Deciding the Applicable Law in Private Antifraud Claims Arising From Cross-Border Security-Based Swaps

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A swap is a derivative in which counterparties exchange cash flows of one party's financial instrument for those of the other party's financial instrument over time. Different from futures and options, swaps are, at least initially, more customized for counterparties and traded over-the-counter. By referencing various financial instruments, swaps have many variations and may involve foreign factors. For example, two counterparties may enter into a swap contract referencing the stock price of a company. This contract is a security-based swap ("SBS") or equity swap. Counterparties may also enter into an SBS referencing certain stock traded on foreign exchange. By entering into such a cross-border SBS, one party can invest in foreign securities markets without incurring taxes, fees, and costs associated with entering and exiting a market.

Prior to the 2008 financial crisis, swaps were largely unregulated. Parties resolved disputes through private ordering. Since the 2008 financial crisis, many commentators have argued that credit default swaps ("CDS") aggravated the crisis.[1] As a result, countries started regulating swaps and SBS.[2] Private antifraud claims regarding cross-border SBS also emerged. A party may bring a fraud claim against its counterparty or others associated with the underlying security. However, despite countries' efforts on regulating SBS, there is no clear rule on which law applies to private antifraud claims arising from cross-border SBS.

This Note seeks to resolve this issue by proposing a rule. First, Part I introduces swaps, SBS, and countries' regulatory schemes over the private antifraud lawsuits regarding SBS. Then, Part II discusses relevant considerations in deciding the applicable law of cross-border SBS fraud claims. Finally, this Note proposes that a treaty is the proper form to

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1. *See infra* note 18.
2. *See infra* notes 42–53, 75–79, and accompanying text.

resolve the issue. As for the content of the treaty, this Note proposes that private antifraud lawsuits regarding SBS should exist only among contractual parties and should be determined by the parties' choice of law.

I. SWAPS, CROSS-BORDER SECURITY-BASED SWAPS, AND REGULATIONS

A. SWAPS, SECURITY-BASED SWAPS, AND CROSS-BORDER SECURITY-BASED SWAPS

A swap is a contract in which counterparties exchange payments over a specified time period when the amounts of payments are determined by the difference in prices of two financial instruments.[3] Unlike futures, swaps are more customized to parties. Parties can alter provisions when entering into swap agreements.[4] On the other hand, some standardized templates, such as the International Swap Dealers Association Master Agreement[5] and the European Master Agreement,[6] provide parties with standard swap provisions. Under these templates, parties can still negotiate certain matters, such as the governing law and tax representations.[7] As the swap market evolved, the range of linked financial instruments has increased and more types of swaps have been developed.[8] Internationalization of the financial markets also facilitates the global swap market.[9]

SBS or equity swaps are a type of swaps where at least one of the two payments are linked to the performance of an equity index, a basket

3. *See, e.g.*, ROBERT L. MCDONALD, DERIVATIVE MARKETS 264 (3d ed. 2009).

4. Commodity Futures Modernization Act of 2000 § 301(a), 114 Stat. at 2763A-449 to 2763A-450 (codified at 15 U.S.C. § 78c note (2006)) ("the term 'swap agreement' means any agreement, contract and transaction . . . , the material terms of which (other than price and quantity) are subject to individual negotiation . . . .").

5. *ISDA 2002 Master Agreement*, INT'L SWAPS & DERIVATIVES ASSOC., http://assets.isda.org/media/e0f39375/d851831a.pdf (last visited Oct. 9, 2014 [hereinafter ISDA Agreement].

6. Eur. Banking Fed'n, *European Master Agreement (EMA)*, http://www.ebf-fbe.eu/european-master-agreement-ema/.

7. *See* ISDA Agreement, *supra* note 5, Schedule at 29; *See also* Eur. Banking Fed'n, *European Master Agreement Special Provisions* (2013), http://www.ebf-fbe.eu/uploads/EMA%20Special%20Provisions%20final.pdf.

8. SATYAJIT DAS, SWAP & DERIVATIVE FINANCING 4 (2d ed. 1994)) ("[H]owever, the range of instruments has increased with the emergence of a whole range of derivative instruments within the basic framework . . . .").

9. *Id.* at 17 ("[T]he rapid growth in the absolute size of the global swap market . . . .").

of stocks, or a single stock.[10] For example, two parties can enter into an SBS in which one party, Party A, makes fixed payments for payments made by a second party, Party B, based on the performance of a single stock.

By referencing different securities, SBS becomes a useful means of implementing an asset allocation and diversification strategy. [11] Furthermore, one can make cross-border investments in foreign securities without directly entering foreign securities markets but via an SBS referencing foreign securities.[12] In the previous example, if the amount of the payment Party B makes is based on the performance of a foreign stock, Party A in effect invests in such foreign stock by making payments to Party B over time. One incentive for Party A to enter into such an SBS is that Party A incurs no taxes, fees, or other costs associated with entering and exiting the foreign securities market.[13] As a result, the SBS market is pretty globalized and diversified. According to the Bank for International Settlements, the notional amounts outstanding of the equity-linked forwards and swaps reached $2.045 trillion as of December 2012.[14] United States equities are the most referenced in the market. However, the notional amount outstanding of U.S. equities only constituted $669 billion, less than one third of total notional amounts outstanding.[15]

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10. BRUCE M. COLLINS & FRANK J. FABOZZI, DERIVATIVES AND EQUITY PORTFOLIO MANAGEMENT 180 (1999) (describing equity swaps as similar in concept to interest rate or currency swaps). However, under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress chose "security-based swaps" to refer to equity swaps. *See* 15 U.S.C. 78c(a)(68) (2010). Therefore, this Note also uses "security-based swaps" or "SBS" to refer to equity swaps. For detailed discussions on the definition of security-based swaps, see Thomas J. Molony, *Still Floating: Security-Based Swap Agreements After Dodd-Frank*, 42 SETON HALL L. REV. 953, 1008 (2012).

11. COLLINS & FABOZZI, *supra* note 10, at 181.

12. *See id.* at 181 ("[A]n example of an equity swap is a 1-year agreement where the counterparty agrees to pay the investor the total return to the S&P 500 Index in exchange for dollar-denominated LIBOR on a quarterly basis . . . .This type of equity swap is the economic equivalent of financing a long position in the S&P 500 Index at a spread to LIBOR.").

13. *Id.* at 182 ("[T]he advantage of entering into an equity swap to obtain international diversification are that the investor's exposure is devoid of tracking error, and the investor incurs no sales tax, custodial fees, withholding fees, or market impact associated with entering and exiting a market."); DAS, *supra* note 8, at 542 ("[E]quity index linked derivatives . . . enables the investors to avoid some of the physical transactions that would otherwise be required including foreign exchange transactions, rebalancing of the portfolio, tracking error, reinvestment of dividend income, as well as the avoidance of costs of custodial arrangement to hold the equities and stamp taxes etc.").

14. *Amounts Outstanding of OTC Equity-linked Derivatives*, BANK FOR INT'L SETTLEMENTS Q. REV., Sept. 2014, at A145 tbl. 22B, *available at* http://www.bis.org/statistics/dt22b22c.pdf.

15. *See id.*

B. REGULATIONS AND RULES ASSOCIATED WITH CROSS-BORDER SECURITY-BASED SWAPS

Prior to the 2008 financial crisis, swaps were largely unregulated.[16] Parties resolved disputes through private ordering.[17] Since the 2008 financial crisis, commentators have argued that the prevalence of CDS aggravated the crisis.[18] Meanwhile, private antifraud claims against counterparties or others associated with the underlying securities emerged in the context of cross-border SBS. In response to the financial crisis, G-20 leaders agreed in Pittsburgh to tighten the regulations on over-the-counter traded derivatives.[19] Accordingly, governments of large economies, such as United States and European Union, implemented new regulations on swaps. This Note introduces recent developments of private antifraud claims and regulatory developments.

1. United States

Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5 provide investors a private cause of action to pursue the securities fraud.[20] For the extraterritorial application of Section 10(b) and Rule 10b-5, the Supreme Court in *Morrison v. National Australia Bank Ltd.*[21] developed the "transactional test" to determine whether Section 10(b) applies. Following *Morrison*, *Elliot Associates v. Porsche Automobil*

16. *See, e.g.*, Letter from Timothy F. Geithner, U.S. Sec'y of the Treasury, to Harry Reid, U.S. Senator (May 13, 2009), *available at* http://online.wsj.com/public/resources/documents/OTCletter20090513.pdf (writing that the credit-default-swap market, among others, before Dodd Frank "[was] largely excluded or exempted from regulation"); *see also* 15 U.S.C. § 77b-1(b)(1) (2006) ("[T]he definition of 'security' . . . does not include any security-based swap agreement."); *id.* § 78c-(a)(78)(B) (same).

17. *See generally* Arthur W.S. Duff & David Zaring, *New Paradigms and Familiar Tools in the New Derivatives Regulation*, 81 GEO. WASH. L. REV. 677, 679–86 (2013) (discussing the history of self-regulation in U.S. derivatives markets).

18. *See, e.g.*, Nicolas Varchaver & Katie Benner, *The 55 Trillion Question*, FORTUNE.COM (Sep. 30, 2008, 12:28 PM), http://archive.fortune.com/2008/09/30/magazines/fortune/varchaver_derivatives_short.fortune/index.htm; Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME (Mar. 17, 2008), http://content.time.com/time/business/article/0,8599,1723152,00.html.

19. The Group of Twenty, Leader's Statement, The Pittsburgh Summit, September 24–25 ¶¶ 11, 13, 17 (Sep. 25, 2009), *available at* http://www.g20.org/documents/ (select "Declaration" for "Search by document type:" Column; then follow "The G20 Pittsburgh Summit Leader's Statement" hyperlink).

20. *See, e.g.*, Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947); Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983).

21. Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2886 (2010).

Holding SE[22] further illustrated the application of *Morrison* in the private antifraud lawsuits arising from SBS. The Dodd-Frank Wall Street Reform and Consumer Protection Act [23] ("Dodd-Frank Act") also modified the *Morrison* test for the governmental actions.

a. Morrison *Decision – The Transactional Test*

Morrison v. National Australia Bank Ltd. is a United States Supreme Court case dealing with the application of Section 10(b) of the Exchange Act to foreign securities. Defendant National Australia Bank ("National") was an Australian Bank with shares traded on the Australian Stock Exchange and American Depositary Receipts ("ADRs") listed on the New York Stock Exchange.[24] Plaintiffs were Australian shareholders of National, alleging National violated Section 10(b) by misrepresenting its subsidiary's success before writing down the value. [25] The U.S. Supreme Court affirmed the lower court's dismissal, but rejected the lower court's "conduct and effects" test[26] in determining whether Section 10(b) applies to foreign securities.[27] Instead, the Supreme Court held that Section 10(b) only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[28]

b. Porsche *Decision – The Economic Reality Test*

Elliot Associates v. Porsche Automobil Holding SE is the leading case regarding private antifraud claim in cross-border SBS following *Morrison*. In *Porsche*, plaintiffs were 35 hedge funds that entered into SBS with unknown counterparties referencing the share price of Volkswagen, a German company. [29] In SBS plaintiffs held short positions. In other words, SBS would generate gains for plaintiffs as the price of Volkswagen's shares fell and generate losses as the price of Volkswagen's shares rose.[30]

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22. Elliott Assocs. v. Porsche Auto. Holding SE, 759 F. Supp. 2d 469, 474–76 (S.D.N.Y. 2010).

23. Pub. L. No. 111–203, 124 Stat. 1376 (2010).

24. *Morrison*, 130 S. Ct. at 2875.

25. *Id.* at 2875–76.

26. The "conduct test" examines "whether the wrongful conduct occurred in the United States." *Id.* at 2879. The "effects test" examines "whether the wrongful conduct had a substantial effect in the United States or upon United States citizens." *Id.* Both tests focus on the details of the alleged deception. *See id.*

27. *Id.* at 2881.

28. *Id.* at 2884–86.

29. *Porsche*, 759 F. Supp. 2d at 471.

30. *Id.*

Defendant Porsche, also a German company, was the Volkswagen's largest shareholder by the end of 2007, owning approximately 31% of Volkswagen's shares.[31] Plaintiffs alleged that Porsche made statements in which it declined to take over Volkswagen while continuing to purchase Volkswagen's shares during the first three quarters of 2008.[32] On October 26, 2008, Porsche announced it had 75% of Volkswagen's share, causing the price of Volkswagen's shares to rise.[33] Plaintiffs, suffering losses because of their short positions, sued Porsche for misrepresentation under Section 10(b) of the Exchanges Act,[34] arguing that Section 10(b) applied because they entered into swap transactions in the United States.[35]

The *Elliot* Court dismissed the plaintiffs' claims brought under Section 10(b).[36] Quoting *Morrison*'s opinion as to the scope of Section 10(b), the court first noted that SBS in this case were not traded in domestic exchanges.[37] The court then held that, despite plaintiffs' argument that SBS transactions were entered into in the United States,[38] plaintiffs failed to meet the "transactional test" under *Morrison* because "the economic reality is that the Plaintiffs' swap agreements are essentially 'transactions conducted upon foreign exchanges and markets,' and not 'domestic transactions' that merit the protection of § 10(b)."[39]

c. The Dodd-Frank Act

Prior to the Dodd-Frank Act, SBS had already been subject to private antifraud claims under Section 10(b) of the Exchange Act,[40] even though it was not specified in the Exchange Act's definition.[41] The Dodd-Frank Act later defines "security-based swaps"[42] as a "security"[43]

31. *Id.* at 471–72.
32. *Id.* at 472.
33. *Id.* at 472–73.
34. *Id.* at 473.
35. *Id.* at 474.
36. *Id.* at 476.
37. *Id.* at 473–74.
38. *Id.* at 471, 474.
39. *Id.* at 476.
40. *See Porsche*, 759 F. Supp. 2d at 475; 146 CONG. REC. S11, 946 (daily ed. Jan. 2, 2001) (statement of Sen. Sarbanes).
41. *See* 15 U.S.C. § 78c(a)(10) (2006) (omitting SBS from its definition).
42. Dodd- Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1756 (2010) [hereinafter Dodd-Frank Act] (creating § 3(a)(68) of the Exchange Act, which defines a "security-based swap" as, subject to certain exceptions, any agreement that is a swap under the Commodity Exchange Act or is based on a "narrow-based security index," a "single security or loan," or "the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a

under the Exchange Act. It further provides the following requirements on SBS, with certain exceptions: (1) mandatory clearing and trading through certain registered organizations, subject to certain exceptions;[44] (2) mandatory registration and comprehensive regulation on security-based swap dealers[45] and major security-based swap participants;[46] and (3) reporting and recordkeeping requirements.[47] In addition, the SEC proposed a rule specifying the prohibition against fraud in connection with SBS.[48]

For antifraud jurisdiction, the Dodd-Frank Act provides extraterritorial jurisdiction in the federal securities laws if there is "(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."[49] Accordingly, the SEC promulgated a new rule expressing its antifraud authority in cross-border securities transactions, including cross-border SBS transactions.[50] However, this provision is only available for the federal government.[51] As for private antifraud lawsuits, the Dodd-Frank Act ordered the SEC to study on this topic.[52] The SEC's report made no specific recommendations.[53] As a result, it is unlikely that the similar conduct and

security or the issuers of securities in a narrow based security index.").

43. *Id.* § 761(a).

44. *Id.* § 763(a).

45. *See* 15 U.S.C. § 78c(a)(71) (2010).

46. Dodd-Frank Act, *supra* note 42, § 764. *See* 15 U.S.C. § 78c(a)(67) (2010).

47. *Id.* §§ 764, 766. However, most of these requirements are temporarily exempted by the SEC. *See* Extension of Exemption for Security-Based Swaps, 79 Fed. Reg. 7,570 (Feb. 10, 2014) (to be codified at 17 C.F.R. pt. 230, 240, 260); Order Extending Temporary Exemptions in Connection with the Revision of the Definition of "Security" to Encompass Security-Based Swaps, Exchange Act Release No. 34-71485, 79 Fed. Reg. 9,028 (Feb. 5, 2014).

48. Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, 75 Fed. Reg. 68,560 (proposed Nov. 8, 2010) (to be codified at 17 C.F.R. pt. 240).

49. Dodd-Frank Act, *supra* note 42, § 929P(b).

50. *See* Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Securities-Based Swap Activities, 79 Fed. Reg. 47,277, 47,372 (Aug. 12, 2014) (to be codified at 17 C.F.R. pt 240, 241, 250) (17 C.F.R. § 250.1).

51. *See, e.g.*, David He, Note, *Beyond Securities Fraud: The Territorial Reach of U.S. Laws After* Morrison v. N.A.B., 2013 COLUM. BUS. L. REV. 148, 168; Wulf A. Kaal & Richard W. Painter, *Forum Competition and Choice of Law Competition in Securities Law After* Morrison v. National Australia Bank, 97 MINN. L. REV. 132, 151–52 (2012) ("Section 929P does not restore private rights of action.").

52. Dodd-Frank Act, *supra* note 42, § 929Y.

53. *See* SEC STAFF, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT

effects test available for the government will apply to private antifraud lawsuits after *Morrison*.[54]

2. Other Countries

Other countries' recent development in private antifraud claims for investors increases the possibility that U.S. law and the law of other countries will compete over cross-border private antifraud claims.[55] In addition, countries use different standards to determine whether their antifraud laws apply.[56] Therefore, the inconsistency and conflict in applying the antifraud law may occur among different countries.[57] Countries' new regulations on swaps, like the Dodd-Frank Act, have not addressed this issue.[58]

a. Increase in Private Antifraud Lawsuits

Before the *Morrison* decision, the United States was the premier forum for investors' private antifraud litigations because of the availability of class actions, the fraud-on-the-market presumption,[59] and the liberal application of U.S. laws to disputes arising out of non-U.S. transactions.[60] However, other countries have removed some obstacles for investors to initiate private antifraud actions.[61] For example, some European countries have made it available for investors to bring collective actions.[62] Canada, South Korea, the Netherlands, and Italy also

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OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 AS REQUIRED BY SECTION 929Y OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 69–70 (2012).

54. He, *supra* note 51, at 170; Kaal & Painter, *supra* note 51, at 152.

55. Kaal & Painter, *supra* note 51, at 152.

56. *See infra* notes 68–72 and accompanying text.

57. Kaal & Painter, *supra* note 51, at 157, 198–99.

58. *See infra* notes 75–79 and accompanying text.

59. Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988).

60. Kaal & Painter, *supra* note 51, at 159–60; William F. Sullivan & John J. O'Kane IV, Morrison *and Foreign Securities Class Actions*, INT'L LITIG. Q., Fall 2010, at 20 ("For decades, courts across jurisdictions enforced these rules, even where the alleged fraud or its effects occurred outside the territorial jurisdiction of the United States."); William F. Sullivan et al., *A Global Concern: The Rise of International Securities Litigation*, SEC. REG. & L. REP., Apr. 2013, at 1–2.

61. *See, e.g.*, Noam Noked, *A New Playbook for Global Securities Litigation and Regulation*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 2, 2009, 9:53 AM), http://blogs.law.harvard.edu/corpgov/2012/02/02/a-new-playbook-for-global-securities-litigation-and-regulation/; Sullivan et. al, *supra* note 60.

62. *See generally* Stefano M. Grace, *Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the* Acquis Communautaire, J. OF TRANSNAT'L L. & POL'Y, 281, 290–300 (introducing European countries' adoption of class action); Kaal

recognize some variation of the fraud-on-the-market theory.[63] The Netherlands and Canada also have cases showing that their courts may have jurisdiction beyond their respective domicile.[64] The result is some private antifraud claims have shifted to other countries.[65] For example, a plaintiff in *Porsche*, after the U.S. federal district court dismissed the case, brought the lawsuit in Germany against Porsche based on similar facts.[66] After *Morrison* curtailed the reach of U.S. securities laws, other jurisdictions are more likely to compete with U.S. laws in investors' private antifraud lawsuits.[67]

b. Different Standards in Determining the Applicable Law

Other countries adopt various standards to determine the applicable law of private antifraud lawsuits arising from SBS. For example, the applicable law for a similar fraud claim under the Rome II Regulation of the European Union may be the law of the country where the event giving rise to damage occurs, where both parties' have common habitual residence, or where the contract is "manifestly more closely connected with."[68] Moreover, the parties' choice of law may be the applicable law, subject to certain exceptions.[69]

Like the Rome II Regulation, English law considers several factors to determine the applicable law.[70] Under the Private International Law (Miscellaneous Provisions) Act 1995, the applicable law may be the law of the country where the major parts of events constituting the tort

& Painter, *supra* note 51, at 162–64 (discussing European countries' collective procedures).

63. Kaal & Painter, *supra* note 51, at 139–40 n.25.

64. *Id.* at 169, 186.

65. *See* Sullivan et. al, *supra* note 60, at 2.

66. Noked, *supra* note 61.

67. Kaal & Painter, *supra* note 51, at 134.

68. Regulation 864/2007, art. 4, 2007 O.J. (L199) 40, 44 (EC) ("Unless otherwise provided for . . . the law applicable . . . shall be the law in which the damage occurs irrespective of the country in which the event giving rise the damage occurred . . . .However, where the person claimed to be liable and the person sustaining damage both have their habitual residence in the same country at the time when the damage occurs, the law of that country shall apply . . . .A manifestly closer connection with another country might be based in particular on a preexisting relationship between the parties, such as a contract, that is closely connected with the tort/delict in question.").

69. Regulation 864/2007, art. 14, 2007 O.J. (L199) 40, 46 (EC) (stating that "[t]he parties may agree to submit non-contractual obligations to the law of their choice" either "by an agreement entered into after the event giving rise to the damage occurred" or "where all the parties are pursuing a commercial activity, also by an agreement freely negotiated before the event giving rise to the damage occurred.").

70. Private International Law (Miscellaneous Provisions) Act, 1995, c. 42, §§ 11–12 (U.K.).

occurred or where factors most significantly connected with the tort were.[71]

Hong Kong adopts another rule to determine the applicable law of private fraud claim. When the alleged misrepresentation was made outside of Hong Kong, the plaintiff can pursue the course of action in a Hong Kong court only if the alleged wrong would be actionable both under Hong Kong law and under the law of the foreign country where the alleged misrepresentation was committed.[72]

These tests, considering either the parties' choice of law or where the major parts of events constituting the tort occur, may be quite different from each other and different from the transactional test under *Morrison* or the economic reality test under *Porsche*. As a result, it is possible that two or more applicable laws will apply on the same matter.[73] It is also possible that no applicable laws will apply.[74]

c. Swap Regulations

Following G-20 leaders' statement, other governments also passed new regulations on swaps. For example, the European Union recently passed the European Market Infrastructure Regulation (EMIR)[75] and its delegated regulations [76] to regulate over-the-counter derivatives, [77] including swaps.[78] Under these regulations, swaps are also subject to mandatory clearing, trading, and reporting, with certain exceptions.[79] However, like the Dodd-Frank Act, these regulations are silent on the standard determining the applicable law of private antifraud lawsuits arising from SBS.

71. *See id.* (discussing the general rule for determining applicable law depending on whether the tort or delict occurred in a single or over multiple countries, and discussing when that general rule is displaced).

72. *See* Hung Fung Enterprises Holdings Ltd. v. Agric. Bank of China, [2010] 21 H.K.E.C. 2127, ¶¶ 161–62 (citing Boys v. Chaplin, [1971] A.C. 356 (H.L.)).

73. *See* Kaal & Painter, *supra* note 51, at 157.

74. *Id.* at 198–99.

75. Regulation 648/2012, 2012 O.J. (L 201) 1 (EU).

76. Commission Delegated Regulations 148/2013 - 153/2013, 2013 O.J. (L 52) 1, 1, 11, 25, 33, 37, 41 (EU).

77. Regulation 648/2012, art. 2(5), 2012 O.J. (L 201) 1, 15 (EU).

78. Directive 2004/39/EC, annex I, § C, point (10), 2004 O.J. (L 145) 1, 42.

79. For the comparison between the U.S. and the E.U. swap regulatory scheme, see Morrison & Foerster, *Comparison of EU and US Derivatives Regulatory Regimes*, MOFO.COM, http://www.mofo.com/files/Uploads/Images/Comparison-EU-and-US-Derivatives-Regulatory-Regimes.pdf (last visited Oct. 10, 2013).

II. CONSIDERATIONS TO THE APPLICABLE LAW OF PRIVATE LAWSUITS REGARDING CROSS-BORDER SECURITY-BASED SWAPS

A. PREDICTABILITY

The predictability of the applicable law in the securities context is highly desirable.[80] Whether the rule is predictable hinges on the clarity of the rule.[81] In *Morrison*, the U.S. Supreme Court reasoned that the "transactional test" achieves clarity.[82]

However, the transactional test has also been criticized for the failure to provide clarity in the context of swap transactions.[83] In swap transactions, many factors, such as (1) the trading market for the reference security, (2) the location of one or both parties to the swap agreement, (3) the currency in which the swap agreement is settled, and (4) the place of settlement for the swap agreement, may be associated with the location of the swap transactions.[84] These factors demonstrate the complexity and inconsistency in the standards courts use to approach the question of the transaction location.[85] Furthermore, the majority of swaps are conducted by electronic means,[86] which are difficult to assign the physical locations.[87]

Similarly, the Rome II regulation and the English law also use multiple factors to determine the applicable law.[88] Therefore, they are also likely to be subject to the criticism on the multi-factor *Morrison* transactional test.

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80. *See, e.g.*, Brief of Amici Curiae Law Professors in Support of Respondents, *Morrison*, 130 S. Ct. 2869; Brief of the United Kingdom of Great Britain and Northern Ireland as Amicus Curiae in Support of Respondents, *Morrison*, 130 S. Ct. 2869; Comment Letter from Skadden, Arps, Slate, Meagher & Flom LLP, on Study on Extraterritorial Private Rights of Action in Release No. 34-63174, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, at 2–3 (Feb. 25, 2011), *available at* http://www.sec.gov/comments/4-617/4617-50.pdf [hereinafter Skadden Comment Letter].

81. *See generally* Skadden Comment Letter, *supra* note 80, at 2–3 (arguing the bright-line rule is helpful for investors and issuers to engage in U.S. capital market).

82. *Morrison*, 130 S. Ct. at 2886.

83. *See* Hannah L. Buxbaum, *Remedies for Foreign Investors under U.S. Federal Securities Law*, 75 L. & CONTEMP. PROBS. 161, 168–69 (2012); Wulf A. Kaal & Richard W. Painter, *The Aftermath of* Morrison v. National Australia Bank *and* Elliot Associates v. Porsche, 8 EUR. COMP. & FIN. L. 77, 89 (2011); Kaal & Painter, *supra* note 51, at 200.

84. *See* Richard W. Painter, *The Dodd-Frank Extraterritorial Jurisdiction Provision: Was It Effective, Needed or Sufficient?*, 1 HARV. BUS. L. REV. 195, 224 (2011).

85. *See* Buxbaum, *supra* note 83, at 168.

86. *See* SATYAJIT DAS, DERIVATIVE PRODUCTS & PRICING 82 (3d ed. 2006).

87. Buxbaum, *supra* note 83, at 168.

88. *See supra* notes 68–71.

B. COMITY AND INTERNATIONAL COOPERATION

International comity, or respect for foreign sovereignty,[89] was originated to explain why the forum applied foreign law.[90] In the name of comity, courts consider competing foreign and domestic interests.[91] For example, Restatement (Third) of the Foreign Relations Law of the United States § 403(2) provides that all relevant factors should be considered in determining whether a state may exercise of jurisdiction over a person or activity having connection with another state.[92]

In cross-border securities disputes, international comity has also been an important consideration.[93] In *Morrison*, Justice Scalia used comity to justify limiting the extraterritorial application of Section 10(b) of the Exchange Act.[94]

However, the meaning of comity remains uncertain,[95] especially in cross-border securities disputes. For instance, after the *Morrison* decision, some commentators argued that the "transactional test" conforms to comity.[96] Others argued that the bright-line transactional test is at odds with the notion of comity because comity requires flexible balancing between domestic and foreign interests.[97]

In addressing this issue, Joel R. Paul suggests that the underlying conflicts of interests should be resolved "directly through negotiations

89. Emmanuel Gaillard, *After* Morrison*: The Case for a New Hague Convention on the Law Applicable to Securities Frauds*, 5 No. 1 DISP. RESOL. INT'L 35, 38 (2011).

90. Joel R. Paul, *Comity in International Law*, 32 HARV. INT'L L. J. 1, 5 (1991).

91. *Id.* at 2.

92. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 403(2) (1986).

93. *See* Kellye Y. Testy, *Comity and Cooperation: Security Regulation in a Global Marketplace*, 45 ALA. L. REV. 927 (1994).

94. *Morrison*, 130 S. Ct. at 2885 ("The probability of incompatibility with the applicable laws of other countries is so obvious that if Congress intended such foreign application 'it would have addressed the subject of conflicts with foreign laws and procedures.'").

95. Paul, *supra* note 90, at 3.

96. *See, e.g.*, Skadden Comment Letter, *supra* note 80, at 7; Comment Letter from Vivendi, S.A., on Study on Extraterritorial Private Rights of Action in Release No. 34-63174, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, at 35 (Feb. 18, 2011), *available at* http://www.sec.gov/comments/4-617/4617-38.pdf; John Chambers, Note, *Extraterritorial Private Rights of Action: Redefining the Transactional Test in* Morrison v. National Australia Bank, 31 REV. BANKING & FIN. L. 411, 432 (2011).

97. *See* Roger W. Kirby, *Access to United States Courts by Purchasers of Foreign Listed Securities in the Aftermath of* Morrison v. National Australia Bank Ltd., 7 HASTINGS BUS. L.J. 223, 244–47 (2011); Buxbaum, *supra* note 83, at 173 ("The virtue of the old conduct and effects tests was their grounding in principles of international comity, which focused attention on how our domestic interests coincide with, overlap with, and indeed sometimes conflict with the interests of other nations.").

and harmonized conflicts principles." [98] In the context of swaps regulations, the Dodd-Frank Act also requires the SEC and U.S. Commodity and Futures Trading Commission ("CFTC") to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to" the regulation of swaps and swap participants.[99]

Emmanuel Gaillard further suggests that an "international convention with a universal reach" would be proper to address the underlying conflicts of interests among countries,[100] and that the Hague Conference on Private International Law appears to be the best international organization to handle this matter. [101] However, commentators point out that such a uniform rule does not guarantee a better result and "may be a political and practical impossibility."[102]

C. INVESTOR PROTECTION

Historically, investor protection measures under securities law were implemented to help facilitate the capital market. [103] This policy consideration stands true in the context of SBS. Under the SEC's proposed rule on prohibition against fraud in connection with SBS, the SEC explains that the fraud affecting the value or deliveries of SBS can undermine investors' confidence in the integrity of the market of SBS and the market for the reference securities.[104] On the other hand, the SEC tries to target fraudulent conduct in connection with SBS "without interfering with or otherwise unduly inhibiting legitimate market or business activity." [105] It is therefore worthwhile to take these considerations into account when determining the applicable law of private antifraud lawsuits arising from cross-border SBS.

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98. Paul, *supra* note 90, at 5.

99. Dodd-Frank Act, *supra* note 42, § 752.

100. Gaillard, *supra* note 89, at 42–43.

101. *Id.* at 43.

102. Kaal & Painter, *supra* note 51, at 148.

103. *See, e.g.*, Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 60–61 (2012) (noting the Congress passed the Securities Act and the Exchange Act to improve the reliability of the capital markets by implementing investor protection measures against fraud).

104. Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, 75 Fed. Reg. 68,560, 68,564 (proposed Nov. 8, 2010) (to be codified at 17 C.F.R. pt. 240).

105. *Id.*

III. PROPOSED RULE TO DETERMINE THE APPLICABLE LAW OF PRIVATE LAWSUITS ARISING FROM CROSS-BORDER SECURITY-BASED SWAPS

A. THE FORM OF THE RULE – TREATY

1. The Inconsistency and Potential Conflicts Under Different Countries' Standards

With different countries' standards in determining the applicable law of private lawsuits arising from cross-border SBS, it is likely that two or more applicable laws may apply to the same private antifraud lawsuit regarding SBS.[106] The result is inconsistent with the goals previously stated for the following reasons: (1) it is less predictable for parties in SBS because the applicable law may be different jurisdiction by jurisdiction; (2) it does not address the comity concern; (3) it is more likely to subject to manipulations by either the potential plaintiffs or the potential defendants.

The possibility of multiple applicable laws on the same SBS transaction undermines parties' predictability. For example, consider two German parties who negotiated an SBS in Germany, but later signed the contract in the United States. Under the agreement, German law is the applicable law to the potential antifraud claim. And the underlying securities are solely traded on the U.S. exchange. Under this hypothetical, the applicable law is uncertain because both U.S. law and German law may become the applicable law for the private antifraud claim regarding this SBS. If the plaintiff brings the lawsuit in the U.S., under the "economic reality" test set forth in *Porsche*[107] and the transactional test in *Morrison*,[108] U.S. law, especially Section 10(b) of the Exchange Act, will apply. If the plaintiff brings the lawsuit in Germany, under Article 4 and Article 14 of the Rome II Regulation, it is quite possible that German law will be the applicable law since relevant negotiations occurred in Germany, both parties reside in Germany, and they stipulated German law as the applicable law.[109] When the defendant enters into the contract, he cannot predict the possible applicable law because it is determined by the plaintiff's future decision on jurisdiction.

Moreover, the applications of current standards may further increase the unpredictability of the applicable law. For example, it is disputable

106. *Supra* note 73.
107. *See supra* notes 29–39 and accompanying text.
108. *See supra* notes 24–28 and accompanying text.
109. *See supra* notes 68–69.

what constitutes a "domestic transaction" under the *Morrison* transactional test. In most private antifraud claims following *Morrison*, courts look for the moment when the irrevocable liability is incurred to determine the location of the transaction.[110] This is not always the case. In *Stackhouse v. Toyota Motor Co.*, the court held that "domestic transactions" under *Morrison* also include "purchase and sales of securities explicitly solicited by the issuer within the United States".[111] It is also disputable whether German law will be the applicable law under the Rome II Regulation since none of the factors are determinative under Article 4 and Article 14 of the Rome II Regulation.[112]

The U.S. and Germany both have a substantial interest in regulating this hypothetical case. However, the result that both jurisdictions use their own standard to decide the applicable law may not satisfy comity. For example, U.S. courts weigh the location and economic factors of the transaction more in their comity consideration by applying *Morrison* and *Porsche* to SBS fraud claims, which may not be viewed as proper by Germany because Rome II Regulation deems the governing law or the location of misrepresentation as more important factors in deciding the applicable law.

Investor protection is similarly uncertain under current standards used by each country to determine the applicable law of the private antifraud suit because such standards are subject to the parties' manipulations. For example, the plaintiff in the previous hypothetical case can determine the applicable law by initiating the lawsuit in certain jurisdiction.[113] Conversely, it is easy for the defendant to ensure or eliminate certain applicable law by carefully structuring the transaction and course of dealings,[114] especially when the plaintiff does not have the knowledge that certain arrangements of the transaction will eliminate his eligibility to resort to certain applicable law.

Under current standards developed by countries to determine the applicable law of the private antifraud suits arising from SBS, the goals

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110. *E.g.*, Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60 (2d. Cir. 2012); Basis Yield Alpha Fund v. Goldman Sachs Group, Inc., 798 F. Supp. 2d 533 (S.D.N.Y. 2011); Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co., 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010).

111. Stackhouse v. Toyota Motor Co., No. CV 10-0922 DSF AJWX, 2010 U.S. Dist. WL 3377409, at *1 (C.D. Cal. July 16, 2010); *see also Porsche*, 759 F. Supp. 2d at 476 ("Although Morrison permits a cause of action by a plaintiff who has concluded a 'domestic transaction in other securities,' this appears to mean 'purchases and sales of securities explicitly solicited by the issuer in the U.S.,' rather than transactions in foreign-traded securities . . . .").

112. *See supra* notes 68–69.

113. *See* Gaillard, *supra* note 89, at 42.

114. Kaal & Painter, *supra* note 51, at 142.

of predictability, comity, and investor protection are not achieved.

2. New Regulations Do Not Address the Problem

Unlike courts, the regulators of swaps and SBS have significant expertise in the SBS antifraud regulatory scheme.[115] Such regulators are in a better position to determine the applicable law of private antifraud lawsuits regarding SBS. However, none of the new regulations passed by governments address this issue. For example, the Dodd-Frank Act § 929P only specified *when* the SEC and the Department of Justice could initiate the antifraud claim in extraterritorial matters under Section 10(b) of the Exchange Act.[116] The Act is silent regarding the standard for determining the applicable law of the private antifraud lawsuit regarding SBS.[117] New EU Regulations do not provide such standard, either.[118]

3. Treaty, A Possible Way to Address the Problem

Under the current standards and regulations on SBS, the method that courts use to determine the applicable law in private antifraud lawsuits is ill suited for the goals of predictability and comity. A treaty, setting a unified standard to determine the applicable law in private antifraud lawsuits regarding SBS, could address these problems in many ways and bring predictability and comity to the interaction.

The lack of predictability under the current standards originates from different standards adopted by countries in determining the applicable law.[119] With a uniform standard to determine the applicable law, all jurisdictions will theoretically arrive at the same conclusion on identical matters.

Also, by negotiating with other countries to form a uniform standard, countries directly exchange their considerations, rather than contemplate comity through their own systems.[120] The discrepancy of the considerations on comity will be discussed and negotiated by countries, rather than hidden in individual cases.[121]

Furthermore, it is likely that governmental officials with expertise in

115. *See* Comment Letter of Richard W. Painter on Release No. 34-63174; File No. 4-617, Study on Extraterritorial Private Rights of Action 7 (Feb. 17, 2011) [hereinafter Painter Comment Letter], *available at* http://www.sec.gov/comments/4-617/4617-7.pdf.

116. *Supra* note 49.

117. *Id.*

118. *See supra* notes 75–79 and accompanying text.

119. *See supra* notes 107–14 and accompanying text.

120. *Supra* note 100.

121. *Id.*

SBS antifraud regulations will negotiate the treaty.[122] As noted above, relevant governmental officials will be in a better position to form a standard to determine the applicable law.

While it may be difficult to reach a treaty among countries within the context of SBS, current cooperation between governments presents a possibility for governments to form a uniform standard. For example, CFTC, the U.S. regulator of all swaps other than SBS, and the European Commission recently announced a "Path Forward" to cooperate to "pursue the same objectives and generate the same outcomes."[123] Accordingly, CFTC issued several no-action letters to relieve swap dealers and major swap participants from complying with some CFTC rules if they comply with the corresponding EMIR rules.[124] Based on the negotiation results and framework between the CFTC and the European Commission, the SEC, European Union, and other countries can also make a similar effort to reach agreement on the applicable law of private antifraud claims arising from SBS. The standard determining the applicable law, less ambitious than the rule determining the jurisdiction, would also likely have a better chance to be reached.[125]

If countries could form a treaty that sets a unified standard determining the applicable law of the private antifraud claim regarding cross-border SBS, the next question would be what the uniform standard should be.

B. ONLY CONTRACTUAL PARTIES SHOULD BE SUBJECT TO THE RULE

A successful tortious fraud claim does not require a course of contractual dealings between the plaintiff and the defendant.[126] A plaintiff may bring a fraud claim against a defendant even though they have no contact prior to the claim.[127] On the other hand, there is "a concern that the threat of liability to a large number of unidentified

122. *Supra* note 115.

123. Press Release, Cross-Border Regulation of Swaps/Derivatives Discussions Between the Commodity Futures Trading Commission and the European Union — A Path Forward (Jul. 11, 2013), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6640-13.

124. *See, e.g.*, Press Release, U.S. Commodity Futures Trading Commission, CFTC Staff Issues Four No-Action Letters Providing Relief in Connection with Issues Relating to Swap Regulation (Jul. 11, 2013), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6642-13.

125. *See* Gaillard, *supra* note 89, at 42.

126. *See* KENNETH S. ABRAHAM, THE FORMS AND FUNCTIONS OF TORT LAW 318 (4th ed. 2012).

127. *Id.*

parties will deter desirable involvement" in the activities.[128] New regulations on swaps also consider this concern.[129] The problem then becomes one of balancing the interests of holding parties committing fraud liable and avoiding the deterrence of desirable involvement in the activities.

As for private antifraud claims on SBS transactions, the issue becomes whether the contractual parties in the SBS, or other parties such as the issuer of the referencing securities and others associated with the referencing securities (e.g., Porsche in *Porsche*), are subject to private fraud claims. Considering predictability, comity, and investor protection, this Note argues that private antifraud claims on SBS should exist only among parties with contractual relationships on such SBS.

1. Predictability

If there were a uniform standard to determine the applicable law of the private antifraud claim regarding cross-border SBS, the parties in a SBS transaction would likely find the applicable law predictable. By contrast, a defendant who is not a party to an SBS may not know which applicable law would apply in a private antifraud claim. For example, if a uniform standard uses the location of a transaction or the governing law in the contract to determine the applicable law, a defendant, not a party in the SBS transaction, cannot predict the applicable law because it did not engage in the course of dealings.

This unpredictability exists even if the uniform standard uses the test unrelated to the course of dealings of SBS to determine the applicable law. Since neither party in the SBS transaction is required to actually hold the underlying security,[130] other parties, such as the issuer of a security and others associated with the security, cannot predict how many cross-border SBS will reference the security to determine the payment. If such parties are subject to private antifraud claims arising from SBS, they cannot predict the potential scope of liability arising from their activities associated with the underlying security.

On the other hand, subjecting the contractual parties of the SBS transaction (i.e. counterparties and middlemen such as SBS brokers) to private antifraud lawsuits does not have the similar concern of unpredictability. Parties of the SBS engaged in the course of dealings,

128. *Id.* at 318–19.

129. *See supra* note 106.

130. Brief Amici Curiae of German and American Law Professors in Support of Defendant-Appellant Porsche at 16, Viking Global Equities, LP v. Porsche Automobil Holding SE, 101 A.D.3d 640 (N.Y. App. Div. 2012) (Nos. 650435/2011, 650678/2011) [hereinafter *Viking Global v. Porsche Amicus Brief*].

and therefore are more able to predict the applicable law as long as they know the uniform standard. They are also in a better position to predict the scope of liability arising from SBS since they are only subject to private antifraud claims brought by each other.

2. Comity

Regulating the issuers and other participants of an underlying security under a private antifraud claim on SBS may undermine foreign countries' policy on their securities regulatory framework.[131] Assume the rule is that the issuer of the underlying security may be subject to the antifraud claim on SBS. Assume further that Country A, having authority to regulate such underlying security, does not allow a private antifraud claim based on its policy consideration. As a result, the issuer of such underlying security would not be subject to private antifraud claims arising from the security. However, it may be subject to a private antifraud action on SBS referencing the security, as long as the applicable law on SBS permits such private antifraud claim. Therefore, SBS transactions circumvent Country A's policy which shields the issuer of the underlying security to private antifraud claims. By contrast, subjecting the contractual parties of the SBS to the private antifraud claim does not pose the similar concern that such claim will affect a foreign countries' policy determination on regulating the underlying security.

3. Investor Protection

Investor protection is essential for capital formation,[132] and an antifraud regulatory scheme is essential for investor protection, both in private ordering and in public disclosure.[133] However, subjecting the issuer or other participants of the underlying security to the private antifraud lawsuits may not be the logical conclusion when considering investor protection.

First, the SBS transaction referencing the security, unlike the direct transaction on the security, is less related to capital formation. Facilitating the secondary market of the security will increase the

131. *Id.* at 5–10.

132. *See supra* note 103 and accompanying text; *see also* Luis Aguilar, Comm'r, Sec. & Exch. Comm'n, Opening Address at the SEC Government-Business Forum on Small Business Capital Formation: Effective Small Business Capital Formation Requires Investor Protection to Foster Investor Confidence (Nov. 15, 2012).

133. *See* Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L. Q. 319, 346–47 (1999).

liquidity of the security, thereby increasing investors' incentive to purchase the security in the offering.[134] As a result, "the possibility of resale increases the price of a product."[135] This inference does not apply to SBS transactions. By entering into the SBS transaction referencing a certain security, parties do not actually transfer the underlying security or facilitate the secondary market of the underlying security.[136] This is called a "side bet,"[137] and the law generally does not warrant the same level of protection to these investors as the underlying security holders have.[138]

Second, as reasoned above, subjecting the issuer or other participants of the underlying security creates an additional concern of unpredictability for the issuer or other participants of the underlying security. Given the size of SBS markets, the concern of unpredictability may be "a concern that the threat of liability to a large number of unidentified parties will deter desirable involvement" in the activities.[139] Providing extra protection to SBS parties against the potential fraud committed by the issuer or other participants of the underlying security would be done at the expense of issuers, other participants of the security, and security holders. To counteract the concern of unpredictability, issuers may either leave the market or bear additional cost in public offerings of securities, both of which undermine the function of capital formation.

On the other hand, subjecting contractual parties of SBS to the private antifraud lawsuits assures that neither party manipulates the transaction. It also matches governments' recent move to prevent fraud and manipulation on swap transactions.[140] Furthermore, it does not pose a threat to the market of the underlying securities and does not hinder capital formation.

Limiting the private antifraud lawsuits on SBS only to contractual parties of the SBS transactions conforms to the consideration of predictability, comity, and investor protection. The issuers and other participants of the underlying securities should not be subject to such lawsuits. The next question is how the applicable law should be applied to the private antifraud lawsuits among SBS contractual parties.

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134. *See, e.g.*, Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3393 (2013).

135. *Id.*

136. *Supra* note 130.

137. *Id.*

138. *See* Painter Comment Letter, *supra* note 115, at 6.

139. *Viking Global v. Porsche Amicus Brief*, *supra* note 130, at 17–18.

140. *See supra* note 104.

C. THE APPLICABLE LAW SHOULD BE THE PARTIES' CHOICE OF LAW

Assuming the private antifraud cause of action regarding SBS transactions only exists among contractual parties in SBS transactions, it is worthwhile to consider whether parties' choice of law[141] will apply because the alleged fraud only occurs during the course of contractual dealings among parties. This section analyzes the potential benefits and concerns of using parties' choice of law to determine the applicable law in the context of private antifraud claims arising from cross-border SBS.

1. Potential Advantages of Using Parties' Choice of Law as the Rule

First, it is relatively predictable for parties if the parties' choice of law is applied. Under the transactional test, economic reality test, or the misrepresentation test, the applicable law may be determined by the location of certain course of dealings, the place the underlying securities were traded, or the place the alleged misrepresentation or solicitation was made. None of these places necessarily reflects parties' deliberation or awareness of the applicable law in future potential antifraud claims arising from the transaction. Parties may engage in course of dealings in places out of convenience. Moreover, as swap transactions become global or even electronic, the location where parties engage in the course of dealings becomes more irrelevant and difficult to identify.[142] Therefore, contractual parties, when negotiating, may not predict that the applicable law in the future antifraud claim will be determined by the location they make or receive part of expressions in the course of dealings.

By contrast, parties' choice of law does not have the similar concern. Under the major template swap agreements, such as the ISDA Agreement or the European Master Agreement, the governing law clause is put into the "Schedule" or "Special Provisions" to be negotiated by parties.[143] At least the parties are aware of the term by reviewing the agreement. It is likely that they will also presume that the applicable law in a fraud lawsuit will be the governing law in the contract. After all, in disputes arising from SBS transactions, parties often sue each other based

141. For the discussion of parties' choice of law, or party autonomy, see Eugene F. Scoles et al., CONFLICT OF LAWS 947–74 (4th ed. 2004); William J. Woodward, Jr., *Contractual Choice of Law: Legislative Choice in an Era of Party Autonomy*, 54 SMU L. REV. 697 (2001).

142. *Supra* notes 84–87 and accompanying text.

143. *Supra* note 7.

on both the breach of contract and fraud.[144]

Second, using parties' choice of law as the applicable law avoids some manipulations arising from the geographic locations of the course of dealings.[145] When the applicable law of the private antifraud claim is determined by geographic locations of the course of dealings, one party can structure the course of dealing to manipulate the applicable law without notice by the other party if the other party does not know that the location of certain expressions in the course of dealing will determine the applicable law.[146] By specifying the governing law in the contract, parties at least will be aware of the applicable law in future potential claims. Overall, the asymmetry of information between parties regarding the applicable law of a fraud claim, which increases the incentive of manipulation,[147] will be reduced.

2. Concerns Associated with Parties' Choice of Law

It may be argued that parties' choice of law is not adequate for investor protection.[148] Parties in SBS may agree on an applicable law in which there is no cause of action regarding the private antifraud claim arising from SBS. As a result, parties' choice of law may lead to a "race to the bottom" and eliminate the cause of action.[149]

However, the "race to the bottom" argument is based on the assumption that the party who wants the private antifraud protection will simply agree on the governing law chosen by the party who does not want the private antifraud protection.[150] The empirical data demonstrates that most parties in swap transactions are sophisticated.[151] Hence, it is fair to assume that parties in SBS generally have equal bargaining power to negotiate terms, including the governing law clause. Under the assumption of fair dealing, the governing law may still be the law with

144. For an example of such a case, see Royal Bank of Canada v. Cooperative Centrale Raiffeisen-Boorenleenbank Binding Authority, [2003] EWHC (Comm) 2913. In that case, both parties entered into a "total return swap" referencing shares owned by the Enron Corporation. *Id.* [3]. One party alleged that the other party misrepresented the credit ratings of Enron, *id.* [6], and brought suit in New York State Court and in English Court, *see id.* [5]. Both suits were based on fraud and breach of contract. *Id.* [7].

145. Kaal & Painter, *supra* note 51, at 142.

146. *See supra* note 114 and accompanying text.

147. *Id.*

148. *See* Kaal & Painter, *supra* note 51, at 196.

149. *Id.*

150. *Id.*

151. *See Amounts Outstanding of OTC Equity-linked and Commodity Derivatives*, BANK FOR INT'L SETTLEMENTS Q. REV., September 2014, at A145 tbl. 22B, *available at* http://www.bis.org/statistics/dt21c22a.pdf.

least protection on antifraud. However, it is equally possible that the governing law is the law with the most protection on antifraud. Therefore, the race to the bottom argument may not be that convincing.[152]

Some argue that parties' choice of law should be limited, even though both parties have equal bargaining power.[153] For example, opponents of "party autonomy suggest that, if the parties are granted complete autonomy, they may abuse it to deprive a state of its sovereign power to legislate for the benefit and protection of its citizenry."[154]

These concerns of party autonomy may be legitimate. However, that does not necessarily lead to a rejection of this proposal. Governments still can monitor the risk of fraud on SBS transactions when the applicable law is determined by the parties' choice of law. For example, governments can regulate SBS participants' conduct to reduce the risk of fraud. Indeed, some new regulations on swaps have already done so.[155] SEC's new regulation requires swap dealers and major swap participants to bear additional disclosure duties when they deal with "special entities."[156] Governments can also regulate the eligibility to enter into SBS market to assure all parties in the SBS have enough bargaining power and knowledge to withstand the potential manipulations by counterparties.[157]

Governments have even more powerful methods to compel their policies on private antifraud claims. For example, governments can require SBS brokers, dealers, and other major SBS participants to specify the countries' own laws as the governing law in SBS contracts, much like they did in requiring swap dealers and major swap participants to trade and clear the swaps in authorized institutions.[158] Also, governments may directly pursue antifraud enforcement, regardless of which standard applies in determining the applicable law in private antifraud lawsuits under the Dodd-Frank Act.[159] These more aggressive governmental

152. Kaal & Painter, *supra* note 51, at 196.

153. *See, e.g.*, Steven N. Baker, *Foreign Law Between Domestic Commercial Parties: A Party Autonomy Approach with Particular Emphasis on North Carolina Law*, 30 CAMPBELL L. REV. 437, 439–40 (2008).

154. Jack M. Graves, *Party Autonomy in Choice of Commercial Law: The Failure of Revised U.C.C. Section 1-301 and a Proposal for Broader Reform*, 36 SETON HALL L. REV. 59, 61 (2005).

155. *See, e.g.*, Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants with Counterparties, 77 Fed. Reg. 9,733 (Feb. 17, 2012) (to be codified at 17 C.F.R. pt. 4, 23).

156. For the definition of "special entity", see 15 U.S.C. § 78o-10(h)(2)(C) (2010).

157. *See* Kaal & Painter, *supra* note 51, at 197.

158. *Supra* notes 44–47, 79.

159. Kaal & Painter, *supra* note 51, at 153; *see also* Dodd-Frank Act, *supra* note 42, § 929P.

moves may raise the potential conflicts with foreign countries and undermine the purpose of forming a treaty.[160] This concern should be further addressed by international cooperation.

Overall, using parties' choice of law to determine the applicable law of private antifraud lawsuits regarding cross-border SBS has several advantages, while the concerns of parties' choice of law can be addressed in many ways. Therefore, this Note suggests that the applicable law of private antifraud lawsuits arising from SBS should be parties' choice of law.

CONCLUSION

SBS play an important role in global investment. However, as applied to the law of private antifraud lawsuits arising from cross-border SBS, current standards are insufficient to achieve the expressed goals of predictability, international comity and investor protection in the global market. Despite governmental efforts to regulate swaps, this problem persists. This Note argues that governments should make effort to negotiate a treaty specifying a uniform standard to determine the applicable law of private antifraud lawsuits arising from cross-border SBS. As for the content of such a proposed treaty, this Note concludes that private antifraud lawsuits arising from cross-border SBS should only exist among contractual parties of SBS, and that the applicable law should be determined by the parties' choice of law. Such a proposal would help develop an operative regulatory scheme of private antifraud lawsuits arising from cross-border SBS, and therefore facilitate the cross-border SBS transactions.

160. *See, e.g.*, Joe Mont, *Cross-Border Swaps Regulations Could Pit EU Against U.S.*, COMPLIANCE WEEK (Jun. 19, 2013), http://www.complianceweek.com/cross-border-swaps-regulations-could-pit-eu-against-us/article/299414/.