I. Definition Of A "Security"

1976-77 SECURITIES LAW DEVELOPMENTS

I. DEFINITION OF A "SECURITY"

Recent litigation in the securities field indicates that the most controversial issue in this area may be defining the transactions covered by the securities laws. The courts have applied these laws to various transactions bearing little resemblance to traditionally recognized securities transactions.[1] Judicial analysis in recent cases has yielded little in terms of a cohesive definitional guide concerning a "security." The decisions have agreed, however, that the term "security" must be construed within the ambit of the securities acts.[2]

Section 2 (1) of the Securities Act of 1933 ('33 Act)[3] and section 3(a) (10) of the Securities Exchange Act of 1934 ('34 Act),[4] provide statutory definitions of a security, textual treatments which have been judicially characterized as virtually identical.[5] The generalized

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[1] *See, e.g.*, Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974) (chinchillas); Glenn Arden Commodities, Inc. v. Constantino, 493 F.2d 1027 (2d Cir. 1974) (scotch whiskey receipts); SEC v. Brigadoon Scotch Distrib., Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975) (rare coins).

[2] Securities Act of 1933, 15 U.S.C. § 77a-bbbb (hereinafter '33 Act); Securities Exchange Act of 1934, 15 U.S.C. § 78 (*hereinafter* '34 ACT).

[3] Section 2(1) of the '33 Act, 15 U.S.C. § 77b(1), defines a security as follows:

> [T]he term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, franctional undiveded interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or paticipation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3(a) of the '33 Act, 15 U.S.C. § 77c(a) (1970) exempts from certain provisions of that Act several classes of securities including:

> Any note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

[4] Section 3(a) (10) of the '34 Act, 15 U.S.C. § 78c(a) (10), defines a security in a substantially identical manner as the '33 Act, but omits the term "evidence of indebtedness;" excludes from the definition short term paper; leaves out the "current transactions" language; and makes slight changes in classification of oil and gas interests as securities.

[5] Tcherepnin v. Knight, 389 U.S. 332, 342 (1967).

language of the definitions sections of the statutes, however, precludes significant illumination of the term. The legislative history of the acts similarly fails to define the intended scope of a "security."[6] Although the statutes themselves offer little guidance as to what constitutes a security, some indication of the parameters of a "security" can be derived by examining the statutory purposes behind the securities acts.

The securities statutes enunciate a broad remedial purpose of protecting investors from fraudulent practices in the sale of securities.[7] They attempt to achieve effective investor protection through the means of disclosure and prohibition of deceptive practices in connection with the purchase and sale of securities.[8] The '33 Act[9] requires disclosure by the issuing company of information concerning the character of securities sold in interstate and foreign commerce on the occasion of a public offering.[10] This disclosure method of investor protection is extended under the '34 Act[11] to require registration by corporations listed on the national stock exchanges and certain other corporations.[12] Both acts contain antifraud provisions[13] providing for

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[6] *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847-48 (1975); Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 38-46 (1959).

[7] *See, e.g.*, United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1976); SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

[8] *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Wilko v. Swan, 346 U.S. 427 (1953); Reserve Life Ins. Co. v. Provident Life Ins. Co., 499 F.2d 715 (8th Cir.), *cert. denied*, 419 U.S. 1107 (1974); SEC v. Glenn W. Turner Enterprises, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1974).

[9] 15 U.S.C. § 77a-bbbb (1970).

[10] The '33 Act requires a registration statement to be filed in advance of a public offering, § § 4 and 5 of the '33 Act, 15 U.S.C. § § 77d and 3 (1970); Natural Resources Defense Council, Inc. v. SEC, 389 F. Supp. 689 (D.D.C. 1974) (filing must include information important to a "reasonable investor"). The Act also requires a prospectus to be distributed to those interested in purchasing registered securities during the distribution period. § 5(b)(2) of the '33 Act, 15 U.S.C. § 77e(b)(2) (1970); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1098 (2d Cir. 1972) (prospectus must contain all information in registration statement and most current information concerning sales of security).

[11] 15 U.S.C. § 78 (1970).

[12] Initial registration under the '34 Act is required for corporations with assets of one million dollars and a class of equity securities held by 500 or more shareholders, § 12(g)(1) of the '34 Act, 15 U.S.C. § 78*l*(g)(1) (1970), under the requirements of § 13 of the '34 Act, 15 U.S.C. § 78(m) (1970).

[13] The antifraud provisions of the '33 Act are § 11, 15 U.S.C. § 77k (1970); § 12, 15 U.S.C. § 77*l*(2) (1970); and § 17a, 15 U.S.C. § 77q(a) (1970). Although the entire '34 Act is basically concerned with the prevention of fraud, the principle antifraud

civil and criminal penalties for disseminating false or misleading statements in connection with the purchase or sale of securities against issuing companies, company officials and individuals involved in the retail sales of securities. The Securities and Exchange Commission (SEC) may compel compliance with the provisions of the securities laws[14] and, in addition, the courts have implied a statutory right for an individual injured by a violation to bring a private cause of action under certain provisions of the acts.[15]

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provisions of the '34 Act are § 10(b), 15 U.S.C. § 78j(b) (1970), and the associated Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5 (1976), and § 15(c)(1), 15 U.S.C. § 78 O (1970).

[14] The SEC may seek various judicial remedies to enforce the securities laws. *See, e.g.*, § 20 of the '33 Act, 15 U.S.C. § 77t (1970) (injunction). The office of the Attorney General, however, has the exclusive power to institutue criminal proceedings to enforce the securities acts. *See generally Symposium: Enforcement of the Federal Securities Laws*, 24 EMORY L.J. 557 (1975).

[15] A private civil action for fraud in connection with the issuance of securities has been implied under §§ 11 & 12 of the '33 Act. 15 U.S.C. §§ 77k and *l*. Additional liability may be imposed on controlling individuals in the issuing corporation under § 15, 15 U.S.C. § 77o if liability is found under either § § 11 or 12. There is some dispute as to an implied right of action under § 17(a) of the '33 Act, 15 U.S.C. § 77q(a). Daniel v. International Bhd. of Teamsters, 410 F. Supp. 541, 546 (N.D. Ill. 1976) (implied private right of action); Wulc v. Gulf & Western Indus. Inc., 400 F. Supp. 99, 103 (E.D. Pa. 1975) (implied private right of action), *contra*, Architectural League v. Bartos, 404 F. Supp. 304, 313 (S.D.N.Y. 1975); Welch Foods Inc. v. Goldman, Sachs & Co., 398 F. Supp. 1393, 1401 (S.D.N.Y. 1974).

Under the '34 Act sections 9(e), 15 U.S.C. § 78i(3) (1970); 14(a), 15 U.S.C. § 78n(a) (1970); 16(b), 15 U.S.C. § 78p(b) (1970); and 18(a), 15 U.S.C. § 78r(a) make a private civil action available. Likewise, an implied private right of action exists under the '34 Act through § 10b and Rule 10b-5. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867-68 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). An implied private action has been held to exist under § 12(g), 15 U.S.C. § 78*l*(g) (1970), of '34 Act. Kerber v. Kakos, 383 F. Supp. 625 (N.D. Ill. 1974).

The primary advantage to bringing an action under the securities laws, rather than under common law theories of fraud, was the greater ease with which a violation was established. However, the recent Supreme Court decision in Ernst & Ernst v. Hochfeler, 425 U.S. 185 (1976), held that scienter is a necessary element for private causes of action under § 10(b) or Rule 10b-5. See RULE 10b-5 Section, *infra*, for a discussion of the impact of *Ernst & Ernst*. This requirement has made significant inroads into plaintiffs' ability to prevail in a securities action. *See, e.g.*, Mallinckrodt Chem. Works v. Goldman, Sachs & Co., 420 F. Supp. 231, 243 (S.D.N.Y. 1976) (failure to show scienter defeats fraud action concerning commercial paper); Alton Box Bd. Co. v. Goldman, Sachs & Co., 418 F. Supp. 1149, 1157 (E.D. Mo. 1976) (failure to show scienter defeats actions concerning alleged concealment of information by broker-dealer on rating of commercial paper). Some cases hold that a securities action no longer retains the advantage of not requiring the proof of reliance necessary to support a common law action. *See, e.g.*, Chelsea Assocs. v. Rapanos, 527 F.2d 1266, 1271-72

To develop the broad remedial purposes of the securities laws, courts generally have looked to the substance, rather than the form of a transaction in determining whether a scheme is within the regulatory scope of the acts.[16] The Supreme Court formulated this approach in *SEC v. C.M. Joiner Leasing Corp.*,[17] in determining whether the sale of oil leases in property situated near the site of a proposed test oil well involved an investment contract. In *Joiner Leasing* the Court avoided an express definition of a security, holding only that the sale of the leases "had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end."[18]

A few years later the Court affirmed and refined this approach in *SEC v. W.J. Howey Co.*[19] The case involved the sale of citrus groves to purchasers who were also offered service contracts for cultivation, harvest, and marketing of the crops. In holding that the sale involved a security, the Court stated that "the test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[20] These four criteria are often cited as providing the basic framework for determining the existence of a "security."[21] The Supreme Court recently stated that the *Howey* test was the "touchstone" of the essential attributes of a security.[22]

(6th Cir. 1975); Titan Group, Inc. v. Faggen, 513 F.2d 234, 238-39 (2d Cir.), *cert. denied*, 423 U.S. 840 (1975).

Other procedural advantages, however, for bringing a suit under the securities acts still exist. Nationwide venue and service of process is available to the plaintiff under Rule 10b-5, 15 U.S.C. § 77v (1970); 15 U.S.C. § 78aa (1970). *See* Comment, *Notes As Securities Under The Securities Acts of 1933 And The Securities Exchange Act of 1934*, 36 MD. L. REV. 233 (1976).

[16] *See, e.g.*, United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 851-52 (1975); SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969); C.N.S. Enterprises, Inc. v. G&G Enterprises, Inc., 508 F.2d 1354, 1357 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

[17] 320 U.S. 344 (1943).

[18] *Id.* at 349.

[19] 328 U.S. 293 (1948).

[20] *Id.* at 301.

[21] In *Howey*, however, the Supreme Court was defining what constitutes an investment contract under the securities laws, and at least one opinion has recently suggested that the test is of little value in the context of determining whether a note is a security. *See* text accompanying note 20 *supra*. *See* text accompanying note 20 *supra*. Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1136 (2d Cir. 1976).

[22] United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975) (rejecting allegation that shares of stock in a public housing cooperative were investment contracts).

In *United Housing Foundation, Inc. v. Forman*,[23] the Supreme Court emphasized that substance must prevail over form both for excluding and including transactions within the statutory definition of a security.[24] In *Forman* the Court rejected the Second Circuit's expansive analysis[25] of the profit element of the *Howey* test as applicable to stock evidencing ownership in units of a cooperative housing development.[26] The *Forman* opinion indicated that the Court views the *Howey* test as an integrated whole, and that no single element is necessarily sufficient to bring a transaction within the ambit of the federal securities laws. While the Court reaffirmed the validity of the *Howey* criteria, it clearly did not intend the formulation to serve as a vehicle to stretch the federal securities laws to every area where federal regulation might conceivably be desirable.[27]

In employing the definition of "investment contract" set forth in *Howey*, several lower courts have decided cases by focusing on only one or more elements of the formulation.[28] This approach has allowed a variety of transactions to be bootstrapped into the scope of the securities laws under the auspices of the *Howey* test. One of the dangers inherent in this "one element" method is the inevitably anomalous results among various courts. These inconsistent results have had the practical effect of confusing rather than clarifying the definition of a security.

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[23] *Id.*

[24] *Id.*

[25] Although the stockholders were unable to realize any capital gains on their stock, the Second Circuit found at least three ways in which the tenants expected to "profit" from their "investment." The first method of profit was from the tax deductability of the portion of the rental charge used to pay the interest on the mortgage. The second source of profits was the savings over the cost of comparable housing reflected in the low rental charged by the subsidized cooperative. The third proposed source of profit proposed by the Second Circuit was the possibility of net income derived from the leasing by the cooperative of commercial facilities located in the building. However, the Supreme Court held that these potential sources of "profit" were not the type of economic interest that characterized a security. *Id.* at 855-58.

[26] The circumstances surrounding the development of the cooperative would seem to negate any profit expectations. The cooperative's development was sponsored by a nonprofit membership corporation in order to provide low income housing. The cooperative received substantial financial subsidies for from the State of New York. In order to live in an apartment in Co-op City a tenant was required to purchase shares of stock related to the size of his apartment. On relocation, the tenant was required to resell his stock to the corporation at its original cost. *Id.*

[27] 421 U.S. at 859 n.26.

[28] *See, e.g.*, Fargo Partners v. Dain Corp., 540 F.2d 912 (8th Cir. 1976) (not a security where profits not dependent solely from the efforts of others); Hector v. Wiens, 533 F.2d 429 (9th Cir. 1976) ("solely from efforts of others" not construed literally).

This situation is illustrated by the conflict among the lower courts over whether discretionary commodities accounts[29] are investment contracts and, as a result, securities. One line of cases has held that discretionary commodities accounts can never be securities,[30] rationalizing that since there is no sharing of profits and losses by the broker's customers, the commonality element of the *Howey* test is not met.[31] The most recent case to follow this rationale is *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[32] In *Curran* the court reasoned that although the defendant-broker entered into similar contracts with several investors, one investor's success or failure would have no direct impact on the other investors.[33] Thus, although the customers were represented by a common agent, they were not joint participants in a common enterprise in a horizontal sense.[34] The *Curran* court dismissed the case since it found no securities involved.[35]

In contrast, a second line of authority concerning commodities accounts[36] construes the "common enterprise element" of the *Howey* test to be satisfied when a single investor commits his funds to a broker hoping to make a profit.[37] This construction is character-

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[29] Discretionary commodities accounts are usually maintained by inexperienced investors, who give their brokers complete discretion to determine what commodities contracts should be bought or sold for their accounts. Hodes & Dreyfus, *Discretionary Trading Accounts in Commodity Futures—Are They Securities?*, 30 Bus. Law. 99 (1974) [hereinafter cited as Hodes & Dreyfus].

[30] *See, e.g.*, Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Stevens v. Woodstock, Inc., 372 F. Supp. 654 (N.D. Ill. 1974); Arnold v. Bache & Co., Inc., 377 F. Supp. 61 (M.D. Pa. 1973); Stucker v. DuPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa.), *aff'd*, 491 F.2d 752 (3d Cir. 1972).

[31] *See generally* Hodes & Dreyfus, *supra* note 29.

[32] [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,862 (E.D. Mich. Dec. 27, 1976).

[33] *Id.* at 91,131.

[34] *Id.* The *Curran* court followed the reasoning of Milnarik v. M-S Commo dities, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). Cases following *Milnarik* have found the element of commonality lacking where there is no common enterprise in a horizontal sense among several investors. Horizontal commonality is present when the fate of any one investor's capital is directly connected to the success or failure of the other investors' commitments.

[35] [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,862 at 91,131.

[36] *See, e.g.*, Rochkind v. Reynolds Sec., Inc., 388 F. Supp. 254 (D. Md. 1975); Marshall v. Lamson Bros., 368 F. Supp. 486 (S.D. Iowa 1974); Espey v. Shearson, Hamill & Co., 341 F. Supp. 764 (S.D.N.Y. 1972); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968).

[37] *See, e.g.*, Marshall v. Lamson Bros., 368 F. Supp. 486, 489 (S.D. Iowa 1974) (common enterprise requirement refers to relationship between broker and investor;

ized as "vertical commonality" since it requires the fortunes of the investor to be inextricably bound up with the efforts of the promotors.[38] The court in *E.F. Hutton & Co. v. Burkholder*[39] recently referred to this second line of reasoning, implicitly finding that where a customer relies exclusively on the efforts of his broker, the resulting discretionary commodities account is a security.[40] Thus, the court found that where a customer controlled his own account as in *Burkholder*, the account was not a security since the crucial element of reliance on dealer efforts was missing.[41]

Use of these different approaches by the courts lends little guidance prior to adjudication as to whether commodities accounts will be held to be securities. Multiple interpretations are not unique to the commonality element of the *Howey* test; a similar variety of results have been produced under the other criteria.[42] This vacillation by the lower courts has created uncertainty as to what is a security, and has fostered a great deal of judicial creativity in expanding the scope of the securities law to include a wide range of financial dealings. This lack of a clear and consistent definition has left investors to test the applicability of the securities laws to their financial plans on an ad hoc basis.

In *Daniel v. International Brotherhood of Teamsters*[43] a district court recently interpreted the definition of a security to include an interest in a noncontributory, compulsory[44] pension plan.[45] The plain-

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unlikely that protection of securities acts "is available only to those hapless capitalists who are not alone in their misfortune").

[38] The effect of vertical commonality is merger of the dependence and commonality elements of the *Howey* test for defining a security, *see* text accompanying note 20 *supra. But see* Bromberg, *Commondities Law and Securities Law—Overlaps and Preemptions*, 1 J. CORP. L. 217, 253-56 (1976).

[39] 413 F. Supp. 852 (D.D.C. 1976). Plaintiff, a securities and commodities broker, sought a judgment for money allegedly owed on a commodity futures account. The defendant-investor denied authorization of several transactions in his account and counter-claimed for wrongful liquidation of his account.

[40] *Id.*

[41] *Id.* at 860.

[42] *See, e.g.*, Fargo Partners v. Dain Corp., 540 F.2d 912 (8th Cir. 1976) (investor in apartment building not dependent on the efforts of others for profit); United States v. Gibbs, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,839 (10th Cir. April 2, 1976) (investors contributing capital for construction of motel relied on efforts of others to realize profits); SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225 (E.D.N.Y. 1976) (investor franchisees in grocery franchise scheme dependent on the efforts of franchisor).

[43] 410 F. Supp. 541 (N.D. Ill. 1976), *aff'd*, FED. SEC. L. REP. (CCH) ¶96,141 (7th Cir. Aug. 20, 1977) (extensive analysis reflects reasoning of district court).

[44] In a "noncontributory" pension plan the employer bears the total financial

tiff, a member of the union that sponsored the pension plan, alleged fraud under the securities acts[46] in connection with the administration and maintenance of the pension fund.[47]

The *Daniel* court determined that the securities acts were prima facie applicable to employee pension plans, finding nothing in an examination of the legislative history and content of the acts to suggest a contrary conclusion.[48] The court partially documented its conclusion by citing a thirty-six year old opinion of the SEC Commissioner[49] interpreting the registration requirements of the '33 Act as applicable to certain types of employee pension plans.[50] The compulsory type of pension plans involved in *Daniel,* however, were not among those considered to be securities.[51] The SEC counsel had concluded that the compulsory nature of involuntary pension plans precluded them from constituting an "investment" under the *Howey* definition. In order to constitute an investment, value must be exchanged for an interest in the plan. An involuntary plan was consid-

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burden, unlike a contributory plan where the financing is by the employer and employee jointly. Note, *Interests in a Noncontributory, Compulsory Employee Pension Plan Deemed Subject to the Antifraud Provisions of the Federal Securities Laws,* Daniel v. International Brotherhood of Teamsters, 22 VILL. L. REV. 195, 196 n.14 (1977). In a "compulsory" plan the employer routinely deducts the contribution from the employee's salary without his consent.

[45] 410 F. Supp. at 552-53.

[46] The plaintiff in *Daniel* alleged fraud under § 17(a) of the '33 Act, 15 U.S.C. § 77q(a) (1970); § 10(b) of the '34 Act, 15 U.S.C. § 78j (1970); and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1976).

[47] The petitioner in the case was a retired union member, who claimed he was entitled to pension benefits promised by the union after 20 years. The union ruled him ineligible since he had not worked twenty continuous years due to an involuntary two-month lay-off. The union member brought an antifraud action under the securities laws against the union, alleging fraudulent misrepresentations in connection with the sale of plaintiff's interest in the union pension fund and fraudulent practices in connection with the administration of the fund. 410 F. Supp. at 543.

[48] *Id.* at 547 *citing* H.R. REP. No. 1838, 73d Cong., 2d Sess. 41 (1934).

[49] 410 F. Supp. at 547-48 (1941 opinion of SEC Commissioner Purcell). The SEC position on pension plans is contained in the opinion of John F. Davis, Assistant General Counsel of the SEC, [1941-1944 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,195 (1941); 1 FED. SEC. L. REP. (CCH) ¶ 2105.53 at 2579 (1941).

[50] *Id.* The SEC has considered voluntary, contributory pension plans as "an attempt to dispose of a security for value" under § 2(3) of the '33 Act, 15 U.S.C. § 77b(3) (1970), for thirty-five years.

[51] The SEC has not considered pension plans to involve the sale of a security as long as the employee is compelled to contribute to the plan or does not make a voluntary election to contribute to the plan. Where there is no element of volition on the part of the employee, the plans are viewed as a gift and do not involve the sale of anything. 1 FED. SEC. L. REP. (CCH) ¶ 2105.53 at 2579 (1941).

ered a gift from the employer which the employee received for nothing.[52] Since no exchange of value was involved, the pension plan could not be the "sale" of a security to which the federal acts applied.

The *Daniel* court reasoned that the SEC's counsel was unrealistic in viewing an employer's contribution to the pension fund as a gift rather than compensation in return for employees' services. The court could find no distinction, in terms of an investment, between employer contribution plans and situations where the employee receives the contribution in cash as part of his wages and then voluntarily elects to pay the cash into the fund. Consequently, the employee's interest in the pension fund was held to be a voluntary election to exchange labor for value and, thus, no less a "sale" than a voluntary pension plan.[53] The resulting analysis posits that an employee exchanges his labor for an interest, along with fellow employees, in a common fund, managed exclusively by a trustee, from which he expects payment at a later date in the form of pension payments.[54]

The defendant in *Daniel* also argued that special legislation concerning pension funds enacted by Congress in the last twenty years was intended to preempt application of the securities acts to pension funds.[55] The court, however, held that the legislative history surrounding the various pension legislation indicated that these acts were designed to complement the securities laws rather than displace them.[56] Further, even if the recent pension legislation were intended

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[52] *Id. See also* Hipple & Harkelroad, *Anomalies of SEC Enforcement: Two Areas of Concern*, 24 EMORY L.J. 697, 705 (1975) (supporting the SEC position).

[53] 410 F. Supp. at 547-48. The *Daniel* opinion found that the SEC policy of protecting only those employees who participated in a voluntary plan was illogical. The court held that this policy in effect singled out purchasers of pension fund security interests for special inquiry by looking to their subjective state of mind to determine the "voluntariness" of the purchase, and thus, the existence of an "investment decision." *Id.*

[54] *Id.* The *Daniel* court suggested that the employees exercised some degree of discretion concerning participation in the plan through their union votes. *Id.* at 553. *See also amicus* brief of SEC filed in *Daniel* appeal [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,846 (Jan. 1977) (supporting position of permitting recovery under the antifraud provisions where employee's decision to accept or retain job was materially influenced by fraudulent representations about pension).

[55] 410 F. Supp. at 548-49. Other pension legislation discussed included the Investment Company Act of 1940, 15 U.S.C. § § 80a(11) - 80a(52) (1970); the 1958 Welfare and Pension Plans Disclosure Act, 29 U.S.C. § § 301-309 (1970); the Investment Companies Amendment Act of 1970, 15 U.S.C. § 80a(2) (1970); and the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 (1970).

[56] 410 F. Supp. at 549.

to supplant the registration provisions of the securities laws,[57] there were no indications that remedies provided by the pension legislation excluded the application of the antifraud provisions of the securities laws.[58]

The *Daniel* case is the first federal case to construe the securities acts to apply to pension plans since the enactment of recent federal legislation concerning pension plans.[59] The extension of the securities acts in this area was accomplished through a broad application of the *Howey* investment of money criteria, supported by the court's construction of the remedial purposes of the acts.[60] Thus, the *Daniel* case is representative of the expansive approach generally taken by lower courts to extend the remedies afforded by the securities laws to areas not previously considered covered by the acts.[61]

One recent approach used as an aid to characterizing a transaction as an "investment contract" concentrates on the expectations of an investor from his participation in a financial scheme. Although life insurance contracts traditionally have not been considered securities,[62] in *Grainger v. State Securities Life Insurance Co.*,[63] the Fifth Circuit found that certain features of a particular type of insurance contract indicated it was a security. The court focused on two areas: the promotional efforts of the insurance companies in selling the contracts and whether the purchasers of the insurance bought the contracts as an investment.[64] Investigation into what a participant believed he had purchased revealed that the insured expected a large

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57 Arguably, however, the ERISA, Pub. L. No. 93-406, 29 U.S.C. §§ 1001-1381 (1970), a comprehensive regulation of employee benefit plans, provides disclosure requirements similar to the 1933 Securities Act. *Compare* ERISA § § 101, 104, 110, 29 U.S.C. § § 1021, 1024, 1030 (Supp. V 1975) *with* Securities Act of 1933 § 7, 15 U.S.C. § 77g (1970).

58 *But see* Hurn v. Retirement Fund Trust, 424 F. Supp. 80 (C.D. Cal. 1976). The *Hurn* court allowed a motion to dismiss to prevail for failure to state a cause of action in a fraud action under the securities laws brought by a participant in an employee pension benefit plan against the defendant trust. The court summarily held that the plaintiff's acquisition of the pension interest did not constitute the sale of a security, and that ERISA, 29 U.S.C. § 1002 (1970), was plaintiff's exclusive remedy.

59 *See* note 55 *supra*.

60 *See* text acompanying note 54 *supra*.

61 *See* note 28 *supra*.

62 *See, e.g.*, Tcherepnin v. Knight, 389 U.S. 332, 342-43 (1967) (dictum); 1 A. Bromberg, Securities Law: Fraud, SEC Rule 10b-5, § 6.5(1) n.92 (rev. ed. 1975).

63 547 F.2d 303 (5th Cir. 1977).

64 *Id.* at 306-07. The Fifth Circuit rejected the district court's limited approach to consideration of advertising and promotional efforts in defining a security. The lower court had applied a form of the parol evidence rule, looking to advertising efforts only where the instrument was not clear on its face.

monetary return in the form of dividends on his policy.[65] This "state of mind" inquiry parallels the "expectation of profits" element of the *Howey* formulation.[66]

A similar state of mind test was applied in *Grenader v. Spitz.*[67] In *Grenader,* the Second Circuit looked to the expectations of the shareholders to determine whether the stock in a privately sponsored housing cooperative[68] constituted a "security." Relying on the recent Supreme Court decision in *United Housing Foundation, Inc. v. Forman,*[69] where the Court concluded that cooperative shareholders did not acquire the shares for profit but rather for residential living purposes, the Second Circuit held that the shares were not securities.[70] Since the purchase of the stock was tied to the lease of the apartment,[71] the tenants' primary motive in purchasing the stock was to be able to live in the building.[72] This use of the state of mind criteria is aimed at determining the characteristics that indicate the existence of an investment contract. The *Grenader* opinion used the expectations of the purchasers to determine whether they were "led to expect profits solely from the efforts of others,"[73] a combination of

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[65] *Id.*

[66] *See* text accompanying note 20 *supra.*

[67] 537 F.2d 612 (2d Cir.), *cert. denied,* 97 S. Ct. 541 (1976). Plaintiffs were tenants of seventeen apartments in an apartment building converted into a cooperative housing corporation. The owner promoted the plan to convert the building into a cooperative which would issue its shares to tenants, and use the proceeds to purchase the building. Plaintiffs alleged violations of § § 5 & 17 of the Securities Act of 1933, 15 U.S.C. § § 77e & 77q, and § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

[68] 537 F.2d at 618-19. *See generally* Note, *Community Apartments: Condominium or Stock Cooperative?,* 50 CALIF. L. REV. 299 (1962); Note, *Co-operative Apartment Housing,* 61 HARV. L. REV. 1407 (1948).

[69] 421 U.S. 837 (1975).

[70] The court determined that, although there was an opportunity to make a profit as the underlying real estate increased in value, such a profit is possible in any real estate transaction. 537 F.2d at 617.

[71] The court determined that the stock did not have the characteristics of normal securities since the shares were tied to residency in the apartments. The cooperative shares were nontransferable, a terminating tenant was required to relinquish his stock in the cooperative, and there were no possible cash dividends. *Id.*

[72] *Cf.* R. Rosenberg & Sons v. St. James Sugar Coop., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,826 (E.D. La. April 20, 1976) (motive of farmer in purchasing shares in cooperative marketing association was assurance of a place to process and market his crops, thus, insufficient dependence on efforts of others to constitute security); Van Huss v. Associated Milk Producers, Inc., 415 F. Supp. 356 (N.D. Tex. 1976) (shares in milk cooperative not securities since farmer did not rely on efforts of others for production of profits).

[73] *See* text accompanying note 20 *supra.*

two *Howey* criteria. Incorporation of these two criteria into this state of mind test in *Grenader*[74] and *Grainger*[75] creates yet another approach by lower federal courts to determining the existance of an investment security.

Many recent cases have considered the distinction between note instruments that are, and those that are not, securities under the securities laws. Although the *Howey* formulation is widely used in connection with investment contracts, its use in the note context is less helpful.[76] Several approaches to the problem have been offered to fill any void left by an inability to use the *Howey* elements effectively.

The securities acts are textually more expansive in their treatment of notes as securities than of investment contracts. Both the '33 Act and the '34 Act contain an exception from "notes" considered to be securities.[77] These exceptions are usually construed to apply to short-term commercial paper,[78] since this type of commercial paper is not ordinarily held for an investment.[79] However, the general rule that any note executed in connection with a commercial transaction is not a security[80] is qualified by cases holding that if it is executed

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[74] 537 F.2d 612 (2d Cir.), *cert. denied,* 97 S. Ct. 541 (1976).

[75] 547 F.2d 303 (5th Cir. 1977).

[76] Application of the *Howey* elements, *see* note 20 *supra,* to a promissory note transaction indicates that a "common enterprise" is rarely involved. Most transactions involve only a borrower and a lender. The profit element is always present in a note case because the interest paid on the loan is profit. Furthermore, almost all loan arrangements evidenced by a promissory note are "dependent on the efforts of others" for repayment. Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1136-37 (1976) (rejecting use of *Howey* criteria in connection with note transaction) *noted at* 30 VAND. L. REV. 110 (1977). *See* text accompanying notes 82-98 *infra.*

[77] See note 3 *supra* for the '33 Act exemption in § 3(a)(3). Section 3(a) (10), 15 U.S.C. § 78a(10) (1970), of the '34 Act provides:

> The term 'security' means any note, . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78a(10) (1970).

[78] The antifraud provisions of the '33 Act, § § 12 and 17, expressly apply to securities excluded from the other provisions of the Act, 15 U.S.C. § § 77*l* & q (1970). No antifraud provisions in the '34 Act, however, refer to § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970). Presumably, the exclusions contained in § 3(a)(10) pertain to all provisions of the '34 Act.

[79] *See, e.g.,* Sanders v. John Nuveen & Co., 463 F.2d 1075, 1079-80 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972).

[80] *See, e.g.,* McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir.), *cert. denied,* 420

as part of a scheme which has an investment nature, the note will be considered a security.[81] This commercial-investment distinction is based on a court's conclusion that a transaction does not possess subjectively determined characteristics sufficient to associate it with an investment contract.

The subjective nature of the commercial-investment approach is illustrated by the decision in *Emisco Industries, Inc. v. Pro's Inc.*[82] which concerns the issuance of promissory notes to finance the purchase of a business. In *Emisco,* the court applied an "impetus" test as an aid in distinguishing between investment and commercial notes, subjectively concluding that since the impetus for the transaction was the borrower's need for cash, the resulting promissory note was not a security.[83] However, in *NBI Mortgage Investment Corp. v.*

U.S. 930 (1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied,* 414 U.S. 908 (1973); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972).

[81] Any note issued in a commercial context, short or long term, involves the expenditure of money with the expectation of interest or income from the efforts of others with little effort on the lender's part. Thus, any commercial note might conceivably come within the investment contract of *Howey.* Failure to consider the 9 month maturity exception contained in § 3(a) of the '34 Act as controlling short term notes in addition to the *Howey* criteria virtually writes this exception out of the securities acts. *See* McClure v. First Nat'l Bank, 497 F.2d 490, 494-95 (5th Cir. 1974) (investment or commercial nature of note entirely controls applicability of Act); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir. 1973) (demand notes with investment nature are securities). At least one court has suggested that the essential elements of an investment note distinguishing it from a commercial note should be some sort of profit participation or other benefit beyond the repayment of loan interest. Throp Comm'l Corp. v. Northgate Indus., Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶94,929 (D. Minn. Dec. 21, 1974).

[82] 543 F.2d 38 (7th Cir. 1976).

[83] *Id. Emisco* involved the purchase of a division of one company by another company, which gave a promissory note as partial consideration for the purchase of the assets. The plaintiff-buyer subsequently brought action against the vendor, under § 27 of the '34 Act, 15 U.S.C. § 78aa (1970), for fraudulent misrepresentations in violaton of § 10(b), 15 U.S.C. § 78j (1970) and Rule 10b-5. The Seventh Circuit buttressed its opinion with its earlier decision in C.N.S. Enterprises, Inc. v. G&G Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied,* 423 U.S. 825 (1975), where it originated the "impetus" test. *Id.* at 1362-63. The "impetus" test focuses on which party initiated the transaction. An example of its application would be where a consumer seeks a loan for home improvements from a bank. The borrower who initiated the transaction did so for his own purposes and more than likely was not solicited by the bank to interest him in an investment. Under the impetus test the resulting promissory note would not be considered a security. *See, e.g.,* Tri-County State Bank v. Hertz, 418 F. Supp. 332, 341-42 (M.D. Pa. 1976) (uses impetus test concerning promissory notes).

Chemical Bank,[84] in denying a motion for summary judgment, the court found that a participation[85] in a construction loan, might be the sale of a security[86] under the commercial-investment test. The bank had originally agreed to finance completely the construction project, but later sold a participation in the loan to an individual. Arguably, had the *Emisco* "impetus" test been used, the sale would not have been characterized as a security, since the bank offered the participation because it was no longer willing to commit its cash to the venture.[87] These varying results in similar transactions exemplify the lack of uniform criteria for applying the commercial-investment test.

The major weakness of the commercial-investment test is that it is seldom consistently applied. Courts using the test have failed to isolate any generally recognizable characteristics that state the extent and nature of the classes of "investment" or "commercial" notes. The securities acts themselves offer little textual clarification of the distinction between commercial and investment transactions.[88] Thus, the subjective nature of the commercial-investment test does not provide a predictable standard to assess the status of promissory notes prior to litigation.

An alternative approach to the commercial-investment test was recently applied in *Great Western Bank & Trust v. Kotz*,[89] where the plaintiff-bank, on failure to receive repayment on an unsecured note, brought an action alleging fraud against an executive of the issuing company.[90] Determining that the transaction did not involve a security, the Ninth Circuit applied a "risk capital" test.[91] The risk capital

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[84] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,632 (S.D.N.Y. June 25, 1976).

[85] A "participation" is expressly included in § 2(1) of the '33 Act definition of security. 15 U.S.C. § 77(b) (1970).

[86] In *NBI Mortgage* the defendant bank entered into a building construction loan with a realty company evidenced by a promissory note. In holding that the participation could be a security, the court, on a motion for summary judgment, rejected the argument that there was no difference between a bank initially issuing a construction loan, plainly a commercial transaction, and the subsequent sale of a participation in that loan. The court drew the distinction that the owner of the participation was dependent on the managerial efforts of the managing bank. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,632 at 90,147.

[87] *Id.* As a result of delays in construction and resulting extensions of repayment deadlines, the bank sold a participation to an individual. The bank apparently solicited the sale.

[88] '33 Act, 15 U.S.C. § 77b (1970); '34 Act, 15 U.S.C. § 78c (1970).

[89] 532 F.2d 1252 (9th Cir. 1976). The bank in *Great Western* alleged fraud under § 10(b), Rule 10b-5 and § 17(a) of the '33 Act, 15 U.S.C. § 77q(a) (1970).

[90] 532 F.2d at 1253.

[91] This 'risk' analysis was first considered in Silver Hills Country Club v. Sobieski,

test uses the characteristics usually applied in the commercial-investment[92] context to measure the risk of non-payment associated with a loan evidenced by a promissory note. The *Great Western* court reasoned that as the risk of non-payment increased, dependence on the efforts of others for repayment or profit increased proportionally, indicating a transaction of an investment nature.[93] The court of appeals held that this test distinguished between the "risky loan," a commercial transaction, and "risk capital,"[94] money invested in a security.

The risk capital test suffers from a weakness similar to the commercial-investment analysis in its dependence on ill-defined characteristics for its application. The lower courts have offered little guidance as to what level of risk will transform an ordinary note transaction into a security.[95] Thus, the risk capital test foreseeably could permit arbitrary application by the courts resulting in lack of predictability associated with its use.

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55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). There, the court found that memberships sold in a country club were securities. *See, e.g.*, Pollock, *Notes Issued in Syndicated Loans—A New Test to Define Securities*, 32 Bus. Law. 537, 544-45 (1977) [hereinafter cited as Pollock]; Coffey, *The Economic Realities of a "Security:" Is There A More Meaningful Formula?*, 18 Case W. Res. L. Rev. 367 (1967). The Supreme Court recently declined to apply the risk-capital test in United Housing, Inc. v. Forman, 421 U.S. 837, 857 n.24 (1975). However, the Court explained why the test was not applicable to the facts in the *Forman* case, indicating that it did not reject the test for all purposes. Thus, the Supreme Court has not yet definitively ruled on the general applicability of the risk-capital test for defining a security.

[92] *See* text accompanying notes 80-87 *supra*.

[93] In SEC v. W.J. Howey, 328 U.S. 293 (1946), one element of the test to determine whether a transaction involved a security was if the scheme depended on profits "to come solely from the efforts of others." *Id.* at 301. Arguably, the *Great Western* court borrows from the "efforts of others" element of the *Howey* test. *Pollock, supra* note 91, at 544.

A form of the risk-capital approach was recently used in determining whether an investment contract was a security in Ballard & Cordell Corp. v. Zoller & Danneburg Exploration, 544 F.2d 1059 (10th Cir. 1976), *petition for cert. filed*, 45 U.S.L.W. 3588 (U.S. March 1, 1977) (No. 76-1165). The court applied the *Howey* "reliance on the efforts of others" criteria to determine that a sale of oil and gas leases did not involve a security, at the same time observing that most investment contracts involved the financing of "speculative schemes." *Id.* at 1065. Thus, this decision indicates some degree of overlap between the nature of investment contracts and notes held to be securities.

[94] 532 F.2d at 1257.

[95] *Id.* The risk-capital approach appears to yield results inconsistent with traditional opinion when applied to an unsecured note evidencing a personal loan. In personal loans the risk of nonpayment is high, yet the note is a type usually excluded from the securities acts. Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1137-38 (2d Cir. 1976).

Recognizing the basic failure of prior judicial attempts to make the commercial-investment and risk capital test more objective, the Second Circuit rejected these approaches for determining whether a note was a security in *Exchange National Bank v. Touche Ross & Co.*[96] The suit was brought by a bank against the accounting firm of a company that had defaulted on three unsecured promissory notes held by the bank. The bank alleged that the accountants had issued false and misleading opinions concerning the company's financial position.[97]

After discussing the problems inherent in prior approaches to defining note securities,[98] the *Exchange National Bank* court concluded that the best alternative was a "greater recourse to the statutory language" of the securities acts.[99] The court noted that the "plain terms" of the '34 Act provided that a security does not include "any note . . . which has a maturity at the time of issuance of not exceeding nine months." The '33 Act states that a security includes "any note" except for the section 3(a)(3) current transactions exception[100] to that act's registration requirements. The Second Circuit thus determined that the plain terms of the acts' definitions should be applied "unless the context otherwise required."[101] The burden of showing that the context required otherwise is on a party asserting that a note of more than nine months maturity is not within the '34 Act (or that a note maturing in less than nine months is within the '34 Act) or that any note is excluded from the antifraud provisions of the '33 Act.[102] Thus, the burden of proving that the "context of the transaction otherwise requires" would be on the party maintaining that the literal terms of the acts should not be applied.[103]

[96] 544 F.2d 1126 (2d Cir. 1976).

[97] *Id.* at 1128. The bank alleged fraud under § 17 of the '33 Act, § 10(b) of the '34 Act and rule 10b-5.

[98] *Id.* at 1133-37.

[99] *Id.* at 1137.

[100] *Id.* § 3(a) of the '34 Act, 15 U.S.C. § 78a(10) (1970). *See* note 3 *supra*.

[101] The preface to the definition sections of both the '33 and '34 Acts contains the language "unless the context otherwise requires." 15 U.S.C. § 77b (1970); 15 U.S.C. § 78c (1970).

[102] 544 F.2d at 1137. See note 13 *supra* for the antifraud provisions of the '33 Act.

[103] The Second Circuit's approach in *Exchange Bank* is the latest in a series of decisions by that court of appeals attempting to develop a successful test defining the term "security." *See, e.g.*, Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973) (statutory construction approach); Movietab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971) (literal approach).

This burden apparently could be met by showing that the purposes of the securities acts[104] would not be promoted by including the particular transaction under the securities laws. The *Exchange Bank* court found no justification for excluding the particular notes in the case from the securities acts.[105]

This "context" language of the securities acts has been cited in prior opinions[106] as the basis for examining the particular note involved to see whether, in the context of the transaction, it should be regarded as a "security."[107] These cases then apply the commercial-investment test, omitting the emphasis placed by the *Exchange Bank* opinion on the purpose of the securities laws in determining whether a note is a security.

Since the *Exchange Bank* approach focuses inquiry on whether the purposes of Congress would be served by treating the note as a security, the outcome of any decision utilizing this approach is dependent on how broadly the court defined the purposes of the acts. Therefore, a court defining the purposes of the securities laws very broadly might include any note as a security, since it is conceivable that fraud could be associated with any note transaction. In an attempt to discourage this type of overbroad construction, the *Exchange Bank* court cited several examples of notes not within the securities laws. Notes evidencing ordinary consumer transactions were the primary focus of the list, such as character loans and home mortgage[108] loans. The list also included some types of "short term" notes.[109] The Second Circuit concluded that if a note does not have a

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[104] The text of the *Exchange Bank* opinion repeatedly expresses a concern for the purposes of Congress in enacting the securities laws. This purpose is characterized as protection of the "average investor against fraud in the public offering of common investment instruments." 544 F.2d 1133. *See* text accompanying notes 7-10 *supra.*

[105] 544 F.2d at 1139.

[106] *See, e.g.,* C.N.S. Enterprises, Inc. v. G&G Enterprises, Inc., 508 F.2d 1354, 1357 (7th Cir. 1975); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 800 (2d Cir. 1973).

[107] The "context" phrase in the language opening the definitions sections of the acts could possibly refer to the context of the statutes, not the transaction. *Notes As Securities Under The Securities Act Of 1933 And The Securities Exchange Act of 1934,* 36 MD. L. REV. 233, 239 (1976).

[108] 544 F.2d at 1337-38. The court lists several examples of transactions it would hypothetically exclude from the securities acts: "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)." *Id.* at 1138.

[109] The Second Circuit apparently meant to include only those notes not part of a

"strong family resemblance" to these hypothetical examples and "has a maturity exceeding nine months," section 10(b) of the '34 Act should be held to apply.[110]

The "purpose" test offers greater flexibility, thereby allowing it to be used in diverse factual situations.[111] Likewise, the "purpose" test seems preferable to other approaches because it does not attempt to create artificial definitions that may depart from congressional intent. In order to apply the "purpose" test a court must look at the type of activity Congress was trying to prevent by enacting the securities laws.

Theoretically, this approach should focus a court's attention on the congressional purposes behind the securities laws, thus narrowing the field of transactions intended to be included in the term "security." In practical application, however, a court may tend to apply the acts to situations not intended to be securities if the court fails to frame a sufficiently narrow purpose for the securities laws.[112]

Another threat to the workability of the test is that courts may simply use the enumerated examples[113] in the *Exchange Bank* opinion as an exclusive list of notes not intended to be subject to the securities acts. This rigid application of the *Exchange Bank* test would result in bypassing an independent review of whether a particular note is of the type Congress intended to affect. The issue in a misapplication of this type would depend on the similarity to the listed examples of the facts in a particular case. Thus, the "unless the context otherwise requires" element of the "purpose test" would be subsumed under the "strong family resemblance" language of the *Exchange Bank* opinion.

A similar analysis appears to have been the basis for the court's opinion in *The Fund of Funds, Ltd. v. Vesco.*[114] Relying on the

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large investment scheme as "short term notes," since it mentioned "short-term" only in connection with "a small business." *Id.*

[110] *Id.* The court also left "for another day the status under the 1934 Act of a note with a maturity of nine months or less that does not bear a strong family resemblance, and the question whether a note which because of its short term would not be a security under § 10(b) of the 1934 Act might be one within the antifraud provisions of the 1933 Act." *Id.* at 1138 n.19.

[111] The risk-capital and the commercial-investment tests suffer from unpredictability when employed in varying factual situations. *See* text accompanying notes 87-95 *supra.*

[112] The problem of potentially overbroad application of the securities laws associated with the *Exchange Bank* test was pointed out in *Pollock, supra* note 91, at 547.

[113] 544 F.2d at 1137-38. See note 108 *supra* for the examples of notes ordinarily excluded from the securities acts cited in the *Exchange Bank* opinion.

[114] [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶95,644 (S.D.N.Y. July 12, 1976).

Exchange Bank test, the district court denied a motion to dismiss in a securities fraud action in connection with promissory notes.[115] After determining that the notes did not bear a "strong family resemblance" to those examples listed in *Exchange Bank*, the court concluded that there was no justification for excluding the notes from the securities acts.[116]

Application of the "purpose" test in this manner offers no comparative advantage over the "risk-capital" or "commercial-investment" tests, which suffer from a lack of objective criteria for application. Where the "purpose" test has thus far been applied, it has suffered from the same artificial definitions problem evident in other approaches.

Although recent decisions evince an expansive interpretation of the term "security" among lower federal courts, judicial analysis offers little in terms of consistent guidelines as to what financial transactions are excluded from the application of the securities laws. Courts are often willing to discard substantially any restrictive language contained in the securities laws in order to afford protection to an investor. In addition, the courts are willing to expand prior judicial approaches to defining a security, allowing extensive application of the securities acts.

This liberal expansion of the scope of the securities laws may be tempered to some extent by the Supreme Court's recent decision in *Forman.*[117] In that decision, the Court emphasized that while the substance of a transaction should be considered over its form, the securities acts were not intended to be a comprehensive solution for all areas where federal regulation might be needed.[118] Application of the *Howey* criteria, for defining a security, reaffirmed in *Forman,* may restrict the growing tendency of the courts to broaden the potential sweep of the securities laws.[119] An adoption of a more unified

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[115] *Id.* in *Fund of Funds,* a subsidiary brought a fraud action under the securities laws against its parent corporation alleging that the parent corporation, through a series of unauthorized actions, borrowed 60 million dollars from its subsidiary in exchange for three promissory notes. Defendant moved to dismiss the complaint for lack of subject matter jurisdiction, alleging that the three promissory notes were not "securities" within the definition of the securities acts.

[116] *Id.* at 90,195. The *Fund of Funds* opinion concluded that the notes were securities for the purposes of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1970), as well as the '33 and '34 Acts. *Id.* at 90,195.

[117] 421 U.S. 837 (1975).

[118] *Id.* at 859 n.26.

[119] Results in securities cases before the Supreme Court in the last two years indicate that the Court is unwilling to extend the scope of the securities laws. Santa Fe Indus., Inc. v. Green, 97 S. Ct. 1292 (1977) (rule 10b-5 does not extend to cover