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Defining An "Investment Contract": The Commonality Requirement Of The Howey Test

DEFINING AN "INVESTMENT CONTRACT": THE COMMONALITY REQUIREMENT OF THE *HOWEY* TEST

Congress enacted the Securities Act of 1933[1] ('33 Act) and the Securities Exchange Act of 1934[2] ('34 Act) to protect the investing public from fraudulent securities transactions.[3] To fall within the reach of the '33 and '34 Acts' regulatory power, a transaction must employ the use of either interstate commerce or the United States mail,[4] and the transaction must involve a "security" as defined in the '33 and '34 Acts.[5] Accordingly, the more liberal interpretation that courts afford the term "security" under the

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1. Pub. L. No. 73-22, 48 Stat. 74 (1933-34) (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)).

2. Pub. L. No. 73-290, 48 Stat. 881 (1933-34) (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

3. *See, e.g.*, United Hous. Found. v. Forman, 421 U.S. 837, 849 (1974) (primary purpose of Securities Act of 1933 ('33 Act) and Securities Exchange Act of 1934 ('34 Act) is to protect against serious abuses in securities market); Marine Bank v. Weaver, 455 U.S. 551, 555 (1981) (Congress adopted '34 Act to restore investor's confidence in financial markets); Note, *When Is A Security Not A Security: Promissory Notes, Loan Participations and Stock In Close Corporations*, 39 WASH. & LEE L. REV. 1123, 1128-30 & n.22 (1982) (Congress enacted '33 and '34 Acts to restore investors' confidence in financial markets after stock market crash of 1929); *see generally* FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 912-18 (1980) (discussing relation between enactment of '33 and '34 Acts and stock market crash of 1929). The general purpose of the '33 Act is to protect investors from fraud and misrepresentation associated with the sale of securities by requiring that adequate and true information be made available to investors prior to sale. *See* 15 U.S.C. §§ 77e-77h, 77j (1982) (disclosure regulations of '33 Act); *see also* S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 17, at 1 (J. Ellenberger and E. Mahar eds. 1973) [hereinafter cited as ELLENBERGER]. Like the '33 Act, the '34 Act protects investors by requiring continued disclosure of material information that relates to the activity of securities in secondary markets and, thus, provides a safeguard against destructive speculation. *See* 15 U.S.C. §§ 78l-78n (1982) (disclosure regulations of '34 Act); S. REP. No. 792, 73d Cong., 2d Sess. 1 (1934) (quoting President Roosevelt's message to Congress inviting securities legislation), *reprinted in* LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, item 17.1 (J. Ellenberger and E. Mahar eds. 1973).

4. *See* U.S. CONST. art. I, § 8. The United States Constitution expressly limits Congress' power over domestic commerce to interstate commerce. *Id.* The Constitution, therefore, impliedly limits Congress' power to regulate the transactions of securities to those transactions involving interstate commerce or the use of the United States mail. *See id.; see also* 15 U.S.C. § 77e (1982) (federal jurisdictional requirements of '33 Act); 15 U.S.C. § 78aa (federal jurisdictional requirements of '34 Act).

5. *See, e.g.*, Blue Chip Stamp v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring) ('34 Act applies only to purchase and sales of securities); Union Planters Nat'l Bank v. Commercial Credit, 651 F.2d 1174, 1179 (6th Cir.) (threshhold question in action brought under the '33 or '34 Act is whether security exists), *cert. denied*, 454 U.S. 1124 (1981); Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334, 334-35 (W.D. Pa. 1980) (enforcement of '33 and '34 Acts depends upon existence of security transaction); Titsch Printing, Inc. v. Hastings, 456 F. Supp. 445, 447 (D. Colo. 1978) ('34 Act applies only to securities as defined in '34 Act).

'33 and '34 Acts, the broader the potential application of the '33 and '34 Acts' regulatory power.[6] Comparing various courts' interpretations of a security, however, reveals that, although both the '33 and '34 Acts define "security" to include an "investment contract,"[7] uncertainty exists regarding the types of transactions that actually constitute "investment contracts."[8]

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6. *See infra* notes 18-92, 160-85 and accompanying text (discussing effect of judicial interpretations of what transactions constitute securities on application of '33 and '34 Acts).

7. 15 U.S.C. §§ 77a-77aa (1982) ('33 Act); 15 U.S.C. §§ 78a -78kk (1982) ('34 Act). The '33 Act defines a security as follows:

> When used in this subchapter, unless the context otherwise requires—
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> (1) the 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, fractional undivided 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 participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1982).

The '34 Act defines "security" as follows:

> (a) When used in this chapter, unless the context otherwise requires—
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> (10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty of lease, any collateral-trust certificate, preorganization, certificate or subscription, transferable share, investment of deposit, for a security, or in general, any instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; 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.

Securities Exchange Act of 1934 § 3(a)(1), 15 U.S.C. § 78(c)(a)(10) (1982).

Although the statutory definition of security differs slightly between the '33 Act and the '34 Act, Congress intended the definitions to be substantially the same, and courts recognize the two as functionally equivalent. *See, e.g.*, United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1974) ('33 and '34 Act definitions of "security" are virtually identical and coverage of two Acts considered same); Tcherepnin v. Knight, 389 U.S. 332, 336, 342 (1967) (definitions of security in '33 and '34 Acts virtually identical and interpreted substantially same); S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934) (Congress intended definitions of security under '33 and '34 Acts to be substantially same). Additionally, the definition of a security contained in the '33 and '34 Acts is virtually identical to the definition of a security in the Uniform Securities Act adopted in over 35 states. *See* Uniform Securities Act § 401(1) (defining security), *reprinted in* BLUE SKY L. REP. (CCH) 4931, AT 727 (1971); *see also* Note, *supra* note 3, at 1123 n.2.

8. *See e.g.*, Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980) (investment contract requires horizontal commonality between multiple investors), *aff'd*, 456 U.S. 353 (1982); SEC v. Continental Commodities Corp., 497 F.2d 516, 527 (5th Cir. 1974) (requisite commonality for investment contract exists when single investor's return depends upon promoter's efforts and expertise); SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 484 n.7 (9th Cir.) (investment contract requires interdependency of success between investor and either third party or other investor), *cert. denied*, 414 U.S. 821 (1973); *see also*

The United States Supreme Court on several occasions has attempted to establish a clear and practical method of determining whether a transaction constitutes an investment contract under the '33 and '34 Acts.[9] In *SEC v. C.M. Joiner Leasing Corp.*,[10] for example, the Supreme Court initially ruled that whether an instrument constituted an investment contract depended on the "character" of the instrument in commerce as established by the characteristics of the transaction and the economic inducements represented to prospective investors by promoters.[11] In 1946 the Supreme Court in *SEC v. W.J. Howey Co.*[12] refined the *Joiner* "character" test. The *Howey* Court noted that although the '33 Act did not define specifically "investment contract," state courts had construed the term broadly by disregarding the form of the transaction in favor of substance and emphasizing the economic reality of the transaction.[13] Relying on the economic reality analysis, the *Howey* Court adopted a landmark test to determine whether a contract, transaction, or scheme constitutes an investment contract under the '33 and '34 Acts.[14] Under the *Howey* economic reality test, an investment contract exists when a person (1) invests money, (2) in a common enterprise, and (3) is led to expect profits solely from the efforts of others.[15] Since the estab-

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infra notes 17-92 and accompanying text (discussing uncertainty among courts concerning the requirements necessary to characterize instruments or transactions as investment contracts). Various authorities have recognized the phrase "investment contract" within the '33 and '34 Acts definition of a security as a catch-all phrase in light of the congressional intent that the term "security" be construed broadly and flexibly to include the various schemes that fall within the ordinary concept of a security in the commercial world. *See* S.E.C. v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (investment contract embodies flexible principle capable of reaching many profit-seeking schemes); H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933) [hereinafter cited as 1933 HOUSE REPORT] (Congress intended broad rather than narrow or restrictive definition of security); 1 L. LOSS, SECURITIES REGULATION, 483-511 (2d ed. 1961) (courts have employed term "investment contract" as catch-all phrase); *see also* S.E.C. v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) (regulation imposed by '33 Act extends beyond obvious and commonplace to apply to uncommon and irregular schemes that possess characteristics of investment contract).

9. *See infra* notes 10-15 and accompanying text (discussing Supreme Court's establishment of test defining investment contract); *infra* notes 97-159 and accompanying text (discussing Supreme Court's various attempts to clarify definition of investment contract).

10. 320 U.S. 344 (1943).

11. *Id.* at 351-53; *see infra* notes 97-100 and accompanying text (discussing *Joiner*).

12. 328 U.S. 293 (1946); *see infra* notes 107-22 and accompanying text (discussing *Howey*).

13. *Howey*, 328 U.S. at 298 & n.5.

14. *Id.* at 298-301. Expressing the view that economic reality should control the determination of whether a transaction constitutes an investment contract, the *Howey* Court found irrelevant the issue whether formal certificates evidenced an interest in an enterprise. *Id.* at 299. The *Howey* Court also recognized that Congress intended that courts construe the definition of "security" in the '33 and '34 Acts in a flexible manner to fulfill the intended reach of the Act's adaptation to meet the various profit seeking schemes devised by those who solicit the use of other's money. *Id.*

15. *Id.* at 301. Since the Supreme Court decided *Howey*, courts considering the existence of a security within the meaning of the '33 and '34 Acts definition generally have relied on the *Howey* criteria of an investment contract. *See, e.g.*, Tcherepnin v. Knight, 389 U.S. 332, 337-

lishment of the *Howey* test, the Supreme Court periodically has addressed

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39 (1967) (withdrawable capital shares in savings and loan possess attributes of investment contracts as defined in *Howey*); Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 756 F.2d 230, 238-39 (2d Cir. 1985) (relying on *Howey* test in finding that certificates of deposit constitute investment contracts); Stenger v. R.H. Love Galleries, Inc., 741 F.2d 144, 146-47 (7th Cir. 1984) (sale of art with repurchase allowance is not investment contract under *Howey* test); Curran v. Merrill Lynch, Pierce, Fenner, and Smith, Inc., 622 F.2d 216, 221-24 (6th Cir. 1980) (discretionary trading accounts do not constitute investment contracts under *Howey* test), *aff'd,* 456 U.S. 353 (1982); Fargo Partners v. Dain Corp., 540 F.2d 912, 914-915 (8th Cir. 1976) (purchase/management agreement on apartment complex is not investment contract under *Howey* test); S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 520-23 (5th Cir. 1974) (options on commodities future contracts constitute investment contracts under *Howey* test); S.E.C. v. Glenn W. Turner Enter., 474 F.2d 476, 480-82 (9th Cir.) (applying *Howey* test to pyramid investment schemes), *cert. denied,* 414 U.S. 821 (1973); Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 618 F. Supp. 436, 438-40 (S.D.N.Y. 1985) (discretionary commodity futures account is not investment contract under *Howey* test); Wooldridge Homes, Inc. v. Bronze Tree, Inc., 558 F. Supp. 1085, 1086-88 (D. Colo. 1983) (condominium purchase/management agreement constitutes investment contract under *Howey* test); McLish v. Harris Farms, Inc., 507 F. Supp. 1075, 1086-88 (E.D. Cal. 1980) (cattle feedlot operation constitutes investment contract under *Howey* test); *see also* Note, *supra* note 3, at 1055 n.17 (listing additional cases that have followed *Howey* test).

In relying on the *Howey* test, however, courts have relaxed the requirement that investors must expect profits solely from the efforts of others and have held that profits may result from the entrepreneurial or managerial efforts of others and still satisfy the *Howey* test. *See Turner Enterprises,* 474 F.2d at 482; *see also* United Hous. Found. v. Forman, 421 U.S. 837, 855-858 (1975) (acknowledging relaxed standard of "sole" requirement enunciated by *Turner* court). Having relaxed the "sole" requirement of the *Howey* test, courts now hold that the proper inquiry for the third prong of the *Howey* test is whether the efforts of those other than the investor constitute the undeniably significant efforts that determine the success or failure of the enterprise. *See Turner Enterprises,* 474 F.2d at 482 (pyramid investment scheme in which investors participated, but relied on skill and efforts of promoters for profit, satisfied *Howey* test); *see also* Hector v. Wiens, 533 F.2d 429, 433 (9th Cir. 1976) (control of essential managerial efforts by those other than investor satisfies third prong of *Howey* test); McCown v. Heidler, 527 F.2d 204, 211 (10th Cir. 1975) (primary reliance for profit for developer's managerial and development efforts would satisfy third prong of *Howey* test); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414, 417-18 (8th Cir. 1974) (investor may participate in enterprise as long as promoter's skill and efforts determine profit potential); *accord* Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 652 F.2d 1174, 1181 n.9 (6th Cir.) (recognizing relaxed view of *Howey* test's expectation of profits requirement among circuits), *cert. denied,* 454 U.S. 1124 (1981).

The relaxed standard that courts have applied to determine whether an instrument or a transaction satisfies the third prong of the *Howey* test apparently requires that the investor lack either the authority or the expertise and ability to exert meaningful control over the profit making aspect of the enterprise. *See* Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 872 (D. Utah 1981) (courts must consider whether investor or promoter possesses control over factors essential to success of enterprise in determining whether enterprise satisfies third prong of *Howey* test); *see, e.g.,* Williamson v. Tucker, 645 F.2d 404, 418-20 (5th Cir.) (investors' purchase of undeveloped land accompanied by management contract with third party is insufficient to satisfy *Howey* test because purchasers retained right to exercise control over management and use of property), *cert. denied,* 454 U.S. 897 (1981); Fargo Partners v.Dain Corp., 540 F.2d 912, 913-15 (8th Cir. 1976) (purchase of apartment complex accompanied by management contract failed to satisfy *Howey* test because purchaser retained ultimate control by retaining right to cancel management contract); Darrah v. Garrett, [1984 Transfer Binder]

certain aspects of the test in an effort to update and clarify the requirements necessary to qualify an instrument or transaction as an investment contract.[16]

Despite the Supreme Court's efforts to clarify the requirements of the *Howey* test, uncertainty remains concerning the "commonality" necessary to fulfill the common enterprise requirement of the *Howey* test.[17] Some

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FED. SEC. L. REP. (CCH) 91,472 (N.D. OHIO 1984) (LIMITED PARTNERSHIP INTEREST FAILED TO MEET *Howey* test because limited partners actively managed profit making enterprise); Mosher v. Southridge Assoc., 552 F. Supp. 1231, 1232-33 (W.D. Pa. 1982) (purchase of condominium held not security under *Howey* because investor retained right to determine use and management of condominium); *cf.* Kosnoski v. Bruce, 669 F.2d 944, 945-47 (4th Cir.) (purchase of limited partnership interest qualified as investment contract under *Howey* because limited partners delegated managerial responsibilities to general partners), *cert. denied,* 459 U.S. 832 (1982); Wooldridge Homes v. Bronze Tree, Inc., 558 F. Supp. 1085, 1085-86, 1088 (D. Colo. 1983) (purchase of condominium in preconstruction stage satified *Howey* test because management contract bound purchaser, and because purchaser expected capital appreciation from efforts of developers). For example, discretionary trading accounts between investors and brokers satisfy the relaxed expectation of profits standard of the *Howey* test because the broker possesses the ultimate authority to buy and sell. *Walsh,* 510 F. Supp. at 872; *see* Moody v. Bache & Co., 570 F.2d 523, 526 (5th Cir. 1978) (discretionary trading account satisfies third prong of *Howey* test); Troyer v. Karcagi, 476 F. Supp. 1142, 1147 (S.D.N.Y. 1979) (same). Nondiscretionary trading accounts, on the other hand, fail to satisfy the relaxed standard because the investor retains the ultimate control regarding whether to buy, sell, or hold. *Walsh,* 510 F. Supp. at 872; *see* Poplar Grove Planting & Ref. Co. v. Bache Halsey Stuart, Inc., 465 F. Supp. 585, 588-89 (M.D. La. 1979) (nondiscretionary trading accounts fail to satisfy third prong of *Howey* test).

The relaxed expectation of profits standard, however, continues to require that the ultimate burden of management or development rest on the promoter/developer or investment manager. Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1040 (10th Cir. 1980). Furthermore, the profits expected by the investor may arise from either capital appreciation due to a developer's efforts or direct earnings resulting from the investment manager's efforts. *Forman,* 421 U.S. at 852. The investor, however, must not benefit from the personal use or enjoyment of the investment because the necessary expectation of profit then would be absent. *See Howey,* 328 U.S. at 300 (existence of investment contract requires expectation of return on investment); *Forman,* 421 U.S. at 852-53 (existence of investment contract requires motivation centered on expectation of return rather than personal consumption); *Aldrich,* 627 F.2d at 1040 (Howey expectation of profit does not encompass personal use or enjoyment).

16. *See* Marine Bank v. Weaver, 455 U.S. 551, 557 (1982) (instrument or transaction must contain element of risk to investor and must not be so unique as to appear uncharacteristic of security); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559-60 (1979) (investment must supply a separable element of consideration for "security" received to satisfy *Howey* test); United Hous. Found. v. Forman, 421 U.S. 837, 855-58 (1975) (Howey test requires that profits must result from enterpreneurial or managerial efforts of others and cannot come in form of commodity for personal consumption; *infra* notes 97-159 and accompanying text (discussing Supreme Court's application of *Howey* test); *see also* Casenote, *The Definition of Security;* Marine Bank v. Weaver, 29 B.C. L. REV. 1053, 1056-68 (1983) (discussing development of *Howey* test).

17. *See* Morduant v. Incomco, 105 S. Ct. 801, 802 (1985) (lower courts disagree on requirements of "common enterprise" prong of *Howey* test); Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980) (debate among courts generally focuses on whether horizontal or vertical commonality satisfies *Howey* "common enterprise" requirement), *aff'd,* 456 U.S. 353 (1982); *infra* notes 18-92 and accompanying text (discussing split among lower courts concerning *Howey* common enterprise requirement).

courts, including those in the Third, Sixth, and Seventh Circuits, require a horizontal commonality between investors as an essential element to the existence of a common enterprise.[18] The term horizontal commonality refers to an enterprise in which a promoter pools the funds received from multiple investors and the fortune of each investor is contingent upon the success of the overall venture.[19] In essence, each investor's account must constitute an element of a larger principal account, or investment enterprise, composed of more than one investor account.[20] Additionally, the success of each investor's account must depend on the overall success of the principal account.[21] The significant characteristic of horizontal commonality is that the principal account pools the funds received from the individual accounts, rather than attributing any particular transaction to a specific individual account.[22] As a result, courts applying the horizontal commonality requirement consistently have found that discretionary trading accounts which involve only a one-to-one relationship between an investor and a broker do not constitute investment contracts under the *Howey* test.[23] These courts have explained that the

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18. *See, e.g.,* Salcer v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982) (common enterprise requires pooling of investors' funds); Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 221-22 (6th Cir. 1980) (common enterprise requires horizontal relationship that entails pooling of investors' interests), *aff'd,* 456 U.S. 353 (1982); Milnarik v. M-S Commodities, 457 F.2d 274, 276-77 (7th Cir.) (common enterprise requires joint participation of investors in same investment enterprise), *cert. denied,* 409 U.S. 887 (1972); Berman v. Bache, Halsey, Stuart, Shields, Inc., 457 F. Supp. 311, 319-20 & n.10 (S.D. Ohio 1979) (discretionary account failed to establish common enterprise because of one-to-one relationship between investor and broker); Sunshine Kitchen v. Alanthus Corp., 403 F. Supp. 719, 721-22 (S.D. Fla. 1975) (computer sale/management agreement failed to constitute common enterprise because only one-to-one relationship existed between investor and manager of investment); Wasnovic v. Chicago Bd. of Trade, 352 F. Supp. 1066, 1068-70 (M.D. Pa. 1972) (common enterprise requires pooling of investors' funds), *aff'd,* 491 F.2d 752 (3d Cir. 1973).

19. Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1183 (6th Cir.), *cert. denied,* 454 U.S. 1124 (1981); *see* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277-78 (7th Cir.) (horizontal commonality requires that investors share as joint participants in single investment enterprise), *cert. denied,* 409 U.S. 887 (1972).

20. *See* Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1236 (S.D.N.Y. 1981) (pooling exists when multiple investors hold interests in single enterprise and investors profit pro-rata according to success of enterprise).

21. *Id.; see* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277 (7th Cir.) (horizontal arrangement provides interdependent success or failure of each individual investor's account), *cert. denied,* 409 U.S. 887 (1972). The *Savino* court offered as an example of horizontal commonality an arrangement in which investors place funds in a single account and transactions affect the account as a whole rather than each investor's account individually. *Id.* Furthermore, the *Savino* court explained that the investor's realize the same profit or loss as the single large account on a pro-rata basis of the investor's contributions to the single account. *Id.*

22. *See* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 278 (7th Cir.) (horizontal commonality necessitates pooling of funds for common purpose), *cert. denied,* 409 U.S. 887 (1972); Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 618 F. Supp. 436, 439 (S.D.N.Y. 1985) (horizontal commonality coincides each investor's success or failure to that of all other investors within the investment enterprise).

23. *See, e.g.,* Salcer v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 682 F.2d 459 (3d

accounts fail to satisfy the commonality requirement of the *Howey* test because the one-to-one relationship prevents a pooling of funds, even when the broker enters into identical transactions for several individual accounts.[24]

In *Hart v. Pulte Homes of Michigan Corp.*,[25] the United States Court of Appeals for the Sixth Circuit applied the horizontal commonality requirement to a model home sale-leaseback arrangement and found that a common enterprise did not exist.[26] In *Hart*, individual investors purchased twenty-three homes from Pulte Homes of Michigan Corp. (Pulte) on the condition that the purchasers would lease back the homes to Pulte for use as model homes.[27] Pulte, in return, represented that it would develop the subdivisions in which the homes were located.[28] The investors expected to sell the homes upon completion of the development and realize a profit from the increase in the value of the homes brought about by Pulte's development.[29] Upon failing to realize the expected profits that Pulte had represented, the investors

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Cir. 1982) (discretionary trading account held not security under '33 and '34 Acts because account was not part of pooled group of funds); Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 224 (6th Cir. 1980) (discretionary trading account fails to qualify as security under '33 and '34 Acts because fortunes of investors lack interdependent correlation), *aff'd*, 456 U.S. 353 (1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977) (discretionary trading account fails to satisfy *Howey* test because each account possesses unitary nature with independent success and failure rate); Darrel v. Goodson, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) 97,349, at 97,325 (S.D.N.Y. 1980) (discretionary trading account failed to satisfy *Howey* test because necessary pooling of investors' funds was absent); *cf. infra* notes 43-93 and accompanying text (discussing theories of vertical commonality).

24. *See, e.g.*,*Hirk* v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977) (identical transactions among individual discretionary trading accounts resulting in uniform profits and losses fails to satisfy pooling of funds required for horizontal commonality); Schofield v. First Commodity Corp. of Boston, [1984-1985 Transfer Binder] FED. SEC. L. REP. (CCH) 92,065, at 91,314 (D. Mass. 1985) (trading separate accounts in similar or identical pattern fails to establish horizontal commonality); Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1236-37 (S.D.N.Y. 1985) (identical transactions of individual accounts fails to constitute "pooling" of funds necessary to horizontal commonality); Meredith v. Conticommodity Serv., Inc., [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) 97,701, at 98,671-72 (D.C. 1980) (horizontal commonality requires more than incidental equivalence of profits among individual accounts arising from identical transactions).

25. 735 F.2d 1001 (6th Cir. 1984).

26. *Id.* at 1004-05.

27. *Id.* at 1002. In *Hart v. Pulte Homes of Mich. Corp.*, Pulte Homes of Michigan Corp. (Pulte), the developer, offered to sell model homes located in 21 subdivisions around the Detroit area. *Id.* at 1003. Pulte offered the homes on the condition that the purchasers lease back the homes to Pulte for use as model homes. *Id.* at 1002. The investors in *Hart* purchased 23 homes in 8 subdivisions and entered management leases with Pulte ranging from 18 months to two years. *Id.* at 1003. Pulte represented that the leases would return rental income equal to the annual debt service on a mortgage of 80% of the purchase price. *Id.* Pulte, however, retained the right to cancel a lease if Pulte found a purchaser for a house at market value. *Id.*

28. *Id.* at 1002. In *Hart*, Pulte represented to investors that Pulte would develop the subdivisions containing the homes offered for sale and, thus cause the homes to appreciate in value. *Id.* at 1002.

29. *Id.* at 1002. Relying on Pulte's economic inducements, the *Hart* investors expected to maintain a passive role and benefit solely from Pulte's development efforts. *Id.*

filed suit against Pulte, alleging violations of the '33 and '34 Acts.[30] In addressing the investors' claim that the sale-leaseback arrangements constituted securities under the '33 and '34 Acts, the *Hart* court explained that because the homes purchased by the individual investors were situated in eight different subdivisions, the success of each investment was not tied to a common development enterprise.[31] The *Hart* court held, therefore, that the sale-leaseback agreements failed to satisfy the *Howey* common enterprise requirement.[32] The *Hart* court noted in dicta, however, that horizontal commonality did exist in a situation in which individuals had purchased lots in a single planned subdivision because the success of each individual investment was dependent upon the development of that one subdivision.[33]

Similarly, in *SEC v. Professional Associates*[34] the Sixth Circuit applied the horizontal commonality standard to investment trust accounts.[35] In *Professional Associates,* investment promoters offered interests in an investment trust account to individual investors.[36] The promoters circulated brochures which represented that the trust would pool the investor's funds rather than transact each account individually.[37] In determining whether the trust accounts constituted investment contracts subject to regulation under the '33 and '34 Acts, the Sixth Circuit first established that the trust accounts satisfied the first and third prongs of the *Howey* test.[38] The Sixth Circuit

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30. *Id.* at 1002. In *Hart,* the purchasers of the homes alleged that Pulte's representations were false and misleading and that the sale and lease-back arrangements constituted securities under the '33 and '34 Acts and, therefore, necessitated registration. *Id.; cf.* S.E.C. v. C.M. Joiner Leasing Corp., 320 U.S. 344, 348 (1943) (existence of security requires more than sale of interests of land).

31. *See* Hart, 735 F.2d at 1004-5. The *Hart* court found that the *Howey* common enterprise element requires a pooling of individual investor's funds to create an interdependency of success or failure. *Id.* Because the success of each investor's investment was not tied to the development of a single subdivision, the *Hart* court found that the requisite commonality was absent. *Id.*

32. *Id.*

33. *Id.; see* Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1039-40 (10th Cir. 1980) (recognizing that purchase of lots in single development area may satisfy *Howey* common enterprise element).

34. 731 F.2d 349 (6th Cir. 1984).

35. *Id.* at 353-55.

36. *Id.* at 353-54.

37. *Id.* at 354. The promotional brochures in *S.E.C. v. Professional Assoc.* emphasized the increased purchasing power that the pooling of funds within the trust would create in comparison to the purchasing power of an individual investor. *Id.*

38. *Id.* at 354. In *Professional Assoc.,* the Securities and Exchange Commission (SEC) sought to enjoin the promoters from offering or selling the trust account investments, claiming that the investments were securities and that the promoters were selling the investments in violation of the registration and antifraud provisions of the '33 and '34 Acts. *Id.* at 351. The district court granted the injunction, and the promoters appealed to the Sixth Circuit, contending that the district court erred in finding that the trust account investments constituted securities under the '33 and '34 Acts. *Id.* The promoters, however, conceded that the trust account investments satisfied the first prong of the *Howey* test, which requires the investment of money, as well as the third prong which requires that the investor expect profits based on the efforts of others. *Id.* at 354; *see supra* note 16 (discussing relaxed standard of third prong of *Howey* test).

then applied the horizontal commonality standard to determine whether the trust accounts satisfied the common enterprise prong of the *Howey* test.[39] Although the actual trust agreements stipulated that the promoters would manage each account on an individual basis, the Sixth Circuit looked beyond the agreements to the economic reality of the accounts.[40] The *Professional Associates* court concluded that because the promotional brochures represented a pooling of investors' funds and because the promoters, in fact, did pool the investors' funds, the trust accounts also satisfied the horizontal commonality standard imposed under the *Howey* test.[41]

Although courts generally agree that the presence of horizontal commonality satisfies the *Howey* common enterprise requirement, some courts adhere to a less stringent interpretation of common enterprise which requires only a vertical relationship between the investor and the promoter or investment manager.[42] Courts applying the vertical commonality standard, however, differ in their interpretation of the type of relationship necessary to satisfy the *Howey* common enterprise requirement.[43] Some courts apply a broad concept of vertical commonality and require only a one-to-one relationship or link between the investor and the promoter without requiring any interdependency of fortune and success between the investor and either the promoter or other investors.[44] Courts applying the broad approach expressly reject the pro rata sharing of profits requirement essential to

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39. *Professional Assoc.*, 731 F.2d at 354-55.

40. *Id.* at 354-55. In disregarding the trust agreements in favor of the actual management of the trust accounts, the *Professional Assoc.* court relied on *Tcherepnin v. Knight* in which the Supreme Court recognized that the substance and economic reality of a transaction or financial arrangement should control the determination of whether a security exists. *Id.* at 354; *see* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); *infra* notes 123-29 and accompanying text (discussing *Knight).*

41. *Professional Assoc.*, 731 F.2d at 354-55. The *Professional Assoc.* court also considered whether a second type of trust account promising a 9% annual return and requiring only a $25 minimum deposit constituted a security. *Id.* at 35. The *Professional Assoc.* court held that the rate of return in comparison to the minimum payment, coupled with the promotional brochure that implied a pooling of funds, justified concluding that the second type of trust accounts constituted securities. *Id.* at 354-56.

42. *See* Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1236-37 (S.D.N.Y. 1981) (recognizing general acceptance of horizontal commonality as compared to less stringent vertical commonality approaches).

43. *See infra* notes 44-56 and accompanying text (discussing cases adopting broad view of vertical commonality); *infra* notes 57-92 and accompanying text (discussing cases adopting narrow view of vertical commonality).

44. *See, e.g.*, S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 527 (5th Cir. 1974) (requisite commonality for *Howey* test exists when investor's return depends upon promoter's efforts and expertise); Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983) (one-to-one relationship satisfies common enterprise element of *Howey* test); Alvord v. Shearson Hayden Stone, Inc., 485 F. Supp. 848, 853 (D. Conn. 1980) (common enterprise requires only one-to-one relationship between investor and investment manager); Troyer v. Karcagi, 476 F. Supp. 1142, 1147 (S.D.N.Y. 1979) (one-to-one relationship between investor and investment manager creates common enterprise).

horizontal commonality[45] and, instead, focus on whether the fortune and success of the investor depends ultimately on the efforts and skill of the promoter or investment manager.[46] As a result, courts following the broad approach to vertical commonality consistently have found that any discretionary brokerage account satisfies the common enterprise element of the *Howey* test.[47]

The application of the broad concept of vertical commonality, however, extends beyond investor-broker relationships, as evidenced by *McLish v. Harris Farms, Inc.*[48] In *McLish*, the District Court for the Eastern District of California applied a broad concept of vertical commonality to determine whether a cattle feedlot operation satisfied the *Howey* common enterprise requirement.[49] In *McLish*, Harris Farms, Inc. (Harris Farms), the promoter, financed, purchased, and cared for cattle in feedlots owned and operated by Harris Farms.[50] The purchaser/investor, McLish, entered into a contract with Harris Farms whereby Harris Farms would purchase and feed cattle for McLish until the cattle were fattened and ready to market.[51] Harris Farms purchased and managed the desired amount of cattle and, subsequently, marketed and sold the cattle on behalf of McLish.[52] The override on feed and interest, in addition to the general management fee, represented the

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45. *See* S.E.C. v. Continental Commodities, 497 F.2d 516, 522 (5th Cir. 1974) (pro-rata sharing of profits is not essential to finding commonality under *Howey* test); Alvord v. Shearson Hayden Stone, Inc., 485 F. Supp. 848, 853 (D. Conn. 1980) (commonality exists without pro-rata sharing of profits).

46. *See, e.g.*, S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974) (requisite commonality of *Howey* test merely requires interdependency of investor's success and efforts of promoter); S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (critical inquiry in commonality determination is whether success of investment depends upon promoter's expertise).

47. *See, e.g.*, S.E.C. v. Continental Commodities Corp., 597 F.2d 516, 519-22 (5th Cir. 1974) (discretionary trading accounts satisfy *Howey* test); Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983) (discretionary securities and commodities trading accounts constitute securities under '33 and '34 Acts); Alvord v. Shearson Hayden Stone, Inc., 485 F. Supp. 848, 853 (D. Conn. 1980) (discretionary stock option trading account constitutes security under '33 and '34 Acts); Troyer v. Karcagi, 476 F. Supp. 1142, 1147 (S.D.N.Y. 1979) (discretionary securities trading accounts constitute investment contracts).

48. 507 F. Supp. 1075 (E.D. Cal. 1980).

49. *Id.* at 1080-85.

50. *Id.* at 1076-78.

51. *Id.* at 1077-79. In *McLish v. Harris Farms, Inc.*, a feedlot operator, Harris Farms, Inc. (Harris Farms), performed services for its customers such as locating, financing, purchasing, and arranging transportation for cattle to the feedlot. *Id.* at 1078. In addition, Harris Farms constantly monitored the cattle at the feedlot to insure that the cattle remained healthy and that the feeding process continued in an efficient manner. *Id.* at 1077, 1088-89. Furthermore, the purchaser/investor in *McLish* relied on Harris Farms' efforts and skills in determining when to sell the cattle and in procuring a subsequent purchaser of the cattle. *Id.* at 1078-80, 1084.

52. *Id.* at 78-80. In *McLish*, Harris Farms retained the authority to determine when the cattle were fattened and ready to sell. *Id.* at 1085. The dispute in *McLish* arose out of disagreements between the purchaser/investor and Harris Farms concerning the manner in which Harris Farms conducted the selling process. *Id.*

benefit to Harris Farms.[53] McLish, on the other hand, would profit only if the price of cattle rose between the purchase and sale date.[54]

In determining whether the feedlot venture was a security under the '33 Act, the *McLish* court held that although Harris Farms benefited regardless of whether McLish received a profit from the enterprise, the venture constituted an investment contract because the investor relied on the expertise and efforts of Harris Farms in caring for and marketing the cattle to generate potential profits.[55] *McLish,* accordingly, evinces an acceptance of the broad concept of vertical commonality in finding that the feedlot venture qualified as an investment contract, despite the lack of any interdependency of success between McLish and either other investors or the promoter, Harris Farms.[56]

In contrast to the liberal concept of vertical commonality which the Fifth Circuit and various lower courts have adopted, other courts apply a more narrow interpretation of vertical commonality.[57] Under the narrow concept

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53. *Id.* at 1083; *see id.* at 1077 (Harris Farms benefitted solely from keeping feedlots full of customer cattle).

54. *See id.* at 1083, 1077-78. In addition to any expectation of profits, McLish also expected to receive significant tax benefits from the feedlot venture. *Id.*

55. *Id.* at 1083-84. In *McLish,* McLish was dissatisfied with the procedure through which Harris Farms marketed and sold McLish's cattle. *Id.* at 1078-80. McLish filed suit against Harris Farms to recover the losses incurred in selling the cattle, alleging that the feedlot venture was a security under the '33 Act and that Harris Farms' failure to file a registration statement violated the '33 Act. *Id.* at 1075; *see* 15 U.S.C. § 77e (1982) ('33 Act requires filing of registration statement in connection with sale of security). The *McLish* court, in line with the broad view of commonality, emphasized that McLish relied on the efforts of Harris Farms to effectuate a successful transaction. *McLish,* 507 F. Supp. at 1075; *see supra* note 46 and accompanying text (broad view of vertical commonality focuses on whether efforts and skill of promoter determine success or failure of enterprise). The *McLish* court, accordingly, determined that Harris Farms provided the managerial skills essential to the failure or success of the enterprise and that the requisite commonality thereby was satisfied. *McLish,* 507 F. Supp. at 1083-85; *see id.* at 1088-90 (discussing responsibilities and managerial functions of Harris Farms).

56. *See McLish,* 507 F. Supp. at 1079-85 (feedlot venture in *McLish* constituted investment contract); *supra* notes 44-46 and accompanying text (broad concept of vertical commonality requires only one-to-one relationship with expectation of success from efforts of promoter); *cf. supra* notes 19-22 and accompanying text (horizontal commonality requires pooling of investors' funds); *infra* notes 57-62 and accompanying text (narrow concept of vertical commonality requires some degree of commonality of success and failure between investor and promoter).

57. *See, e.g.,* S.E.C. v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 484 n.7 (9th Cir.) (common enterprise requires interdependency of success between investor and either third party or other investor), *cert. denied,* 414 U.S. 821 (1973); Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc., 686 F.2d 818, 819 (9th Cir. 1982) (discretionary trading account not investment contract because broker received commission regardless of account's profitability), *cert. denied,* 460 U.S. 1023 (1983); Brodt v. Bache & Co., Inc., 595 F.2d 459, 461 (9th Cir. 1978) (vertical commonality mandates interdependency between investor and promoter without requiring involvement of multiple investors); Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 618 F. Supp. 436, 439 (S.D.N.Y. 1985) (common enterprise requires interrelation of fortunes of members); Mechigian v. Art Capital Corp., 612 F. Supp. 1421, 1425-27 (S.D.N.Y. 1985) (acknowledging different concepts of vertical commonality); Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1237 (S.D.N.Y. 1981) (vertical relationship that entails interweaving of suc-

of vertical commonality, courts require at least some degree of interdependency between the fortune and success of the investor and either the promoter or other investors.[58] Courts applying the narrow concept, however, do not

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cess between promoter and investor presents acceptable common enterprise structure); Meredith v. Conticommodity Serv., Inc., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) 97,701, at 98,670-72 (D.C. 1980) (recognizing distinction of commonality views applied by courts); Securities Investor Protection v. Associated Underwriters, 423 F. Supp. 168, 178 (D. Utah 1975) (interrelationship between investor and promoter creates common enterprise).

58. *See* S.E.C. v. Glenn W. Turner Enter., 474 F.2d 476, 481-82 & n.7 (9th Cir.) (vertical commonality exists when success or failure of investor correlates with success or failure of either third party or other investors), *cert. denied,* 414 U.S. 821 (1973); *see also* Brodt v. Bache & Co., Inc., 595 F.2d 459, 461 (9th Cir. 1978) (vertical commonality requires at least some correlation of investors and investment manager's success); Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 518 F. Supp. 436, 439 (S.D.N.Y. 1985) (common enterprise demands some degree of correlation of members' fortunes); Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1235-39 (S.D.N.Y. 1981) (recognizing distinction between horizontal and vertical commonality approaches); Meredity v. Conticommodity Service, Inc., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) 97,701 at 98,670-72 (D.C. 1980) (acknowledging various approaches to common enterprise inquiry); *supra* notes 19-42 and accompanying text (discussing horizontal commonality approach).

S.E.C. v. Glenn W. Turner Enterprises is the landmark case that established the narrow concept of vertical commonality. *See Turner,* 474 F.2d at 481-82 & n.7; *see also Brodt,* 595 F.2d at 460 (adopting *Turner* definition of common enterprise); Savino v. E.F. Hutton, 507 F. Supp. 1225, 1237 (S.D.N.Y. 1981) (recognizing impact of *Turner).* In *Turner,* the Ninth Circuit considered whether a pyramid scheme requiring minor efforts from investors, but ultimately dependent upon the promoters for success, constituted an investment contract under *Howey. Turner,* 474 F.2d at 480-83. The pyramid scheme in *Turner* involved a scam arrangement whereby purchasers of interests in the enterprise received self-motivation packets. *Id.* at 478. Based on the status of the purchasers, which depended upon the purchase price of the interest, the purchasers performed various skills at conventions held by the enterprise to induce new prospects to purchase an interest. *Id.* at 478-79. High level purchasers, or those who invested the greater amounts of money, became salesmen and received a percentage of sales income from the enterprise according to the number of sales the individual purchaser consummated. *Id.* at 478. Horizontal commonality did not exist under the scheme because each investor/purchaser profited on an individual basis pro-rata with the enterprise. *Id.* In considering whether the pyramid scheme transactions constituted a security, the *Turner* court found that a common enterprise existed between purchasers sharing pro-rata in income with the enterprise because the success of the individual investor/purchaser was interwoven with and dependent upon the success of the enterprise. *Id.* at 481-82 & n.7. Since *Turner,* many courts have adopted the narrow concept of vertical commonality as the standard by which to judge the existence of a common enterprise, recognizing that the rigid pooling requirement of the horizontal concept is too strict a standard. *See* Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981) (courts should not penalize investor simply because he is alone in his misfortunes); *supra* note 57 (identifying courts that have adopted narrow concept of vertical commonality).

At least one court expressly has stated that the requisite commonality for the narrow concept of vertical commonality requires not only that the fortunes of investor and promoter must rise together, but also that the fortunes must fall together. *See* Michigan v. Art Capital Corp., 612 F. Supp. 1421, 1427 (S.D.N.Y. 1985) (relying on *Savino* in explaining narrow concept of vertical commonality); *see also Savino,* 507 F. Supp. at 1237 (vertical commonality exists when fortunes of investor and investment manager rise and fall together). The contention that the fortunes must fall together, however, appears irrelevant to the existence of a common enterprise because the relevant inquiry remains whether some degree of commonality exists. *See*

require strict interdependency among multiple investors as the horizontal approach demands.[59] In essence, courts adhering to the narrow concept of vertical commonality require that only some degree of correlation between the fortunes of the members of a venture exist to create a "common" enterprise.[60] The correlation, however, need not entail a pooling of investors' funds.[61] Under the narrow vertical commonality approach, therefore, a one-to-one relationship between an investor and a promoter or investment manager may satisfy the *Howey* common enterprise requirement, provided that a requisite correlation of success or failure between the two parties exists.[62] For example, in *Brodt v. Bache & Co.*,[63] the Ninth Circuit considered whether a discretionary trading account constituted an investment contract under the *Howey* test.[64] In *Brodt*, representatives of Bache & Co., an investment brokerage firm, maintained discretionary authority to trade with funds from an investor's account and collected a commission on each transaction regardless of the overall success of the account.[65] Applying the

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Savino, 507 F. Supp. at 1237 (stating that investor and investment manager's fortunes must rise *and fall* together, but holding that discretionary trading account constitutes investment contract because broker received 10% commission on profits of account); *Silverstein*, 518 F. Supp. at 439 (essential element of common enterprise is direct relation between fortunes of enterprise members); Morduant v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982) (direct relationship between success or failure of members of enterprise must exist to create "common" enterprise).

59. *See supra* note 58 and accompanying text (discussing vertical concept of commonality); *cf. supra* notes 18-41 and accompanying text (discussing horizontal commonality).

60. *See* Brodt v. Bache & Co., Inc., 599 F.2d 459, 461 (9th Cir. 1978) (common enterprise requires correlation of profit and loss among participants); Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 618 F. Supp. 436, 439 (S.D.N.Y. 1985) (correlation of fortunes between enterprise members constitutes essential element of common enterprise); *supra* note 58 and accompanying text (vertical commonality requires interdependency of enterprise members' fortunes).

61. *See* Brodt v. Bache & Co., Inc., 595 F.2d 459 (9th Cir. 1978) (vertical commonality exists without presence of multiple investors in venture); Securities Investor Protection Corp. v. Associated Underwriters, Inc., 423 F. Supp. 168, 178 (D. Utah 1975) (vertical commonality alleviates pooling of funds requirement from common enterprise); *supra* notes 57-59 and accompanying text (discussing narrow view of vertical commonality).

62. *See* Brodt v. Bache & Co., Inc., 595 F.2d 459, 461 (9th Cir. 1978) (vertical commonality requires investor and promoter commonality without necessitating involvement of other investors); Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981) (purpose of vertical commonality is to not deny protection of securities laws to single investor solely because of absence of co-investors); Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1237-39 (S.D.N.Y. 1981) (individual investors trading accounts comprise common enterprise when interdependency of investor's and broker's fortunes exists).

63. 595 F.2d 459 (9th Cir. 1978).

64. *Id.* at 460-62. In *Brodt v. Bache & Co., Inc.*, an employee of Bache & Co. induced one of the plaintiffs, Robert T. Brodt, to open a discretionary commodities futures account with Bache & Co. *Id.* at 460. The Bache employee represented that the investments would reap large economic profits and Brodt's resulting account allowed employees of Bache & Co. to trade with the funds at the employees' discretion. *Id.* Bache & Co. lost all of Brodt's invested money and the company through which Bache & Co. had purchased the futures became insolvent. *Id.* at 460. Brodt subsequently filed suit claiming that Bache & Co. had violated the '33 and '34 Acts. *Id.*

65. *Id.* at 460.

narrow vertical commonality approach to determine whether the trading account created a common enterprise under the *Howey* test, the *Brodt* court held that the account failed to satisfy the common enterprise requirement of the *Howey* test because the brokers profited by commissions based solely on the frequency of account transactions, rather than on the profitability of the account.[66] In comparison, the district court for the Southern District of New York in *Savino v. E.F. Hutton & Co.*[67] adopted the narrow concept of vertical commonality in finding that a discretionary trading account satisfied the common enterprise requirement of the *Howey* test.[68] The *Savino* court explained that because the broker in *Savino* took a bonus of ten percent of the account's profit, the success of the investor and of the broker were interdependent and, accordingly, satisfied the narrow concept of vertical commonality.[69]

The Tenth Circuit recently adopted the narrow concept of vertical commonality, holding in *McGill v. American Land & Exploration Co.*[70] that a joint venture of two equal partners, an investor and a developer, created a common enterprise under the *Howey* test.[71] In *McGill,* Joe Vance, a representative of defendant Commercial Funding Corporation (Commercial), approached Gene McGill regarding a real estate venture.[72] Vance sought to induce McGill to invest $80,000 in a joint venture with Commercial for the purpose of developing a residential subdivision.[73] Vance represented the

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66. *Id.* at 461-62. The Ninth Circuit in *Brodt* expressly rejected the horizontal approach of commonality as well as the broad vertical approach, explaining that merely providing investment counseling does not constitute a common enterprise. *Id.* In addition to finding that the existing investor-broker relationship failed to fall within the narrow concept of commonality, the *Brodt* court explained that the investor did not share his profits and the financial success of the investor was unrelated to the financial success of the broker. *Id.* at 462.

67. 507 F.2d 1225 (S.D.N.Y. 1981).

68. *Id.* at 1237-39. The plaintiffs in *Savino v. E.F. Hutton & Co., Inc.*, the Savinos, maintained discretionary trading accounts with defendant E.F. Hutton & Co. (E.F. Hutton). *Id.* at 1228-29. Under the account agreements in *Savino,* E.F. Hutton received 10% of the accounts' profits as a bonus. *Id.* at 1230, 1239; E.F. Hutton failed to disclose information concerning the financial situation of the Savino accounts, and the Savinos filed suit claiming violations of the '33 and '34 Acts. *Id.* at 1228-31. In determining whether the Savino accounts constituted securities under the '33 and '34 Acts, the *Savino* court applied the *Howey* test. *Id.* at 1235-39. The *Savino* court first found that the accounts failed to satisfy the horizontal concept of common enterprise because E.F. Hutton treated the funds of each separate account on an individual basis, rather than pooling the funds into a single account. *Id.* at 1236-37. The *Savino* court explained, however, that the absence of horizontal commonality did not preclude the existence of a common enterprise. *Id.* at 1237. The *Savino* court then applied the narrow concept of vertical commonality and determined that each individual account created a common enterprise between the investor and E.F. Hutton. *Id.* at 1237-39.

69. *Id.* at 1239. The *Savino* court explained that a one-to-one relationship creates a common enterprise when an interdependency between the profits and losses of the two parties exists. *Id.* at 1238.

70. 776 F.2d 923 (10th Cir. 1985).

71. *Id.* at 925-26.

72. *Id.* at 923-24.

73. *Id.* at 924.

investment as "sure-fire" and "risk free" on the basis that American Land & Exploration Company (American), a codefendant, had agreed to purchase all of the lots in the subdivision after the completion of certain agreed upon improvements by the joint venture.[74] McGill invested the $80,000 with the expectation of sharing in the operating profits generated by the joint venture.[75] Commercial, however, failed to develop the subdivision, and, as a result, the joint venture never became active.[76] McGill filed a civil suit in the United States District Court for the Western District of Oklahoma against Commercial, American, and various promoters, including Vance, claiming that the defendants misrepresented material facts concerning the joint venture in violation of the '33 and '34 Acts.[77] Applying the *Howey* test, the district court considered whether the joint venture constituted an investment contract.[78] The district court adopted the horizontal concept of commonality and found that the vertical relationship between a single investor and a promoter failed to satisfy the common enterprise requirement of the *Howey* test.[79] The district court subsequently dismissed all of McGill's claims.[80] McGill appealed to the United States Court of Appeals for the Tenth Circuit.[81]

On appeal, the Tenth Circuit considered whether the joint venture between McGill and the defendants provided the commonality necessary to

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74. *Id.* In *McGill v. American Land & Exploration Co.*, the promoters provided written representation to the plaintiff, Gene McGill, that American Land & Exploration Co. had agreed to purchase lots in the proposed subdivision from the joint venture after the joint venture completed certain developments, including water, sewer, and street installation. *Id.; see* Brief for Appellant at 3, McGill v. American Land & Exploration Co., 776 F.2d 923 (10th Cir. 1985) [hereinafter cited as Brief for Appellant]. The agreed upon purchase price for each lot was $9,800. 776 F.2d at 924.

75. *McGill,* 776 F.2d at 924-25. In *McGill,* McGill expected to receive one-half of the operating profits plus his original investment upon the liquidation of the joint venture. *Id.* at 925.

76. *McGill,* 776 F.2d at 924. In *McGill,* after McGill invested $80,000 in the joint venture the defendants made no progress in developing the proposed subdivision. *Id.;* Brief for Appellant, *supra* note 74, at 4. In explaining the delay in progress to McGill, the defendants misrepresented that replatting and bureaucratic delays were responsible for slowing the progress when, in fact, certain contractors that had performed work on the project had not been paid. Brief for appellant, at 4.

77. 776 F.2d at 924. In *McGill,* in addition to alleging violations of the '33 and '34 Acts, McGill also claimed that the misrepresentations violated rule 10b-5 of the Securities Exchange Act of 1934, the Racketeer Influenced and Corrupt Organization (RICO) Act, and various Oklahoma statutes. *See id.* at 925; *see also* 17 C.F.R. § 240.10b-5 (S.E.C. rule 10b-5); 18 U.S.C. §§ 1961-1968 (1982) (RICO).

78. *McGill,* 776 F.2d at 924; *see supra* notes 12-16 and accompanying text (discussing *Howey* test); *infra* notes 107-22 and accompanying text (discussing Supreme Court decision in *Howey).*

79. *McGill,* 776 F.2d at 924.

80. *Id.* Upon determining that the *McGill* transaction did not constitute a security, the *McGill* district court dismissed all of McGill's claims without considering any further evidence. *Id.*

81. *Id.* at 923.

satisfy the *Howey* common enterprise requirement.[82] The Tenth Circuit initially recognized that several other circuits adhere to the rigid horizontal commonality requirement.[83] The Tenth Circuit observed, however, that the *Howey* opinion contemplates a judicial application of the *Howey* doctrine based on the economic reality of the transaction.[84] In light of *Howey's* emphasis on economic reality, the *McGill* court stated that the correct common enterprise test should consider whether the transaction is purely commercial in nature or, in reality, an investment.[85] The Tenth Circuit explained that when the economic reality of a transaction indicates that the transaction is an investment, the transaction creates a common enterprise and qualifies as a "security" under the *Howey* test, regardless of whether horizontal commonality exists.[86]

Applying the economic reality rationale to the *McGill* joint venture, the Tenth Circuit found that because McGill invested money with the expectation of obtaining a return based on the joint venture's operating profits, rather than from capital appreciation, the transaction constituted an investment.[87] The Tenth Circuit distinguished a commercial transaction as providing a specified rate of return and an absence of any right to participate in the operation profits derived from the transaction.[88] Furthermore, the Tenth Circuit found that because McGill expected to share in the joint venture's operating profits with Commercial, the joint venture constituted a common enterprise.[89] Accordingly, the Tenth Circuit held that the joint venture investment scheme satisfied the common enterprise requirement of the *Howey* test.[90] In support of the *McGill* holding, the Tenth Circuit stated that a lack

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82. *Id.* at 924.

83. *Id.* at 924. *See generally* Salcer v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 682 F.2d 459 (3d Cir. 1982) (following horizontal commonality requirement); Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216 (6th Cir. 1980) (same); Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir. (same), *cert. denied,* 409 U.S. 887 (1972); *see also supra* notes 18-42 and accompanying text (discussing horizontal commonality requirement).

84. *See id.* at 925. The *McGill* court relied on the clarification of the *Howey* test announced in *Tcherepnin v. Knight* to emphasize the economic reality of a transaction over the rigid horizontal commonality requirement. *Id.; see* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (Howey requires substance over form analysis with emphasis on economic reality); *infra* notes 123-29 and accompanying text (discussing *Knight).*

85. *McGill,* 776 F.2d at 925.

86. *See id.* at 925-26 (McGill Court found one-to-one vertical relationship between investor and promoter satisfies *Howey* test).

87. *Id.* at 925.

88. *Id.*

89. *Id.* at 925-26.

90. *Id.* at 926. Although the *McGill* joint venture satisfied the common enterprise requirement of the *Howey* test, joint venture and general partnership interests generally do not constitute a security under the '33 and '34 Acts because these types of interests often entail the exercise of extensive control over the profit and loss potential of the enterprise by the investors and, thus, violate the third prong of the *Howey* test. *See, e.g.,* Goodwin v. Elkins & Co., 730 F.2d 99, 102-04 (3d Cir.) (general partnership interest held not security under *Howey* test because general partner possesses right to exercise extensive control in partnership matters),

of horizontal commonality cannot obscure the economic reality of a transaction or bar the existence of a common enterprise under the *Howey* test.[91] Although the *McGill* court did not adopt expressly the narrow concept of vertical commonality, the court's emphasis on McGill and Commercial's interdependency of success appears to evince an endorsement of the narrow view of vertical commonality.[92]

Although a split of authority exists among the lower courts concerning whether a common enterprise requires horizontal or a form of vertical commonality, the Supreme Court expressly has declined to decide the issue.[93] Moreover, in those cases in which the Supreme Court has applied the substance over form analysis embodied in the *Howey* test and found that an investment contract existed, horizontal commonality appears to have been present.[94] The Supreme Court has declined, however, to state specifically that a common enterprise requires horizontal commonality, as opposed to only vertical commonality.[95] Rather, the decisions in which the Supreme Court has considered the existence of an investment contract emphasize the economic reality of the transaction and the congressional intent to construe the definition of a security in a broad sense to include as wide an array of proposed profit seeking activities in the commercial setting as possible.[96]

For example, in *SEC v. C.M. Joiner Leasing Corporation,*[97] the Supreme Court's first attempt to define an investment contract, the Court considered whether assignments of oil leases for the purpose of financing the drilling of

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cert. denied, 105 S. Ct. 118 (1984); Gordon v. Terry, 684 F.2d 736, 741 (11th Cir. 1982) (general partnership interests generally do not constitute securities under '33 and '34 Acts because general partners retain right to control significant partnership decisions), *cert. denied,* 103 S. Ct. 1188 (1983); Oxford Finance Cos. v. Harvey, 385 F. Supp. 431, 432-35 (E.D. Pa. 1974) (joint venture held not security under '33 and '34 Acts because joint venture agreement required that both venturers must consent to all management decisions); *see also* Darrah v. Garret, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) 91,472, at 93,364-65 (N.D. Ohio 1984) (limited partnership interest held not security under '33 and '34 Acts because limited partners retained extensive control over profit and loss potential of partnership).

91. *McGill,* 776 F.2d at 926.

92. *See id.* The *McGill* court directly linked McGill's expectation of sharing in the operating profits of the joint venture to the court's holding that the joint venture qualified as a common enterprise. *Id.*

93. *See* Morduant v. Incomco, 105 S. Ct. 801 (1985) (declining to address *Howey* commonality issue).

94. *See* Tcherepnin v. Knight, 389 U.S. 332 (1974) (savings and loan pooled investors' funds as working capital); S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1949) (promoter pooled investors' funds to benefit promoter's citrus enterprise); S.E.C. v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) (promoter pooled investors' funds to finance proposed drilling of oil well); *see also infra* notes 97-159 and accompanying text (discussing Supreme Court's application of economic reality theory embodied in *Howey* opinion).

95. *See infra* notes 97-159 and accompanying text (discussing Supreme Court's treatment of *Howey* economic reality rationale).

96. *Id.; see* 1933 HOUSE REPORT, *supra* note 8, at 11 (Congress intended '33 and '34 Acts to regulate wide range of instruments within the ordinary concept of security).

97. 320 U.S. 344 (1943).

a test well constituted investment contracts under the '33 Act.[98] In *Joiner,* the promoter, Joiner Leasing Corporation (Joiner Leasing), sought multiple investors to purchase leaseholds surrounding a proposed drilling site.[99] The promoters represented the leases as providing an opportunity for "splendid returns" and assured the investors that Joiner Leasing would complete a test well to determine the oil producing capacity of the leaseholds.[100] The investors relied on both the economic inducements of Joiner Leasing in purchasing the leaseholds, and the proposed efforts of Joiner Leasing's drilling of a test well to provide the expected returns.[101] Joiner Leasing's venture embodied horizontal commonality because, as the *Joiner* Court recognized, the fortunes of the holders of the leaseholds depended on the overall success of the exploration enterprise into which Joiner Leasing purportedly had pooled the investors' funds.[102] Relying on the character of the lease assignments in commerce as established by Joiner Leasing's offering, the *Joiner* Court found that the leaseholds constituted investment contracts.[103] The *Joiner* Court emphasized that the economic reality of the leasehold offerings as represented to the investors should control the existence of an investment contract.[104] In addition, the *Joiner* Court recognized that by including such catch-all phrases as "investment contract" and "instruments commonly

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98. *Id.* at 345-46. In *Joiner,* the owners of a parcel of land granted leases to a promoter, Joiner Leasing Corporation (Joiner Leasing), on the understanding that Joiner Leasing would drill a test well. *Id.*

99. *Id.*

100. *Id.* at 346 & n.3. In *Joiner,* Joiner Leasing mailed sales campaigns to approximately 1,000 people throughout the several states in an effort to attract investors. *Id.* at 346. The sales literature contained the terms of the leases offered and insured the prospective investors that Joiner Leasing would complete the test well. *Id.* at 346. In addition, the literature contained optimistic opinions regarding the potential success of the venture. *Id.* at 346 n.3.

101. *Id.* at 347-49. The *Joiner* Court emphasized that the presence of the economic inducements in Joiner Leasing's offer distinguished the offer from that of an ordinary leasehold. *Id.* at 348.

102. *Id.* at 348. In *Joiner,* Joiner Leasing represented to prospective investors that Joiner Leasing would employ the money received from the investors to drill a test well. *Id.* at 346. The investors purchased leaseholds surrounding the proposed drilling site and expected to profit from the increase in the value of the leaseholds based upon the success of the drilling enterprise. *Id.* at 346-48. Absent the drilling of the test well, the leases possessed virtually no value. *Id.* at 349. The success of all of the investors in *Joiner,* therefore, depended upon the success of the drilling enterprise as a whole. *Id.*

103. *Id.* at 349-53. In *Joiner,* the Court recognized that Joiner Leasing's offerings embodied not only a lease, but also a development project. *Id.* at 349. The *Joiner* Court then explained that because the development project was the sole reason for Joiner Leasing's offering the leaseholds and because the drilling enterprise provided the incentive and value of the offerings, the leaseholds constituted investment contracts. *Id.* Supporting the conclusion that the leaseholds constituted investment contracts, the *Joiner* Court noted that courts should apply a flexible interpretation to descriptive terms such as "investment contract," consistent with the economic character of the instrument in question. *Id.* at 351. The *Joiner* court further explained that the economic, or commercial, character of an instrument depends on the "terms of the offer, the plan of distribution, and the economic inducements" as represented to prospective investors. *Id.* at 353.

104. *Id.* at 352-53; *see supra* note 103 (discussing *Joiner's* approach to economic reality).

known as a security" in the '33 Act's definition of a security,[105] Congress intended the application of the '33 Act to extend beyond the obvious and commonplace and to reach all instruments that possess the character of a security in the commercial setting.[106]

Three years after deciding *Joiner*, the Supreme Court in *SEC v. W.J. Howey Co.*[107] refined the "character in commerce" definition of an investment contract.[108] In *Howey*, the promoter, Howey Company (Howey Co.), owned large tracts of citrus acreage in Florida.[109] Howey-in-the-Hills Service, Inc., (Hills) cultivated and developed many of Howey Co.'s groves.[110] In an effort to finance additional development, Howey Co. offered approximately one-half of the citrus acreage to the public.[111] Howey Co. provided to each prospective customer both a land sales contract and a service contract, advising each prospect that to invest in a grove would not be feasible unless service arrangements were made.[112] Howey Co. stressed the superiority of Hills, and, as a result, Hills obtained contracts covering eighty-five percent of the acreage sold during a three year period.[113]

Although the land sales contracts conveyed a specific plot of land to each purchaser,[114] small land marks distinguishable only through a plat record book provided the sole means of dividing the tracts.[115] In addition, under the service contracts the owners of the land possessed no right to the fruit produced by the trees on their individual plats of land.[116] Instead, Howey Co. and Hills would pool all the harvested fruit and allocate the profits attributable to each tract to the owner based on a "check" made at the time of picking.[117] Horizontal commonality appears present in the *Howey* scheme because Howey Co. pooled the investors' funds in the Howey Co. citrus enterprise.[118]

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105. *See supra* note 7 (text of '33 and '34 Acts' definition of "security").

106. *Id.* at 341; *see* 1 L. Loss, SECURITIES REGULATIONS 483-511 (2d ed. 1961) (courts have employed "investment contract" as "catch-all" phrase).

107. 328 U.S. 293 (1946).

108. *Id.* at 298-301.

109. *Id.* at 295.

110. *Id.* In *S.E.C. v. W.J. Howey Co.*, W.J. Howey Co. (Howey Co.) and Howey-in-the-Hills Service, Inc. (Hills) were corporations under common control and management. *Id.*

111. *Id.* In *Howey*, the Securities and Exchange Commission (SEC) alleged that Howey Co. violated the registration requirements of § 5(a) of the '33 Act. *Id.* at 293-94; *see* 15 U.S.C. § 77(e)(A) (1982) (section 5(a) of '33 Act prohibits sale of unregistered securities).

112. *Howey*, 328 U.S. at 295.

113. *Id.* In *Howey*, the service contracts gave Hills a leasehold interest and full possession rights to the citrus acreage purchased by the investor. *Id.* at 296. Under the service contract in *Howey*, Hills applied its expertise in the citrus enterprise and managed and marketed the crops for a specified fee. *Id.*

114. *See id.* at 295. The tract of citrus acreage offered in *Howey* consisted of narrow strips of land containing a row of 48 trees. *Id.*

115. *Id.*

116. *Id.* at 296.

117. *Id.*

118. *See id.* at 295-96. The *Howey* scheme entailed the use of funds obtained from the

Considering whether the transactions between the investors' and Howey Co. were securities under the '33 and '34 Acts, the *Howey* Court held that the transactions constituted investment contracts because the presence of the service contracts suggested that the purchasers actually invested money in a common enterprise with the expectation of sharing in the profits derived solely from the efforts of others—Howey Co. and Hills.[119] The *Howey* Court, however, declined to rule on the question of whether a single sales/service contract transaction, possessing only vertical commonality, would satisfy the common enterprise element of the *Howey* test.[120] On the contrary, the *Howey* Court emphasized that the economic reality of a transaction should control the determination of whether a transaction is an investment contract under the '33 Act.[121] The *Howey* Court explained that the economic reality approach embodies a flexible principle to facilitate the congressional intent that the '33 Act apply to the numerous schemes devised by individuals seeking profit for themselves through the use of others' money.[122]

The Supreme Court extended the application of the *Howey* economic reality test to the '34 Act in *Tcherepnin v. Knight.*[123] In *Knight,* individual investors held withdrawable capital shares in City Savings Association of Chicago (City Savings), a state chartered savings and loan association.[124] The investors received dividends on the shares based on City Savings' profits rather than a fixed rate of return.[125] In determining whether the capital shares were securities under the '34 Act, the *Knight* Court found specifically that the investors' participation in City Savings' moneylending operation constituted a common enterprise dependent on the skill and efforts of the promoter, City Savings, for success and profitability.[126] The *Knight* Court

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multiple investors for the overall development of Howey Co.'s citrus operation which produced the investor's return. *See id.*

119. *Id.* at 298-301. In *Howey,* the sales/service contracts offered by Howey Co. were not registered pursuant to the '33 Act. *Id.* at 294. The SEC, alleging that the sales/service contracts were securities, filed suit to enjoin Howey Co. from using the United States mail or instruments of interstate commerce in connection with the offer and sale of unregistered securities in violation of the '33 Act. *Id.* at 293-95; *see* 15 U.S.C. § 77e (1982) ('33 Act prohibits use of interstate commerce or United States mail in connection with offer or sale of unregistered securities); *see also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974) (relaxing *Howey* requiremente that investors expect profits *solely* from the efforts of others); *supra* note 15 (discussing relaxed standard of *Howey* expectation of profits standard).

120. *See Howey,* 328 U.S. at 298-301.

121. *Id.* at 298-99.

122. *Id.*

123. 389 U.S. 332 (1967).

124. *Id.* at 332-33.

125. *Id.* at 337. In addition to providing a dividend return, the capital shares in *Knight* granted to each holder of a share both membership status and voting rights in City Savings. *Id.*

126. *Id.* at 338. In *Knight,* the plaintiff investors filed suit against City Savings, claiming that the withdrawable capital shares were securities and that City Savings had violated § 10(b) and SEC rule 10b-5 of the '34 Act by including false and misleading statements regarding City Savings' financial stability in printed solicitations sent to investors regarding the purchase of

then found that the withdrawable capital shares constituted investment contracts under the *Howey* test.[127] Horizontal commonality existed in *Knight* by virtue of City Savings pooling of the investors' funds as working capital and the correlation between the investors' return and City Savings' profits.[128] In *Knight,* however, the Court once again failed to address the requisite commonality of a common enterprise and, instead, reiterated the premise that courts should accommodate the flexible interpretation of "security" that Congress intended by focusing on the economic reality when determining whether a transaction constitutes a security within the meaning of the '33 and '34 Acts.[129]

The Supreme Court reaffirmed the *Howey* substance over form analysis in *United Housing Foundation v. Forman*[130] in determining whether shares of "stock" in a housing co-op constituted an investment contract under the *Howey* test.[131] In *Forman,* a state-subsidized housing cooperative required prospective tenants to purchase shares labeled "stock" as a prerequisite to obtaining an apartment in the complex.[132] The shares carried no voting rights,

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capital shares. *Id.* at 333-34; *see* 15 U.S.C. § 78j(b) (1982) (section 10(b) of '34 Act prohibiting use of deceptive devices in connection with purchase or sale of security); 17 C.F.R. § 240.10b-5 (1985) (SEC rule 10b-5 requiring full and honest disclosure in connection with purchase or sale of any security). The investors, consequently, sought to rescind the sales of the capital shares under § 29(b) of the '34 Act. *Knight,* 389 U.S. at 332; *see* 15 U.S.C. § 78cc(b) (1982) (contract made in violation of any provision of '34 Act is void). Addressing the investors' claim that the capital shares were securities under the '34 Act, the *Knight* Court determined the shares most closely resembled investment contracts and, accordingly, applied the rationale of the *Howey* test to determine whether an investment contract actually existed. *Knight,* 389 U.S. at 336; *see supra* note 7 ('34 Act definition of security contains investment contract); *supra* notes 12-15 and accompanying text (discussing *Howey* test); *see also infra* note 128 and accompanying text (discussing *Knight's* finding that common enterprise existed between investors and City Savings).

127. *Knight,* 389 U.S. at 339. The *Knight* court also relied on *S.E.C v. C.M. Joiner Corp.* in finding that not only did the withdrawable capital shares satisfy the *Howey* test as an investment contract, but that the shares could also qualify as a security under the '34 Act as "certificates of interest or participation in any profit-sharing agreement," as "stock," or as "transferable shares." *See id.* at 339; S.E.C. v. C.M. Joiner Corp., 320 U.S. 344, 351 (1943) (instrument may qualify as security if instrument, on its face, falls within term listed in '34 Act's definition of security); *supra* note 7 ('34 Act's definition of "security"). *But see* United Hous. Found. v. Forman, 421 U.S. 837, 850-58 (1974) (applying *Howey* economic reality test to certificates labeled as "stock"); *infra* notes 130-38 and accompanying text (discussing *Forman); cf.* Landreth Timber Co. v. Landreth, 105 S. Ct. 2297, 2304-06 (1985) (limiting *Forman); infra* notes 139-59 and accompanying text (discussing *Landreth).*

128. *Knight,* 389 U.S. at 337-39. The *Knight* Court concluded that a common enterprise existed on the basis that City Savings pooled the investors funds as working capital and each investor's success depended on the overall success of City Savings' money lending enterprise. *See id.; see also supra* notes 18-24 and accompanying text (discussing requirements of horizontal commonality).

129. *Knight,* 389 U.S. at 338 & n.19; 1933 HOUSE REPORT, *supra* note 8, at 11 (Congress intended broad interpretation of term "security").

130. 421 U.S. 837 (1974).

131. *Id.* at 851-58.

132. *Id.* at 842. In *Forman,* prospective tenants were required to purchase 18 shares of

and the holders of the shares could not transfer the shares to nontenants, or pledge or encumber the shares.[133] In addition, if a tenant wished, or was forced, to vacate the dwelling, the occupancy agreement required the tenant to offer the shares back to the co-op at the original purchase price.[134]

In considering whether the shares constituted securities under the '33 and '34 Acts, the *Forman* Court emphasized the need to favor substance over form and to apply the economic reality theory developed in *Howey* to effectuate Congress' intended application of the '33 and '34 Acts.[135] The *Forman* Court then followed the substance over form analysis and found that the economic reality of the transactions revealed that the primary purpose of purchasing the shares was to acquire housing for personal use rather than to pursue profits from the efforts of others.[136] Accordingly, the *Forman* Court held that the shares did not constitute investment contracts under the *Howey* test.[137] Having found that the transactions failed to satisfy the third prong of the *Howey* test, the *Forman* Court did not address the *Howey* commonality issue even though the housing arrangement in *Forman* entailed a form of horizontal commonality between the tenants and the cooperative enterprise.[138]

Primarily in response to the confusion created among the lower courts regarding the application of *Howey* in the wake of *Forman,* the Supreme Court recently considered the application of the *Howey* test in *Landreth Timber Co. v. Landreth.*[139] Although the Supreme Court in *Landreth* once again failed to clarify the commonality required for a common enterprise to exist, the *Landreth* Court's discussion of the *Howey* test lends insight into

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stock in the housing co-op for each room desired. *Id.* The purchasers of the shares, however, did not acquire the right to obtain legal title to an apartment, but merely gained the right to occupy the dwelling. *Id.* at 842 & n.4.

133. *Id.* at 842. In addition to the alienation restrictions placed on the *Forman* shares, the shares descended with the apartment only to a surviving spouse. *Id.*

134. *Id.* The purchase price for each share in *Forman* was $25. *Id.* At the time the *Forman* suit was brought, all tenants that had vacated the co-op apartments had received back the initial payment for the shares in full. *Id.* at 842 n.6. In the event that the co-op refused to refund the vacating tenants purchase price, however, restrictions continued to prevent the tenant from selling the shares for more than the initial purchase price plus a percentage of the retired mortgage. *Id.* at 842-43. Furthermore, the restrictions imposed eligibility requirements on prospective purchasers of the shares. *Id.* at 843.

135. *Id.* at 853-85.

136. *See id.* at 853 (relying on *Howey* in concluding that when transaction involves acquisitions for personal use or consumption, securities laws do not apply). In addition to finding that the shares failed to constitute investment contracts, the *Forman* Court also found that because the shares failed to possess characteristics generally associated with stocks, the shares were not securities under the '33 and '34 Acts by virtue of the label "stock." *Id.* at 848-50.

137. *See id.* at 853 (relying on *Howey* to conclude that when transaction involves acquisitions for personal use, securities laws do not apply).

138. *See* 421 U.S. 837 (1974) (Forman Court's reasoning failed to necessitate discussion of commonality requirement of *Howey* test).

139. 105 S. Ct. 2297 (1985).

the intended application of the *Howey* test and, hence, the requisite commonality.[140] In *Landreth,* the respondents sold one-hundred percent of the stock of their timber business (the "Mill") to multiple investors.[141] The purchasers of the stock formed Landreth Timber Company, the petitioner.[142] When the Mill failed to live up to the purchasers' expectations, the petitioner filed suit alleging violations of the '33 and '34 Acts and seeking to rescind the sale of the stock.[143] The respondents claimed that under the "sale of business doctrine,"[144] the stock purchased did not constitute a security within the meaning of the '33 and '34 Acts.[145] The respondents argued that *Forman* instructs courts, in every instance, to apply the economic reality analysis embodied in the *Howey* test to determine whether a transaction constitutes a security under the '33 and '34 Acts.[146]

In determining whether the stock constituted a security under the '33 and '34 Acts, the *Landreth* Court first recognized the general rule that the language of the '33 and '34 Acts controls the determination of whether an instrument or transaction constitutes a security under the '33 and '34 Acts.[147]

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140. *See id.* at 2304-06 (discussing application of *Howey* test).

141. *Id.* at 2299.

142. *Id.*

143. *Id.* In *Landreth,* the purchasers of the respondents' timber business stock alleged that the respondents had offered and sold the stock without registering the stock pursuant to the '33 Act, and that the respondents had failed to disclose fully all material information concerning the timber business in violation of the '34 Act. *Id.* at 2301; *see* 15 U.S.C. § 77e(a) & (c) (1982) (registration requirements of '33 Act); 15 U.S.C. § 78j(b) (prohibiting deceptive activity in connection with sale of security).

144. *Landreth,* 105 S. Ct. at 2301. Under the "sale of business" doctrine, the transfer of 100% of stock in a closely held corporation, accompanied by a transfer of control of the corporation to the purchaser, does not constitute a transfer of a security under the '33 and '34 Acts. *See* Hazen, *Taking Stock Of Stock And The Sale Of Closely Held Corporation: When Is Stock Not A Security.,* 62 N.C. L. REV. 393, 403-4 (1983) (sale of business doctrine also may apply to less than 100% transfer of corporation's stock); Seldin, *When Stock Is Not A Security: The "Sale of Business" Doctrine under the Federal Securities Laws,* 37 BUS. LAW. 637, 637-38 (1982) (discussing sale of business doctrine). The rationale of the sale of business doctrine is that because the purchaser of 100% of the stock of a corporation gains the authority to actively control the business, no commonality or expectation of profits from the efforts of others exists—a rationale premised in *Howey.* Hazen, *supra,* at 404. The significant inquiry under the sale of business doctrine, however, is not merely whether the purchaser obtains the right to actively control the business, but whether the purchaser intends to exercise that right to actually run the business. *See* Seldin, *supra,* at 679 (purchaser's intent is significant consideration in determining application of sale of business doctrine); *see also Landreth,* 105 S. Ct. at 2306-07 (application of sale of business doctrine depends on control passing to purchaser as well as purchaser's intent to exercise control). In *Landreth,* the Court found that the purchasers of 100% of the timber business, a closely held corporation, did not intend to run the sawmill business themselves because they retained one of the owners to manage and run the business. *Landreth,* 105 S. Ct. at 2307. The *Landreth* Court found, therefore, that the sale of business doctrine did not preclude the transfer of the timber company's stock from constituting a transfer of securities. *Id.* at 2307-8.

145. 105 S. Ct. at 2301.

146. *Id.* at 2301-04.

147. *Id.* at 2301-02.

The *Landreth* Court explained that when an instrument bears a title expressly defined in the '33 and '34 Acts' definition of security, the instrument generally will constitute a security under the '33 and '34 Acts.[148] The *Landreth* Court then distinguished *Forman* as providing an exception to the general rule when an instrument bears the label "stock."[149] The *Landreth* Court explained that the proper inquiry of whether an instrument labelled stock constitutes a security under the '33 and '34 Acts is whether the instrument possesses the significant characteristics traditionally associated with stock.[150] The *Landreth* Court then found that the stock involved in the sale of the Mill possessed the characteristics typically associated with stock and, therefore, constituted a security.[151] Under the *Landreth* Court's reasoning, when the instrument in question possesses both the label "stock" and the significant characteristics of stock, the instrument is a security and the inquiry ends.[152] The *Landreth* Court rejected respondents' argument that *Forman* mandates the application of the *Howey* test in every determination of whether a security exists under the '33 and '34 Acts, distinguishing the line of cases applying *Howey* as involving "unusual instruments not easily characterized as 'securities.'"[153] The existence of unusual characteristics associated with an instrument or transaction, according to *Landreth*, necessitates the application of the *Howey* test to determine whether the instrument or transaction qualifies as a security under the catch-all phrase "investment contract."[154] The *Landreth* Court, accordingly, clarified that the sole impact of *Forman* is to instruct courts to apply the *Howey* test to instruments labelled "stock" only when the instruments fail to carry the characteristics traditionally associated with stock.[155] The *Landreth* Court expressly declined to extend its reasoning to other categories listed in the '33 and '34 Acts' definitions of security, noting that stocks present the clearest case for applying the "characteristics" rationale because of the commonly known and usual characteristics associated with stock.[156]

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148. *Id.* at 2302.

149. *Id.* at 2302-05.

150. *Id.* at 2304-05 & n.5. The Supreme Court in *Landreth Timber Co. v. Landreth* identified the characteristics generally associated with common stock as "(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owed; and (v) the capacity to appreciate in value." *Id.* at 2302. The *Landreth* Court noted, however, that characteristics of preferred stock may differ and yet still fall under the '33 and '34 Acts. *Id.*

151. *Id.* at 2302-03; *see supra* note 150 (listing general characteristics of common stock recognized by *Landreth).*

152. *See Landreth,* 105 S. Ct. at 2304-05 & n.5 ('33 and '34 Acts apply to instruments that possess characteristics consistent with the instrument's label).

153. *Id.* at 2304; *see supra* notes 98-156 and accompanying text (discussing Supreme Court cases applying *Howey* test).

154. *Landreth,* 105 S. Ct. at 2305 & n.6.

155. *Id.* at 2303-05 & n.5.

156. *Id.* at 2306. The *Landreth* Court explained that traditional stock represents the concept of a security to a wide range of people. *Id.*

Although *Landreth* limits the *Howey* test to a secondary application concerning instruments labeled "stock,"[157] the *Landreth* Court actually endorsed a broad application of the economic reality theory by requiring courts initially to look beyond the label "stock" and to determine the characteristics of an instrument in the commercial setting. *Landreth,* in essence, instructs courts to look at the economic reality of instruments labelled stock to determine whether the instruments bear the characteristics of the label.[158] Extending the economic reality rationale to determine whether instruments labelled stock constitute securities under the'33 and '34 Acts, *Landreth* supports the Supreme Court's emphasis on economic reality expressed in *Howey* and, consequently, accommodates a flexible interpretation of the '33 and '34 Acts' definition of a security.[159]

In light of the Supreme Court's emphasis on economic reality and the characteristics of an instrument in the commercial setting, the narrow concept of vertical commonality appears the most consistent with *Howey* and its progeny.[160] Courts adhering to the narrow concept of vertical commonality forego applying the strict requirement of the horizontal view that investors funds be pooled and, instead, examine the relationship between the parties involved and the nature of the transaction that occurred.[161] Courts applying the narrow concept focus on the interdependency of success between the parties of a venture, and attempt to determine whether the members intended the arrangements to constitute an investment between or among themselves, as in *McGill,*[162] or whether the investor simply intended to use the promoter

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157. *See supra* notes 148-52 and accompanying text (Landreth explains that *Howey* test applies to instruments labeled "stock" only when instruments fail to possess characteristics generally associated with stock).

158. *See Landreth,* 105 S. Ct. at 2302 (Landreth instructs courts to look beyond label of instrument and determine characteristics actually associated with instrument).

159. *See* S.E.C. v. W.J. Howey Co., 328 U.S. 239 (1946) ('33 and '34 Acts definition of security embodies flexible interpretation); 1933 HOUSE REPORT, *supra* note 8, at 11 (Congress intended courts to afford broad interpretation to '33 and '34 Acts definition of security); *see also supra* notes 97-159 and accompanying text (Supreme Court's development of *Howey* test emphasizes that economic reality of transaction should control determination of whether security exists).

160. *See* S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-301 (1946) (courts should disregard form in favor of substance and focus on economic reality of transaction to determine whether investment contract exists); S.E.C. v. C.M. Joiner Leasing Co., 320 U.S. 344, 351-53 (1943) (commercial character of instrument controls determination of whether instrument constitutes investment contract); *see also supra* notes 97-159 and accompanying text (discussing Supreme Court's development of *Howey* economic reality test).

161. *See supra* note 59 and accompanying text (narrow concept of vertical commonality alleviates necessity of pooling of funds that horizontal commonality requires); *supra* notes 57-92 and accompanying text (discussing narrow concept of vertical commonality). Focusing on the relationship between the parties to a transaction, the narrow concept of vertical commonality requires that only some degree of correlation exist between the enterprise members. Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 618 F. Supp. 436, 439 (S.D.N.Y. 1985); *see supra* notes 58-60 and accompanying text (discussing interdependency of success requirement of narrow vertical commonality).

162. *See* McGill v. American Land & Exploration Co., 776 F.2d 923, 925-26 (10th Cir.

or investment manager as a middleman to effectuate an independent investment, as in a commission broker-investor relationship.[163]

Courts following the horizontal concept, on the other hand, although following the substance over form analysis and focusing on economic reality, conclusively determine that an instrument or transaction does not constitute an investment contract when only a single investor and promoter or investment manager are involved.[164] Under the horizontal approach, courts also automatically exclude a transaction involving multiple investors if the promoter has failed to either represent or effectuate a pooling of investors' funds.[165] The horizontal approach, therefore, fails to apply a true economic reality analysis as contemplated by *Howey* because, in practice, a common enterprise can exist in either a one-to-one relationship or a multi-investor enterprise absent a pooling of funds.[166]

While horizontal commonality circumvents a true economic reality test, the broad concept of vertical commonality appears inconsistent with the *Howey* test's requirements for an investment contract. Courts applying the broad concept to determine the existence of an investment contract inquire only whether one has invested money with the expectation of deriving profits from the efficacy of another.[167] By finding that an investment contract exists

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1985) (holding that investor intended to create common enterprise through joint venture with promoter); *supra* notes 70-92 and accompanying text (discussing *McGill).*

163. *See supra* notes 63-69 and accompanying text (discussing application of narrow vertical commonality to commission broker-investor relationships).

164. *See supra* notes 19-24 and accompanying text (courts adhering to horizontal commonality theory require pooling of investors' funds).

165. *See supra* notes 19-22 and accompanying text (significant characteristic of horizontal commonality is pooling of investors' funds).

166. *See* Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1238 (S.D.N.Y. 1981) (language of *Howey* does not require horizontal relationship between investors to create common enterprise). In *Howey,* the Supreme Court stated simply that an investment contract requires that "a person" invest money in a common enterprise. *See* S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). Although the *Howey* Court failed to clarify the exact meaning of a common enterprise, the term common enterprise is synonymous with such terms as "joint enterprise" and "joint venture," which require the association of two or more persons in a profit seeking enterprise. *See Howey,* 328 U.S. at 298-301 (failing to clarify meaning of common enterprise); Locke, *Existence Of Joint Venture,* 12 AM. J. JUR. P.O.F.2d, 295, 305 (1977) (two or more persons may form joint venture); BLACKS LAW DICTIONARY 751-752 (5th ed. 1979) (defining "joint adventure", "joint venture" and "joint enterprise" as synonymous with "common enterprise"). Courts adopting the horizontal concept of commonality, therefore, apparently have read the horizontal requirement into the *Howey* reasoning and have overlooked the rationale of the narrow concept of vertical commonality—to not punish a single investor merely because he is the sole investor in a profit seeking enterprise. *See* Walsh v. International Precious Metals Corp., 510 F. Supp. 867,871 (D. Utah 1981) (discussing rationale of narrow concept of vertical commonality); *supra* notes 18, 23-41 and accompanying text (discussing courts that have adopted horizontal commonality theory).

167. *See* S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (transaction or scheme in which promoter's efforts and skills determine investor's fortune satisfies commonality requirement of *Howey* test under broad concept of vertical commonality); Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1255, 1237 n.11 (S.D.N.Y. 1981) (recognizing

when an investor advances money and relies on the efforts and skill of another for a return, courts adhering to the broad concept require that a transaction or scheme satisfy only the first and third prongs of the *Howey* test.[168] By allowing a transaction or scheme to constitute an investment contract simply on the basis that the investor relies on the efforts and skill of a third party for success of the investment, courts following the broad concept virtually eliminate the commonality requirement of the *Howey* test because a common enterprise requires some interdependency of success between the members of the enterprise.[169] In light of the divergence from the *Howey* rationale that the application of the horizontal and broad vertical concepts produce, the narrow concept of vertical commonality is the more appropriate of the three approaches because the narrow concept embodies a true substance over form analysis which omits the pooling of funds requirement and yet stays within the guidelines established by the Supreme Court in *Howey*.[170]

In addition to providing a true economic reality analysis, the narrow concept of vertical commonality best comports with Congress' intent that the '33 and '34 Acts apply to the numerous schemes devised by individuals seeking profit for themselves through the use of others' money.[171] Courts applying the more stringent horizontal approach limit the reach of the '33 and '34 Acts by barring the application of the '33 and '34 Acts to all two

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that courts applying broad concept of vertical commonality treat commonality requirement of *Howey* as satisfied if success of investment depends on promoter expertise); *see also supra* notes 44-46 and accompanying text (discussing broad concept of vertical commonality).

168. Berman v. Bache, Halsey, Stuart, Shield, Inc., 467 F. Supp. 311, 319 (S.D. Ohio 1979); *cf. supra* note 16 and accompanying text (Howey test entails three requirements). *See supra* notes 44-46, 56 and accompanying text (courts applying broad concept of vertical commonality emphasize efforts and skill of promoter rather than existence of common enterprise).

169. *See* Savino v. E.F. Hutton & Co., Inc., 507 F. Supp. 1225, 1237 n.11 (S.D.N.Y. 1981) (discussing relaxed application of *Howey* test exercised by courts adopting broad concept of vertical commonality); Berman v. Bache, Halsey, Stuart, Shields, Inc., 407 F. Supp. 311, 319 (S.D. Ohio 1979) (courts applying broad concept of vertical commonality eliminate common enterprise requirement of *Howey* test); *cf.* Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 618 F. Supp. 436, 439 (S.D.N.Y. 1985) (correlation of members' success is essential element of *any* common enterprise).

170. *See supra* notes 57-92 and accompanying text (discussing application of narrow concept of vertical commonality). Courts adhering to the narrow concept of vertical commonality enforce the common enterprise prong of the *Howey* test by requiring some degree of interdependency between the fortunes of the enterprise members. *See supra* notes 58-62 and accompanying text (discussing interdependency of success requirement of narrow concept of vertical commonality); *see also* Silverstein v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 618 F. Supp. 436, 439 (S.D.N.Y. 1985) (any common enterprise requires some degree of correlation between success of enterprise members).

171. *See* 1933 HOUSE REPORT, *supra* note 8, at 11 (courts should construe '33 and '34 Acts definition of security broadly to encompass wide array of instruments commercially construed as securities); *see also* S.E.C. v. W.J. Howey Co., 328 U.S. 298-99 (1946) (Congress intended flexible interpretation of '33 and '34 Acts definition of security to apply to various schemes devised by profit seekers); *supra* notes 3, 8, 96 & 122 (discussing purpose of '33 and '34 Acts).

party transactions as well as to schemes involving multiple investors with individual accounts that do not involve a pooling of the funds received to one common enterprise.[172] Courts following the narrow concept of vertical commonality, on the other hand, extend the reach of the '33 and '34 Acts beyond that allowed by the horizontal approach by holding that any degree of correlation between the fortunes of an enterprise's members satisfies the commonality requirement of *Howey*.[173] In contrast, courts adhering to the broad concept of vertical commonality overextend the application of the '33 and '34 Acts to relationships that do not involve a third party seeking self-profits through the use of another's money.[174] For example, courts applying the broad concept have found that simple investor-broker relationships create a common enterprise, even though the broker seeks profits through providing the service of trading an investor's account rather than through increasing the value of an investor's portfolio.[175] The correlation requirement that courts following the narrow concept have employed, however, prevents the expansion of the '33 and '34 Acts regulations into areas which do not involve an interdependency of investor-promoter/investment manager success.[176] Courts adhering to the narrow concept of vertical commonality, therefore,

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172. *See supra* notes 19-41 and accompanying text (discussing horizontal commonality); *see also* Hart v. Pulte Homes of Mich. Corp., 735 F.2d 1001, 1004-05 (6th Cir. 1984) (sale-leaseback arrangement failed to satisfy horizontal commonality); *supra* notes 25-33 and accompanying text (discussing *Hart).*

173. *See supra* notes 57-62 and accompanying text (discussing interdependency of success requirement of narrow concept of vertical commonality).

174. *See supra* notes 44-56 and accompanying text (discussing broad concept of vertical commonality). Courts applying the broad concept of vertical commonality have found that a common enterprise exists when an investor relies on a third party (generally a promoter or an investment manager) to procure profits for the investor, regardless of the fact that the third party benefits solely from performing the services that create the profit for the investor. *See* McLish v. Harris Farms, Inc., 507 F. Supp. 1075, 1082-85 (E.D. Cal. 1980) (cattle feedlot operation constituted investment contract under *Howey* test even though promoter benefitted solely from services related to caring for and marketing cattle for investor); *supra* note 47 and accompanying text (any discretionary brokerage account constitutes investment contract under broad concept of vertical commonality); *see also supra* notes 48-56 and accompanying text (discussing *McLish).* Courts following the broad concept, therefore, have extended the '33 and '34 Acts regulatory power to transactions in which the promoter or investment manager merely provides personal or professional services significant to the success of the enterprise. *See supra* notes 44-56, 167-69 and accompanying text (discussing application of broad view of vertical commonality). This widespread potential administration of the '33 and '34 Acts extends beyond Congress' intent that courts apply the '33 and '34 Acts to activities involving a party attempting to benefit himself through the use of another's money—a situation much more conducive to foul play and misrepresentation. *See supra* notes 3, 8, 96 & 171 and accompanying text (discussing Congress' intended application of '33 and '34 Acts).

175. *See supra* note 47 and accompanying text (under broad concept of vertical commonality any discretionary brokerage account satisfies *Howey* common enterprise requirement).

176. *See supra* notes 58-62 and accompanying text (courts applying narrow concept of vertical commonality require at least some degree of correlation between success of enterprise members).

extend the reach of the '33 and '34 Acts to the farthest bounds that the requirements of the *Howey* test suggest.[177]

Although the Supreme Court has declined to grant certiorari to clarify the *Howey* common enterprise requirement,[178] the narrow concept of vertical commonality appears best suited to the various modern day transactions and schemes devised by profit seekers such as promoters and investment managers.[179] The narrow concept is the most consistent with the *Howey* economic reality test and the congressional intent of far reaching securities regulation.[180] Furthermore, the narrow concept concerns the substance of the transaction and is dispositive of whether the transaction actually constitutes an investment contract, without the restricted view that a common enterprise requires more than two parties.[181] Accordingly, business transactions that involve a one-to-one relationship as well as an interdependency of success between the investor and the promoter should satisfy the common enterprise requirement of the *Howey* test.[182] Parties conducting transactions under vertical relationships involving interdependent success, therefore, should comply with the '33 and '34 Acts to avoid liability should a court question the transaction.[183]

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177. *See supra* notes 58-62 and accompanying text (courts adhering to narrow concept of vertical commonality effectively employ *Howey* commonality requirement to relieve horizontal pooling requirement, but necessitate some degree of success commonality).

178. *See* Morduant v. Incomco, 105 S. Ct. 801 (1985) (declining to clarify commonality requirement of *Howey* test).

179. *See supra* notes 57-92 and accompanying text (discussing narrow concept of vertical commonality). Because courts applying the narrow concept of vertical commonality allow a one-to-one relationship to create a common enterprise when the requisite correlation of success is present, courts applying the narrow approach protect investors from dishonest promoters who could circumvent the '33 and '34 Acts regulation under the horizontal approach by treating each investor's account on an individual basis. *See supra* notes 19-22 and accompanying text (courts following horizontal commonality require pooling of investors' funds); *cf. supra* notes 58-69 and accompanying text (courts applying narrow concept of vertical commonality reject pooling of funds requirement and require only some degree of success interdependency among enterprise members). In addition, unlike courts adhering to the broad concept of vertical commonality, courts following the narrow approach do not impose federal securities regulation on transactions which involve a promoter or investment manager providing services and skill directed to procure a profit for the investor when the transaction does not involve the requisite correlation of success between the parties. *See supra* notes 58-69 and accompanying text (courts applying broad concept of vertical commonality require at least some degree of correlation between success of enterprise members).

180. *See supra* notes 160-77 and accompanying text (discussing narrow concept of vertical commonality in light of *Howey* test and Congress' intended application of '33 and '34 Acts).

181. *See supra* notes 58-92 and accompanying text (courts applying narrow concept of vertical commonality realize that common enterprise can exist between as few as two parties).

182. *See supra* notes 58-92 and accompanying text (courts adhering to narrow concept of vertical commonality find that common enterprise exists in one-to-one relationships involving interdependent success of parties).

183. *See supra* notes 57, 62-92 and accompanying text (discussing cases applying narrow concept of vertical commonality). Because courts applying the narrow concept of vertical commonality allow a one-to-one relationship involving interdependent success to create a common enterprise under the *Howey* test, transactions that involve these relationships in connection with an investment of money with the expectation of profits from the efforts and skill of

Furthermore, parties to transactions involving vertical relationships with independent success between the investor and promoter or investment manager must continue to recognize and be aware of the broad concept of vertical commonality recognized by some courts.[184] In the event that the Supreme Court should decide to grant certiorari and address the commonality issue, however, the narrow concept of vertical commonality appears best suited for today's multi-faceted investment schemes and, therefore, the Court should endorse the narrow approach.[185]

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another, accordingly, will constitute investment contracts under the narrow concept as applied to the *Howey* test. *See id.*; S.E.C. v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (investment contract exists when transaction or scheme involves investment of money in common enterprise with expectation of profits from the efforts of others). Constituting investment contracts, consequently, will subject transactions to regulation of '33 and '34 Acts. *See supra* notes 5 & 7 and accompanying text ('33 and '34 Acts apply to investment contracts).

184. *See supra* notes 44-56 and accompanying text (discussing broad concept of vertical commonality).

185. *See supra* notes 160-81 and accompanying text (analyzing superiority of narrow concept of vertical commonality over both broad and horizontal concepts of commonality).