SECURITIES LINKED TO THE PERFORMANCE OF TIGER WOODS?
NOT SUCH A LONG SHOT

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A significant and growing number of the millions of Americans who watch Tiger Woods tee it up on any given weekend are likely to have an economic interest in his performance. In America, sports wagering has enjoyed a sharp rise in recent years to the point where betting on sporting events has become a socially acceptable leisure activity.

Many experts have examined the disparate legal treatment that gambling and investing have been afforded under the federal laws of the United States.1 At least one commentator has posited that “there should be greater parallel in applicable regulatory structures [between gambling and investing].”2 However, far less attention has been devoted to suggesting a framework that accomplishes such a parallel regulatory structure and, at the same time, protects the interests of all stakeholders. This Article contends that such a structure already exists under the federal securities laws. Furthermore, this Article contends that a significant portion of the sports wagering activity in the United States could be neatly and effectively regulated under the existing federal securities law regime.

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2. See Hazen, supra note 1, at 402.
Part I of this Article examines sports wagering and describes the harsh treatment that it has been afforded in the United States. Specifically, sports wagering is currently regulated through a patchwork of various statutes, rules, and regulations stitched together over the last century. While lawmakers have focused their most recent legislative actions on imposing an outright ban on sports wagering, their efforts have been largely unproductive. Additionally, legislative hostility leaves the United States with a small, single, arbitrary monopoly for legalized gambling and an enormous, underground, unpredictable, fragmented, and unsavory illegal market. Part II of this Article provides an overview of the regulation of securities in the United States and describes the tests that courts have employed to determine whether instruments qualify as securities and, therefore, are subject to the federal securities regime. Part III of this Article describes the structured products sector of the securities market, including an explanation of the structured products readily available to investors. The structured products market is carefully monitored by regulators and, as a result, offers a stable and predictable platform for a wide variety of offerings with a full complement of investor protections. These protections are also explored in Part III of this Article. Part IV of this Article examines a hypothetical Tiger Woods Note as a vehicle through which to analyze the resemblance between sports wagering and certain existing structured products. Part IV of this Article concludes that, if properly structured, certain types of sports wagers would fit neatly within the existing structured products framework. Part IV of this Article also addresses some of the legal obstacles to be navigated by a successful sports note issuer. Finally, in Part V of this Article, an examination of the suggested framework reveals the benefits to the various stakeholders and highlights the fact that the proposed framework is preferable to the ineffective structure that turns a blind eye to much of the gambling activity in the United States today. Moreover, the proposed structure for sports wagers will result in tangible benefits to the investor/gambler, financial intermediaries, and the government alike, which currently do not exist.

To understand the roots of the divergence between gambling and investing, an individual needs only to look at American leaders' resistance to perceived immorality. However, at least one great American, Theodore Roosevelt, recognized the underlying kinship between gambling and investing, remarking: "[t]here is no moral difference between gambling at cards or in lotteries or on the race track and gambling in the stock market. One method is just as pernicious to the body politic as the other in kind, and in degree the evil worked is far
With the incredible innovation in financial markets, the arbitrary lines drawn to support the strained gambling/investing distinction are becoming increasingly blurred. In fact, any such distinction no longer remains tenable. The time has come to regulate certain wagering activities under today’s existing securities offerings regulations.

I. REGULATING GAMBLING ACTIVITIES IN THE UNITED STATES

Gambling has been a part of the culture of the United States from the nation’s earliest days. In fact, each of the original thirteen colonies employed lotteries to raise monies. Also present since the beginning of the American republic has been the difficulty in describing hedging or investing, on the one hand, and wagering or gambling on the other. In attempting to distinguish between the two, courts have found their efforts “between the devil and the deep sea.” Such difficulty should come as no surprise because, at the most basic level, gambling and investing represent identical wagers on an outcome in an environment of uncertainty. The divergence of gambling and investing in the United States’ national history and under its laws merely represents the evolution of a notion that the former represented a so-

3. See Hazen, supra note 1, at 403 (quoting 42 Cong. Rec. 1347, 1349 (1908)).
4. Christopher T. Pickens, Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and Does It Even Matter?, 14 Geo. Mason L. Rev. 227, 229 (2006) (“[A]ny attempt to distinguish categorically between investing and gambling is unprincipled and unworkable, and the prevailing regime predicated on that philosophy should be abandoned.”); see also Roy Kreitner, Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk, 100 Colum. L. Rev. 1096, 1135 (2000) (“While attitudes toward gambling have changed over the last hundred years, the basic problem of distinguishing legitimate risk allocation from illegitimate speculation is still alive and unsettled, and perhaps unsettling.”); Bill Bamber & Andrew Spencer, Bear Trap: The Fall of Bear Stearns and the Panic of 2008, at 196 (2008) (offering that “[i]nvesting is as close to legalized gambling as you might hope to come,” adding that “[t]he whole process is fraught with risk; it’s the nature of the game”).
7. Edwin W. Patterson, Hedging and Wagering on Produce Exchanges, 40 Yale L.J. 843, 878 (1931); see also Benjamin Graham et al., Security Analysis Principles and Technique 48 (4th ed. McGraw-Hill Book Co. 1962) (“[T]he difference between investment and speculation . . . is understood in a general way by nearly everyone; but when we try to formulate it precisely, we run into perplexing difficulties.”).
8. Hurt, supra note 5, at 440.
cially undesirable activity (and should therefore be prohibited by law) and the latter was socially redeeming (and, in turn, deserved the support and encouragement of the law).9

A. **Traditional Arguments in Opposition to Gambling**

Whenever gambling is discussed, there is no shortage of traditional attacks employed by its opponents. Indeed, "gambling is not generally viewed as a productive activity or one that provides any benefit to society" aside from its entertainment value.10 Its opponents often associate gambling with (i) an increased crime rate11 and the presence of organized crime,12 (ii) economic loss,13 (iii) gambling addictions which cost the government monies related to treatment and prevention,14 and (iv) moral depletion which instills the negative social value that money can be won without hard work.15 All of this opposition has taken place while the gambling industry – legal and illegal – has grown exponentially.16

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9. Id.


14. Id.


16. See infra notes 51-82 and accompanying text.
B. ANTI-WAGERING LAWS IN THE UNITED STATES

In the United States, hostility toward wagering has had a long history within the law. One of the most basic tenets of common law contract doctrine is that contracts to wager are unenforceable because they are deemed to be in contravention of public policy. Around the turn of the twentieth century, "in dozens, if not hundreds of cases," counterparties refused to pay debts owed to investment brokers, claiming that the underlying transactions were illegal wagers. These cases came in two varieties: either (i) "clients sued brokers to recover payments" they had already made, relying on anti-gaming statutes to recover monies lost in gambling activity; or (ii) brokers brought actions to secure monies or notes against the wishes of the client who claimed that the monies or notes, as the case may be, represented consideration for an illegal gambling contract. In deciding these two varieties of cases, the courts concerned themselves with the issue of whether the parties intended to perform under the terms of the contract. Courts consistently attempted to distinguish contracts in which one party intended to physically deliver a commodity from so-called difference contracts, which were entered into with no intention of any physical delivery of a commodity, but instead merely represented a wager requiring one party to "pay differences according to the rise or fall of the commodity's price in the market." This disdain for wagering survives in many states today. For instance, New York General Obligations Law provides: "[a]ll wagers, bets or stakes, made to depend on any race, or upon any gaming by lot or chance, or upon any lot, chance, casualty, or unknown or contingent event whatever, shall be unlawful."
1. **The Gambling Devices Act of 1951**

At the federal level, the patchwork of rules, regulations, and statutes comprising today’s gambling regulatory regime began in the early 1950s. Originally aimed at bolstering state hostilities toward wagering, these legislative initiatives signaled federal legislators’ increasing animosity toward gambling and their growing desire to regulate gambling-style activities at the federal level. Building on the common law bias against wagering, and following Congressional investigations into the role of organized crime in the gambling industry, Congress enacted the Gambling Devices Act of 1951 which made it a crime to transport gambling devices across state lines to locations not specifically exempted by local or state law.

2. **The Wire Act**

Ten years after the passage of the Gambling Devices Act of 1951, Congress stepped up its efforts and passed the Wire Act to further assist the states in their anti-gambling efforts. The statute begins with the text:

> Whoever being engaged in the business of betting or wagering knowingly uses a wire communication facility for the transmission in interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest, or for the transmission of a wire communication which entitles the recipient to receive money or credit as a result of bets or wagers, or for information assisting in the placing of bets or wagers, shall be fined not more than $10,000 or imprisoned not more than two years, or both.

As the statute and subsequent case law suggest, a successful prosecution under the Wire Act requires that two elements be proven: (i) the defendant transmitted information through interstate wire facilities that assisted in the placing of wagers; and (ii) the defendant was involved in the “business of wagering or betting.” However, prosecu-
tions of gamblers under the Wire Act have been limited because in interpreting the "business of wagering or betting" element of the test, courts have consistently required that a defendant be a bookie (i.e. engaged in the business of receiving or taking bets). Thus, courts explicitly refuse to apply the Wire Act to those individuals who simply act as bettors.\textsuperscript{30}

The federal aiding and abetting statute provides for the conviction of anyone who "aids, abets, counsels, commands, induces or procures" an offense against the United States.\textsuperscript{31} However, the commission of a crime under another statute is a prerequisite for a conviction under the federal aiding and abetting statute. While there has not been a successful prosecution of a bettor under the Wire Act, there remains a theory that a single bettor might be seen as aiding and abetting a bookie in violation of the Wire Act and might, himself, be held accountable for aiding and abetting.\textsuperscript{32} In addition to the Wire Act, Congress enacted the complimentary Interstate and Foreign Travel or Transportation in Aid of Racketeering Enterprises Act ("Travel Act") which prohibits travel or the use of mail to carry on any unlawful activity.\textsuperscript{33}

3. The Illegal Gambling Business Act

In 1970, as part of the Organized Crime Control Act,\textsuperscript{34} Congress passed the Illegal Gambling Business Act ("IGBA").\textsuperscript{35} In order to prove a prima facie case under the IGBA, the government must establish the existence of a gambling operation (i) in violation of the state or local law where it is conducted, (ii) involving five or more persons that conduct, finance, manage, supervise, direct, or own all or part of the business that (iii) remains in substantially continuous operation for more than thirty days or has a gross revenue of $2000 in any single day.\textsuperscript{36} However, it was Congress' intent that mere bettors not be

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29. United States v. Tomeo, 469 F.2d 445, 447 (10th Cir. 1972) ("The statute deals with bookmakers - persons 'engaged in the business of betting or wagering.' Bookies take bets, they receive them, they handle them.").


32. Pickens, supra note 28, at 260.

33. 18 U.S.C. § 1952 (2006); see also Slavin, supra note 25, at 718 ("In defining the phrase "any unlawful activity," the Travel Act provides as an example "any business enterprise involving gambling").


36. United States v. Sacco, 491 F.2d 995, 998 (9th Cir. 1974).
counted for purposes of the *five or more persons* requirement.\(^{37}\) Nonetheless, Congress intended to count, for the purposes of the five or more persons requirement, anyone engaged in the operation of the illegal gambling business “regardless of how minor their roles.”\(^{38}\) With respect to the third element, “Congress did not purport to require absolute or total continuity in the gambling operations.”\(^{39}\) Instead, the phrase *substantially continuous* has been interpreted to mean an operation conducted with some degree of regularity.\(^{40}\)

In addition to the IGBA, the Organized Crime Control Act included the Racketeer Influenced and Corrupt Organizations Act (“RICO”).\(^{41}\) RICO was designed to eradicate organized crime by attacking the sources of its revenue, including syndicated gambling and bookmaking.\(^{42}\) RICO subjects an individual who engages in prohibited activities to criminal and civil penalty.\(^{43}\) Whether a RICO violation is civil or criminal in nature, a conviction under RICO requires proof of (i) the existence of an enterprise, (ii) the enterprise engaging in a pattern of racketeering activity or the collection of an unlawful debt, and (iii) the enterprise engaging in or affecting interstate commerce.\(^{44}\)

4. **The Professional and Amateur Sports Protection Act**

In 1992, faced with the fact that thirteen states were considering legislation to legalize state-sponsored sports betting, Congress undertook “the task of preventing what many members . . . deem[ed] to be an evil affecting the nation at large.”\(^{45}\) The result of its efforts was the Professional and Amateur Sports Protection Act (“PASPA”),\(^{46}\) which was signed into law by President George H. W. Bush on October 28, 1992. PASPA represented an outright ban on the expansion of state-sanctioned gambling on professional and amateur sporting


\(^{38}\) Schullo, 363 F.Supp. at 249-50.

\(^{39}\) United States v. Trupiano, 11 F.3d 769, 773 (8th Cir. 1993).

\(^{40}\) Trupiano, 11 F.3d at 773-74.


events throughout the United States and marked a shift for Congress, which, until that point, had largely deferred to the individual states in gambling matters under traditional Tenth Amendment principles.\footnote{47} While the Tenth Amendment provides that “the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people,” Congress asserted that its authority to legislate the ban was supported by its Commerce Clause power.\footnote{48}

5. The Unlawful Internet Gambling Enforcement Act

Finally, the Unlawful Internet Gambling Enforcement Act (“UIGEA”)\footnote{49} was passed as part of the SAFE Port Act in 2006 immediately before Congress adjourned for midterm elections. With the notable exceptions of fantasy sports, online lotteries, and horse/harness racing, the UIGEA prohibits the transfer of funds from a financial institution to an internet gambling site. However, the UIGEA specifically excludes from its reach any activities governed by U.S. securities laws.\footnote{50}

\footnote{47} Cabot & Csoka, supra note 15, at 208 (“[T]his was a radical departure from the historic policy that gambling laws were a state decision.”); Bradley, supra note 45, at 9 n.18 (noting that Oregon, Delaware and Nevada were exempted from the Act because sports betting was legal in those states at the time and the elimination of that activities in those states was seen as too harsh a result).

\footnote{48} U.S. CONST. amend. X; see U.S. CONST. art. I, § 8 (providing in part, “the Congress shall have Power . . . to regulate Commerce . . . among several States”); see United States v. Cappetto, 502 F.2d 1351 (7th Cir. 1974), cert. denied, 420 U.S. 925 (1975) (holding that the Organized Crime Control Act of 1970, which made it a federal offense to participate in a gambling business, was authorized under the Commerce Clause); United States v. Smaldone, 485 F.2d 1333, 1342 (10th Cir. 1973), cert. denied, 418 U.S. 936 (1974), reh'g denied, 417 U.S. 926 (1974) (holding that Congress acted within its Commerce Clause power in prohibiting bookmaking on sporting events); see also Slavin, supra note 25, at 722 (“While the Supreme Court has not explicitly stated that collegiate gambling is within the power of Congress to regulate under the Commerce Clause, it has upheld statutes of a similar nature.”); Bradley, supra note 45, at 6 (“Congress has regulated gambling activities in the past. It has also exercised its Commerce Clause powers to regulate activities that are arguably more intrastate than sports gambling without running afoul of the Tenth Amendment.”).


\footnote{50} 31 U.S.C. § 5362. In addition to each of the regulatory regimes described herein, there exists the possibility that certain wagers are subject to regulation by the Commodities Futures Trading Commission (CFTC). The Commodities Futures Modernization Act of 2000 (CFMA), 7 U.S.C. § 27(c) (2006), clarified that certain “hybrid instruments” qualifying as predominantly securities are beyond the scope of the Commodities Exchange Act and the jurisdiction of the CFTC. Hybrid instruments include financial instruments which have a payout linked or indexed to other securities or commodities. In order to qualify as “predominantly” a security, the CFMA requires that (i) the issuer of the instrument receive full payment of the purchase price contemporaneously with the delivery of the instrument; (ii) the purchaser not be obligated to make any payment to the issuer other than the initial payment of the purchase price; (iii) if the hybrid instrument is a secured debt instrument, the issuer not be subject to mark-to-market margin requirements; and (iv) the instrument not be marketed as a futures contract.
All told, better than half a century has passed since the federal government began tinkering with legislating the boundaries around gambling activities, which had traditionally been the providence of the individual states. Despite this increased focus and intensity by the federal government—ultimately aimed at the outright eradication of sports wagering—gambling activities have only grown in popularity and acceptance, have filled the coffers of the unsavory elements of society, and have left gamblers exposed to a system that affords little in the way of protections. A new game plan seems long overdue.

C. SPORTS WAGERING ACTIVITIES IN THE UNITED STATES

One commentator notes that “[s]ports betting is probably as old as spectator sports themselves” and traces the activity back to the gladiatorial fights and chariot races of Ancient Rome.\textsuperscript{51} Sports wagering describes the general activity of betting on the outcome of a sporting event. Aside from simple, friendly, and informal wagers, sports betting is usually done through a person who makes a business out of accepting the bets of others on the outcome of sporting events—commonly referred to as a bookmaker or bookie. The bookmaker earns a commission, or \textit{vig},\textsuperscript{52} by requiring that a bettor place a larger bet than the deemed money at risk.\textsuperscript{53} As discussed previously, bookmaking activities have been the subject of legislative hostility in the United States, resulting in a small, single, and arbitrary monopoly for legalized activities and an enormous, underground, unpredictable, fragmented, and unsavory illegal market. In much of Europe, by contrast, the profession of accepting sports wagers is regulated, but not criminalized.\textsuperscript{54}

Two traditional types of bets dominate the legal and illegal sports wagering market in the United States—the moneyline bet and the point spread bet. Moneylines are quoted in terms of the amount of money required to win $100 betting on a favorite or the amount paid for a $100 bet on an underdog.\textsuperscript{55} These types of wagers are generally


\textsuperscript{52} From the Yiddish “vigorish,” this is sometimes referred to as the “juice.”

\textsuperscript{53} \textit{ARTHUR S. REBER}, \textit{THE NEW GAMBLER’S BIBLE} 278 (1996).

\textsuperscript{54} Gomber et al., \textit{supra} note 51, at 171 (summarizing legalized activities in the UK, Germany, and Sweden).

\textsuperscript{55} The amount “won” in a moneyline bet represents the net amount over and above the initial wager. If a bettor wins $300 on a bet of $100, he will receive $400,
favored in sports where the scoring nature of the contest makes betting on a point spread impractical.

Conversely, the point spread bet is the preferred wager in the United States in higher scoring sports. In the typical point spread wager, a point spread is established prior to the game and a bettor risks $110 to win $100, the extra $10 represents the commission, or vig, to the bookmaker in the event that the bettor loses. A bettor that has placed a wager on the favorite only collects on a point spread bet if the favorite wins the contest by a large enough margin of victory—enough points to cover the spread.\(^\text{56}\) Underdog bettors, in turn, can collect even when their team loses as long as the team loses by fewer points than the spread quoted by the bookmaker.\(^\text{57}\) A push results from a favorite winning by exactly the points provided in the point spread. Following a push, common practice in the United States dictates that all monies (including the vig) are returned in full to each party to the wager.\(^\text{58}\)

In addition to the moneyline and point spread wagers, many bookmakers offer customized alternatives including proposition bets, parlays, teasers, over/unders, and future wagers. A proposition bet describes a wager made on a very specific outcome of a sporting event. Examples of proposition bets include betting on the number of innings a pitcher will last in a game, the number of goals a team might score, or whether or not a running back will run for a set amount of yardage.\(^\text{59}\) A parlay involves multiple bets and awards a successful bettor with a large payout.\(^\text{60}\) Perhaps the most common parlay bet includes betting on several football teams on the same weekend. A four team parlay usually pays approximately 10-1 due to the long odds representing the $300 in winnings plus the return of his original $100 “investment.”

Consider the following sports wagering “line”: “Miami Dolphins minus 6 over the New York Giants with the moneyline set at -170 for Miami and +120 for the Giants.” This moneyline means that a bettor who believes that the Dolphins will win (regardless of the margin of victory) will need to bet $170 to win $100. The bettor picking the Giants to win (again, regardless of points) would “lay $100” to win $120.

56. Consider the following sports wagering “line”: “Denver Nuggets minus 4 at New Jersey Nets.” A bettor wagering on Carmelo Anthony and the Nuggets will only win if the Nuggets beat the Nets by a margin greater than 4 points. See Jeffrey Standen, The Beauty of Bets: Wagers as Compensation for Professional Athletes, 42 Willamette L. Rev. 639, 662 (2006) (“The spread allows bookmakers to attract bettors to potentially lopsided contests; by frequent modifying of the spread, bookmakers search for the ‘correct’ or equilibrium spread for the game, where an equal number of bettors wager on each side, thus eliminating the bookmakers (sic) exposure to betting losses.”).

57. See Gomber et al., supra note 51, at 173 (“[W]inning by betting on underdogs becomes more likely and betting on top teams will be possible with better odds but also with more risk.”).

58. Pushes can be avoided by setting point spreads at half-point intervals.

59. See Gomber et al., supra note 51, at 172 (referring to these wagers as “special bets”).

60. Id.
of a bettor being successful in all four contests. A teaser is a wager which allows the bettor to combine bets in two or more games. A teaser bettor is permitted to adjust the point spreads by a certain additional number of points to account for the fact that the bettor must win all of the contests in order to be paid. An over/under, or total bet, involves predicting the total number of points scored by the two teams in a contest. If you choose the over, you are betting that the combined number of points will exceed the predetermined over/under number. If you choose the under, you are betting that the combined number of points will fall short of the over/under number. Bookmakers often set the over/under as a half-point in order to avoid pushes. Finally, a future wager is a bet that attempts to predict a future accomplishment of an individual player or team.

Today, despite the historical bias against the activity, the ever-increasing ire of legislators throughout the nation, and the fact that it is illegal in all but two states, sports betting represents the most widespread and popular form of gambling in the United States. As the National Gambling Impact Study Commission concedes in its report, "[f]rom informal, illegal office pools to legal bookmaking in Nevada, wagering on sports events is a pervasive activity in our culture." Law enforcement efforts have failed to eradicate illegal bookmaking in the United States. In fact, despite Congress' great efforts to arrest the "evil affecting the nation at large," illegal sports wagering has flourished. Annual estimates of the scope of sports wagering in the United States range from $80 billion to $380 billion. Yet, in Nevada, some 170 legal sports books account for only $2.4 billion in wagering activity each year, representing possibly less than one percent of the

61. Assuming that the odds of a win and a loss on any single game are equally likely, the chances of winning a four team parlay can be described as [(50%)], representing a 6.25% chance.
62. See generally Gomber et al., supra note 51, at 172 (referring to these wagers as "combination bets").
63. Gomber et al., supra note 51, at 173 n.5.
64. One example is the bet that a certain team will win the World Series in the upcoming season. If the odds are given as 25-1, a successful bettor will collect twenty five times his wager in the event that his team prevails.
66. Id. at 6.
68. Id.
nation's total. As one commentator observed, "the other ninety-nine percent is controlled by persons who are assuredly criminals because, by the very act of accepting the sports wagers, they are breaking the law."71

Sports history is replete with colorful stories (some of questionable veracity) of athletes and gamblers conspiring to fix the outcome of sporting events in an effort to decrease – or even remove – the uncertainty of particular wagers.72 The most infamous betting scandal in U.S. history is the "Black Sox Scandal" of 1919 in which eight members of the heavily-favored Chicago White Sox were allegedly bribed to lose (or throw in sports betting parlance) the World Series to the Cincinnati Reds.73 Other notorious scandals involve the 1951 City College of New York basketball team,74 the Boston College basketball team,75 major league baseball all-time hits leader Pete Rose,76 and most recently, National Basketball Association referee Tim Donaghy.77


72. See Udovicic, supra note 42, at 425 (providing a timeline of the various gambling incidents and scandals in college sports); cf. Standen, supra note 56, at 662 ("Betting scandals involving thrown games are rare. . .").

73. See Thomas J. Ostertag, From Shoeless Joe to Charlie Hustle: Major League Baseball’s Continuing Crusade Against Sports Gambling, 2 SETON HALL J. SPORT L. 19, 22, 34-36 (1992) ("[T]he sports community, and MLB in particular, has long been concerned by the influence of gambling activities surrounding its games – a concern that dates back to the World Series scandal of 1919 that threatened to destroy baseball."); see also Hearings on S.474 Before the Senate Subcomm. on Patents, Copyrights and Trademarks, 102d Cong., 1st Sess. (1991) (quoting Francis T. "Fay" Vincent, Commissioner of Major League Baseball, as stating "[t]he intense feelings with which I approach betting on Baseball might best be understood if one remembers that the Office of the Commissioner of Baseball was created in direct response to the 1919 'Black Sox' scandal. Protecting the integrity of the game is our primary job.").


76. See generally Ostertag, supra note 73.

77. See Michael S. Schmidt, Referee Gets 15 Months for His Role in Gambling Ring, N.Y. Times, July 30, 2008, at D7. Perhaps the most unlikely sports betting casualty of all, however, was Andres Escobar, a defender for the Colombia national soccer team. Escobar, in an attempt to clear the ball from in front of his own goal, inadvertently scored a goal against his own team in the 1994 FIFA World Cup, resulting in Colombia being knocked out in the first phase of the championship. Escobar was murdered shortly after returning home to Colombia. It is widely believed that he was executed by the Medellin drug cartel because it had lost large sums of money on a wager that Colombia would advance, and they blamed Escobar for their losses. Daniel W. Drezner, The Soccer Wars: Bono Says the World Cup Is a Peacemaker. Not Quite., WASH. POST, June 4, 2000, at B1.
Lost in all of the scandals and the commentary are certain positive externalities that can be attributed to gambling activities. One such benefit is the financial revenue generated from legitimate gambling. The National Gambling Impact Study Commission even concedes, in its Final Report, that "[g]ambling revenues have proven to be a very important source of funding for many tribal governments, providing much needed improvements in the health, education and welfare of Native Americans on reservations across the United States."78 Traceable and legalized sports wagering on the scale of $380 billion per year might also create a sizeable tax base if legalization and government regulation were embraced.79 The benefits of gambling activities may also spill over to professional sports leagues in the form of strengthened and expanded fan bases and increased attendance and ticket sales.80 As a contextual note, it is important to remember that, in reality, the American public does not shy away from gambling activity.81 In fact, a Gallup Poll revealed that eighty percent of Americans surveyed favor the legalization of gambling, while a full sixty percent of American adults partake in some type of gambling themselves.82

II. REGULATING INVESTING ACTIVITIES IN THE UNITED STATES

In contrast to unsavory gambling behavior, those activities fortunate enough to be labeled as investing have traditionally enjoyed great acclaim, with cheerleaders highlighting investing as "an enterprise of skill in which the assiduous and diligent may earn deserved rewards."83 Its proponents generally trumpet the fact that investing supplies capital for corporations, generates fees and commissions for

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78. NGISC Final Report, supra note 65, at 6-2; see also Gosker, supra note 15, at 187 ("[S]tate and local governments view casino gambling as a source of revenue because it attracts tourists, creates jobs and generates taxes.").
79. See also Pickens, supra note 28, at 229 (lamenting the lost tax revenue from online gambling); David O. Stewart, An Analysis of Internet Gambling and Its Policy Implications 1 (Am. Gaming Ass’n ed. 2006) ("[N]either federal nor state governments receive tax revenues from online gambling.").
80. See Boswell, supra note 15, at 1275 (suggesting that fantasy sports have a positive impact on professional sports leagues).
81. One estimate is that Americans bet approximately $1 trillion per year in both legal and illegal gambling. Rychlak & Hinshaw, supra note 10, at 828. (citing Robert M. Jarvis et al., Gaming Law: Cases and Materials 17 (2003)).
financial intermediaries, and raises substantial monies for the federal government through the taxation of dividends and capital gains. In addition, futures markets provide an efficient outlet for the systemic hedging of particular economic exposures. Based on the assumption that investment markets serve socially beneficial purposes, the government has chosen to regulate, rather than prohibit, investment in an attempt to promote these functions.

A. TRADITIONAL BIAS IN FAVOR OF INVESTING ACTIVITIES

The bias in favor of investment has only grown in recent years with the advent of modern portfolio theory, which holds that, by diversifying the assets in any portfolio (assuming anything less than perfect positive correlation between those assets), investors can reduce the variance of their returns. The general acceptance of modern portfolio theory has encouraged market participants to structure - and emboldened market regulators to approve - new financial instruments designed to reap these diversification benefits. The government's regulation and encouragement of these activities takes place under the securities regulation regime encompassed largely by the Securities Act of 1933 and the Securities and Exchange Act of 1934.


85. See WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 159 (Foundation Press 6th ed. 2008) ("Financial futures contracts perform hedging functions for financial institutions in the same way that commodities futures contracts reduce the risks of firms that deal in commodities.").


87. Pickens, supra note 86, at 244. Modern portfolio theory was introduced to the world in Harry Markowitz's paper Portfolio Selection, which appeared in the Journal of Finance in 1952. Basing his research on the properties of diversification, Markowitz proposed that investors base investment decisions on aggregate risk-reward profiles of the portfolio instead of characteristics of individual stocks. Markowitz's "efficient frontier" was comprised of portfolios that were optimally balanced for volatility and expected return (i.e. risk and reward).

88. See LAWRENCE E. MITCHELL ET AL., CORPORATE FINANCE AND GOVERNANCE: CASES, MATERIALS, AND PROBLEMS FOR AN ADVANCED COURSE IN CORPORATIONS 241 (Carolina Academic Press 2d ed. 1996) ("[R]isk of a portfolio of investments is not necessarily the weighted sum of the risks (or dispersion in the returns) of the individual investments. Unless the portfolio consists entirely of investments that are expected to behave in exactly the same way in response to various external stimuli, then the risk on the portfolio will be less than the weighted sum of the risk of the individual investments."). See generally BURTON G. MALKEIL, A RANDOM WALK DOWN WALL STREET 206-19 (W.W. Norton & Co. rev. ed. 1999) (1973) (discussing modern portfolio theory).

89. Pickens, supra note 86, at 244.
B. Securities Regulation in the United States

The deceptive trading and investment scandals that plagued the securities transactions of the 1920s and early 1930s led to Congress' passage of the Securities Act of 1933 ("Securities Act"), 1 the Securities and Exchange Act of 1934 ("Exchange Act"), 2 and the creation of the Securities and Exchange Commission ("SEC"). 3 This legislation embraced a disclosure-based system of regulation and represented an attempt to minimize the financial risks that an investor faces when investing on the basis of imperfect or insufficient information. 4

There are several rationales for a disclosure-based system of regulation. 5 First, rules regarding disclosure indirectly influence corporate decision-making, therefore encouraging companies and their executives to behave more diligently and honestly. 6 Second, ade-

90. Prior to the 1930s, securities regulation in the U.S. was handled by the states, which operated "blue sky" laws designed to protect investors from fraudulent schemes. This regulatory effort could not root out the fraud of alluring promises of easy wealth made without any attempt to bring to the investor's attention those facts essential to understanding the worth of the security.


93. K. FRED SKOUSEN, AN INTRODUCTION TO THE SEC 4 (2d ed. 1980). The SEC was created pursuant to Section 4(a) of the Exchange Act. 15 U.S.C. § 78d(a) (2006) ("There is hereby established a Securities and Exchange Commission . . . to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate.").

94. See S. REP. No. 73-1455, at 5 (1934); 77 CONG. REC. 2982-83 (1933) (statement of Sen. Fletcher).

95. See H.R. REP. No. 73-85, at 2 (1933). President Franklin D. Roosevelt, in ushering in the new system, emphasized the importance of adequate risk disclosure by the seller of a security:

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

77 CONG. REC. at 2982-83.

quate disclosures ensure that the investor is able to make a decision to purchase or sell a security based on full and complete information. Without the benefit of a system of full and fair disclosure, an investor is left with inadequate information regarding the risks associated with a particular investment.97

I. The Definition of “Security”

For an aggrieved investor, whether a purchaser or seller, to pursue a cause of action under the federal securities laws, the subject matter of the transaction in question must fall within the statutory definition of a security.98 The definitions of a security contained in the Securities Act and the Exchange Act encompass a broad range of investment instruments.99 Section 2(a)(1) of the Securities Act defines the term security100 “in sufficiently broad and general terms so as to include . . . many types of instruments that in our commercial world fall within the ordinary concept of a security.”101 However, courts have recognized that Congress did not intend the application of this definition to “provide a broad federal remedy for all fraud.”102 As a result of the inherent and, perhaps, intentional ambiguities in the definition of security, the Supreme Court has been tasked with defining what a security is for purposes of the Securities Act or the Exchange Act on numerous occasions.103 Unfortunately, the resulting case law contains inconsistent and often confusing approaches with respect to the term’s definition.104 In fact, the Supreme Court itself has conceded that “cases have not been entirely clear on the proper method of

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97. See Howell E. Jackson, Regulation in a Multisected Financial Services Industry: An Exploratory Essay, 77 WASH. U. L.Q. 319, 345 (1999) (“The premise of all these mandatory disclosure rules is that in the absence of these rules investors would have inadequate information about the risks associated with particular securities.”).

98. See 15 U.S.C. §§ 77v(a), 78aa (2006). In addition, the remedial provisions only apply if the transaction involves a security. 15 U.S.C. §§ 77k(a), 77l(2), 78j(b) (2006).

99. See 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (defining “security”); see also Lynn T. Burleson, When Is a Note a Security? A Historical Perspective on the Supreme Court’s Adoption of the Family Resemblance Test: Reves v. Ernst & Young, 24 CREIGHTON L. REV. 371, 376-77 (1990) (“Given the size of the problem in the market place and the seemingly infinite variation of transactions available, it is not surprising that Congress defined ‘security’ in such generic and encompassing terms.”).

100. The Exchange Act provides a slightly different definition of “security” which the Court has treated as essentially identical. See 15 U.S.C. § 78c(a)(10); see also United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975).


analysis for determining when an instrument is, in fact, a 'security.'\textsuperscript{105} However, three things are certain based on the case law.

First, there is no universal or generic test of the term security.\textsuperscript{106} Instead, each type of financial instrument enumerated in the definition of security requires its own separate analysis to qualify as a security.\textsuperscript{107} Second, because the definition of security is preceded by the language: "when used in this subchapter, unless the context otherwise requires," the Supreme Court and lower courts are entitled to examine more broadly the factual circumstances of a transaction that may involve a security.\textsuperscript{108} Finally, "the existence of another body of comprehensive federal legislation providing the equivalent to the investor protection regulation of the securities laws 'severely undercuts' arguments for defining a financial instrument as a Section 2(a)(1) security."\textsuperscript{109} In two separate instances, the Supreme Court excluded financial instruments that would have otherwise qualified as securities from the definition of the term security due to the presence of federal regulation that served the same investor protection purpose as the federal securities laws.\textsuperscript{110}

2. \textit{The Howey Test}

Following the enactment of the Securities Act and the Exchange Act, the SEC noted that "[t]he efficient enforcement of [the securities acts] in the field of stocks and bonds has driven [fraudulent] promoters into veiled and devious ways of accomplishing their ends."\textsuperscript{111} In turn, the Supreme Court cases of the time focused mainly on the meaning of the phrase \textit{investment contract}, one of the proscribed financial instruments included in the Securities Act's definition of the

\begin{itemize}
  \item \textsuperscript{105} Landreth, 471 U.S. at 688.
  \item \textsuperscript{106} Loss \& Seligman, supra note 101, at 231-32.
  \item \textsuperscript{107} Id. at 232; see also Landreth, 471 U.S. at 692 ("[A]pplying the Howey test to traditional stock and all other types of instruments listed in the statutory definition would make the Act's enumeration of many types of instruments superfluous.").
  \item \textsuperscript{108} Loss \& Seligman, supra note 101, at 232; see Reves v. Ernst \& Young, 494 U.S. 56, 61 (1990) ("In discharging our duty, we are not bound by legal formalisms, but instead take account of the economics of the transaction under investigation."); Marine Bank, 455 U.S. at 558-59 ("The definition of 'security' . . . provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires."); cf. Landreth, 471 U.S. at 687 (foreclosing the possibility of an inquiry into the context of a transaction by stating "[u]nder the circumstances of this case, the plain meaning of the statutory definition mandates that the stock be treated as 'securities' subject to the coverage of the Acts").
  \item \textsuperscript{109} Loss \& Seligman, supra note 101, at 233.
  \item \textsuperscript{110} Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 569-70 (1979).
\end{itemize}

*Howey* involved an investment scheme whereby purchasers were offered strips of land in an orange grove and service contracts to farm the land simultaneously. The Supreme Court concluded that the offer for the land and the service contract together constituted an investment contract for purposes of federal securities law. Despite the Supreme Court’s own admonition not to thwart the statutory policy of investment protection “by unrealistic and irrelevant formulae,” it prescribed a four-part test in establishing an investment contract. In particular, the Supreme Court stated that “an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [(i)] invests his money [(ii)] in a common enterprise and [(iii)] is led to expect profits [(iv)] solely from the efforts of the promoter or a third party . . .” Courts have developed and refined each of the four elements in the years since *Howey* and, therefore, the elements warrant further investigation.

First, a person *invests his money* when he or she lays out something of value. In *International Brotherhood of Teamsters v. Daniel*, the Supreme Court concluded that the financial instrument at issue was, in fact, a security and commented that “[i]n every case the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security.” Note that, in a later case, the Supreme Court determined that the first element of the *Howey* test was not satisfied because “investors were not attracted by . . . financial returns on their investments.”

The second prong of the *Howey* test focuses on the extent to which the successes of an individual investor are intertwined with the success or failure of additional parties in the relevant enterprise. The

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112. Globerman, supra note 92, at 285.
113. 328 U.S. 293 (1946).
116. *Id.* at 299 (“The transactions in this case clearly involve investment contracts as so defined.”).
117. *Id.* at 301; Loss & Seligman, supra note 101, at 250.
120. *Id.* at 286.
123. Forman, 421 U.S. at 853 (observing that, instead, investors were motivated by the “prospect of acquiring a place to live”).
elements required to satisfy this prong of the Howey test are the subject of a split of opinion among the circuit courts.124 The First, Sixth, and Seventh Circuits have adopted a horizontal commonality approach, requiring a pooling of investments among participants.125 The vertical commonality approach, favored by the Fifth and Eleventh Circuits, requires merely that all of the investors have their fortunes dependent upon the promoter's expertise.126 The Ninth Circuit has adopted a more restrictive vertical approach, which defines a common enterprise as one in which "the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties."127 To date, the Supreme Court has not ruled with respect to the commonality required to satisfy the test. However, at least one commentator has expressed the view that "both vertical and horizontal commonality should suffice in meeting the common enterprise element" because the underlying intent of the Securities Act and the Exchange Act was to apply to "all transactions that attempt to defraud public investors."128

In analyzing the third, or expectation of profits, prong of the Howey test, the Supreme Court has separately examined the meaning of the term profits and the meaning of the phrase reasonable expectations.129 The Supreme Court has interpreted the term profits to mean capital appreciation resulting from the development of the initial investment130 or dividends on the underlying investment based on its profits.131 In Securities and Exchange Commission v. Infinity Group Company,132 the Supreme Court also made clear that the definition of security does not turn on whether an investor receives a fixed or variable rate of return.133 The Supreme Court has rejected several attempts to define profit under this rationale.134 In particular, in

124. Perez et al., supra note 104, at 944.
125. SEC v. SG Ltd., 265 F.3d 42, 49-50 (1st Cir. 2001); Newmyer v. Philatelic Leasing, Ltd., 888 F.2d 385, 395-97 (6th Cir. 1989); Stenger v. R.H. Love Galleries, 741 F.2d 144, 146 (7th Cir. 1984); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972).
126. See SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974) ("The critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts."); SEC v. Unique Fin. Concepts, Inc., 196 F.3d 1195 (11th Cir. 1999).
127. SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1972), cert. denied, 414 U.S. 821.
129. LOSS & SELIGMAN, supra note 101, at 253.
132. 212 F.3d 180, 189 (3d. Cir. 2000).
134. LOSS & SELIGMAN, supra note 101, at 254.
Tcherepnin v. Knight, the Supreme Court rejected the argument that the deductibility, for tax purposes, of a portion of the monthly rental charge that was applied to the interest on the mortgage amounted to income or profits. In United Housing Foundation, Incorporated v. Forman, the Supreme Court disagreed that profits existed where low rents were derived from subsidies provided by the State of New York. The Supreme Court also established the principle that when the profit producing purpose is incidental and appurtenant, the purchase will not be deemed to be a security.

While the final element of the Howey test requires that the profits of an investment contract must flow solely from the efforts of others, at least ten United States Circuit Courts of Appeals have adopted an interpretation that is more liberal than a literal reading would render. In fact, even the SEC has urged a flexible interpretation. As commentary has consistently noted, a mechanical limitation of the application of the investment contract concept only to those instances in which investors remain totally passive would be easily circumvented whenever a purchaser contributed a modicum of effort.

3. The Reves Test and its Progeny

The statutory definitions of security in both the Securities Act and the Exchange Act expressly include any note. Nevertheless, Congress could not have intended the phrase any note to be read literally or the courts would be swamped with every unsatisfactory personal contract deemed a note “without regard to diversity of citizenship or jurisdictional amount as a fraudulent ‘purchase’ of a ‘security.’” Unlike investment contracts, which benefited from the certainty provided by the Howey test, a “workable test for determining when a ‘note’ should be considered a security eluded the courts” until Reves v. Ernst & Young. In fact, prior to the Reves decision, the

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136. Forman, 421 U.S. at 855.
137. See id. ("This benefit cannot be liquidated into cash; nor does it result from the managerial efforts of others.").
138. Id. at 857.
139. Loss & Seligman, supra note 101, at 256.
141. Loss & Seligman, supra note 101, at 256-57.
143. Loss & Seligman, supra note 101, at 234.
United States Circuit Courts of Appeals had adopted four different tests to determine whether a note should be considered a security.\(^{145}\)

As observed by the Supreme Court in *Reves*, "Congress' purpose in enacting the securities laws . . . was to regulate investments, in whatever form they are made and whatever name they are called."\(^{146}\) In deference to the plain meaning of the words of the Securities Act, the Supreme Court held that there is a rebuttable presumption that a note is, in fact, a security.\(^{147}\) In characterizing and expanding upon a list of instruments that the United States Circuit Court of Appeals for the Second Circuit had deemed *non-securities*, the Supreme Court set forth the clearest roadmap to date on what constitutes a security when it stated:

First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" to determine whether it is an instrument in which there is "common trading for speculation or investment . . . ." Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.\(^{148}\)

Under the family resemblance test, a note is presumed to be a security unless it is shown to have a strong family resemblance to one of the enumerated *non-securities* or the Supreme Court is convinced to

\(^{145}\) See id. (discussing the application of (i) the Howey test, (ii) the commercial/investment dichotomy test, (iii) the risk capital test, and (iv) the family resemblance test to determine whether notes should be considered securities).

\(^{146}\) *Reves*, 494 U.S. at 61 (emphasis omitted).

\(^{147}\) Id. at 65 ("The test begins with the language of the statute; because the Securities Acts define 'security' to include 'any note,' we begin with a presumption that every note is a security.").

\(^{148}\) Id. at 66-67.
add to the existing list of exceptions. The Supreme Court prescribed four standards for determining whether an instrument bears a family resemblance to a non-security: (i) the motivations of a reasonable seller and buyer; (ii) the plan of distribution; (iii) the reasonable expectations of the investing public; and (iv) other risk reducing factors, including other regulatory schemes rendering the securities law protections unnecessary.

In Reves, the Supreme Court found that the notes at issue were, in fact, securities. It ended its inquiry there. The Supreme Court, however, did not indicate whether further analysis would be warranted had the notes failed the family resemblance test. In this regard, at least one commentator has observed that the Supreme Court's "favorable references to United Housing Foundation v. Forman [in Reves] are instructive." After stock failed a resemblance test in Forman, the Supreme Court analyzed whether the instrument nonetheless fell within the general category of an investment contract by applying the Howey test. While the instrument at issue in the Forman case ultimately failed the Howey test as well, the actions of the Supreme Court suggest that the Howey investment contract test is "alive and well, albeit in the second and sometimes unnecessary step of the analysis."

III. STRUCTURED PRODUCTS AND THEIR REGULATION AS SECURITIES

Approximately $114 billion in face amount of structured products were issued in the United States in 2007, up from $64 billion in 2006 and $48 billion in 2005. However, the market for structured products in the United States represents just a small percentage of the $193.6 billion of structured products issued worldwide in the same year. While there is no standardized definition of a structured

150. Id. (noting that the same factors could be utilized to convince a court to add to the accepted list of non-securities).
153. Id.
154. Id. at 902.
156. SPA Survey, supra note 155; see also Jennifer Bethel & Allen Ferrell, Policy Issues Raised by Structured Products 3-4 (Harvard Law Sch., Econs. & Bus. Discussion
product in the federal securities laws, at least one self-regulatory organization has attempted to define structured products as "securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency." 157 Structured products come in many varieties and can be used within a portfolio to achieve a number of objectives including providing an investor (i) protection from a decline in the price of the underlying asset, 158 (ii) enhanced exposure to the return of the underlying asset, 159 (iii) yield enhancement in the form of an oversized coupon, 160 or (iv) a customized payout different from the traditional return profile availa-
ble from buying or selling a portion in the underlying asset.\textsuperscript{161} These products can also provide investors with an opportunity to access asset classes, such as commodities and foreign currencies, which have been primarily available solely to institutional investors in the past.\textsuperscript{162}

A. TYPES OF STRUCTURED PRODUCTS

The types of structured products continue to evolve and are only limited by the imagination of their Wall Street designers. In the most typical case, a structured product provides for the investor to make an initial investment, at the time of purchase, in exchange for the issuer's obligation to pay an amount at maturity which is dependent upon certain contingent events and their magnitudes. Issuers have become particularly enamored with structured products in recent years because the investor's initial investment represents an inflow to the issuer at the time of the structured product's issuance.

A typical structured product has two components – a note and a derivative.\textsuperscript{163} The note portion of the structured product provides for the payment of interest to an investor, if any, at specified rates and intervals. The derivative component establishes the payment, if any, due to the investor at maturity. The profile of a structured product is shaped, in large part, by the construction of its derivative portion.\textsuperscript{164} In the structured products business, an issuer is not attempting to make its money from the market movements of the underlying asset. Instead, an issuer is hoping to earn its own vig through the collection of fees, commissions, and transaction costs. Therefore, before offering a structured product, a trader at the issuing bank must be sure that the trader can price and purchase the individual underlying components that replicate the return profile of the structured product from financial instruments available in the marketplace. The trader can accomplish the purchase of these financial instruments by entering into trades of products listed on an exchange or by entering into so-called over-the-counter transactions with market counterparties.\textsuperscript{165}

Very often, the derivative embedded in the structured product is so

\textsuperscript{161} HSBC Securities (USA), Inc., Form FWP, Free Writing Prospectus, Buffered Enhanced Market Participation Note Linked to the Financial Select Sector SPDR Fund (July 18, 2008) (on file with author).

\textsuperscript{162} Merrill Lynch & Co., Inc., Form FWP, Final Term Sheet No. 3054, Accelerated Return Notes Linked to the Gold Spot Price due September 29, 2009 (July 8, 2008) (on file with author).

\textsuperscript{163} NASD Notice to Members 05-59, supra note 157, at 2.

\textsuperscript{164} "Derivative" is the term used to describe a financial instrument that "derives" its value from the movements in price (or level) of another asset.

\textsuperscript{165} An "over the counter" transaction is a bilateral contract in which two parties agree on the terms of a particular trade. For derivatives, these trades are usually gov-
customized in terms of its commencement date, term, or other attributes that the appropriate hedge cannot be found on a listed exchange. Whether the trader is able to complete the requisite purchases and/or sales on an exchange or via over-the-counter market, once the appropriate financial instruments are purchased and/or sold, the issuer will be fully hedged.

In this context, fully hedged means that the payout that the issuer will receive from the combination of the assets that it purchases and/or sells will exactly equal and offset any payout amounts due to its investor under the structured product. A fully hedged issuer will be indifferent to the market movements of the underlying assets.

The examination of some of the most popular structured products that follows is intended to highlight some of the uses, benefits, and risks of structured products. The descriptions of these products and the hedging techniques employed by issuers will serve as a comparison for the Tiger Woods Note that is introduced in Part IV of this Article.

1. The Leveraged Note

It may be difficult for an investor who believes that certain market returns are likely to be only moderately higher over a period of one to three years to monetize its view through traditional long or short positions in a stock portfolio. Fortunately, for such investors, there are a host of available structured products that provide a leveraged return on an underlying asset's moderate gains in exchange for the investors' forfeiting the right to fully participate in the significant rally that they consider unlikely. Perhaps the simplest form of this type of structured product provides an investor (i) a leveraged return on an underlying asset and (ii) the added benefit of principal protection in the event that the underlying asset falls in value during the term of the note. In exchange for this customized payout, investors

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166. The payout amounts should include both the payments, if any, due at maturity (under the derivative portion of the product) or any payments due throughout the term (under the note portion of the product).

167. A "long" position in a security means that the security's holder will profit from a rise in the security's price. Likewise, a long position in a derivative implies that a holder of that position will profit from a rise in the price of the derivative's underlying asset.

168. Being "short" describes the strategies by which an investor can profit from the decline in price of a security.

169. "Principal Protection" provides that an investor will be returned at least the principal amount of his investment, regardless of the performance of the underlying reference asset, if he holds his note until maturity.
agree to forego some of the upside available from a direct investment in the underlying asset.\textsuperscript{170}

In effect, the issuer of this structured product is offering its investors a customized payout designed to monetize a particular market expectation. While an investor could certainly replicate such a strategy on his or her own with readily available financial instruments, the structured product allows the investor the benefit of one stop shopping. The issuer will (i) package the different assets together in a single note, (ii) mark that note to market each evening in the customer’s account, and (iii) enjoy the potential benefit of favorable pricing on each of the underlying financial instruments because of its status as an institutional investor and its ability to aggregate orders.

As a hedge to the leveraged note, the issuer will purchase (i) a zero coupon bond\textsuperscript{171} with a face amount equal to the size of the note and a maturity date matching the note’s maturity and (ii) a call option\textsuperscript{172} on the underlying asset at a strike price equal to the asset’s current market price.\textsuperscript{173} In addition, the trader will sell an out-of-the-money call option\textsuperscript{174} with a strike price equal to the price at which the investor begins to forego the asset’s upside. The first hedging asset, the zero coupon bond, will accrete to par by the note’s maturity date, thereby ensuring that principal protection is achieved. The second and third hedging assets, in each case a call option, will finish \textit{in} or \textit{out of the money} depending on the performance of the underlying asset during the term.

\textsuperscript{170} This portion of the payout structure is customarily referred to as the “cap” or the maximum.

\textsuperscript{171} A zero coupon bond (also referred to as a “discount bond” or “deep discount bond”) is a bond bought at a price lower than its face value, with the face value repaid at the time of maturity. Zero coupon bonds do not make periodic interest payments. Instead, investors earn their return from the compounded interest all paid at maturity plus the difference between the discounted price of the bond and its par (or redemption) value. Examples of zero-coupon bonds include U.S. Treasury bills, U.S. savings bonds, and long-term zero-coupon bonds.

\textsuperscript{172} A call option gives its owner the right, but not the obligation, to buy a certain quantity of the underlying asset at a specified price (the “strike price”) on a specified date (the “expiration date”).

\textsuperscript{173} An option with a strike price equal to the current price of the underlying asset is said to be “at-the-money.”

\textsuperscript{174} An “out-of-the-money” call option is an option, providing the buyer the right, but not the obligation, to buy a certain quantity of the underlying asset on the expiration date at a strike price that is higher than the asset’s current market price. This option is said to be out-of-the-money because a rational investor would not exercise that option today because, if he did, he would be paying more than he would have to pay if he simply bought the asset in the market.
2. The Reverse Convertible Note

The most popular type of structured product in the United States is the reverse convertible note or recon. Reverse convertible notes are commonly linked to the performance of a single underlying stock. In the standard reverse convertible note payout, at maturity, investors will receive 100% of their initial investment as long as the price of the underlying stock either (i) does not close below a predetermined barrier price on any day during the term of the notes or (ii) closes at or above its initial price on the final valuation date. Assuming that neither of the events described in (i) or (ii) above occurs, at maturity, investors typically receive a number of shares of the underlying stock. However, the value of the stock received will be less than the investor's initial investment. The investor will not participate in any appreciation of the stock underlying the reverse convertible note, but, in exchange for this forbearance, the investor will receive a fixed coupon (typically at a very high interest rate) that will be paid on a quarterly, semi-annual, or annual basis. Similar to most structured products, reverse convertible notes generally represent unsecured debt securities of their issuer.

Reverse convertible notes are designed for investors who are moderately bullish and/or who expect the price of the underlying stock to remain within a certain trading range over the term of the notes and who can bear a loss of principal if, instead, the price of the underlying stock falls below the specified barrier price. Because reverse convertible note investors do not participate in any appreciation of the underlying stock during the term of the notes, the investors must feel comfortable owning shares of the underlying stock in the event that the barrier price is breached and the final price of the underlying stock is less than its initial price. If the shares of the underlying stock never close below the barrier price, investors receive their full initial investment in cash at maturity even if the price of the underlying stock is below the initial price. If, on the other hand, the shares of the underlying stock close below the barrier price on any day during the term of the reverse convertible notes, but close at or above the initial price on the valuation date, at maturity the investors are returned their full initial investment in cash. If the shares of the underlying stock (i) close below the barrier price on any day during the term of the reverse convertible notes and (ii) below the initial price on the val-

176. The "closing price" of an asset is generally determined by the price of that asset as of the "close" of the regular trading session of the exchange on which it trades, without giving effect to any transactions that occur outside of the normal trading hours.
valuation date, investors will receive physical delivery of shares of the underlying stock. The number of shares will typically be determined upfront by dividing the investor's initial investment by the underlying stock's initial price.

In order to hedge a reverse convertible note, the issuer of the note must establish a position generating enough money to provide investors (i) the guaranteed fixed coupon payments on each coupon payment date and (ii) at maturity, either the number of shares of the underlying stock or 100% of the initial investment. The issuer achieves this result by selling put options (or options giving the purchaser of such option the right to sell the underlying stock at a predetermined price to the seller of the option if a certain contingency occurs) and reinvesting both 100% of the initial investment received from buyers of the note and the proceeds earned from the sale of the put options at the risk-free rate of interest. If the reverse convertible note pays a number of shares of the underlying stock at maturity because the underlying stock both (i) closed below a predetermined barrier price on some day during the term of the notes and (ii) closed below its initial price on the valuation date, then the issuer would receive the shares it needs to deliver to the investor as a result of its position as seller of the put option.

3. The Buffer and Barrier Notes

Another type of structured product popular in the United States is the buffer note and its close cousin, the barrier note. The inclusion of a buffer protects investors from losing any of their principal investment unless the level of the underlying asset is below the specified buffer level on a predetermined valuation date. However, for every percentage point that the final level of the underlying asset is below

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177. By way of example, if an investor purchases $3,000,000 of reverse convertible notes linked to the shares of Company X (which hypothetically at that moment trades for $66.40 per share) from the issuer, the issuer would need to hedge 45,180 shares ($3,000,000 divided by $66.40). If each put sold for $3.50, the issuer (as put seller) will raise $158,132.50 from the hedging transactions (or $3.50 multiplied by 45,180 shares). As a result, the issuer would have $3,158,133 available for reinvestment on the issue date ($3,000,000 principal amount plus $158,133 in hedging proceeds). Growing this reinvestment at 2.4% (risk free rate for a hypothetical six-month term of the note) allows the reinvestment amount to be $3,233,928 at the end of the six month term. In terms of interest, $183,750 is owed to the investor at maturity ($3,000,000 x 6.125%, which represents the stated interest rate multiplied by the number of years to maturity). Taking the reinvestment amount held by the issuer at the end of the term of the notes ($3,233,928) and subtracting the amount owed to the investor at such time ($3,183,750, or the principal amount of $3,000,000 plus the interest payment of $183,750), leaves the issuer with a profit of $50,178 ($3,233,928 minus $3,183,750) for its efforts.
the buffer level, the investor loses one percent of his or her principal investment (or more if there is downside leverage).

The payout on a buffer note may be point to point (i.e. based on the performance of the underlying asset from issuance of the note to the final maturity of the note) or based on averaging dates (i.e. based on interim valuations of the performance of the underlying asset during the term of the note). Buffer notes do not pay any coupon and, of course, will not be 100% principal protected as they provide principal protection up to, but not beyond, the pre-specified buffer level. The final payout of a buffer note will equal the product of (i) the final (or average) level of the underlying asset divided by its initial level and (ii) the principal amount, subject to the buffer. These notes, generally, will have a term to maturity of one year or more.

Similarly, a barrier (or knock-in) feature means that a note is principal protected unless the level of the underlying asset falls beneath the barrier level at any point during the term of the note. If the barrier is breached, the note loses its principal protection and investors suffer loss on a one-to-one basis as the reference asset declines from its initial level. The difference between a barrier and buffer note is simple. Once the buffer level is breached, an investor in a buffer note only then begins to participate in the downside performance of the underlying asset. In the barrier note, by contrast, once the barrier is breached, the investor participates in the downside performance of the underlying asset down to and through the barrier.

Buffer and barrier notes are designed for investors who are bullish with respect to the underlying asset, but who would like to receive a certain extent of downside protection in case such underlying asset does not perform to expectations. In both these products, the spread between the initial level of the underlying asset and the barrier/buffer level provides that extent of principal protection for the investor in case of downward movement in the level of the underlying asset. On the other hand, if the underlying asset performs well, as expected, the investor will participate in such performance subject to performances caps or leverage opportunities, if any.

B. FACTORS AFFECTING THE PERFORMANCE OF STRUCTURED PRODUCTS

Depending on the terms of a specific structured products offering, the issuer may commit to provide liquidity to investors during the term of the note in the form of a secondary market. While a secondary market provides some assurance of liquidity, it does not ensure that an investor will be able to sell the investor’s notes prior to maturity at a particular price. In fact, there are many factors outside of the con-
trol of either the issuer or the investor that may affect the price that an investor may realize from the sale of the investor's notes prior to maturity. Some of these factors are interrelated in complicated ways. As a result, the effect of any one factor may be offset or magnified by the effect of another factor. In general, the factors that affect the value of a structured product that contains an embedded option are the same factors that are the inputs in determining that option's value pursuant to trading pricing models, most notably the Black-Scholes Option Pricing Model. 178

In most structured products, the performance of the underlying asset is expected to have the greatest effect on the value of the structured product. This makes sense, as often the magnitude of the return under the note, if any, is a function of the underlying asset's level at maturity. In addition to the pure price performance, other factors may affect the trading value of the underlying reference asset and, therefore, the notes.

The volatility of the underlying asset will also have a substantial effect on the price of a structured product that contains an embedded option. The reason that the underlying asset will have a substantial effect on the price of a structure product is because volatility, which represents the size and frequency of market fluctuations, is one of the most important variables in determining the value of an option. As a general rule, as an underlying asset's volatility increases, an option linked to that underlying asset increases in value.

Finally, the time remaining to maturity will help determine the value of a note. A time premium results from expectations concerning the value of the underlying reference asset during the period prior to the note's maturity. As the time remaining to the note's maturity decreases, the time premium will also decrease, which, in turn, decreases the value of the note, all else remaining equal.

C. THE SECURITIES OFFERING PROCESS AND INVESTOR PROTECTIONS

When dealing with a structured product, issuers and distributors must analyze the regulatory framework of the federal securities laws, the rules of the applicable self-regulatory organizations ("SROs"), and, if applicable, the requirements of the exchanges on which the instrument is to be listed. This section of the Article briefly describes the

178. The Black-Scholes Option Pricing Model refers to a formula used to calculate the value of European style options. The formula, introduced in 1973 by Fischer Black and Myron Scholes, assumes that the primary factors affecting the price of an option are the value of the underlying asset, the exercise price of the option, the volatility of the underlying asset, the risk-free rate of interest, and the remaining time to expiration. Not surprisingly, these same factors will affect the value of the structured product containing the embedded option.
typical offering process for a structured product and highlights the protections that are afforded to an investor. Investor protections in this area come in three forms. First, the Securities Act of 1933 ("Securities Act") and the Securities and Exchange Act of 1934 ("Exchange Act") provide a whole host of protections common to all securities offerings. Second, SROs have codified specific additional protections in both their rule making function and by the articulation of best standards and practices. Finally, the Securities and Exchange Commission ("SEC") has specifically addressed the issue of structured products and the permissible underliers that can support these products in a No-Action Letter that led the way to a significant expansion of the structured products market following its release. The SEC's No-Action Letter is summarized later in this section.

Under the Securities Act, all securities must be registered unless an exemption from registration exists. Therefore, structured products are generally issued by investment banks or their affiliates in public offerings of securities registered under the Securities Act.179 In many cases, these products are offered from a shelf registration.180 Prior to a purchase decision, a potential structured product investor will receive a preliminary prospectus supplement describing the characteristics and the risks of the structured product being offered.181

179. Bank entities issuing structured products typically rely on the exemption from registration provided by Section 3(a)(2) of the Securities Act. Under Section 3(a)(2), any security issued or guaranteed by any bank or any security issued by or representing an interest or direct obligation of a Federal Reserve bank is exempt from the registration requirements of the Securities Act. 15 U.S.C. § 78c(a)(2) (2006). The Securities and Exchange Commission has stated that the definition of "bank" under the Securities Act includes branches of foreign banks "where they are subject to domestic regulation by federal or state banking authorities that is substantially equivalent to that applied to domestic banks." U.S. Branches and Agencies of Foreign Banks, SEC No-Action Letter, 1989 WL 245457, at *2 (January 4, 1989).

180. In the case of registered structured notes, an issuer would use Form S-3 to register the notes. This form requires that additional information be included in the prospectus relating to the notes. Form S-3 incorporates by reference disclosure requirements set forth under Regulation S-K, and so the form itself is relatively short and simple. In addition, Rule 408 requires the inclusion of "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading," with provision made for information made in a free writing prospectus.

Generally the term "shelf registration" describes an arrangement that allows a single registration document to be filed permitting the issuance of multiple securities. The shelf registration rules provided in Rule 415 of the Securities Act allow a well-known seasoned issuer (WKSI) to register securities under an "automatic shelf" registration statement.

In order to qualify as a WKSI, an issuer must be eligible to register a primary offering on Form S-3 or F-3, having been reporting under the Exchange Act for at least one year and timely in its filings under that act; and either (i) have $700 million of public float in common equity or (ii) in the case of debt issuers, have issued $1 billion of registered public debt securities in the preceding three years.

181. NASD Notice to Members 05-59, supra note 157, at 3.
On June 29, 2005, the SEC adopted significant reforms aimed at the registration, communications, and offering requirements of securities offerings under the Securities Act. The so-called Securities Offering Reform was aimed at eliminating unnecessary and outmoded restrictions and focused on modernizing the communications regulatory framework applicable to registered securities offerings by affecting (i) written communications other than the preliminary and final statutory prospectuses, (ii) procedural aspects of the so-called shelf registration process, (iii) prospectus delivery, and (iv) liability for the information conveyed in an offering.

The Securities Offering Reform ushered into securities offerings the concept of a free writing prospectus. This type of prospectus is defined to include any written offer, including electronic communications, other than a statutory prospectus. All eligible issuers and underwriters of a securities offering are permitted to use a free writing prospectus once a registration statement is filed, provided that the free writing prospectus is filed with the SEC and contains a statutorily prescribed legend.

Section 11 of the Securities Act ("Section 11") imposes civil liability, providing that an individual acquiring a security covered by a registration statement who suffers a loss may sue the issuer, its directors, its officers who sign the registration statement, underwriters, accountants, and other experts named in the statement if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." However, Section 11 liability is not absolute. Instead, the Securities Act allows a defendant to escape liability with respect to a registration statement that contains a misstatement or omission of a material fact by proving that either (i) the plaintiff knew of the misstatement or omission at the time of purchase or (ii) the plaintiff’s damages did not result from the misstatement or omission.

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183. Id. at 1.
185. See generally Securities Offering Reform, supra note 182; see also Securities Act Rule 405 (defining free writing prospectus).
186. See 17 C.F.R. § 230.433(c) (2008) (requiring that a free writing prospectus contain the prescribed legend).
188. 15 U.S.C. §§ 77k(c), (e).
189. § 77k(e). In addition, defendants other than the issuer can escape liability by establishing the so-called “due diligence” defense. See 15 U.S.C. § 77k(b)(3) (2006).
A prospectus supplement used in connection with a shelf offering is subject to Section 11 liability.\textsuperscript{190} As such, a prospectus supplement used in connection with a shelf offering is deemed to be part of the relevant registration statement of the issuer as of the earlier of the date it is first used or the date of the first contract of sale of securities to which the prospectus supplement relates.\textsuperscript{191}

Section 12(a)(2) of the Securities Act ("Section 12(a)(2)") provides an express, private party cause of action for rescission of the sale of a security "by means of a prospectus or oral communication" that includes a material misstatement or omission.\textsuperscript{192} In order to establish a \textit{prima facie} case, a plaintiff must show: (i) there was the sale of a security; (ii) made through instruments of interstate commerce or the mails; (iii) by means of a prospectus or oral communication; (iv) which included a misstatement or omission of a material fact; and (v) that there existed the requisite degree of privity between the plaintiff and the defendant.\textsuperscript{193} At least one commentator has observed that liability under Section 12(a)(2) \textit{takes on importance} because of the advantages it offers plaintiffs relative to the principal alternative causes of action.\textsuperscript{194}

For purposes of Section 12(a)(2), information delivered after the investor has made an investment decision will not be taken into account in determining whether the investor received all material information in connection with the sale of a security.\textsuperscript{195} As a practical matter, the new rules base liability on the preliminary prospectus or preliminary prospectus supplement (including any Exchange Act reports incorporated by reference) as of the time an investor commits to purchase the security and any free writing prospectus that is provided to an investor. As a result, any modifications, clarifications, or corrections in the final prospectus or prospectus supplement (including any subsequently filed Exchange Act reports) will not alter liability under Section 12(a)(2).

Section 10(b) of the Exchange Act ("Section 10(b)") and the related Rule 10b-5 ("Rule 10b-5") make it unlawful for any individual, in connection with the purchase or sale of any security: (i) to employ any device, scheme, or artifice to defraud; (ii) to make any untrue statement of a material fact or to omit to state a material fact necessary in

\begin{itemize}
\item \textsuperscript{190} 17 C.F.R. § 230.433(d) (2008).
\item \textsuperscript{191} \textit{Id}.
\item \textsuperscript{192} 15 U.S.C. § 77l(2) (1988).
\item \textsuperscript{193} \textit{Id}.
\item \textsuperscript{194} See Stephen M. Bainbridge, \textit{Securities Act Section 12(2) After the Gustafson Debacle}, 50 Bus. Law. 1231, 1233 n.15 (1995) (observing that both Section 11 and Rule 10b-5 limit plaintiffs to damages and require causation and reliance as either an element or an affirmative defense).
\item \textsuperscript{195} 17 C.F.R. § 230.159 (2008).
\end{itemize}
order to make the statements made, in light of the circumstances under which they were made, not misleading; or (iii) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.196

Section 17(a) of the Securities Act ("Section 17(a)") bars actions intended to defraud others in the "offer or sale of any securities," including the making of false statements and material omissions.197 Section 17(a) is the Securities Act's general antifraud provision, similar to Section 10(b) of the Exchange Act (and its corresponding Rule 10b-5).198 Although the elements of a Section 17(a) claim are similar to the elements for a Rule 10b-5 claim, there is no bar to punitive damages under Section 17(a) as there is under the Exchange Act. Additionally, the scienter required under Rule 10b-5 is not required for an action under Sections 17(a)(2) or (3). Scienter is, however, a required element to establish a violation of Section 17(a)(1).199 In recent years (although the issue has not reached the Supreme Court), courts have consistently held that there is no implied private right of action under Section 17(a).200 In particular, circuit courts have concluded that there is no private right of action under Section 17(a).201

In addition to these traditional protections arising under the federal securities laws, the structured products market has benefited from the watchful eyes of the SEC, SROs, and various industry

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197. 15 U.S.C. § 77(q) (2006). Section 17(a) provides:
   "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly –
   (1) to employ any device, scheme, or artifice to defraud, or
   (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
   (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."  
   *Id.* (emphasis added).
198. See SEC v. Gottlieb, 88 F. App'x 476 (2d Cir. 2004) (stating that essentially the same elements are required under Section 17(a) as under Section 10(b) of the Exchange Act).
200. Maldonado v. Dominguez, 137 F.3d 1, 6, 7 (1st Cir. 1998). *But see* James v. McCoy, 56 F. Supp. 2d 919, 927-28 (S.D. Ohio 1998) (granting a private cause of action for purchasers under Section 17(a)).
201. See Finkel v. Stratton Corp., 962 F.2d 169 (2d Cir. 1992) (concluding that there is no private right of action under Section 17(a) and noting that circuit courts since the 1980s have uniformly come to this conclusion); Maldonado, 137 F.3d at 1 (stating that in recent years every circuit to have addressed the issue has refused to recognize a private right of action under Section 17(a)).
groups. For example, the Financial Industry Regulatory Authority ("FINRA"), formerly the National Association of Securities Dealers, Inc. ("NASD"), has provided specific guidance to its members in connection with the sale of structured products on at least three occasions and various industry groups have offered best practices in the sale and distribution of these products to the public. All told, the requirements of the federal securities laws coupled with the guidance from the SROs offer ample protection to investors who wish to purchase structured products.

While the Exchange Act provides for the registration and supervision of broker-dealers, it does not spell out the specific duties that a broker-dealer has to its customers. However, the SEC has articulated standards of conduct applicable to broker-dealers in cases and administrative hearings. Moreover, all national securities associations and national exchanges must register with the SEC as SROs. As a condition to this registration, the SEC insists upon the association or exchange, as the case may be, adopting rules to promote "just and equitable principals of trade" among its members. A broker-dealer that engages in business with the public makes an implied representation to each customer that it will deal fairly and in accordance with the standards that prevail in the marketplace. A

202. See Gadziala, supra note 157, at 2 ("S]ales of certain structured products have increasingly been targeted at retail customers. Therefore, the U.S. Securities and Exchange Commission (SEC) and the self-regulatory organizations (SROs) are focusing attention on sales of structured products.").

203. The Financial Industry Regulatory Authority (FINRA), a so-called "self regulatory organization," is the largest non-governmental regulator for all securities firms doing business in the United States. All told, FINRA oversees nearly 5,000 brokerage firms, over 170,000 branch offices and more than 650,000 registered securities representatives. FINRA was created in July 2007 through the consolidation of the National Association of Securities Dealers (NASD) and the member regulation, enforcement and arbitration functions of the New York Stock Exchange, and is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services.


205. See generally FIN. SERVS. AUTH., POLICY STATEMENT 07/11 RESPONSIBILITIES OF PROVIDERS AND DISTRIBUTORS FOR THE FAIR TREATMENT OF CUSTOMERS (2007).


207. Id. (observing that such cases were brought "under the broadened fraud concepts of the anti-fraud provisions.").


209. § 78f(b)(5).
broker-dealer's duty to deal fairly with each customer ensures that the broker-dealer only recommends specific securities or investment strategies that are suitable for a customer. Two theories of this obligation have evolved under the case law: (i) reasonable basis suitability and (ii) customer-specific suitability.

Under the reasonable basis suitability standard, a broker-dealer must have an *adequate and reasonable basis* for any recommendation made by the broker-dealer.\textsuperscript{210} Unlike the customer specific suitability standard, this standard relates to a particular recommendation and not an individual customer.\textsuperscript{211} The theory behind the reasonable basis suitability standard is that when an investment strategy "is completely devoid of any sound basis, there can be no reasonable grounds for believing a security suitable."\textsuperscript{212} Thus, a broker-dealer has a legal duty to investigate the securities that it recommends and it therefore becomes fraudulent for the broker-dealer to make statements regarding securities without an adequate basis.\textsuperscript{213}

The customer-specific suitability standard imposes an affirmative duty upon a broker-dealer to make recommendations in light of an individual customer's specific financial situation and level of sophistication.\textsuperscript{214} The customer-specific suitability standard also obligates a

\begin{footnotes}
\item[210] See *In re Application of F.J. Kaufman and Co.*, 50 S.E.C. 164, 1989 SEC Lexis 2376 (1989) (citing Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969)) (observing that a broker-dealer "cannot recommend a security unless there is an adequate and reasonable basis for such recommendation").
\item[211] See Denis Rice, *Recommendations by a Broker-Dealer: The Requirement For a Reasonable Basis*, 25 *Mercer L. Rev.* 537, 537 (1974) (noting that a broker lacking a reasonable basis cannot satisfy the suitability rule since he "would have difficulty contending that a recommendation was suitable for a given customer when he lacked adequate information about the security involved").
\item[213] Weiss, *supra* note 206, at 100; see also *Distribution by Broker-Dealers of Unregistered Securities*, Securities Act Release No. 4445, Exchange Act Release No. 6721, 27 Fed. Reg. 1415 (Feb. 2, 1962) ("The making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for such a recommendation which, in turn, requires that, as a prerequisite, he shall have made a reasonable investigation.").
\item[214] NASD Conduct Rule 2310 provides that when a financial representative recommends to an investor the purchase, sale, or exchange of any security, he shall have reasonable grounds for believing that the recommendation is suitable for such investor based upon the facts, if any, disclosed by such investor as to her own security holdings and her financial situation and needs. The rule sets forth that the financial representative is required to obtain the investor's financial status, tax status, investment objectives and any other information used or considered to be reasonable in making a securities recommendation prior to executing any transaction. While Rule 2310 is implicated when there is a securities recommendation, it does not define what constitutes a securities recommendation. The issue of whether a specific communication constitutes a recommendation is a factual consideration based on the actual interaction and the context in which it was made. In the situation where a financial representative
broker-dealer to understand the investment in light of the customer's other securities holdings.

FINRA Rule 2210, which regulates broker-dealer advertisements and sales literature, provides that materials will be misleading unless there is fair and balanced treatment of risks and potential benefits. The disclosure of the risks inherent in conflicts of interest has been a particular point of emphasis for FINRA, as has the requirement that "each piece of sales literature [must] independently comply with the rules' standards." The disclosure of the risks inherent in conflicts of interest has been a particular point of emphasis for FINRA, as has the requirement that "each piece of sales literature [must] independently comply with the rules' standards." The first of FINRA's Notices to Members with significant instruction for structured products issuers was Notice to Members 03-71 ("NTM 03-71"). Specifically, NTM 03-71 was aimed at reminding members of their obligations when selling non-conventional investments. Members offering a non-conventional product were reminded of their obligations to: (i) conduct adequate due diligence to understand the product and each of its features; (ii) perform a reasonable basis suitability analysis; (iii) perform customer-specific suitability analysis in connection with any proposed sale; (iv) provide a balanced disclosure with respect to the product's risks and rewards to an investor; (v) implement appropriate internal controls; and (vi) train those engaged in selling regarding the features, risks, and suitability of the product.

In April 2005, FINRA released Notice to Members 05-26 ("NTM 05-26"), which urged member firms to "take a proactive approach to reviewing and improving their procedures for developing and vetting new products." Observing that investors were increasingly turning to non-conventional products to enhance returns, FINRA also asserted that "adequate procedures for reviewing new products before they are offered to the public can greatly enhance a firm's ability to

merely gathers information for an investor or simply transacts on the investor's behalf, without a recommendation, the rule should not be applicable.

215. Advertisements and sales literature include "written or electronic communication distributed or made generally available to clients or to the public", including circulars, research reports, market letters, performance reports, form letters, telemarketing scripts, seminar texts and reprints or excerpts. In addition, the NASD has interpreted "sales literature" to include press releases concerning a firm's products or services. See NASD Notice to Members 99-79, FIN. INDUS. REG. AUTH., September 1999, at 1, http://www.finra.org/web/groups/rulesregs/documents/notice_to_members/p004084.pdf.

216. NASD Rule 2210(d)(1)(D).


218. NASD Notice to Members 03-71, supra note 204, at 765. See also NASD Rule 3010 (requiring members to establish supervisory procedures to ensure that sales of securities comply with applicable securities laws, SEC rules and NASD rules); NASD Rule 3012 (requiring firms to have written supervisory control procedures to test and verify compliance with NASD Rule 3010).

219. NASD Notice to Members 05-26, supra note 204, at 1.
detect and avoid conflicts, unsuitable recommendations and other problems before violations occur." After surveying the industry for best practices, FINRA suggested that its members consider a system that included an initial product review, a formal approval process, and an additional post-approval review for each new product offered to the public. The SRO believed that these procedures would be helpful in ensuring that issuers of new products could manage concerns about suitability and potential conflicts of interest.

The third release from FINRA was Notice to Members 05-59 ("NTM 05-59") which provided specific and wide-ranging guidance concerning the sale of structured products. Echoing the concerns of its predecessors, NTM 03-71 and NTM 05-26, NTM 05-59 reminded members to present a "fair and balanced picture regarding both the risks and benefits" in all sales materials and oral presentations regarding structured products. NTM 05-59 also warned that "sales materials and oral presentations that omit a description of the derivative component of the product and instead present such products as ordinary debt securities would violate [FINRA] Rule 2210" and that "[p]resentation of a credit rating for a structured product that suggests that the rating pertains to the safety of the principal invested or the likely investment returns will be viewed as misleading."

NTM 05-59 also addressed customer-specific suitability and the adequacy of personnel training, noting that "[t]he derivative component of structured products and the potential loss of the principal for many such products may make them unsuitable for investors seeking alternatives to debt securities." NTM 05-59 further warned members against making any generalized conclusions about the relative suitability of a structured product, on the one hand, and a direct investment in the reference asset, on the other.

In a 1996 No-Action Letter addressed to Morgan Stanley (hereinafter the "Morgan Stanley Letter"), the SEC identified guidelines for the level of disclosure of the underlying securities that would be required in connection with a structured products offering. In the re-
quest for no-action, Morgan Stanley argued that the sale of a structured product linked to an underlying equity is not at all analogous to an issuance by the issuer of that underlying equity, but, instead, is more akin to a secondary offering of freely transferable shares. It follows, Morgan Stanley offered, that the structured products issuer should, therefore, be able to issue the structured product "without having to present the buyer with copies of the [underlying equity] issuer's Exchange Act filings, no matter how material they may be."

The SEC rejected Morgan Stanley's analogy to a secondary offering, pointing out that the performance of the structured product is so intertwined with the performance of the underlying security that investors should be provided with full and fair disclosure about the issuer of the underlying reference security in addition to the information provided with respect to the issuer of the structured product. However, abbreviated disclosure regarding the underlying security is permissible pursuant to the Morgan Stanley Letter "where there is sufficient market interest and publicly available information regarding the issuer."

The rationale of the Morgan Stanley Letter was bolstered, at least in part, by a case that addressed the effectiveness of disclaimers in the disclosure document for a structured product linked to the performance of an underlying reference security. In In Re WorldCom, plaintiffs claimed that UBS AG ("UBS") violated Section 11 in connection with its issuance of reverse convertible style notes linked to the performance of WorldCom, Inc ("WorldCom"). As required by the Morgan Stanley Letter, UBS had included, in its prospectus supple-

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228. Morgan Stanley & Co., Inc., SEC No-Action Letter [1996-1997 Transfer Binder] Fed. Ser. L. Rep. (CCH) ¶ 77,256, at 77,292 (June 24, 1996). In support of this secondary offering analogy, Morgan Stanley asserted that the issuer of the underlying equity lacks involvement in the structured product offering: "the equity issuer does not receive any proceeds from the offering; it does not participate in the marketing process, and it does not provide the issuer of the exchangeable security or the underwriters of the offering with an opportunity to conduct due diligence review of the equity issuer's business and financial condition. In some cases, the equity issuer may not even be aware of the offering until it has been made public." Id. at 77,292-93.

229. Id. at 77,293. The Commission found that "sufficient market interest and publicly available information exists" where the underlying issuer (1) has a class of equity securities registered under Section 12 of the Exchange Act and (2) is either (x) eligible to file an S-3 or F-3 under the Securities Act or (y) meets the listing criteria to be listed on a national exchange. Id. It is not at all clear that these requirements represented the exclusive manner in which the "sufficient market interest and publicly available information" test could be satisfied with respect to an issuer. In fact, it seems that issuers have grown more and more comfortable that this was not meant as the exclusive manner by which the test could be satisfied. Id.


ment, historical price information of WorldCom common shares. In addition, UBS included extensive disclaimers stating, among other things, that it had not performed due diligence with respect to the issuer of the underlying WorldCom shares. While the plaintiffs did not assert that UBS had prior knowledge of any WorldCom problems, the plaintiffs alleged that the presentation of the historical prices in the prospectus supplement (which were inflated due to the massive fraud at WorldCom) amounted to false and misleading statements for which UBS should be held strictly liable.

The Southern District of New York ruled that the accurate reporting of the historical stock prices of the reference shares by UBS did not support a claim under Section 11. The court's analysis turned on the fact that UBS did not make an untrue statement of a material fact because the historical stock prices that it reported in the prospectus supplement were not falsely described. In addition, UBS had disclaimed that the information had been obtained from Bloomberg L.P., without independent verification and had warned investors to undertake their own investigation of WorldCom. Finally, consistent with the theme of the Morgan Stanley Letter, UBS had directed investors to the sources of WorldCom's public filings.

In addition to the presentation of historical prices, an issuer presents balanced hypothetical examples and analyses relating to payment or performance, including charts and other illustrative disclosure as necessary, in an attempt to provide disclosure that is adequate at the time that it was made. The presentation of hypothetical examples is one method that issuers of structured products have adopted to address time-of-sale conveyance concerns.

All told, there are ample protections afforded to the structured products investor. An aggrieved investor can find protection in either (i) the private right of action or the rescission right available under the Securities Acts, (ii) the rules, regulations, and best practices codified by FINRA, or (iii) the additional disclosure requirements articulated by the SEC in the Morgan Stanley Letter. In the aggregate, these protections serve to make structured products a highly desirable market for an investor to employ capital.

233. WorldCom, 303 F. Supp. 2d at 387 (observing that stock closing prices for each quarter for the years 1998 through 2001, and as of January 17, 2002, were provided in the prospectus supplement).
234. Id. at 387-88.
235. Id. at 389.
236. Id. at 390.
237. Id.
238. Id. at 389.
239. Id.
IV. INTRODUCING THE “TIGER WOODS NOTE”

Against the backdrop of the current regulatory regimes for wagering and securities, could a principal protected note be structured and sold to investors, in a fully registered securities offering, if its return is an amount at maturity contingent upon whether an over/under is satisfied with respect to the number of major golf championships Tiger Woods wins during the next three golf seasons? Comparing the Tiger Woods Note, as it will be called, to (i) existing structured products being regularly offered to investors today and (ii) the traditional tests for Section 2(a)(1) securities (“Section 2(a)(1)”), under the Securities Act of 1933 (“Securities Act”), it is possible that such a product could be sold to investors in registered form and regulated by the Securities and Exchange Commission (“SEC”) and the self-regulatory organizations (“SROs”) pursuant to the powers prescribed to them through the application of the existing federal securities law architecture. Further, given the lack of success that the federal government has had in its attempts to eradicate sports wagering and the voracious appetite Americans have for sports wagering products, a regulated structure for these activities is both advisable and overdue.

A. HEDGING THE TIGER WOODS NOTE

Similar to any structured product, a good issuer would do homework before offering the Tiger Woods Note to the public. To hedge the Tiger Woods Note, the issuer would need to purchase the note’s component parts in the available marketplace. Here, instead of turning to the listed exchange or a Bloomberg terminal to determine the price of an option that matches the embedded option in the note, the issuer would look to Las Vegas (or any other available sports book) to

240. There are four “majors” each golf season: The Masters; The PGA Championship; the United States Open Championship; and the (British) Open Championship.
241. The world’s greatest golfer.
242. See supra notes 17-50 and accompanying text.
243. See supra notes 51-82 and accompanying text.
244. Aside from the legalistic tests, which are explored at great length throughout this section of the article, as a practical matter, the Tiger Woods Note belongs under the federal securities laws because it is primarily an investment. While certainly a topic beyond the scope of this article, the advent of structured products has clouded the investment/speculation spectrum. No longer can a product be classified based merely on the type of its underlier. Instead, each product must be understood more holistically. The attributes of its underlier, its ability to preserve capital and its ability to generate income must all be considered. Examining the Tiger Woods Note, it is plain that it fits squarely within Graham and Dodd’s definition of an investment operation as one which “upon thorough analysis, promises safety of principal and a satisfactory return.” See BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS PRINCIPLES AND TECHNIQUE 48 (4th ed. McGraw-Hill Book Co. 1962).
245. See supra notes 167-74 and accompanying text.
determine the price of the available wager that best matches the wager embedded in the Tiger Woods Note.\textsuperscript{246}

The price to the investor of the resulting Tiger Woods Note would be a function of the prices that the issuer would pay to purchase the appropriate hedge\textsuperscript{247} – which, in this case – would consist of (i) a zero coupon bond required to accrete to the principal protected amount as of the maturity date and (ii) the gambling equivalent of a call option on Tiger Wood’s major wins with a strike price of the over/under and an expiration of the note’s maturity.\textsuperscript{248}

The Tiger Woods Note described above is a single, simple example of what can be done through the marriage of structured products and sports wagering. Much like with traditional structured products, the limits to the types and varieties of sports notes are only constrained by the imaginations of their potential creators and the appetites of investors. Certainly proposition bets, parlays, and teasers are not out of the question. The future wager, of course, seems like a tailor-made candidate for a sports note.

B. CLASSIFYING THE TIGER WOODS NOTE AS A SECURITY

To qualify investors in sports notes for the protections afforded by the federal securities laws and the pronouncements of the self-regulatory organizations ("SROs"), it must be demonstrated that the Tiger Woods Note and its progeny represent securities for purposes of the federal securities laws. Examining the Tiger Woods Note against the test articulated by the Supreme Court in \textit{Reves v. Ernst & Young}\textsuperscript{249} should result in it being classified as a security. First and foremost, the Supreme Court in \textit{Reves} expressed a rebuttable presumption in favor of regulating any note as a security.\textsuperscript{250} In analyzing an individual transaction, the Supreme Court favored a four part inquiry, examining (i) the motivations of the buyer and seller, (ii) the plan of distribution, (iii) the reasonable expectations of the investing public, and (iv) the presence of risk reducing factors.\textsuperscript{251} The first part of the \textit{Reves} inquiry, assessing the motivations of the buyer and seller in en-

\textsuperscript{246} See generally, Peter Gomber et al., \textit{Sports Betting as a New Asset Class – Current Market Organization and Options for Development}, 22 Fin. Mkt. & Portfolio Mgmt. 169, 171 (2008), http://www.springerlink.com/content/m783161t4361k18/full text.pdf. ("A bet can be described as a leveraged product with the character of an option.").

\textsuperscript{247} The issuer and/or distributor might also embed a fee in the product.

\textsuperscript{248} See Gomber et al., supra note 246, at 171 ("The outcome is based on an underlying event which defines its maturity."). The payoff in this example is similar to that of a digital option, which investment banks routinely trade. See generally id.

\textsuperscript{249} 494 U.S. 56 (1990).

\textsuperscript{250} \textit{Reves v. Ernst & Young}, 494 U.S. 56, 63-64 (1990).

\textsuperscript{251} \textit{Reves}, 494 U.S. at 66-67.
tering into the transaction, should be satisfied quite easily with respect to any sports note issued by a financial intermediary. In almost all instances of notes issued as structured products, the issuer's purpose is to raise money for its general use rather than "to facilitate the sale of a minor asset or consumer good." This purpose will, no doubt be reflected in the plan of distribution section of the Tiger Woods Note prospectus provided to potential investors. By preparing an offering document and engaging in the usual selling efforts that accompany a structured products offering, an issuer of the Tiger Woods Note, and its agents, can most certainly satisfy the "common trading for speculation or investment" and "the reasonable expectations of the investing public" elements of Reves. The final part of the Reves inquiry, an examination of whether there exists another regulatory scheme, is by far the most interesting.

While some might interpret the final element of the Reves inquiry and the International Brotherhood of Teamsters v. Daniel and Marine Bank v. Weaver cases to support the proposition that notes similar to the Tiger Woods Note cannot qualify as a Section 2(a)(1) security due to the presence of an alternative regulatory scheme, such a reading would represent an incorrect application of the law. In Daniel, for instance, the Supreme Court refused to extend the application of the securities laws to non-contributory pension plans because the existing Employee Retirement Income Security Act rules and regulations dealt "expressly and in detail with pension plans." No such federal rules deal with sports wagering expressly and in detail. First, there is no evidence in the record that it was ever Congress' intent, at the time of the enactment of the Securities Act of 1933 ("Securities Act") and the Securities and Exchange Act of 1934 ("Exchange Act"), to maintain sports wagering as an asset class beyond the applicability of the two acts. In fact, at the time of the enactment of the Securities Act and the Exchange Act, Congress seemed uninterested in sports wagering, allowing issues of gambling generally to be settled at the state level under Tenth Amendment principles. In addition, today's existing patchwork of gambling rules and prohibitions exists through the often inexact application of the Wire Act, the Interstate and Foreign Travel or Transportation in Aid of Racketeering Enterprises Act ("Travel Act"), and the Professional and Amateur Sports Protection Act ("PASPA"). Such an intricate web of overlapping

254. See supra notes 17-50 and accompanying text.
256. See supra note 48 and accompanying text.
257. See supra notes 17-50 and accompanying text.
statutes does not compare favorably with the Supreme Court's articulated requirement of the presence of a detailed enough regime providing abundant protection. The prohibition that exists through the application of the PASPA at the state level fails to provide abundant protection in either expectation or reality. In fact, as discussed above, the federal bar on wagering activity encompassed in the PASPA is a bar aimed at the states and not a prescription for federal action or inaction.

In *Marine Bank*, the Supreme Court's reluctance to characterize a certificate of deposit as a security rested on two pillars. First, the Supreme Court advanced the strained notion that a certificate of deposit guaranteed payment in full while the holder of a long-term debt obligation, by contrast, "assumes the risk of the borrower's insolvency." Second, the Supreme Court concluded that the "holders of bank certificates of deposit are abundantly protected under the federal banking laws." The Supreme Court's analysis in *Marine Bank* was based solely on the nature of the issuer and not on the instrument itself.

No such analysis into the nature of the issuer would be available to eliminate a sports note issued by an issuer/borrower that sells structured products (apart from any sports notes) day in and day out to thousands of investors who assume the issuer's insolvency risk with each offering.

Separate and apart from the fact that the *Daniel* and *Marine Bank* cases hold limited applicability to the proposed sports notes, there is an argument that the Supreme Court in both cases severely overreached. In both instances, by allowing the examination of statutes enacted after the Securities Act, the Supreme Court failed to implement Congressional intent. At least outside of constitutional review, judicial decisions may only interpret — and not amend — legislative acts. Thus, consideration of subsequent statutes is appropriate only if the subsequent statute somehow amends or repeals the prior statute.

262. *Id.* (establishing that ERISA has a broad savings clause and "does not implicitly repeal the Securities Acts' antifraud provisions").
263. *Id.* (citing J. Hurst, *Dealing with Statutes* 17-18 (1982)).
C. Surviving a Disclosure Challenge

A second attack on the proposed sports note framework will, undoubtedly, concern itself with disclosure. Critics will note that the only material Securities and Exchange Commission ("SEC") pronouncement with respect to permissible underlying assets for structured products is the Morgan Stanley No-Action Letter ("Morgan Stanley Letter"). Certainly, the Morgan Stanley Letter did not go nearly as far as to concern itself with the possibility that a fully registered structured product might someday be linked to an underlying asset which was as far removed from a regulatory filing as the Tiger Woods Note. In recent years, however, the market has made giant leaps from the early days of linking structured products to the return of single stocks. Today, structured products exist in the marketplace linked to things as far flung as the Baltic Exchange Dry Index and the HSBC Global Climate Change Benchmark Index. These structured products flourish and have been sold to investors without public objection from the SEC for some time. The introduction of even more structured products (i.e. sports notes) should be welcomed by a market that, in a certain sense, is self-policing.

Examining the proposed Tiger Woods Note against the SEC's articulated concerns with respect to the dual standards of sufficient market interest and available public information, the Tiger Woods Note should fall squarely within the permissible limits of a structured product underlying asset. Some care would need to be given, however, in designing sports notes linked to lesser known players or teams to be sure that enough substantial information existed to satisfy the sufficient market interest and available public information standards.

Bolstering the defense of any attack of sports notes on the basis of insufficient disclosure is the proliferation of sports broadcasting. Sports scores and statistics are readily available on the internet, on crawling sports tickers at the bottom of cable television channels, on cellular telephones, and on personal digital assistants of all types. In

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266. See supra note 229 and accompanying text.

267. A recent Google search reveals over 17,000,000 hits for the search term "Tiger Woods".

268. Ante Z. Udovicic, Sports and Gambling a Good Mix? I Wouldn't Bet On It., 8 MARQ. SPORTS L.J. 401, 405 (1988) ("While the acceptance of gambling by the public has greatly contributed to its growth in sports, perhaps an even bigger reason for the increase is the explosion of sports programming on television.")
addition, historical research and statistical services are increasingly available from individual vendors in the mold of the founder of this field of statistics, the Elias Sports Bureau.269

D. Surviving a Wire Act Challenge

In hedging a sports note, a trader must manage not to run afoul of the Wire Act's prohibition on using: "a wire communication facility for the transmission of interstate or foreign commerce of bets or wagers or information assisting in the placing of bets or wagers on any sporting event or contest."270 At least two theories exist that support the notion that a trader, in relaying and executing a hedge order on a sports note, should be able to survive the accusation of a Wire Act violation. First, heretofore, Wire Act prosecutions have only been successful against bookies because of the statute's requirement that the violator must be "engaged in the business of betting or wagering."271 The activities of a hedging financial institution can be distinguished from those of the traditional bookie. At the most basic level (and distinguished from a bookie), the hedging financial institution and its trader are indifferent as to how much action is being wagered on any side of a particular bet.272 Secondly, because the federal securities laws are so detailed and expansive in their oversight and regulation with respect to securities offerings, by qualifying the sports note as a securities offering, an argument can be supported that any lesser conflicting laws should be disregarded. Basically, this is the Marine Bank v. Weaver argument in reverse.

E. Surviving the "Integrity of the League" Challenge

The loudest resistance to the proposed sports notes is likely to come from the sports leagues themselves, in their attempts to protect the integrity of their leagues. Over the years, the sports world has

269. The Elias Sports Bureau (ESB) has provided historical research and statistical services in the field of professional sports since its founding in 1913. The ESB is the official statistician of Major League Baseball, the National Football League, the National Basketball Association and the National Hockey League, and serves as the primary source of statistics for ESPN.
271. See supra notes 26-33 and accompanying text.
272. See also Koleman S. Strumpf, Illegal Sports Bookmakers 1 (February 2003) (unpublished paper), http://www.unc.edu/~cigar/papers/Bookie4b.pdf (observing that "bookmakers gamble and take positions on games"). Bookmakers have to pay attention to the action on each side of a bet because, if they are not "laying off" their risk, they stand to lose on the other side of a wager. Traditional hedgers, by contrast, are market neutral and make their profit from a piece of the transaction costs in the form of a fee or commission.
certainly not suffered from a dearth of commissioners willing to confront any argument in favor of an expansion of gambling activity.\textsuperscript{273} Today, these commissioners remain steadfast in their position, viewing wagering activities as contrary to the goals of maintaining the competitiveness and credibility of their respective games.\textsuperscript{274} However, the professional sports leagues and their commissioners do not offer their arguments with entirely clean hands. As Senator Chuck Grassley noted, "[t]he professional sports leagues have long been aware of extensive wagering on their games, have taken virtually no action to prevent it, have recently acquiesced in it, and, in fact, have benefited from it."\textsuperscript{275} The joint ventures between teams, team owners, and certain gambling interests are well documented, and profes-

\textsuperscript{273} For example, National Football League Commissioner Paul Tagliabue, National Basketball Association Commissioner David Stern, and Major League Baseball Commissioner Francis T. ("Fay") Vincent each testified before Congress prior to the adoption of the Professional and Amateur Sports Protection Act. \textsuperscript{274} See Hearings on H.R. 74 Before the Subcomm. on Economic and Commercial Law, 102d Cong. 14 (1991) (statement of Paul Tagliabue, Commissioner, NFL). Commissioner Tagliabue stated:

Sports gambling inevitably fosters a climate of suspicion about controversial plays and intensifies cynicism with respect to player performances, coaching decisions, officiating calls and game results. Cynical or disappointed fans would come to assume "the fix was in" whenever the team they bet on failed to beat the point spread.

Id.; see also Hearings on H.R. 74 Before the Subcomm. on Economic and Commercial Law, 102d Cong. 14 (1991) (statement of Francis T. ("Fay") Vincent, Commissioner, MLB) Commissioner Vincent stated:

The net effect of legalized gambling will be to increase the overall volume of betting. Those who bet with illegal bookies are likely to continue to do so, because the bookmakers usually offer different betting formulas, greater odds, betting on credit and the ability to hide income. Once the moral status of sports betting has been redefined by legislation, however, many new gamblers will be created. The legalization of team sports betting would increase the chances that persons gambling on games will attempt to influence the outcome of those games.

\textsuperscript{275} See S. Rep. No. 102-48, at 14 (1992) (minority views of Mr. Grassley). Mr. Grassley states further:

[The leagues have not even prevented wagering on their games that they could have prevented. For the last 4 years, NBA exhibition games have been played in Las Vegas. Nevada regulations allowed the NBA to prohibit wagering on these games. The NBA chose not to do so, and several casinos accepted wagers on the games.]

\textit{Id.}
sional sports franchises continue to play a dangerous game when it comes to managing each of these interests. Furthermore, at least one court has noted with respect to a major sports league, "there is overwhelming evidence already reviewed that, in actual experience, widespread gambling, both illegal and state-authorized, has not hurt the [National Football League]."

F. SURVIVING THE ILLEGAL GAMBLING BUSINESS ACT CHALLENGE

To be successful, a prosecution under the Illegal Gambling Business Act ("IGBA") must establish the existence of a gambling business (i) in violation of the state or local law where it is conducted, (ii) involving five or more persons that conduct, finance, manage, supervise, direct or own all or part of the business that (iii) remains in substantially continuous operation for more than thirty days or has a gross revenue of $2000 in any single day. The IGBA defines gambling to include "pool-selling, bookmaking, maintaining slot machines, roulette wheels or dice tables, and conducting lotteries, policy, bolita or numbers games, or selling chances therein." Thus, the activities of the issuer of a sports note fall squarely outside of the definition of gambling provided for by the IGBA because the activities of the issuer of a structured product are clearly distinguishable from those of a traditional bookmaker. The issuer is instead a hedger and has no interest in balancing the action on each side of its book. The issuer does not search for an equilibrium spread to eliminate exposure to betting losses, and, instead, will be indifferent to the number and size of bets on any one side of a contest. The issuer of a structured product does not make money from a vig like a traditional bookie and its issuing and hedging activities, therefore, should remain beyond the applicability of the IGBA.

G. SURVIVING THE PASPA CHALLENGE

While the Professional and Amateur Sports Protection Act ("PASPA") might represent Congress' last and best hope for the eradication of gambling on sports contests in America, it will not derail the issuance of a sports note. Congress' actions only serve to preclude the individual states from sponsoring gambling on professional and amateur sporting events. No such activity is being proposed in this Arti-

278. United States v. Sacco, 491 F.2d 995, 998 (9th Cir. 1974).
cle. In contrast, the sponsors of the types of notes discussed in this Article will be financial institutions operating as individual issuers or distributors of structured products.

In summary, Part IV of this Article laid out the case for a Tiger Woods Note and offered a rationale for treating it as a security and regulating it in a manner similar to the more traditional structured products. In addition, Part IV offered a roadmap by which some of the legal obstacles can be navigated to bring sports notes to market. In Part V, this Article turns its attention to the benefits of such a structure, asserting that investors, financial institutions, and the federal and state governments will all be winners in such a regime.

V. A BENEFIT FOR THE STAKEHOLDERS

There are at least three stakeholders standing to benefit from a structure which incorporates sports wagering activities under the existing securities law regulatory regime. First and foremost, the investor would benefit significantly from the predictability and stability of a system that provides the litany of protections that attach to all federal offerings of securities. Secondly, financial institutions, in turn, would benefit from the capital that would be raised from the issuance of sports notes and all of the fees and commissions that could be realized from their distribution. Thirdly, the federal and state governments would realize the benefits that come from removing much of the stigma and unsavory elements from sports wagering activities in favor of a more standardized, predictable framework. In addition, tax revenues would expand significantly at both the state and federal level as gains and losses on sports wagering that are currently realized outside of the government’s view will become more transparent to the taxing authorities.

A. THE INVESTOR

Comparing the choices available to an individual who desires to engage in sports wagering, it is easy to see why the architecture proposed by this Article makes sense. Today, a responsible sports gambler can (i) travel to Las Vegas to place a bet at the only legal sports book in the country or (ii) engage in illegal activity with an unregulated counterparty and uncertain enforceability. In contrast, regulating sports wagering, in a manner consistent with a securities offering, would require that the investor be provided with an offering document adequately describing the investment and its applicable risks prior to any investment decision. Moreover, the investor could take comfort in the fact that his credit risk was to a known financial intermediary
with a credit rating and a track record of securities issuances. Finally, the investor would have all of the benefits of (i) the remedies available under the Securities Act of 1933 and (ii) the protections afforded by the regulation of both the issuer and distributor of the structured product by the federal securities laws and the rules and regulations of the self-regulatory organizations (“SROs”).

Regulating sports wagering under the federal securities laws in the face of Congress’ intent to bar the states from similar activities should not be seen as removing protections for the gambler. In fact, quite the contrary is true. By regulating the wagering activities under the federal securities regime, the investor is afforded a whole host of protections previously beyond the investor’s reach. Should the offering document delivered to any investor in connection with any structured product make a material misstatement or omission, the issuer, and any underwriter of that structured product, would be subject to liability. Moreover, the investor in a sports note would benefit from the protections afforded by the rules, regulations, and best practices prescribed by the SROs. For instance, a gambler wishing to spend his or her last dime at the casino is Las Vegas is free to do so today. Should that same investor wish to spend that same dime on a sports note, his or her actions should be resisted by a broker who enforces customer-specific suitability with respect to the investor’s securities purchases. Likewise, a product created today at a Las Vegas casino that is not suitable for any investor can be sold to the gambling public with no consequence. Reasonable basis suitability, in contrast, dictates that such a product not find its way to the public in a securities offering. Finally, by leveling the playing field with respect to the information possessed by each investor in the market, all investors benefit from the fact that those trading while in possession of material non-public information are subject to sanction under the securities regime. No such protection protects today’s gamblers under the existing structure for illegal and legal gambling.

B. THE FINANCIAL INSTITUTIONS

Financial institutions are likely to embrace the architecture proposed by this Article as it offers a new line of products and the potential to raise money and generate new streams of fees and commissions. However, such a nod from the financial services industry is not with-
out irony as some have posited that the endeavors of this community might have encouraged the early efforts of gambling’s opponents.\(^{281}\) According to one theory, gambling competed with other speculative activities for the scarce disposable income of Americans. Such competition for the disposable income of Americans resulted in powerful individuals in the banking and securities world fighting hard to protect their pecuniary interests.\(^{282}\)

For most financial services companies, product innovation is at the heart of their growth strategy.\(^{283}\) Today, well into the credit crunch that began in 2007, financial institutions are hungrier than ever to increase their product offerings. A sports note product poses a particularly attractive opportunity for potential issuers because it does not bring much in the way of added complexity. As we have seen, sports notes fit nicely into the existing structured products framework and offer a set of potential underlying assets that are both simple to understand and transparent. In addition, the size of the market, the public's familiarity with its potential underlying assets, and the limitless combinations of possible products make this a once in a lifetime opportunity for financial service companies.

C. THE FEDERAL AND STATE GOVERNMENTS

Certainly, there is no shortage of appetite at both the federal and state level to increase the coffers of the government. With the U.S. economy slowing significantly after a decade of expansion, the federal government and each of the states should be particularly interested in new sources of funding. While it is difficult to responsibly project the magnitude of the tax revenues available from sports notes in light of the scant reliable data that exists regarding the size and shape of the sports wagering market in the United States, past experiences involving the legalization of gambling activities should be somewhat instructive by analogy.

In 1964, New Hampshire residents registered seventy-six percent of the vote in favor of a referendum to institute a state-sponsored lot-

\(^{281}\) See Christine Hurt, Regulating Public Markets and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox, 86 B.U. L. Rev. 371, 403 (2006) (“Moralistic arguments against gambling may also have been spurred by proponents of the nascent banking and securities industry.”).

\(^{282}\) Id. at 403; see also Christopher T. Pickens, Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and Does it Even Matter?, 14 Geo. Mason L. Rev. 227, 252 (2006) (“It is probable that when the moral criticism emerged, banks viewed gambling activities as competition.”).

\(^{283}\) See GLITTER PRIZE: HOW FINANCIAL INSTITUTIONS CAN DRIVE GROWTH THROUGH PROCESS AND SERVICE INNOVATION, A DELOITE RESEARCH STUDY 5 (2005) (observing that the world’s top 100 financial services companies combine to spend nearly $11 billion on product development annually).
tery.\textsuperscript{284} Since that vote, forty-one additional states and the District of Columbia have followed suit.\textsuperscript{285} Lottery revenue has become an important source of funding in many states, with $48 billion spent on lottery products and $14 billion in net lottery revenue being enjoyed by the states in 2004.\textsuperscript{286} The spread of state lotteries coincides with changing attitudes toward legalized gambling, growing state and local expenditures, and growing opposition by citizens to both new taxes and increased rates of existing taxes.\textsuperscript{287} Similar to the process surrounding a decision to adopt a state lottery, politicians are likely to look at a series of determinants in deciding the feasibility of any policy that legalizes any gambling activity. When faced with the pressures to increase revenues, politicians are likely to examine at least three alternatives: (i) increasing the rates of existing taxes; (ii) expanding the universe of what is taxable; and (iii) adopting and implementing new taxes.\textsuperscript{288}

In Canada, for example, the liberalization of morals in the 1960s and the desire to raise funds for the 1976 Olympic Games in Montreal led to a 1969 amendment to the Civil Code, permitting the Canadian federal government and the provinces to operate lotteries.\textsuperscript{289} Prior to 1969, gambling had been illegal in Canada. While legalized gambling activity still has its detractors, the dramatic expansion of government-sanctioned, regulated, and promoted gambling, and the monies that it has generated in the United States' neighbor to the north, has turned out to be "a politically effective response to the demand by many citizens and lobby groups for tax cuts without spending cuts."\textsuperscript{290}

Legal gambling operations in the United States account for millions of dollars in taxes annually to local and federal governments.\textsuperscript{291} By allowing sports wagers to take place under federal securities laws, politicians can "have their cake and eat it too."\textsuperscript{292} Politicians can raise more money without having to face the political consequences of raising income, sales, or property taxes.\textsuperscript{293} Instead, the states and the federal government will have access to sizeable gains heretofore be-

\textsuperscript{286} Id.
\textsuperscript{287} Id.
\textsuperscript{288} Id. at 170.
\textsuperscript{289} Thomas R. Klassen & Jim Cosgrove, \textit{Look Who's Addicted to Gambling Now}, Pol'y Options, July/August 2002, at 43-44.
\textsuperscript{290} Id. at 46.
\textsuperscript{292} See Hansen, \textit{supra} note 284 at 10.
\textsuperscript{293} Id.
yond their reach. Monies earned by gamblers from their bookies will be replaced with monies earned by investors from the issuer of their structured products. In other words, a product not transparent to the taxing authority will be replaced with a transparent one.

VI. CONCLUSION

Sports notes in many varieties can be tailored to fit the definition of a security and, in turn, be subject to the federal securities laws. Such a result should be welcomed, as it can be achieved neatly and effectively and offers significant benefits to the investor, financial institutions, and the federal and state governments alike.