GROUP, https://www.ig.com/uk/spread-betting/spread-betting-vs-cfds [https://perma.cc/KBD2-3A9C] (noting that profits from spread betting are not subject to capital gains tax, whereas profits from CFDs are).

113. Donal Griffin, *Why 'Contracts for Difference' Are Under Scrutiny: QuickTake Q&A*, BLOOMBERG (Sept. 21, 2017, 12:00 AM), https://www.bloomberg.com/news/articles/2017-09-21/why-contracts-for-difference-are-under-scrutiny-quicktake-q-a [https://perma.cc/7KR2-A6E4].

They were deemed security-based swaps in joint guidance issued under Dodd-Frank by the SEC and the U.S. Commodity Futures Trading Commission.[114] As such, these contracts are subject to a substantial regulatory burden.[115] Because no brokers have taken the steps necessary to list them on an exchange, none are offered to U.S. investors.[116] However, U.S. investors can already enjoy several key features of these contracts—such as access to U.S. stocks and leverage—by opening a margin account with a brokerage. Foreign regulators have become increasingly skeptical of these contracts from a consumer-protection standpoint.[117] Like other derivatives, these contracts facilitate more risk exposure than an equivalent investment in the underlying equity. With the generous margin policies of many brokers, retail investors face the prospect of losses exceeding principal.

The peril of CFDs and spread bets from a U.S. perspective is that they can use U.S. stock as the underlying asset. Foreigners with inside information about U.S. companies can trade on the basis of that information—an activity that would generally be illegal if conducted in the United States. Because insider trading using foreign derivatives is a degree removed from the United States, it is important to articulate

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114. Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208, 48,260 (Aug. 13, 2012) ("CFDs, unless otherwise excluded, fall within the scope of the swap or security-based swap definition, as applicable.").

115. COX ET AL., *supra* note 1, at 567 (stating that those subject to swap regulations must "clear swaps through a clearing agent or execute the trade through an exchange, as well [as] satisfy certain capital, margin, reporting, and business conduct requirements").

116. *See* Jon Matonis, *Another Market Not Available to U.S. Citizens*, FORBES (Apr. 9, 2012, 7:50 AM), https://www.forbes.com/sites/jonmatonis/2012/04/09/another-market-not-available-to-u-s-citizens/#5ce31a2d3482 [https://perma.cc/5B5G-HZVC] ("Due to restrictions by the Securities and Exchange Commission on over-the-counter financial instruments, trading in the CFD market is not an option for U.S. residents and U.S. citizens . . . ."). However, there are a few U.S. providers of foreign-exchange or "forex" CFDs, which are based on currency exchange rates rather than stocks. *See* James O'Neill, *CFD Regulation and the Global Impact—A Comprehensive Guide*, FINANCEFEEDS (Aug. 11, 2017, 12:18 PM), https://financefeeds.com/cfd-regulation-global-impact-comprehensive-guide [https://perma.cc/JRM4-DCRP] (explaining that "[t]he United States' NFA crackdown on the industry has contributed to th[e] reduction" of forex providers to a mere three remaining firms). Because forex CFDs are based on foreign currencies, they are regulated by the U.S. Commodity Futures Trading Commission ("CFTC") rather than the SEC. *See* Commodity Exchange Act, 7 U.S.C. § 2(c)(2)(B) (2018) (granting the CFTC jurisdiction over certain transactions in foreign currency).

117. *See, e.g.*, Oscar Williams-Grut, *Britain's Financial Watchdog has 'Serious Concern' about a 'High-Risk, Complex' Corner of the Market*, BUS. INSIDER (Jan. 10, 2018, 3:42 AM), http://www.businessinsider.com/fca-serious-concern-cfds-ig-cmc-plus500-share-prices-fall-2018-1 [https://perma.cc/H6CK-L28V] (describing U.K. financial regulators' concern that brokers have been recommending CFDs to clients for whom they are unsuitable investments).

a theory of harm to U.S. markets. There are at least three such theories in this context.

First, these contracts have a direct relationship with the underlying stock. CFDs entail a purchase of stock by the broker on a U.S. exchange, meaning that the foreign trader causes the same price effects in the company's stock as if she had bought it herself, due to basic principles of supply and demand. Spread bets indirectly impact demand for the underlying stock, even if the broker does not purchase the stock. If hedged via a derivative transaction with another broker, the demand for the stock has not disappeared; it has merely shifted to another party, and that party has the same incentive to hedge using the underlying stock. Although someone in the hedging chain is likely to purchase the ordinary shares, it will not always be possible to pinpoint that hedge as an evidentiary matter.[118]

Second, foreign insider trading necessarily involves the theft of American information. As Professor Donald C. Langevoort writes:

> "[I]t is hard to quarrel with the right of a country to structure its laws in a way that protects inside information as a form of intellectual property. And one cannot reject out of hand the idea that the American securities laws may have this as at least a subsidiary purpose."[119]

Viewed through this lens, foreign insider trading harms U.S. companies to the same extent as domestic insider trading.

A third—and potentially significant—theory of harm warrants further exploration. Modern global markets are characterized by cross border arbitrage, in which market professionals simultaneously buy and sell interchangeable instruments in different markets.[120] There is little empirical scholarship on the extent to which this occurs between

118. This fact pattern is illustrated in the IG Index-Macquarie-Barclays hedge in *SEC v. Sabrdaran*, 252 F. Supp. 3d 866, 895 (2017), discussed *infra* Part III.A.3.

119. DONALD C. LANGEVOORT, 18 INSIDER TRADING REGULATION, ENFORCEMENT AND PREVENTION § 14:3, Westlaw (database updated Apr. 2018) (emphasis omitted) (citations omitted); *see also* Levine, *supra* note 4.

120. *See supra* notes 95–96 and accompanying text; *see also International Arbitrage*, NASDAQ, https://www.nasdaq.com/investing/glossary/i/international-arbitrage [https://perma.cc/3K82-RUKH] (defining international arbitrage as the "[s]imultaneous buying and selling of foreign securities and ADRs to capture the profit potential created by time, currency, and settlement inconsistencies that vary across international borders").

these contracts and the underlying U.S. stock.[121] However, an analogous phenomenon may be instructive: arbitrage between ordinary shares of foreign companies and American Depositary Receipts ("ADRs") traded in the United States.[122] Scholarship suggests that cross border arbitrage between ADRs and the underlying foreign stock occurs,[123] and there may be similar opportunities for arbitrage between foreign derivatives and U.S. stock.[124] If this arbitrage does occur, then foreign insider trading harms the United States because the demand effects caused by an inside trader's position will impact the U.S. market. For a highly simplified illustration, suppose that a European inside trader takes a long position on a derivative. This would increase demand for the underlying U.S. stock in Europe, thus raising its price. The arbitrageur could purchase the cheaper underlying stock in the United States and resell it in Europe, pocketing the difference and causing price convergence between the European and U.S. markets. Those U.S. investors who sell to the arbitrageur would be harmed just as if they had sold to the inside trader directly.

III. INSIDER TRADING AND FOREIGN DERIVATIVES

There is a meaningful economic relationship between these foreign derivatives and the underlying U.S. exchange–traded stock. Yet the legal significance of that relationship, if any, remains to be

121. Indeed, there is little scholarship on CFDs at all. As of January 13, 2019, searching for "contracts for difference" on JSTOR produces twelve results, and the same search on SSRN yields seventeen results.

122. ADRs are certificates that trade in the United States and represent ownership of a foreign company's stock held overseas. *Fast Answers: American Depositary Receipts*, U.S. SEC. & EXCH. COMM'N (Jan. 31, 2007), https://www.sec.gov/fast-answers/answersadrshtm.html [https://perma.cc/H5DV-M4CV].

123. *See, e.g.*, Jennifer Blouin, Luzi Hail & Michelle H. Yetman, *Capital Gains Taxes, Pricing Spreads, and Arbitrage: Evidence from Cross-Listed Firms in the U.S.*, 84 ACCT. REV. 1321, 1323 (2009) (finding that when a firm's barriers to arbitrage are low, tax changes affecting U.S. holders of ADRs impact the price of the firm's home-country ordinary shares). JPMorgan, the inventor of ADRs, states that "arbitrage trading has played a role in the ADR market" since its creation. J.P. MORGAN, DR ADVISOR INSIGHTS: ADR ARBITRAGE AND PROGRAM BALANCES 1 (Feb. 2014), https://www.jpmorgan.com/cm/BlobServer/ADR_Arbitrage_and_Program_Balances.pdf?blobkey=id&blobwhere=1320635141557&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs [https://perma.cc/UB3J-B66E]; *cf.* LANGEVOORT, *supra* note 119 ("[I]t is probably accurate to say that in multiple trading contexts, given arbitrage activity, all the particular markets where a single stock can be traded are really a single market.").

124. Arbitrage is only likely to occur when the price difference between the two markets exceeds the transaction costs of the strategy. It is an empirical question whether the transaction costs of arbitrage using CFDs and spread bets are greater or less than those of ADRs.

determined. Recall that under *Morrison*, a foreign inside trader can only be liable if the fraud is in connection with the purchase or sale of a security listed on a U.S. exchange. Because the Court declined to provide guidance for law enforcement, two critical questions about the elements of foreign insider trading are left in law enforcement's lap: whether an inside trader must have had subjective awareness that his broker would hedge on a U.S. exchange, and whether law enforcement must prove that such hedging in fact occurred.

A. Hedging Theory in Action

Only three district-court opinions have explored the hedging theory with any depth. Although these courts were correct to find liability, each case leaves much to be desired. The hedging theory will result in the disparate treatment of equally culpable defendants, perverse incentives for industry participants, and a body of law unmoored from traditional insider-trading doctrine. The following cases are valuable illustrations not only of the hedging theory, but of the importance of holding international fraudsters accountable—hopefully, under a more coherent legal rule.

1. *SEC v. Compania Internacional Financiera.* The earliest opinion resulting from the SEC's use of the hedging theory came a year after *Morrison*, in *SEC v. Compania Internacional Financiera.*[125] In that case, a Swiss money manager, Chartwell, allegedly engaged in insider trading using CFDs.[126] Arch Chemicals, Inc., a then–publicly traded U.S. company, was in talks to be acquired by a Swiss biotechnology company.[127] Arch was thinly traded in the period leading up to the merger announcement, but both the stock price and trading volume spiked dramatically in the week before the announcement.[128] On one day during this period, Chartwell and its affiliates engaged in CFD trades equivalent in value to 70 percent of the daily NYSE trading volume of Arch's common stock.[129] However, at no point did Chartwell actually purchase Arch stock; it purchased only CFDs from a London-based broker, ADM Investor Services International.[130]

125. SEC v. Compania Internacional Financiera S.A., No. 11 Civ. 4904 (DLC), 2011 WL 3251813 (S.D.N.Y July 29, 2011).

126. *Id.* at *1.

127. *Id.*

128. *Id.* at *2.

129. *Id.* at *3.

130. *Id.*

Morrison was a major issue in the district court's opinion, which granted a preliminary injunction and asset freeze against Chartwell. Chartwell argued that it could not be liable under *Morrison* because its CFD transactions were not purchases or sales of securities on U.S. exchanges.[131] The court disagreed:

> This interpretation misreads *Morrison*, which never states that a defendant must itself trade in securities listed on domestic exchanges or engage in other domestic transactions. . . . [T]he central issue here is insider trading in the domestic securities of Arch stock listed on the NYSE. Even though Chartwell may have engaged in this insider trading by trading CFDs in London that were tied to transactions on the NYSE in Arch's domestic securities, this does not negate the fact that its alleged deceptive conduct involved securities listed on a domestic exchange.[132]

This was the first description of the hedging theory. It is somewhat oblique, in part because satisfying *Morrison* was relatively simple in the case. The CFD broker used the 100 percent hedged DMA model, and the court emphasized that the broker, ADM, automatically purchased shares of the underlying stock when Chartwell entered the CFD.[133] As such, the fraud involved a U.S. exchange. The court should have explained whether this hedging was necessary or sufficient for fulfilling *Morrison*'s transactional test. Instead, in granting the injunction sought by the SEC, the court relied on one of *Morrison*'s broadest phrases, stating that the alleged conduct "involved securities listed on a domestic exchange."[134] In the context of *Morrison*'s more specific language, this "involves" formulation is not particularly illuminating.[135]

Regardless, the SEC's success at obtaining an injunction seems to have been the end of its luck in this case. The following year, the SEC moved to dismiss its own complaint without prejudice due to difficulties during discovery—in particular, the SEC's inability to obtain documents and interview insiders abroad, despite requests to

131. *Id.* at *6.

132. *Id.*

133. *See id.* at *3 (explaining that CFD brokers "purchase[] matching shares of the stock") (citation omitted).

134. *Id.* at *6.

135. *See* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 272 (2010) ("Not deception alone, but deception with respect to *certain purchases or sales* is necessary for a violation of the statute." (emphasis added)).

European regulators.[136] Further, a key target destroyed evidence that would have been key to the SEC's case.[137] These roadblocks are emblematic of the practical difficulties in overseas enforcement actions despite the numerous international conventions designed to facilitate the process.[138]

2. *SEC v. Maillard*. In *SEC v. Maillard*,[139] the SEC sought a temporary restraining order against Cedric Cañas Maillard ("Cañas"), a Spanish consultant. Cañas worked with a financial advisor on a company's unsolicited bid to acquire Potash Corporation of Saskatchewan, Inc., a company listed on the NYSE.[140] Allegedly, with advance notice of the bid, he purchased Potash CFDs from Internaxx, a broker based in Luxembourg.[141] As in *Compania*, the broker hedged the transaction by purchasing Potash common stock on the NYSE.[142]

The court adopted the reasoning of *Compania* in granting the SEC's motion for an asset freeze against Cañas.[143] In its discussion of both personal jurisdiction and the applicability of *Morrison*, the court suggested that Internaxx's purchases of Potash stock could be attributed to Cañas on the theory that he was aware that Internaxx would likely hedge his CFDs in the U.S. stock market.[144] However, exercising more caution than did the court in *Compania*, the *Maillard* court acknowledged that applying this framework to a situation where the broker did not hedge might be inappropriate.[145] Still, the court did not endeavor to address that problem in ruling on the motion before it.[146]

136. SEC v. Compania Internacional Financiera, No. 11 Civ. 4904(JPO), 2012 WL 1856491, at *3 (S.D.N.Y. May 22, 2012).

137. *Id.*

138. *What We Do*, *supra* note 6.

139. SEC v. Maillard, No. 13–CV–5299 (VEC), 2014 WL 1660024 (S.D.N.Y. Apr. 23, 2014).

140. *Id.* at *1.

141. *Id.* at *2.

142. *Id.*

143. *Id.*

144. *See id.* at *5–6 ("Cañas was well aware that his CFDs were conditioned on the ability of Internaxx to purchase an equivalent number of shares . . . .").

145. *See id.* at *7 ("Although one could theoretically imagine a case in which a CFD was purchased and the seller decided not to hedge the transaction by purchasing the underlying security, that did not happen here . . . .").

146. *Id.* at *5.

3. *SEC v. Sabrdaran*. The most recent and most nuanced application of the hedging theory is *SEC v. Sabrdaran*.[147] It is unique among hedging cases to date because it involved a jury trial and produced multiple opinions at various stages: motion to dismiss,[148] summary judgment,[149] and postverdict motion for judgment as a matter of law.[150] It was a classical insider-trading case in which a British citizen named Farhang Afsarpour was tipped by his friend, Sasan Sabrdaran; Sabrdaran was a California resident and employee of InterMune, Inc., a U.S. exchange–traded pharmaceutical company.[151] InterMune had received a favorable opinion from a European drug-marketing regulator, and Afsarpour made spread bets with a U.K. broker, IG Index, in the days leading up to the public announcement of the decision.[152] The announcement, of course, caused InterMune's stock price to soar.[153]

The court partially granted Sabrdaran's motion to dismiss because the SEC had not alleged that IG Index hedged Afsarpour's spread bets.[154] This was significant for two reasons. First, the court functionally treated hedging as a pleading requirement for international insider trading using derivatives. Second, it clarified a point left open in *Compania* and *Maillard*: it is definitely not enough that contracts are merely based on stock—there must, in fact, be a *transaction* in that stock that can be traced to the defendant.

Things got more complicated when the SEC amended its complaint and moved for summary judgment.[155] First, unlike *Compania* and *Maillard*, the defendant here traded in spread bets, contracts that do not result in a 100 percent hedged transaction like CFDs do. Afsarpour's broker used a market-maker model and disclosed to clients only that it "may" hedge in the underlying

147. SEC v. Sabrdaran, 252 F. Supp. 3d 866 (N.D. Cal. 2017).
148. SEC v. Sabrdaran, No. 14–cv–04825–JSC, 2015 WL 901352 (N.D. Cal. Mar. 2, 2015).
149. SEC v. Sabrdaran, No. 14–cv–04825–JSC, 2016 WL 4791771 (N.D. Cal. Sep. 14, 2016).
150. *Sabrdaran*, 252 F. Supp. 3d 866.
151. *Sabrdaran*, 2015 WL 901352, at *1.
152. *Id.* at *4–5.
153. *Id.*
154. *Id.* at *12.
155. *Sabrdaran*, 2016 WL 4791771, at *1.

market.[156] In fact, IG Index directly hedged only some of Afsarpour's positions.[157]

Second, the court had a difficult interpretive issue before it: whether there is a knowledge requirement for the "in connection with the purchase or sale of any security" element of Rule 10b-5. Incorporating *Morrison*'s gloss, the question was whether a defendant needs to know that his purchases are being hedged *on a U.S. exchange*. The reason this is so difficult is that there is rarely a need to litigate that element of insider trading; the typical insider-trading case involves someone purchasing ordinary shares for his own account, so there is no dispute as to knowledge. Yet, here, Afsarpour could credibly claim that he did not know how IG Index would hedge and thus that he did not know that his spread bet would cause a transaction in the United States. The court ordered supplemental briefing and a hearing on the question and ultimately decided that "the SEC need not necessarily prove that Afsarpour subjectively knew that his fraudulent activity was 'in connection with the purchase or sale of any security.'"[158] This holding embodies a central problem with the hedging theory: a bifurcated mens rea analysis for international insider trading.[159]

The SEC lost its motion for summary judgment, and the case proceeded to jury trial.[160] The jury ultimately ruled against Afsarpour.[161] The jury issued a general rather than special verdict—that is, the jury did not identify *which* of Afsarpour's spread bets were in connection with U.S. securities because the court said that that was a question of remedies, not liability.[162] Afsarpour had independently purchased InterMune stock and call options himself through his U.S. brokerage account, so his "general scheme to defraud" was in connection with U.S. securities.[163] Unfortunately, the general verdict did little to clarify the contours of the hedging theory. It is unclear what role the broker's hedging played in the jury's deliberations—the jury

156. *Id.* at *3.

157. SEC v. Sabrdaran, 252 F. Supp. 3d 866, 895 (N.D. Cal. 2017) (permitting disgorgement for the trades that IG Index's broker "actually hedged" but not those where the SEC did not "connect[] the dots" with a U.S. transaction).

158. *Sabrdaran*, 2016 WL 4791771, at *1.

159. *See infra* notes 179–84 and accompanying text.

160. *Sabrdaran*, 2016 WL 4791771, at *3.

161. *Sabrdaran*, 252 F. Supp. 3d at 873.

162. *Id.* at 884.

163. *Id.* at 888.

instructions included no explicit mention of hedging,[164] and the jury was not asked to apply the "in connection with" standard to individual trades.[165]

In deciding the SEC's motion for disgorgement of the profits made on the trades, the court drew a distinction between profits from the spread bets actually hedged by IG Index in the U.S. market and profits from spread bets that were hedged more indirectly.[166] In particular, IG Index hedged some of Afsarpour's spread bets not by purchasing the underlying shares but by entering into CFDs with a French broker.[167] The court was still satisfied that these transactions passed *Morrison*, though it used some specious reasoning in the process. First, the court analyzed whether CFDs were securities, reasoning that Afsarpour's fraud would meet the in-connection-with standard if it resulted in the purchase of CFDs.[168] CFDs are securities, but *Morrison* requires that securities be traded on a U.S. exchange for liability to extend abroad. CFDs are not traded on a U.S. exchange, so the court should have treated their status as securities as irrelevant. Second, the court suggested that the two-step hedge could still satisfy *Morrison* because IG Index "instructed [the other broker] to purchase the underlying stock."[169] However, there was no evidence that this stock was purchased at all,[170] a notable omission, given that the SEC was previously required to amend its complaint to specifically allege the timing of hedges.[171]

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164. The relevant jury instruction read:

> "In connection with" means that there was some nexus or relationship between the allegedly fraudulent conduct and the sale or purchase of securities in the United States securities market. A defendant's conduct may be in connection with a purchase or sale of a security even if the defendant did not actually participate in any securities transaction.

Defendants' Motion for Judgment as a Matter of Law or in the Alternative a New Trial at 18, SEC v. Sabrdaran, 252 F. Supp. 3d 866 (N.D. Cal. 2017).

165. *Id.* at 18 n.1.

166. *Sabrdaran*, 252 F. Supp. 3d at 895.

167. *Id.* at 875.

168. *See id.* at 888 (arguing that even if the French broker did not purchase the underlying shares, the in-connection-with standard was met because "courts have held that contracts for difference are securities within the meaning of Section 10(b) and Rule 10b–5").

169. *Id.* at 887.

170. *Id.*

171. *See* SEC v. Sabrdaran, No. 14–cv–04825–JSC, 2015 WL 901352, at *8 (N.D. Cal. Mar. 2, 2015) (stating that "the spread bets are 'in connection with' securities to the extent that they were hedged, but the complaint lacks sufficient allegations regarding the timing of the hedging").

In other instances, IG Index hedged by entering into a swap with the firm Macquarie, which in turn hedged through a transaction with Barclays, which *then* purchased InterMune options on a U.S. exchange.[172] These transactions were "too far attenuated to meet the 'in connection with' test," in part because of a lack of evidence connecting Barclays to IG Index.[173] As a result, Afsarpour was able to escape disgorgement for these trades—although ultimately not his liability from the jury verdict.[174]

B. Critique of the Hedging Theory

The foregoing cases illustrate the brief history of the hedging theory in the insider-trading context, from its relatively shallow origins in *Compania* to its thoughtful yet problematic application in *Sabrdaran*. No appellate court has squarely addressed the theory.[175] However, this should not be taken as diminishing the theory's stakes; it is of relatively recent vintage, developing quickly in the wake of *Morrison*. And continued application of the theory would have significant implications for the coverage of the securities laws.

The hedging theory should not be the basis for insider-trading liability. First, relaxing the mens rea standard of a key element of insider trading is inappropriate. Second, the theory results in arbitrary windfalls to certain defendants. Third, it invites bad faith on the part of derivatives brokers. Fourth, it makes litigating insider trading harder than it needs to be. Finally, it relies on a different conception of fraud than the rest of insider-trading doctrine.

1. *Intent and the In-Connection-With Standard.* The *Sabrdaran* court determined that, under *Morrison*, a defendant need not be aware of hedging.[176] To understand the problem with that announcement, recall that the hedging theory is a means of establishing a particular element of Rule 10b-5: "in connection with the purchase or sale of any security."[177] That is, the hedge is what makes the foreign trader's fraud

172. *Sabrdaran*, 252 F. Supp. 3d at 895.

173. *Id.* at 895.

174. *Id.* at 895–96.

175. An appeal has been docketed in *SEC v. Traffic Monsoon, LLC*, No. 17-4059 (10th Cir. filed Apr. 17, 2017), which may reduce the need for future use of the hedging theory. *See infra* Part IV.A.

176. *See* SEC v. Sabrdaran, No. 14-cv-04825-JSC, 2016 WL 4791771, at *1 (N.D. Cal. Sept. 14, 2016).

177. 17 C.F.R. § 240.10b-5 (2018).

"in connection with" the purchase or sale of any security. The consequence is that lowering the intent requirement with respect to hedging effectively lowers the intent requirement of the in-connection-with standard as a whole, at least in the international context. This lowered mens rea standard means that the defendant can be held liable though he was unaware not only that his contract was hedged but also that his fraud touched a U.S. security at all. This arguably broadens Rule 10b-5 just as *Morrison* sought to narrow it: "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."[178]

Further, this mens rea holding is likely at odds with criminal insider-trading doctrine. To be held criminally liable, a defendant must "willfully" violate Rule 10b-5.[179] Although the hedging theory has been used solely in civil actions—not criminal—the same law applies,[180] although the burden of proof differs.[181] The application of the theory in civil cases may open the door to its use in criminal cases. Whether DOJ presses parallel criminal charges in insider-trading cases depends on many factors, but the decision is a matter of discretion.[182] It is not problematic, as a normative matter, to predicate liability on a lesser mens rea, and some criminal statutes do so.[183] However, it would potentially raise concerns of notice and due process for the *courts*, rather than Congress, to broaden the scope of liability so substantially.[184]

178. Marine Bank v. Weaver, 455 U.S. 551, 556 (1982).

179. United States v. O'Hagan, 521 U.S. 642, 665 (1997) (citing 15 U.S.C. § 78ff(a)).

180. *Cf.* Walter Pavlo, *Insider Trading: Civil Or Criminal Crime?*, FORBES (Oct. 24, 2013, 8:15 AM), https://www.forbes.com/sites/walterpavlo/2013/10/24/insider-trading-civil-or-criminal/#34b127b56564 [https://perma.cc/Y56B-NTWA] (describing the extent of wrongdoing as a principal factor affecting prosecutorial discretion).

181. *See* Peter J. Henning, *Blurred Lines in Pursuing Insider Trading Cases*, N.Y. TIMES DEALBOOK (Aug. 15, 2016), https://www.nytimes.com/2016/08/16/business/dealbook/blurred-lines-in-pursuing-insider-trading-cases.html [https://perma.cc/7FN9-JP3M] (noting that criminal cases carry "a higher burden of proof" than SEC actions).

182. Pavlo, *supra* note 180. It may well be the case that DOJ would choose not to prosecute cases based on the hedging theory, whether to conserve limited resources or to avoid the complexities of international criminal law. It is nonetheless desirable to have a doctrinal limiting principle, rather than allowing prosecutorial discretion alone to be determinative.

183. *See, e.g.*, N.Y. PENAL LAW § 125.10 (McKinney 2018) (prohibiting "criminally negligent homicide").

184. *Cf.* Miriam H. Baer, *Insider Trading's Legality Problem*, 127 YALE L.J. FORUM 129, 148 (2017), http://www.yalelawjournal.org/forum/insider-tradings-legality-problem [https://perma.cc/U4T2-968P] (analyzing criminal insider-trading doctrine and arguing that "if we think criminal law is truly exceptional, not just in its power to deprive individuals of their liberty, but because it

Finally, lowering the intent requirement for the in-connection-with standard was not necessary. The theory confuses the relationship between the fraud and the *security* for the relationship between the fraud and the *United States*. A third party's hedge is not what makes the defendant's fraud in connection with a transaction in U.S. exchange–traded security—the defendant's act of betting on the price movement of a U.S. exchange–traded security is. Subsequent acts by the *broker* do not change the relationship between the *defendant's* fraud and the security, which should be evaluated as of the time of defendant's conduct. Whether a trade is hedged is really a question of the degree to which U.S. investors are harmed, and that question is more properly incorporated as a consideration for prosecutorial discretion than as a doctrinal element.

2. *Arbitrariness.* The hedging theory's focus on direct hedging by brokers provides arbitrary windfalls to traders whose brokers do not hedge directly in the U.S. market. A trader who enters a spread bet with a market maker can fortuitously escape liability if the broker hedges by means other than U.S. exchanges—for instance, via another derivative—while a trader with identical fraudulent intent can be liable because he chose a broker that happened to hedge differently.

For example, consider a situation in which a broker would otherwise have hedged a trader's spread bet, but a second trader enters an opposite spread bet shortly thereafter, thus returning the broker's portfolio to a neutral position. Consider also a situation in which one trader's spread bet is too small to warrant hedging, but a second, identical bet entered by a second trader causes the broker to hedge—that is, each trader is necessary but not sufficient for the broker to decide to hedge. The extent to which the outcome depends on the actions of the broker, and perhaps even other traders, renders the hedging theory a poor fit for the deterrent purpose of the insider-trading prohibition.

3. *Perverse Incentives*. Relatedly, the importance of the *type* of hedging undertaken by a derivatives broker could create perverse incentives. Recall that in *Sabrdaran*, some of Afsarpour's trades failed the in-connection-with standard because the broker hedged not by purchasing stock in the underlying market but by engaging in a swap

originates in statutes duly enacted by democratically elected representatives, then we must view this state of affairs with at least a bit of unease").

with another broker.[185] If it became widely known that only one type of broker—those with the DMA business model—exposed their clients to insider-trading liability, unsavory characters might be drawn to market makers instead. And potential U.S. liability may alter market makers' cost-benefit analysis when hedging. For example, suppose a longtime client of a broker enters into a suspicious spread bet. If the broker suspects that the trade is based on material nonpublic information, it may be in the broker's best interest to hedge that trade outside of a U.S. exchange. That would shield the broker's client somewhat from SEC scrutiny, and the broker would thus be able to enjoy the continued business of the client. Even absent a quid pro quo, such a scenario is far from healthy and obviously at odds with the aims of the securities laws.

4. *Administrability*. The hedging theory is difficult for the SEC to plead and for courts to administer. The SEC and DOJ have fewer powers at their disposal to investigate abuses abroad,[186] which makes procuring international trading data more obnoxious than the streamlined domestic process.[187] As *Sabrdaran* illustrates, the hedging theory essentially requires courts to reverse engineer a trade placed on an exchange, sometimes across multiple national boundaries and brokerages. The crux of insider-trading enforcement should be the conduct of the trader. By requiring proof of the conduct of potentially numerous nonparties, the hedging theory complicates life for the courts and the SEC at the pleading stage and beyond.

It is also unclear how a jury in a criminal trial would react to the forensics required to prove an intricate chain of hedging trades. While juries often must resort to opaque documentary evidence in white-collar cases, circuitous proof like that offered in *Sabrdaran*—multiple

185. *See supra* note 172 and accompanying text.

186. For example, while subpoenas are generally enforceable in the United States, compulsory process abroad often must proceed through a mutual legal assistance treaty administered by DOJ or via memorandums of understanding between the SEC and foreign counterparts. *International Enforcement Assistance*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/about/offices/oia/oia_crossborder.shtml [https://perma.cc/68E8-EZLF].

187. For example, the SEC may obtain trading data from domestic brokers without a subpoena. *See* 17 C.F.R. 240.17a-4(j) (2018) (requiring registered brokers to "furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records . . . that are required to be preserved under this section"). Foreign brokers that rely on an exemption from registration, in particular Rule 15a-6, need not comply with this requirement. 17 C.F.R. 240.15a-6 (2018).

hedging chains between different brokerages *possibly* resulting in a purchase of stock—can only add further confusion.[188]

5. *Inconsistency with Insider-Trading Doctrine.* A related but distinct problem is the hedging theory's disconnect with broader insider-trading doctrine. In the Supreme Court's seminal insider-trading cases, the person trading in the securities was also a participant in the fraud. In particular, fraud is "consummated, not when [a] fiduciary gains the confidential information, but when, without disclosure to his principal, *he uses the information to purchase or sell securities*."[189] Under this framework, the fraud should be complete upon the trader's purchase of CFDs—not once the broker purchases stock in the United States. In *United States v. O'Hagan*, the Government offered a hypothetical in which a defendant steals money from a bank and then uses that money to purchase securities.[190] That fraud would not be in connection with a securities transaction because "the fraud would be complete as soon as the money was obtained."[191] The thing of value to the defendants in the cases analyzed here are the CFDs and spread bets; for that reason, acquisition of these contracts is the natural end point of the fraud. For CFDs using a DMA model, this problem can be overcome because hedges are frequently automatic and simultaneous with a CFD trade. With spread bets using market-maker models, this is a more substantial problem.

IV. IMPROVEMENTS

Ultimately, the hedging theory is well intentioned but unworkable. Its problems are significant enough to warrant discarding the theory. But as this Note has argued, the securities laws provide a robust shield that should protect U.S. markets from the manipulation of insider trading, even if overseas. Imagining a proper enforcement regime requires deciding the features it should have and the problems it should address.

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188. *See* Matthew A. Reiber & Jill D. Weinberg, *The Complexity of Complexity: An Empirical Study of Juror Competence in Civil Cases*, 78 U. CIN. L. REV. 929, 963 (2010) (finding that jury "comprehension declines as factual complexity increases").

189. United States v. O'Hagan, 521 U.S. 642, 656 (1997) (emphasis added).

190. *Id.*

191. *Id.* (quoting Brief for United States at 24 n.13, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842)).

The brief history of the hedging theory demonstrates the need for a bright-line rule—fraudulently trading in U.S. stock–backed derivatives is *always* in connection with the purchase or sale of a security on a U.S. exchange. As a practical matter, this is intuitive; going long on a derivative based on the value of a particular stock increases the global demand for the stock itself, ultimately causing price effects in the U.S. market. Even in causally attenuated hedges involving multiple broker-to-broker transactions, the U.S. market is ultimately impacted. At some point in the chain, someone will hedge via the underlying stock itself rather than a derivative. In a rare case where no hedge whatsoever occurs, the increased international demand for the stock-backed derivative is still likely to ultimately impact the underlying U.S. ordinary stock through cross border arbitrage.

The breadth of this proposed standard is admittedly inconsistent with the spirit of *Morrison*, which plainly sought to limit the coverage of section 10(b). Part I argues that *Morrison* produced a bad rule of law, and the corresponding conclusion here is that it is impossible to have a logically coherent international enforcement regime that requires pointing to a *particular* transaction on a U.S. exchange. As such, the following judicial and legislative reforms seek to replace *Morrison*.[192] Importantly, Dodd-Frank may have already provided a fix for this problem.

A. Judicial

The best option available to courts is to hold that *Morrison* was abrogated by Dodd-Frank for the purposes of enforcement actions brought by the SEC or DOJ. Although the bulk of *Morrison* analyzed the extraterritorial reach of the '34 Act, a threshold issue in the

192. Although administrative action by the SEC may be helpful in filling the gaps created by *Morrison*, the SEC has relatively little room for unilateral action. The brokers involved in these transactions are overseas and thus subject to foreign regulators as far as their derivative products are concerned. The best bet is the SEC's continued and expanded cooperation with its foreign counterparts. Although this would not impact the doctrinal problems described here, a strong relationship would ease some of the practical hurdles associated with international enforcement.

The Financial Conduct Authority ("FCA"), the British securities regulator, has become more aggressive towards CFDs. *See* Williams-Grut, *supra* note 117. The theme of its objections to that family of instruments is consumer protection—especially the ease with which losses can exceed principal because of leverage. Ideally, the SEC and FCA could cooperate to find a regime that, if nothing else, would (1) require brokers to conspicuously advertise that trades may be hedged in the U.S. market, and (2) facilitate the sharing of suspicious derivative positions that are based on U.S. stocks.

decision was whether this is a question of subject-matter jurisdiction or merits.[193] The Court held that because the '34 Act confers subject-matter jurisdiction over any violation of the Act, without regard to location, the international reach of section 10 is a merits question going to the substance of the statute.[194]

The day *Morrison* was decided, June 24, 2010, was also the final conference-committee meeting prior to the passage of Dodd-Frank.[195] Dodd-Frank added the following language to section 929P of the '34 Act:

> (b) Extraterritorial jurisdiction
>
> The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by the Commission or the United States alleging a violation of the antifraud provisions of this chapter involving—
>
> > (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
> >
> > (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.[196]

This addition clearly meant to codify the conduct-and-effects test in use by the Second Circuit prior to *Morrison*. Yet, the same day that this language earned its place in the final bill (but still about a month before it became law), *Morrison* held that subject-matter jurisdiction is not relevant to extraterritorial applications of the '34 Act.

On the one hand, this is as clear an indication of congressional intent as can be imagined. When language from case law is codified verbatim, it generally indicates that Congress intended to continue the approach from those cases. On the other hand, the provision is

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193. Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247, 253–54 & n.3 (2010).

194. *See id.* at 254 (quoting 15 U.S.C. § 78aa to establish that the district court had subject-matter jurisdiction to adjudicate "all suits in equity and actions at law brought to enforce any liability or duty" under the '34 Act).

195. *Actions Overview H.R.4173—111th Congress (2009-2010)*, CONGRESS.GOV, https://www.congress.gov/bill/111th-congress/house-bill/4173/actions [https://perma.cc/G7EK-9KJQ].

196. 15 U.S.C. § 78aa (2012).

imperfectly drafted, in light of *Morrison*'s holding.[197] The amendment should have omitted reference to subject-matter jurisdiction, and it perhaps should have been in section 10(b) itself, rather than in the jurisdictional section.

Imperfection notwithstanding, there are two ways that the Dodd-Frank provision may be taken as having overruled *Morrison*. First, courts should recognize what Congress was attempting to do—restore the conduct-and-effects test for foreign insider-trading enforcement actions—and allow the provision to have that effect, despite the error. Courts seek to read statutes to avoid superfluity,[198] and interpreting section 929P(b) as solely a grant of jurisdiction likely renders it superfluous because section 929P(a) already provides for jurisdiction.[199] Put differently, the SEC and DOJ must have different or additional powers under subsection (b) than under subsection (a) for the Dodd-Frank amendment to have any meaning at all.[200]

Second, even if section 929P(b) is unsuccessful in restoring the conduct-and-effects test, it may have overruled *Morrison* by providing an explicit indication of extraterritorial application—exactly what the *Morrison* Court said was needed to overcome the presumption against extraterritoriality. Importantly, the Dodd-Frank provision is specific to actions brought by the SEC or DOJ, so it does not risk bringing any private f-cubed 10b-5 actions back into U.S. courts. Further, the language of this amendment is more forceful than any of the language *Morrison* discarded in applying the presumption against extraterritoriality.

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197. *See* Thel, *supra* note 80, at 40 n.127 (describing the Dodd-Frank amendment as "clumsy" because *Morrison* "emphasized that the decision was on the reach of section 10(b), not on the jurisdiction of courts").

198. *See, e.g.*, Corley v. United States, 556 U.S. 303, 314 (2009) (describing as "one of the most basic interpretive canons" the rule that a "statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant") (quoting Hibbs v. Winn, 542 U.S. 88, 101 (2004)).

199. *See, e.g.*, SEC v. Traffic Monsoon, LLC, 245 F. Supp. 3d 1275, 1293 (D. Utah 2017) ("To assume that Congress intended this amendment to be mere surplusage, with no discernable effect, flies in the face of reason.").

200. At oral argument before the Tenth Circuit, Traffic Monsoon argued that section 929P(b) was not a nullity but rather operated to strip courts of jurisdiction they otherwise would have had under the statute's plenary jurisdictional grant. Judge Mary Briscoe responded: "Which would be the exact opposite of what Congress intended." Oral Argument at 13:00, SEC v. Traffic Monsoon, LLC, No. 17-4059 (10th Cir. filed Apr. 17, 2017), https://www.ca10.uscourts.gov/sites/default/files/clerk/17-4059.mp3 [https://perma.cc/8SUL-QQ2X].

Several courts have confronted this question, including in *Compania*[201] and *Sabrdaran.*[202] Like numerous other courts that have considered whether Dodd-Frank overruled *Morrison*, they instead found a way for the transaction at issue to pass muster even under *Morrison.*[203] Two cases stand alone in depth of analysis: *SEC v. Traffic Monsoon LLC*[204] and *SEC v. Chicago Convention Center*.[205] Both undertook a rigorous analysis of the legislative history behind Dodd-Frank and of section 929P's interaction with *Morrison.*[206] The *Traffic Monsoon* court was confident that section 929P overruled *Morrison* in light of evidence of congressional intent,[207] while the court in *Chicago Convention Center* was more reticent, noting that it is not the courts'

201. SEC v. Compania Internacional Financiera, No. 11 Civ. 4904(DLC), 2011 WL 3251813, at *6 n.2 (S.D.N.Y. July 29, 2011) ("This question need not be addressed in this Opinion . . . .").

202. SEC v. Sabrdaran, 252 F. Supp. 3d 866, 895 (N.D. Cal. 2017) ("[T]he Court need not address the parties' dispute over whether Section 929P(b) of Dodd-Frank revived the broader tests that *Morrison* rejected.").

203. *See* United States v. McLellan, No. 16-cr-10094-LTS, 2018 WL 1083030, at *2 n.5 (D. Mass. Feb. 27, 2018) (declining to resolve whether Dodd-Frank superseded *Morrison* because the charges satisfied even the *Morrison* test); SEC v. Battoo, 158 F. Supp. 3d 676, 692 (N.D. Ill. 2016) (declining to hold whether Dodd-Frank superseded *Morrison* because, even if it did, the amendment would not apply retroactively); SEC v. Chi. Convention Ctr., LLC, 961 F. Supp. 2d 905, 916–17 (N.D. Ill. 2013) (declining to resolve whether *Morrison* was superseded because the complaint stated a claim under the *Morrison* standard); Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 627 n.3 (S.D.N.Y. 2010) (applying the *Morrison* transactional test, but noting that in recent legislation, "Congress explicitly granted federal courts extraterritorial jurisdiction under the conduct or effect test for proceedings brought by the SEC").

Some courts have affirmatively stated in dicta that Dodd-Frank was successful in superseding *Morrison*. *See* United States v. Vasquez, 899 F.3d 363, 373 (5th Cir. 2018) (citing *Morrison* as superseded by Dodd-Frank); *Traffic Monsoon*, 245 F. Supp. 3d at 1293–94 (holding that 929P(b)'s conduct-and-effects test superseded *Morrison*'s transactional test, and holding, in the alternative, that the transactions at issue satisfied the *Morrison* standard); SEC v. Tourre, No. 10 Civ. 3229(KBF), 2013 WL 2407172, at *1 n.4 (S.D.N.Y. June 4, 2013) (remarking that the "Dodd-Frank Act effectively reversed *Morrison* in the context of SEC enforcement actions"); Asadi v. G.E. Energy (USA), LLC, Civ. No. 4:12–345, 2012 WL 2522599, at *4 (S.D. Tex. June 28, 2012) (finding that Dodd-Frank restored extraterritorial jurisdiction for the SEC); *In re* Optimal U.S. Litig., 865 F. Supp. 2d 451, 456 n.28 (S.D.N.Y. 2012) (stating that "Congress . . . restor[ed] the conducts and effects test for SEC enforcement actions"); SEC v. Gruss, 859 F. Supp. 2d 653, 664 (S.D.N.Y. 2012) (holding that "Section 929P(b) restores the SEC's extraterritorial authority" in the context of a different statute).

204. SEC v. Traffic Monsoon, LLC, 245 F. Supp. 3d 1275 (2017).

205. SEC v. Chi. Convention Ctr., LLC, 961 F. Supp. 2d 905 (2013).

206. *Traffic Monsoon*, 245 F. Supp. 3d at 1290–94; *Chi. Convention Ctr.*, 961 F. Supp. 2d at 914–16.

207. *See Traffic Monsoon*, 245 F. Supp. 3d at 1293–94 (applying the *Morrison* test in the alternative, in case "the court has erred in concluding that Section 929P(b) reinstated the conduct and effects test").

job to fix drafting errors.[208] *Traffic Monsoon*'s analysis is more persuasive because it does not require reading section 929P as a nullity. Further, the case is particularly noteworthy because an appeal has been docketed which will result in the first ruling from a circuit court on the issue.[209]

B. Statutory

Congress can amend the '34 Act to clarify that international insider trading is within the scope of section 10(b) and Rule 10b-5. It has an array of options for accomplishing that goal, but the most obvious is eliminating the current language in section 929P(b) and adding something similar to the SEC's Rule 250.1, which states that "the antifraud provisions of the securities laws apply to . . . [conduct] occurring outside the United States that has a foreseeable substantial effect within the United States."[210]

The value of this rule is that it is not couched in the language of jurisdiction; it is about the substance of the antifraud provisions. However, Rule 250.1 is just that—a rule. It was promulgated in 2012 under the authority of the general rulemaking power of the SEC and the jurisdictional provisions of the '33 Act, the '34 Act, and the Investment Advisers Act.[211] Although it purports to cement the SEC's

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208. *Chi. Convention Ctr.*, 961 F. Supp. 2d at 915–16.

209. SEC v. Traffic Monsoon, LLC, No. 17-4059 (10th Cir. filed Apr. 17, 2017). In *United States v. Vasquez*, 899 F.3d 363, 373 (5th Cir. 2018), the Fifth Circuit included the phrase "superseded by statute" when it cited *Morrison*, referencing Dodd-Frank. This suggests that the Fifth Circuit is of one mind with the *Traffic Monsoon* district court, but few conclusions can be drawn from dicta.

210. In full, the rule states:

> (a) Notwithstanding any other Commission rule or regulation, the antifraud provisions of the securities laws apply to:
>
> > (1) Conduct within the United States that constitutes significant steps in furtherance of the violation; or
> >
> > (2) Conduct occurring outside the United States that has a foreseeable substantial effect within the United States.
>
> (b) The antifraud provisions of the securities laws apply to conduct described in paragraph (a)(1) of this section even if:
>
> > (1) The violation relates to a securities transaction or securities transactions occurring outside the United States that involves only foreign investors; or
> >
> > (2) The violation is committed by a foreign adviser and involves only foreign investors.
>
> (c) Violations of the antifraud provisions of the securities laws described in this section may be pursued in judicial proceedings brought by the Commission or the United States.

SEC Cross-Border Antifraud Law-Enforcement Authority Rule, 17 C.F.R. § 250.1 (2018).

211. *Id.* (citing as authority 15 U.S.C. §§ 77s, 77v(c), 78w, 78aa(b), 80b–11, and 80b–14(b)).

extraterritorial authority, a regulation is bound by its enabling statute. As such, the argument that the rule currently confers any power distinct from section 929P is not particularly persuasive. Hence the need for congressional action.

CONCLUSION

The importance of the American securities markets is paramount, not just to the United States but to the global economy. The markets' depth is the hard-won result of American enterprise, and the markets' reliability is owed to the vigilant oversight of the SEC. In a globalized economy, bad actors are able to victimize the U.S. securities markets without ever stepping foot on American soil. The scholarly and lay consensus is that insider trading is a species of fraud both morally wrong and damaging in effect. Even if the doctrine of insider trading has occasionally trafficked in hyperbole and legal fiction, that should not detract from the important function it serves.

The arrival of overseas derivatives based on U.S. stock poses a novel challenge to law enforcement. Inside traders are able to profit at the expense of U.S. investors while one step removed from U.S. exchanges. In 2010, *Morrison* called into doubt whether the antifraud provisions of the securities laws cover the conduct of these actors by requiring that fraud be in connection with a transaction in a U.S. exchange–traded security.

The SEC, out of fidelity to its role as an enforcer, has advocated a flawed theory of liability—that foreign inside traders are liable only when the derivatives they purchase are hedged on a U.S. exchange. The hedging theory satisfies no one. Under this theory, the SEC must gather evidence from foreign brokers over which it has no direct authority, putative defendants face the prospect of divergent legal exposure based on their choice of broker, and courts must sort through voluminous records of trades and hedges. Indeed, there is a commonsense notion that this proof is ancillary to the centerpiece of the crime: trading on the basis of inside information.

Problematic though it may be, the hedging theory is the natural outgrowth of *Morrison*, and therefore *Morrison* should not govern in the enforcement context. Courts should recognize Congress's express intent to expand law enforcement's toolbox with the passage of Dodd-Frank, confining *Morrison*'s holding to private rights of action under section 10(b) and Rule 10b-5. Ideally, Congress would also correct its draftsman's error in Dodd-Frank to eliminate any doubt that the

United States has the will and capacity to fight back against those who would defraud its markets, wherever they are.