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I. What Is A Security?

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1977-78 SECURITIES LAW DEVELOPMENTS

I. WHAT IS A SECURITY?

Recent Supreme Court decisions limiting access to the courts under the federal securities laws[1] manifest a restrictive approach in discerning what is a security.[2] Essentially, the issue in cases defining a "security" is whether the securities laws[3] regulate a particular activity. The activity to

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[1] *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 463 (1977);Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *See generally* Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977) [hereinafter cited as *The Pendulum Swings*].

[2] One of the most controversial areas of the securities field involves the definition of what transactions are covered by such laws. The courts have found the securities laws applicable to numerous transactions bearing little resemblance to traditionally recognized securities. For example, a security existed where chinchillas were sold by a promoter who falsely promised purchasers that the animals were easy to raise and resalable to the promoter at a profit. Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974). A security also was found to exist where scotch whiskey receipts were sold by a promoter guaranteeing that the receipts would double in value within four years and that he would manage the goods during that period. Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027 (2d Cir. 1974); *see* Tcherepnin v. Knight, 389 U.S. 332 (1967) (savings and loan withdrawable certificates are securities); SEC v. Brigadoon Scotch Distrib., Ltd., 388 F. Supp. 1288 (S.D.N.Y. 1975) (sale of rare coin portfolios to general public are securities).

Generally, "security" refers to a "written obligation, evidence or document of ownership or creditorship giving the holder the right to demand and receive property not in his possession, such as issued to investors to finance a business enterprise." 1 FED. SEC. L. REP. (CCH) ¶ 1071 (1977). For an overview of the types of securities, see Bloomenthal, *The Many Faces of a Security* (Pts. 1-2), 22 PRAC. LAW. 43 (Jan. 1976), 29 (March 1976).

[3] There are two major securities acts. The first is the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1976). The '33 Act requires a company which issues a security to be sold in interstate or foreign commerce to disclose all information important to a reasonable investor. *See* Natural Resources Defense Council, Inc. v. SEC, 389 F. Supp. 689 (D.D.C. 1974). Public disclosure is accomplished by requiring the issuing company to file a registration statement open to public inspection with the Securities and Exchange Commission (SEC). Section 5 of the '33 Act, 15 U.S.C. § 77e (1976). The statement must contain a description of the registrant's properties and business, information about management, a description of the offered security and its relationship to the registrant's other capital securities, and financial statements certified by independent public accountants. *See* 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 1.02[3] (rev. perm. ed. 1977) [hereinafter cited as BLOOMENTHAL]. Furthermore, disclosure is accomplished by requiring the issuer to provide each purchaser with a prospectus containing the information in the registration statement and to notify each purchaser of any material changes in such information prior to the sale. Section 5(b)(2) of the '33 Act, 15 U.S.C. § 77e(b)(2) (1976); *see* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1098 (2d Cir. 1972).

The second major law is the Securities Exchange Act of 1934, 15 U.S.C. § 78 (1976). The '34 Act extends the disclosure provisions of the '33 Act by requiring corporations listed on the national stock exchanges and those corporations with assets over one million dollars and a class of equity securities held by five hundred or more shareholders to register with the SEC. Section 12(g)(1) of the '34 Act, 15 U.S.C. § 78l(g)(1) (1976).

be regulated usually involves a purchaser[4] alleging that a promoter[5] disseminated misleading facts[6] in connection with a particular scheme.[7] Although the courts generally focus on the circumstances surrounding the scheme,[8] the statutes list only certain types of documents as securities.[9] Accordingly, the generalized definitions given in section 2(l)[10] of the Securities Exchange Act of 1933 ('33 Act) and section 3(a)(10)[11] of the Securities

[4] The term "purchase" encompasses a wide variety of activities. Although generally "purchase" involves an investor providing funds in return for some evidence of ownership in an enterprise, it can also include less obvious actions. Thus one may be a purchaser of a security when supplying funds to be invested in the sole discretion of a fund manager, SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974), or by being a member of a union who through collective bargaining receives an employer funded pension plan. Daniels v. International Bhd. of Teamsters, 561 F.2d 1223 (7th Cir. 1977), *cert. granted,* 98 S. Ct. 1232 (1978).

[5] The term "promoter" includes those parties who directly or indirectly take the initiative in organizing a profit making activity. *See* Oklahoma-Texas Trust v. SEC, 100 F.2d 888 (10th Cir. 1939); 17 C.F.R. 230.405(g) (1977).

[6] Both Acts contain antifraud provisions providing civil and criminal penalties against issuing companies, company officials and individuals who disseminate false or misleading statements in connection with the retail purchase or sale of securities. *See* §§ 11, 12, & 17(a) of the '33 Act, 15 U.S.C. §§ 77k, 77l, 77g(a) (1976); §§ 10(b) & 15(c)(1) of the '34 Act, 15 U.S.C. §§ 78j(b), 78o(c)(1) (1976); Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5 (1977). Furthermore, a private implied right of action for fraud has been found under a number of sections of the Acts. *See, e.g.,* Deckert v. Independence Share Corp., 311 U.S. 282 (1940) (§ 12 of '34 Act, 15 U.S.C. § 77 (l) (1976)); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867-68 (2d Cir. 1968) (Friendly, J., concurring), *cert. denied,* 394 U.S. 976 (1969) (§ 10b of '34 Act, 15 U.S.C. § 78j(b) (1976)) Surowitz v. Hilton Hotels Corp. 342 F.2d 596 (7th Cir. 1965) *rev'd on other grounds,* 383 U.S. 363 (1967) (§ 17(a) of '33 Act, 15 U.S.C. § 77g(a) (1976); Martin v. Hull, 92 F.2d 108 (D.C. Cir.), *cert. denied,* 302 U.S. 762 (1937) (§ 11 of '33 Act, 15 U.S.C. § 77k (1976)).

[7] "Scheme" denotes the process by which the promoter obtains his working capital. *See, e.g.,* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1948).

[8] *See, e.g.,* United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

[9] *See* notes 10-11 *infra.*

[10] Section 2(l) of the '33 Act defines a security as follows:

> 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 of, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1976).

Section 3(a) of the '33 Act exempts from certain provisions of that Act several classes of securities including:

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

15 U.S.C. § 77c(a)(3) (1976).

[11] Section 3(a)(10) of the '34 Act, 15 U.S.C. § 78c(a)(10) (1976), defines a security in

Exchange Act of 1934 ('34 Act) supply little guidance to the courts.[12] Furthermore, the legislative history fails to help delineate the limits of the Acts.[13] Therefore in discerning the scope of the legislation, the lower courts rely primarily on Supreme Court decisions concerning the definition of "security" and those opinions indicating the Courts receptiveness to expansion of coverage under the Acts.

Recent interpretations of what constitutes a "security" emphasize the analysis adopted in *SEC v. W.J. Howey Co.*,[14] one of the few Supreme Court cases on this issue.[15] Under this decision, a scheme is considered a security when it "involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[16] Traditionally, courts have relied on this functional test[17] when determining whether a security exists.[18] *Howey* itself involved the issue of whether the offering of

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substantially the same manner as the '33 Act, *see* note 10 *supra*, but omits the term "evidence of indebtedness," excludes short term paper from the definition, omits the "current transactions" language, and makes minor changes in the classifications of oil and gas interests as securities.

[12] *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975); Tcherepnin v. Knight, 389 U.S. 332 (1967).

[13] *See Definition of a "Security," 1976-1977 Securities Law Development*, 34 WASH. & LEE L. REV. 863, 864 (1977) [hereinafter cited as *Definition of a "Security"*].

[14] 328 U.S. 293 (1948). *Howey* involved an investment contract; however, the definition espoused in this case arguably could be adopted as the generic definition of a security under the securities laws. Newton, *What Is a Security?: A Critical Analysis*, 48 MISS. L.J. 167, 176 n.21 (1977) [hereinafter cited as Newton]. For an in depth discussion supporting emphasis on *Howey* in determining the existence of a security, see Tew & Freedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer and the Securities*, 27 U. MINN. L. REV. 395 (1973).

[15] The Supreme Court cases defining a security are SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943); SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Tcherepnin v. Knight, 389 U.S. 332 (1967); and United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

[16] 328 U.S. at 301.

[17] Both courts and commentators generally divide the *Howey* test into three or four component parts: (1) an investment of money (2) in a common enterprise (3) with profits (4) to come solely from the efforts of others. *See, e.g.*, Daniel v. International Bhd. of Teamsters, 561 F.2d 1223 (7th Cir. 1977); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); Newton, *supra* note 14, at 174; *Definition of a "Security": Survey of 1974 Securities Law Developments*, 32 WASH. & LEE L. REV. 721 (1975) [hereinafter cites as *'74 "Security"*]. Failure to satisfy one of these elements requires a finding that the contract is not a security within the meaning of the securities laws. *See, e.g.*, Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666, 669-70 (19th Cir. 1972) (no security where "solely from efforts of others" component not met). *But see* Bronstein v. Bronstein, 407 F. Supp. 925, 926-27 (E.D. Pa. 1976) (security existed even though "solely from efforts of other" test not satisfied).

[18] *See, e.g.*, United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975); Tcherepnin v. Knight, 389 U.S. 332 (1967); Fargo Partners v. Dain Corp., 540 F.2d 912 (8th Cir. 1976); SEC v. Haffenden-Rimar Int'l, Inc., 496 F.2d 1192 (4th Cir. 1974); Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162, 168 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). For a discussion of the application of *Howey* to less traditional security schemes, see Comment, *What is a Security? Howey, Turner Enterprises, and Franchise Agreements*, 22 U. KAN. L. REV. 55 (1973) [hereinafter cited as *Franchise Agreements*].

plots of a citrus grove development constituted an investment contract when sold in conjunction with a contract for cultivating, marketing and remitting of net proceeds from fruit sales.[19] The Court found the core of the scheme to be no more than a contribution of money by the purchaser in return for a share of the profits generated by the promoter.[20] The Court held that this scheme, involving the sale of real estate, was a traditional "investment contract."[21] Since real estate transactions are beyond traditional security concepts,[22] the decision signified a flexible approach to defining a security. Underlying this approach was a desire to fulfill the statutory purpose of full and fair disclosure in connection with schemes where one seeks to use the "money of others on the promise of profit."[23]

The Supreme Court reaffirmed *Howey* in *Tcherepnin v. Knight.*[24] The *Tcherepnin* opinion underscores the *Howey* rationale that the term "security" should be construed broadly to effectuate the remedial purposes underlying the securities laws.[25] The case involved withdrawable capital shares[26] which the Seventh Circuit had found not covered by the Acts because the instruments were facially distinguishable from traditional securities.[27] The Supreme Court, in reversing the court of appeals, reasoned that because of the congressional policy of preventing fraud in investment areas, the investment character of the shares dictated that the shareholders be entitled to the protection afforded by the securities laws.[28] Thus even though emphasis on elements stressed by the Seventh Circuit could have allowed a contrary result, the Supreme Court expanded the Acts' coverage

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[19] 328 U.S. at 297.

[20] *Id.* The Court emphasized that realistically the individual purchaser would be unable to develop his lot due to lack of experience, lack of equipment, and economies of scale. *Id.*

[21] *Id.* at 299.

[22] *See* BLOOMENTHAL, *supra* note 3, at § 2.14.

[23] *Id.* The securities laws were a response to a congressional finding that over half of the securities issued in the decade following World War I proved to be worthless. *See* BLOOMENTHAL, *supra* note 3, at § 2.01[1]. A congressional report stated that "[t]he flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise." H.R. REP. No. 85, 73 Cong., 1st Sess. (1934), *quoted in* BLOOMENTHAL, *supra* note 3, at § 201[1] (1933). The disclosure requirements of the Acts were designed to correct this situation in two ways. First, fraudulent schemes would be hampered and deterred merely by the requirement that details be revealed. *See* Douglas & Bates, *The Federal Securities Act of 1933,* 43 YALE L.J. 171, 173 (1933). Second, the availability of all relevant financial information on a security would allow investment services and expert investors to appraise more accurately the worth of a security and thereby establish a reasonable price. *Id.*

[24] 389 U.S. 332 (1967).

[25] *Id.* at 336.

[26] Withdrawable capital shares are basically savings accounts with dividends being determined by the profit of the investing institution. *Id.*

[27] 371 F.2d 374 (7th Cir. 1967). In finding the shares distinguishable from traditional securities, the Seventh Circuit emphasized that there were no limits on the number of shares issued, the shares were nonnegotiable and there were no rights in the holders to inspect corporate books. *Id.* at 376.

[28] 389 U.S. at 345-46.

by use of the *Howey* test.[29]

Supreme Court decisions since *Tcherepnin,* however, indicate a policy of limiting the coverage of the securities laws.[30] During this period, a more restrictive view of the Acts has prevailed in each major securities decision.[31] These decisions show a tendency to curb the power of the Securities Exchange Commission[32] and to encourage plaintiffs to concentrate upon state remedies.[33] One of these recent decisions, *United Housing Foundation, Inc. v. Forman,*[34] involved the definition of a security. *Forman* concerned certain "stocks" the ownership of which allowed the purchaser to lease apartments in a state subsidized, non-profit housing cooperative.[35] The major issue of the case was whether the *Howey* "expectation of profit" criterion was satisfied.[36] Reading *Howey* broadly, the Second Circuit found

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[29] *See generally* Comment, 34 Mo. L. Rev. 260 (1969).

[30] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Piper v. Chris-Craft Indus., 430 U.S. 1 (1977); TSC Indus., Inc. v. Northway, Inc., 326 U.S. 438 (1976); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976); Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975); United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973); *The Pendulum Swings, supra* note 1, at 919. The lack of legislative history behind the definitional sections of the Acts is critical in distinguishing cases defining a security from recent Supreme Court cases limiting plaintiff's rights under the Acts. For example, in a recent case refusing to allow a cause of action to nonpurchasing offerors of stock, the Supreme Court was able to rely on legislative history indicating that Congress had rejected an amendment to the '34 Act which would have extended protection to certain nonpurchasers. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 732. Legislative history also was emphasizd in a case involving a short term purchase-sale sequence which allegedly violated § 16(b) of the '34 Act, 15 U.S.C. § 78p(b) (1976). In finding for the defendant, the Court relied primarily on an exemption in early drafts of § 16(b) which by implication could be incorporated into the final version. *See* Foremost-McKennon, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976). Since the legislative history of the definitional sections of the Acts is limited, the lower courts attempting to limit the application of the Acts lack a rationale central to some of the recent cases. *But see* United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) (coverage of Acts limited without reference to legislative history).

[31] *See* note 30 *supra; The Pendulum Swings, supra* note 1, at 921.

[32] *See, e.g.,* TCS Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) (weakens SEC staff's position when negotiating for additional disclosure in registration statements); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (may require SEC to prove scienter when seeking injunctions); Rondeau v. Mosiness Paper Corp., 422 U.S. 49 (1975) (undercuts SEC position that traditional prerequisites for injunctive relief need not be shown by SEC); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (limits SEC's standing to those factual situations that fit within narrow purchaser-seller requirements).

[33] *See,* e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (encourages use of common law fraud actions); Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975) (federal remedies limited to less imaginative forms than available in state courts); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 81975) (denial of standing in federal court will require nonpurchaser-seller plaintiffs to rely on state remedy).

[34] 421 U.S. 837 (1975).

[35] *Id.* at 842.

[36] *Id.* at 854-60. A second issue in *Forman* was whether the securities laws applied solely because the promoter had used the term "stock" in describing the scheme. Generally the

an expectation of profit based on future rental reductions of nominal amounts, available tax deductions and savings from renting state subsidized apartments.[37] Consistent with its recent policy, the Supreme Court reversed the appellate court's decision and refused to extend the securities laws to cover areas possessing such a limited profit motive.[38]

Although the Supreme Court's rationale in *Forman* is reasonable, the

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courts deemphasize the terminology associated with a particular scheme and focus on whether the investor's risk is of the nature typically associated with traditional securities. *See generally* Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities,* 25 HASTINGS L.J. 219 (1974). This focus is usually denoted the "economic reality" of a scheme. *Id.* at at 220. In determining whether a security is involved in a particular scheme, analysis of the type, character and allocation of risk is more important than the terminology involved. *Id.* at 241. Thus in *Forman,* the Supreme Court rejected the Second Circuit's reasoning that the use of the word "stock," a term listed in the Act's definition of a "security," was enough to allow coverage, 421 U.S. at 851.

The recent case of SEC v. Commodity Options Int'l, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,072 (9th Cir. 1977), illustrates the emphasis on "economic reality" in determining whether a scheme involves traditional security risk. At issue in this case was whether a naked double commodity option was an "investment contract." Futures contracts, agreements obligating the investor to purchase various commodities not yet produced, and future options, agreements by which the purchaser buys the right to sell or purchase a future contract at some later date, underlie such schemes. *Id.* at 91,825. The profitability of such agreements depend on what the market believes will be the ultimate value of the produce involved and this in turn will be based on expectations as to certain agricultural conditions. *Id.* at 91,825-26, *quoting* Jones & Cook, *The Commodity Futures Trading Commission Act of 1974,* 5 MEM. ST. U. L. REV. 457, 460 (1975). Since the profitability of both the futures contract and the futures option do not depend on entreprenurial activity neither are considered securities. SEC v. Commodity Option Int'l, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,072, at 91,827; *see, e.g.,* Sinva v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 253 F. Supp. 359, 365-67 (S.D.N.Y. 1966) (futures contract not a security but only obligation to buy produce at later date).

When dealing with naked double options of the type involved in *Commodity Options,* as distinguished from typical futures options, the futures characteristics are a mere facade. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,072, at 91,828. The dealers in such options do not maintain adequate inventories of the underlying futures contracts and there is generally no intent that the actual commodities represented by the futures will be traded. *See* Long, *The Naked Commodity Option Contract as a Security,* 15 WM. & MARY L. REV. 211, 213 (1973). The investor actually does not acquire an interest in an underlying futures contract or an option, but rather obtains a share of the profits of the promoting corporation. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,072, at 91,828. The investor's money is pooled with that of other investors to be reinvested at the discretion of the promoters. Thus the investor's risk is not based on the market conditions pertaining to a certain commodity; but rather is based on the expertise of the promoter in speculating in the commodity market. *Id.* This risk is essentially the same as the risk associated with traditional securities and therefore the economic reality of the scheme illustrates that it should be covered by the securities laws. *See* SEC v. American Commodity Exch., Inc., 546 F.2d 1361, 1366-67 (10th Cir. 1976). Accordingly, the *Commodity Options* court found that a naked double commodity option was a security. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,072, at 91,828; *cf.* Melton v. Unterreiner, 436 F. Supp. 740 (E.D. Mo. 1977) (a scheme denoted a "trust" was found to be more like traditional securities than traditional trusts not covered by the Acts).

[37] *See* Forman v. Community Servs., Inc., 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom,* United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

[38] 421 U.S. at 855-56.

essential point is that the Second Circuit's position was not totally unreasonable. In fact, the court of appeals' result appears consistent with the broad protective policy underlying the *Tcherepnin* decision. The *Forman* opinion thus indicates that the Court is now less willing to expand the *Howey* test so as to achieve the remedial purposes emphasized in *Howey* and *Tcherepnin.*[39] This limitation is not absolute, however, as the *Forman* opinion reaffirmed both *Howey* and *Tcherepnin.*[40] Therefore, the rule that arguably results from *Forman* is that the *Howey* test generally should be read strictly so as to effectuate the Supreme Court's policy of limiting the scope of the Acts; but in situations in which the need for disclosure under the Acts is acute, a broad reading of the *Howey* standard may be adopted.[41]

The tension between the *Forman* presumption against expanding the scope of the Acts and the *Howey-Techerepnin* emphasis on fostering the broad congressional purposes underlying the legislation is illustrated by the differing analysis in two recent cases, *Daniel v. International Brotherhood of Teamsters*[42] and *Robinson v. United Mine Workers,*[43] both involving employee retirement benefit plans. The *Daniel* decision stressed the remedial nature of the Acts. *Daniel* involved a noncontributory,[44] compulsory[45] pension plan sponsored by the plaintiff's union. The plan called for twenty years of service before a member would be eligible for benefits. The union denied the plaintiff benefits claiming that the service requirement had not been met since he had not worked twenty continuous years because of an involuntary, two month layoff.[46] The plaintiff sued alleging fraud under the securities laws in connection with the administration and maintenance of the pension fund.[47] The *Daniel* court held that not only are pension plans the sort of investment Congress intended to regulate under

[39] See *The Pendulum Swings, supra* note 1, at 906-11.

[40] *See* 421 U.S. at 848, 852; Brief of the SEC, Amicus Curiae at 21, Daniel v. International Bhd. of Teamsters, 561 F.2d 1223 (7th Cir. 1977) ("The *Forman* decision is in no way inconsistent with the principles enunciated in the previous [Supreme Court] decisions").

[41] *Compare* Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977) (technical compliance with *Howey* required even where disclosure beneficial) *with* Daniel v. International Bhd. of Teamsters, 561 F.2d 1233 (7th Cir. 1977), (*Howey* read broadly to cover pension plan primarily because the plans constituted the major form of investment for workers).

[42] 561 F.2d 1233 (7th Cir. 1977), *cert. granted,* 98 S.Ct. 1232 (1978).

[43] 435 F. Supp. 245 (D.D.C. 1977).

[44] In a "noncontributory" pension plan, the total financial burden of the plan is borne by the employer. Note, *Interest in a Noncontributory, Compulsory Employee Pension Plan Deemed Subject to the Antifraud Provisions of the Federal Securities Laws,* Daniel v. International Brotherhood of Teamsters, 22 VILL. L. REV. 195, 196 n.14 (1977) [hereinafter cited as *Interest in Pension Plan*].

[45] In a "compulsory" plan, the employee cannot choose to receive the contribution personally in lieu of future payments from the fund. *Id.* at 196 n.14.

[46] 561 F.2d at 1256.

[47] *Id.* at 1229-30. The plaintiff's first count alleged a breach of § 10(b) of the '34 Act, 15 U.S.C. § 78j(b) (1976), and of Rule 10b-5, 17 C.F.R. § 240.10(b)(b) (1977). 561 F.2d at 1229-30. Count II alleged a violation of § 17(a) of the '33 Act, 15 U.S.C. § 77g(a) (1976). The plaintiff claimed that the union materially misrepresented the plan to its member. Of particular importance was the failure of the union to inform the plaintiff that the actuarial probability of an employee receiving pension benefits was as low as eight percent. 561 F.2d at 1229.

the securities laws[48] but also that the alleged fraud was the type that the securities laws were passed to prevent and remedy.[49]

The *Daniel* court found the pension plan to be substantially similar to

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[48] 561 F.2d at 1241; *accord,* Schlansky v. United Merchants & Mfg., Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,353 (S.D.N.Y. Nov. 7, 1977). The *Daniel* court reasoned that since the securities laws were aimed at protecting the average investor, the most common forms of investment should be subject to the disclosure provisions of those laws. 561 F.2d at 1257; *see* Alberto-Culver Co. v. Scherk, 484 F.2d 611, 617 n.4 (7th Cir.), (Stevens, J., dissenting), *quoting* SEC Amicus Curiae brief, *rev'd* 419 U.S. 506 (1973). For a discussion of the importance of pension plans to the average worker, see Comment, *Securities Regulation of Employee Pension Plans In the Wake of the Daniel Decision,* 38 U. PITT. L. REV. 697 (1977) [hereinafter cited as *Wake of Daniel*].

The *Daniel* court maintained that although the legislative history of the '33 and '34 Acts are silent on whether pension plans are covered, subsequent legislative action supported their coverage in two ways. 561 F.2d at 1237-38. The court first noted that Congress in 1934 rejected an amendment to the '33 Act which would have exempted employment plans for extra compensation or stock investment from registration requirements. *Id.; see* H.R. REP. No. 1838, 73d Cong., 2d Sess. 41 (1934). The failure to adopt this amendment arguably demonstrates that Congress had some form of employee security in mind when it enacted the '34 Act and that the broad definition given in the Acts reveals an intent to cover pension plans. 561 F.2d at 1238 n.32.

Secondly, the court noted that a 1970 amendment exempting certain pension plans from the registration requirements of the '33 Act indicated a congressional determination that such plans are "securities." *Id.* at 1239; *see* 15 U.S.C. § 80a-3(c)(11) (1976). A similar amendment was added to the '34 Act. 561 F.2d at 1238; *see* 15 U.S.C. § 78c(a)(12) (1976). Although the court's interpretation is reasonable, there is no basis for the court to defer to a congressional interpretation of a prior Congress' intent. *See* Waterman S.S. Corp. v. United States, 381 U.S. 252, 269 (1964); United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 346-49 (1963); United States v. Price, 361 U.S. 304, 313 (1960).

[49] 561 F.2d at 1242. If the union members had realized the minimal likelihood of receiving benefits, they could have attempted to alter the scheme. Cognizant of this fact, the Seventh Circuit reasoned that since full disclosure would have achieved this protection, the rationale underlying the full disclosure provisions of the Acts dictated the extended coverage. *See Wake of Daniel, supra* note 48, at 699. *See also* Frankfurter, *The Federal Securities Act: II,* FORTUNE, August 1933, at 55.

In 1975, Congress passed the Employee Retirement Income Security Act (ERISA). 29 U.S.C. §§ 1001-1381 (1976). ERISA requires that a "summary plan description" be provided to all employee pension plan participants and beneficiaries. *Id.* at § 1021(a). This summary plan must disclose such information as eligibility requirements and circumstances which may result in disqualification or denial of benefits. *Id.* at § 1022(b). Since this was the type of information involved in *Daniel,* the defendant argued that the antifraud provisions of the '33 and '34 Acts were impliedly repealed as applied to pension plans even if the sections were originally applicable. 561 F.2d at 1246.

Provisions in ERISA indicate that such an implied repeal was not intended. Section 514(d), 29 U.S.C. § 1144d (1976), provides that ERISA shall not be construed to supersede any federal law or rule promulgated as part of its implementation. Furthermore, § 514(b)(3)(A), 29 U.S.C. § 1144(b)(2)(A) (1976), explicitly preserved each state's securities laws which generally do not exclude pensions from their antifraud provisions. *See* Daniel v. International Bhd. of Teamsters, 561 F.2d at 1246. When these two provisions are read in light of the fact that disclosure under the securities laws is to take place prior to the investment, as opposed to ERISA's providing for disclosure only to "participants and beneficiaries," the implied repeal argument appears especially specious. *Id.* at 1248; *Wake of Daniel, supra* note 48, at 714-17.

traditional securities.[50] The court maintained that such a finding was required by language introducing the definitional sections of the Acts.[51] The plan was held to resemble a mutual fund since in both devices a pool of money is invested for the benefit of the fund by the fund manager.[52] Whereas the mutual fund shareholder provides money when purchasing shares in the fund, the employee invests money through his employer's contributions to the plan's trust on his behalf.[53] The Seventh Circuit reasoned that since an interest in a mutual fund is a security,[54] the interest in a pension plan, which involves risk[55] and has features similar to a mutual fund, should also be considered a security.[56]

In contrast, the district court in *Robinson* refused to extend coverage of the Acts to retirement trust funds finding such schemes too far removed from traditional securities to warrant inclusion within the definition given in the Acts.[57] *Robinson* involved a union retirement fund out of which death benefits and health care coverage were to be extended to the spouse and dependents of members.[58] A beneficiary brought suit alleging that the deceased employee had been told that the plan entailed lifetime health coverage instead of the five year coverage actually offered the beneficiary.[59] Alluding to the Supreme Court's recent reluctance to extend the scope of the securities laws,[60] the *Robinson* court noted that, until *Daniel*,[61] no court

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[50] 561 F.2d at 1235-36.

[51] *Id.* The court felt compelled to compare the pension plan to traditional securities because of the words "unless the context otherwise requires" which introduces the definitional section of both the '33 and '34 Act. *Id.* at 1236, *quoting* 15 U.S.C. §§ 77b, 78c (1976). Although similarities with traditional securities help in determining coverage, this factor is not determinative. *See* Tcherepnin v. Knight, 389 U.S. 332 (1967). Thus the Seventh Circuit's reasoning that the Acts require such a comparison is questionable.

[52] 561 F.2d at 1236. For a discussion of mutual funds, see generally *The Mutual Fund Industry, A Symposium,* 13 B.C. INDUS. & COM. L. REV. 955 (1972).

[53] 561 F.2d at 1231-32.

[54] *Id.* at 1236. *See* Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811 (2d Cir. 1975).

[55] *See* note 36 *supra.*

[56] 561 F.2d at 1236; *accord,* Schlansky v. United Merchants, & Mfg., Inc. [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,353 (S.D.N.Y. Nov. 7, 1977). The Seventh Circuit also found the plaintiff's interest in the pension plan to be like an interest in a variable annuity contract. These contracts are forms of insurance in which premiums collected are invested primarily in common stock and other equities with benefit payments varying with the success of the investment policy. Such contracts have been held to be securities within the meaning of the security laws. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 69 (1959); *see* SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1966). For a discussion of such contracts, see generally *Proceedings of Conference on Variable Annuities and Variable Life Insurance,* 32 BUS. LAW. 675 (1977).

[57] *See* 435 F. Supp. 245, 246 (D.C.C. 1977).

[58] 435 F. Supp. at 245.

[59] *Id.*

[60] *Id., citing,* United Hous. Foundation v. Forman, 421 U.S. 837 (1975); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[61] The *Robinson* decision was subsequent to the district court ruling in *Daniel,* 410 F. Supp. 541 (N.D. Ill. 1976), but prior to the Seventh Circuit's opinion. The circuit court

had held an involuntary, noncontributory pension or health benefit plan to be a security.[62] Contrary to *Daniel*, the *Robinson* court maintained that such plans do not involve investment decisions similar to those the securities laws were enacted to protect.[63]

The *Robinson* court failed to address the fact that the disclosure provisions of the '33 Act might have prevented the alleged fraud in both *Robinson* and *Daniel*. The investment decision involved in *Robinson* and *Daniel* was whether to exchange one's labor for an interest in a scheme promising specific benefits at a later date.[64] Had the employees in *Robinson* known that the benefits were to last only five years or had the plaintiff in *Daniel* known that an involuntary lay-off could eliminate coverage, the employees might not have accepted the plan as part of their collective bargaining agreement.[65] This result is substantially similar to an investor refusing to invest capital in a mutual fund due to the disclosure of material facts by the promoter.[66] Thus the *Robinson* court's distinction based on the character of the investment appears questionable.

The *Robinson* court also maintained that such retirement plans could

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opinion, however, reflects the reasoning of the district court decision and therefore the *Robinson* court's criticism is applicable. *See Definition of a "Security"*, *supra* note 13, at 869 n.43.

[62] 435 F. Supp. at 246; *accord*, Weins v. International Bhd. of Teamsters [1977-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,005 (C.D. Cal. March 28, 1977). *Daniel* and Robinson are distinguishable on their facts but the distinctions are inconsequential. In stressing the distinctions, the *Daniel* court placed particular emphasis on the fact that the beneficiary-plaintiff's in *Robinson* were spouses and dependents of the deceased employee. The Seventh Circuit maintained that such a plaintiff could not be considered an investor as was the employee-plaintiff in *Daniel* because they could not be said to have contributed to the fund. 561 F.2d at 1233. Although this criticism is justifiable as to the "actual purchaser" standing requirements enunciated in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the factor is irrelevant in determining whether a "security" exists in light of the disclosure purposes of the Acts. The employee in *Robinson* would have been as equally concerned as the employee in *Daniel* had he been informed that expected benefits were unlikely to be received. To attempt to discern whether a scheme was a security on the basis of the plaintiff's standing would be contrary to the Supreme Court's focus on the character of the scheme. *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293 (1948).

The Seventh Circuit also distinguished *Robinson* because in *Robinson* benefits had traditionally been paid out of current contributions from the employer. Thus the *Daniel* court reasoned that Robinson lacked the expectation of profit existing in *Daniel*, 561 F.2d at 1733. There is no indication, however, that the scheme in *Robinson* was dependent on current contributions being used as benefits. In fact, an investment trust was central to scheme. 435 F. Supp. at 246. Thus in terms of the scheme as presented to the employee evaluating the employment contract, there was an expectation of profit from investment of trust funds in both *Daniel* and *Robinson*.

[63] 435 F. Supp. at 246.

[64] *See* Daniel v. International Bhd. of Teamsters, 561 F.2d 1223 (7th Cir. 1977); *cf.* Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948), *cert. denied in part*, 336 U.S. 960 (1949), *aff'd on other grounds*, 339 U.S. 381 (1950) (employer's contribution to the plan is in exchange for employee's labor).

[65] *See Wake of Daniel*, *supra* note 48, at 699.

[66] *See* Competitive Assoc., Inc. v. Laventhol, Kerkstein, Horwath & Horwath, 516 F.2d 811 (2nd Cir. 1975).

not satisfy the *Howey* criteria for an investment contract. The court stressed that all contributions were to be made by the employer on a fixed formula.[67] From this fact, the court reasoned that the employees had not "invested money" within the meaning of *Howey* because they lacked control over the amount of investment.[68] The court further asserted that the plan generated no "profits" for the employees because the interests in the funds were inalienable and because excess funds would not be reinvested for the individual employee's profit.[69] The employee, therefore, could receive only the amount established by the collective bargaining agreement. Because this resulted in the employee exchanging a fixed amount of labor for a specified return of benefit, the court held that the *Howey* profit criterion was not met.[70]

In contrast, the *Daniel* court stated that the plan satisfied all the *Howey* criteria for an investment contract.[71] This reasoning is logically more sound than the *Robinson* decision. The threshold issue under the *Howey* criteria is whether there is an "investment of money." If the employer-paid contributions to the pension fund can be considered economic compensation to the employee, this criterion is met.[72] In *Daniel,* the contributions were equivalent to compensation since the money the employer was contributing into the fund otherwise might have been paid as wages. In addition, the pension plan, like wages, may have induced employees to keep their present employment rather than obtaining higher wages from employers not offering such a plan. Accordingly, the employee had made an "investment of money."[73] Furthermore, the plan undoubtedly satisfied the "common enterprise" requirement as the fund managers pooled the employer's contribution made on behalf of each employee.[74] Despite the reasoning of the *Robinson* court, the employees in both *Daniel* and *Robinson,* also had an "expectation of profits"[75] because they realized

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[67] *Id.* Contributions by the operators were on a per tonnage basis and the employees could neither convert the payments to personal use nor change the amount of the payments. 435 F. Supp. at 247.

[68] *Id.*

[69] *Id.* The inability to transfer interest in the plans and the fixed rate of return makes the scheme comparable to that involved in *Forman. See* United Hous. Foundation, Inc. v. Forman, 421 U.S. at 838-39.

[70] 435 F. Supp. at 247.

[71] 561 F.2d at 1231-35.

[72] *Id.* at 1233. The Seventh Circuit listed substantial authority for the proposition that employer contributions to a pension fund are in fact compensation to the employee. *See* Lewis v. Benedict Coal Coop., 361 U.S. 459, 469 (1960); Employing Plasterers' Assoc. v. Journeyman Plasterer's Protective & Benevolent Soc'y, 279 F.2d 92, 99 (7th Cir. 1960); P. DRUCKER, THE UNSEEN REVOLUTION 8, 34 (1976); Note, *Legal Problems of Private Pension Plans,* 70 HARV. L. REV. 490, 494 (1957). *But see* United Hous. Foundation, Inc. v. Forman, 421 U.S. at 854-58 (non-cash benefits such as lower rent found not to be profit).

[73] *See* 561 F.2d at 1231-35; 5 FORDHAM URBAN L.J. 591, 600 (1977).

[74] *See* 561 F.2d at 1233; notes 89-106 *infra.* For a discussion of the pooling requirement within the *Howey* "common enterprise" context, see generally Bennett, *How Common Is A Common Enterprise?,* 1974 ARIZ. ST. L.J. 339, 346-62 (1974).

[75] 561 F.2d at 1233-35.

that the fund managers would invest the contributions in profit making schemes[76] and because the viability of the fund depended on such profits being realized.[77] Finally, since the fund managers invested the funds on behalf of the employees, the profits came solely from efforts of noninvestors.[78] Thus the Seventh Circuit correctly found that the pension plan encompassed all of the elements required under *Howey* for an investment contract.

Despite being contrary to the recent Supreme Court policy of limiting the scope of the securities laws, the *Daniel* decision should be followed. By 1980, forty-two million American workers are expected to belong to pension plans.[79] As emphasized by the *Daniel* court, not only are such plans the sole form of retirement investment for a majority of the industrial work force, but the plans also control over a quarter of the entire capital market.[80] The need for maximum protection in this area is illustrated by the fact that in 1972, 1,227 pension plans were terminated, resulting in a loss of $49,000,000 in pension benefits for 19,400 participating workers.[81]

Although recent federal regulation should help eliminate many pension fund problems,[82] application of the securities laws in this area would furnish the extra precaution of providing the employee-investors with a right to information on the character of the scheme prior to the actual contribution of any money.[83] Anti-fraud provisions of the securities laws would require plan managers to disclose all material facts prior to the employee's investment decision.[84] Thus by providing "a self-executing compulsion"[85] to disclose adequate information, fund managers, like those involved in *Daniel* and *Robinson*, would be required to disclose such information as the statistical probability of benefits being paid and the length of time benefits will continue.[86] Providing this information to the union membership prior to voting on a collective bargaining agreement, containing a plan, and to the individual deciding to accept employment, would allow employees to understand fully what benefits would be received in exchange

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[76] *See Wake of Daniels, supra* note 48, at 704.

[77] *See* 561 F.2d at 1233-35; *Wake of Daniels, supra* note 48, at 704.

[78] 561 F.2d at 1233-35.

[79] S. REP. No. 93-127, 93d Cong., 1st Sess. 2-3 (1973). *Reprinted in* [1973] 3 U.S. CODE CONG. & AD. NEWS at 4838; PRESIDENT'S COMM. ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS: A REPORT TO THE PRESIDENT ON PRIVATE EMPLOYEE RETIREMENT PLANS vi (1965).

[80] 561 F.2d at 1235.

[81] DEP'T OF THE TREASURY & DEPT. OF LABOR, STUDY OF PENSION PLAN TERMINATION 18 (1973); *see* Note, *The Employee Retirement Income Security Act of 1974: Policies and Problems*, 26 SYRACUSE L. REV. 539, 542-45 (1975).

[82] *See* 29 U.S.C. §§ 1001-1381 (1976); Comment, *Application of Federal Securities Laws to Noncontributory, Defined Benefit Plans*, 45 CHI. L. REV. 124, 145-49 (1977).

[83] *See Wake of Daniels, supra* note 48, at 717.

[84] 561 F.2d at 1249. The *Daniels* court stated that a pension fund would not be required to comply with registration requirements due to an 1970 amendment of § 5 of the '33 Act, 15 U.S.C. § 77e (1976), exempting certain funds from registration. 561 F.2d at 1239-1243.

[85] 561 F.2d at 1249.

[86] *See Wake of Daniels, supra* note 48, at 722.

for their labor. Since the securities laws were designed to achieve equality of information between those promoting a scheme and those seeking investment,[87] and since the plans arguably can satisfy the *Howey* definition of investment contracts, application of the Acts is appropriate.[88]

Other recent lower court decisions focusing on the elements of an "investment contract" illustrate the conflict between the remedial focus of *Howey* and *Tcherepnin* and the restrictive policy underlying *Forman.* One area especially illuminating is the reading given the "common enterprise" element of *Howey.* Recent decisions indicate two entirely different interpretations of this requirement.[89] One interpretation establishes a vertical approach by requiring an interdependence between the "fortunes of the investor" and the "efforts and success" of the promotors.[90] Under this analysis, a common enterprise exists when each investor's profit is a function of the same factors, primarily the investing expertise of the promoters.[91] The other interpretation is more restrictive and horizontal in nature requiring that the fortunes of any one investors be directly related to the success or failure of other investors.[92] Thus this approach requires an actual pooling of funds resulting in a "sharing in the earning and profits" of the scheme.[93]

Differing results reached in circuits deciding whether discretionary trading accounts[94] are securities evidence the effect of these horizontal and vertical approaches.[95] Discretionary trading accounts involve an investor placing funds in an account and executing a power of attorney appointing

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[87] *See* note 23 *supra.*

[88] The Seventh Circuit in *Daniel* succinctly stated the issue underlying the policy argument favoring application of the securities laws to pension plans:

> Since the anti-fraud provisions do not impose an undue burden on anyone, [why] should [they not] be available to employees to remedy fraud. . . . The proper inquiry then is not whether interests in employee pension plans are securities but rather why such a vital investment vehicle should be nevertheless excluded from the protection of the securities law.

561 F.2d at 1242.

[89] *See, e.g.,* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100 (7th Cir. 1977); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,862 (E.D. Mich. Dec. 27, 1976); Newton, *supra* note 14, at 176-81.

[90] *See, e.g.,* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 478 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973); '74 "Security", *supra* note 17, at 724.

[91] *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 473-79 (5th Cir. 1974).

[92] *See, e.g.,* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 276-77 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972).

[93] *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977), *quoting,* SEC v. W.J. Howey, 328 U.S. at 300.

[94] For a discussion of different types of trading accounts, see E.F. Hutton v. Burkholder, 413 F. Supp. 852, 860 (D.D.C. 1976).

[95] *Compare* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100 (7th Cir. 1977) (a discretionary trading account is a security only if there is a sharing of profits) *with* Marshall v. Lamson Bros., 368 F. Supp. 486, 489 (S.D. Iowa 1974) (sharing of profits not determinative because unlikely that protection of securities laws are "available only to those hapless capitalists who are not alone in their misfortune").

an account manager as his agent and attorney in fact to invest the funds.[96] The key factor in terms of *Howey* is that each investor's account is kept separate from the accounts of other investors.[97] The courts adopting the horizontal approach maintain that there is no "common enterprise." The success of the account of the individual investor is not related to the success of other investors[98] because there is not a pooling of the funds and sharing of profits.[99] The courts adopting the vertical approach, however, have found the requisite commonality to exist because the success of the segregated accounts is tied inextricably to the efficacy of a single promoter.[100] Therefore, courts following the vertical approach do not require a pooling of funds.[101]

The Supreme Court's treatment of the facts in *Howey* favors the use of the horizontal approach. The *Howey* Court emphasized that, in reality, the investor did not purchase a unit of land, but rather the right to an interest in the profits of the orange grove as a whole.[102] He provided capital by which the promoter developed the grove. The investor had no rights in any particular fruit, but rather the total produce was pooled for sale.[103] In return for his capital, the investor received a percentage of the profits on the total sale of produce based on the percentage of capital contributed.[104] Since *Forman* requires a narrow reading of *Howey* to effectuate the Supreme Court's policy of limiting the scope of the Acts,[105] the pooling aspect

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[96] *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 98 (7th Cir. 1977); Bartley v. P.G. Commodities Assoc., [1978-1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,365 (S.D.N.Y. March 22, 1978); Note, *Discretionary Commodities Trading Account as a Security: Is There a Common Enterprise?*, 28 S.W.L.J. 602 (1974).

[97] *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100 (7th Cir. 1977).

[98] *Id.* In *Hirk*, the plaintiff had established a discretionary trading account with the defendant upon the defendant's representation that he could not possibly lose more than $7,500. *Id.* at 98. In fact, the plaintiff lost $17,880. The Seventh Circuit denied plaintiff's claim under the securities laws, reaffirming its opinion by present Justice Stevens in Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972). The Seventh Circuit relied on the language in *Howey* which focused on the "sharing in the earnings and profits." 561 F.2d at 101, *quoting*, SEC v. W.J. Howey, 328 U.S. at 300. Under *Milnarik* and *Hirk*, a discretionary trading account can never be a security because each individual invests in different areas and there is no understanding or expectation that the investors will share in a common fund comprised of returns on their investments. *See* Hirk v. Agri-Research Council, Inc., 561 F.2d at 101-02.

[99] 561 F.2d at 100.

[100] *See* SEC v. Continental Commodities Corp., 497 F.2d 516-22 (5th Cir. 1974).

[101] *See id.;* Marshall v. Lamson Bros., 368 F. Supp. 486, 489 (S.D. Iowa 1974). Under the vertical approach, the fact that the common investors defer to the expertise of the common agent suffices for demonstrating *Howey's* "common enterprise." *Cf.* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974) (pyramiding scheme satisfies "common enterprise" requirement due to the uniformity of impact of the promoter's effort). For a discussion in support of this approach, see Long, *Introduction Student Symposium: Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations,* 6 ST. MARY'S L.J. 96, 123-26 (1974).

[102] SEC v. W.J. Howey Co., 328 U.S. at 300.

[103] *Id.* at 296.

[104] *Id.*

[105] *See* cases cited at note 30 *supra.*

of the investment contract in *Howey* cannot be disregarded. Thus those schemes, including discretionary trading accounts, in which there is no pooling of funds should not be considered investment contracts for purposes of the securities laws.[106] Consequently, the vertical approach to the common enterprise element of *Howey* should be abandoned in favor of the horizontal approach requiring an actual pooling of funds and a percentage distribution of profits.

A second area of *Howey* which has become increasingly controversial is the "solely from the efforts of others" criterion.[107] Primary focus has been placed on the word "solely."[108] Recent decisions modify the "solely" requirement, applying instead a test of whether the investor possesses a significant managerial function which affects the success or the failure of the enterprise.[109] This adaptation of the "solely" criterion resulted from a judicial desire to include inherently fraudulent pyramiding schemes,[110] within the provisions of the Acts.[111] Although such a modification avoids

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[106] *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100 (7th Cir. 1977); *cf.* Sullivan v. Chase Investment Servs. Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,224 (N.D. Cal. March 25, 1977) (investor's use of common agent of investment advisory service insufficient to satisfy *Howey* "common enterprise" element).

[107] *See, e.g.*, Crowley v. Montgomery Ward & Co. [1978-1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,313 (10th Cir. Feb. 3, 1978); Schultz v. Dain Corp., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,303 (8th Cir. Jan. 27, 1978); Bell v. Health-Mor, Inc., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,007 (5th Cir. March 24, 1977).

[108] *See, e.g.*, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482-83 (9th Cir. 1973); Newton, *supra* note 14, at 185-92.

[109] *See, e.g.*, Crowley v. Montgomery Ward & Co., [1978-1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,313 (10th Cir. Feb. 3, 1978); Bitter v. Hoby's Int'l Inc., 498 F.2d 183, 184-85 (9th Cir. 1974); Lino v. City Investing Co., 487 F.2d 689, 691-93 (3rd Cir. 1973).

[110] *See generally* Note, *Pyramid Scheme Regulation: The Evolution of Investment Contracts As A Security Under The Federal Securities Law*, 25 SYRACUSE L. REV. 690 (1974). "Pyramid scheme" is a term denoting a particular use of middlemen by a promoter to help distribute his products to ultimate consumers. Each salesperson, or middleman, recruits new members into the scheme. Although the middleman often must purchase this recruitment right, he obtains commissions both on the salespersons brought in and on the products they sell. *Id.* at 693. In this manner, the salesman builds his own distribution pyramid by searching out new recruits. For example, a salesperson who recruits five distributors who in turn recruit five more will earn the commission of thirty salesmen in his chain. Note, *Multi-level or Pyramid Sales Systems: Fraud or Free Enterprise*, 18 S.D.L. REV. 358, 359-61 (1973). The basic problem with the scheme is that eventually there will be no one left to buy a distributorship and thus the later buyers are left "holding the bag." 6 CREIGHTON L. REV. 450, 457 (1973).

[111] The cases encouraging the abandonment of the "solely" requirement are SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973), and SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974). Koscot was a subsidiary of Glenn Turner Enterprises and the pyramiding schemes in both cases were substantially the same. Both schemes included fraudulent, high pressure sales tactics for obtaining new members. Prior investors portrayed to prospective investors that great profits had been made even though in reality few members of the plan obtained any monetary gain. There was little question that the schemes satisfied the *Howey* requirement of "investment of money" and "common enterprise." SEC v. Koscot Interplanetary Inc., 497 F.2d at 478-79; SEC v. Glenn W. Turner Enterprise, 474 F.2d at 480-83. The investor, however, clearly did not contemplate that his profits were to be made "solely from the efforts of others" since the investor's ability to attract others to the plan was critical to the success of both schemes. Both the *Turner* and *Koscot*

the constraints of the "solely" standard in those cases where state remedies are unavailable,[112] the "efforts of others" criterion should not be read so broadly as to encourage expansion of the Acts.

Recent decisions indicating an adoption of the "no managerial efforts" test,[113] have tended to find that a security did not exist because of the presence of managerial powers on the part of the investors. Thus, in *Crowley v. Montgomery Ward & Co.*,[114] a case involving a franchise arrangement,[115] the Tenth Circuit found that the "no managerial efforts" test was not met when a franchisee-investor had the power to hire and fire employees, set prices below the franchisor's suggested price and extend credit apart from the franchisor's credit plan.[116] Likewise, in *Schultz v. Dain Corp.*,[117] the Eighth Circuit found that the sale of an apartment complex coupled with management services failed to satisfy the "no managerial efforts test" because the investor retained the right to obtain new management even though all the managerial powers were vested in the

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courts held, however, that the remedial purposes of the Act required an abandonment of the "solely" requirement. Thus the courts replaced the requirement with a determination of whether the efforts of the investors are the essential managerial efforts which affect the success or failure of the enterprise. SEC v. Koscot Interplanetary Inc., 497 F.2d at 483; SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d at 482.

[112] Recent Supreme Court securities cases illustrate a policy of fostering the use of state remedies. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975); Blue Chip Stamps v. Manor Drug Store, 421 U.S. 723 (1975). By the time of the pre-trial hearings in SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973), however, forty-one states had brought actions against the varied plans of Glenn Turner. *See* In re Glenn W. Turner Enterprises Litigation, 521 F.2d 775, 777 (3rd Cir. 1975). Most of these actions were brought under state deceptive practices statutes, *see, e.g.*, Dare To Be Great, Inc. v. Commonwealth, 511 S.W.2d 224 (Ky. 1974), or related provisions aimed at pyramiding schemes. *See, e.g.*, State v. Koscot Interplanetary, Inc., 212 Kan. 668, 512 P.2d 416 (1973). Besides injunctions, state laws often allowed either the private party, *see e.g.*, KAN. STAT. § 50.636 (1976); KY. REV. STAT. § 367.220 (Cumm. Supp. 1976) (actual damages or statutory penalty), or the attorney general of the state on behalf of such party, *see, e.g.*, KAN. STAT. § 50.632 (1976) (actual damages), to recover actual and punitive damages for violation of the statutes. Since the states adequately regulate pyramiding schemes, those decisions expanding the securities laws to cover such schemes seem questionable in light of the Supreme Court's policy towards fostering the use of state remedies when adequate.

[113] *See* Hector v. Wiens, 533 F.2d 429, 433 (9th Cir. 1976); McCown v. Heidler, 527 F.2d 204, 211 (10th Cir. 1975); Jones v: International Inventors, Inc., 429 F. Supp. 119, 124-25 (N.D. Ga. 1976); SEC v. Norton, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,709 (N.D. Ill. Aug. 3, 1976).

[114] 570 F.2d 875 (10th Cir. 1978).

[115] A franchise arrangement typically involves the franchisor offering to establish a franchisee in a business under the franchisor's recognized name. The franchisee pays for the right to establish the business and must operate the enterprise within broad guidelines established by the franchisor. *See, e.g.*, Bitter v. Hoby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974). Franchises generally fail to meet the "efforts of others" test of *Howey*. *See* Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666, 669-70 (10th Cir. 1972), *aff'g*, 324 F. Supp. 640 (D. Colo. 1970); *Franchise Agreements, supra* note 18 at 65-67.

[116] 570 F.2d at 877; *accord*, Bitter v. Hoby's Int'l, Inc., 498 F.2d 183, 184-85 (9th Cir. 1974).

[117] 568 F.2d 612 (8th Cir. 1978).

promoter.[118] The results in *Crowley* and *Schultz* accord with outcomes obtainable by use of the "solely" standard because under that standard the investors' activity beyond capital contribution would have precluded denoting the schemes securities. Accordingly, a restrictive application of the "no managerial efforts" test, as illustrated by *Crowley* and *Schultz,* is no more than the "solely" standard under another name. Nevertheless, the modification appropriately allows flexibility in those circumstances warranting extended protection because it provides potential coverage to those investors who do more than just furnish capital. Thus the "no managerial efforts" test properly provides courts with the means to balance the judicial policy of restricting the scope of the Acts with the remedial purposes underlying the legislation.

Besides limiting the trend of expanding the coverage of the securities laws, the *Forman* Court's reaffirmance of *Howey* makes questionable the "risk capital" approach which some courts had substituted for the forty-two year old *Howey* test.[119] Under this approach, the courts analyze the nature[120] and the degree of investor risk which accompanies a transaction.[121] The theory underlying this approach is that as the risk of non-payment increases, dependence on the efforts of others for repayment or profit increases proportionally indicating a scheme paralleling traditional securities.[122] In *Forman,* the Supreme Court explicitly refused to apply the "risk capital" approach.[123]

In focusing on the nature of the risk involved under the "risk capital" approach, the issue is whether the impetus for the investor is primarily of a commercial or of an investment nature.[124] The distinction has been char-

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[118] *Id.* at 93,021; *accord,* Fargo Partners v. Dain, 405 F. Supp. 739 (D.N.D. 1975), *aff'd,* 540 F.2d 912 (8th Cir. 1976).

[119] *See* Comment, *Securities Regulations—Securities Covered—Shares in Cooperative Housing Corporation As Securities Under The Federal Securities Acts,* 26 CASE W. RES. L. REV. 735, 753-56 (1976) [hereinafter cited as *Co-op Shares*]; 1 J. CORP. L. 639, 649-50 (1976).

[120] The focus on the "nature" of the risk parallels the "economic reality" analysis often used in conjunction with the *Howey* test. *See* note 36 *supra.*

[121] *See, e.g.,* El Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1228-30 (9th Cir.), *cert. denied,* 419 U.S. 900 (1974).

[122] *See* Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1259-60 (9th Cir. 1976); Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P. 2d 906, 13 Cal. Rptr. 186 (1961) (membership in a country club found to be a security under state securities laws because success of club depended on promoter attracting sufficient investors); *Definition of a "Security," supra* note 13, at 877.

[123] United Hous. Foundation, Inc. v. Forman, 421 U.S. at 857 n.24. The Court did not say it would never use the "risk capital" approach. Had the test been used, however, the court likely would have reached a different result as the holders of the *Forman* shares faced a significant risk of loss on the resale of their shares if the housing project proved unsuccessful. *See Co-op Shares, supra* note 119, at 756-57; 1 J. CORP. L. 639, 649-50 (1976). Since the Supreme Court refused to use the "risk capital" approach to classify the shares in *Forman* as securities, the use of the approach is questionable in circumstances where use of the *Howey* test is reasonable.

[124] *See* Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1256-57 (9th Cir. 1976); Motel Co. v. Commissioner, 340 F.2d 445, 446 (2d Cir. 1965) (distinction is between "risk loan" and "risk capital").

acterized as the "commercial-investment" dichotomy.[125] This dichotomy is illustrated by the recent case of *McGovern Plaza Joint Venture v. First of Denver Mortgage Investors.*[126] In *McGovern,* the Tenth Circuit adopted an analysis utilizing both the *Howey* test and the nature of the risk aspect of the risk capital approach.[127] The question raised in this case was whether the term "security" as used in the Acts encompassed construction loan or permanent loan commitments, a category of documents not listed in the definition of "security" in either act.[128] In focusing on the nature of the risk, the court reasoned that the plaintiff was seeking financing to build a hotel and that any profits which the plaintiff expected resulted from the operation of that enterprise rather than from obtaining the commitments.[129] The court concluded that the plaintiff's efforts in obtaining the commitments were purely commercial in nature and therefore the commitments were not investment securities under the "risk capital" approach.[130] Accordingly, the court found that, in terms of the *Howey* test, the commitments failed to satisfy the "efforts of others" criterion.[131]

The Ninth Circuit's recent decision in *United California Bank v. THC Financial Corp.*[132] illustrates the degree of risk aspect of the "risk capital" approach. At issue in *THC Financial* was whether a finance company's agreement to purchase on demand all notes taken by a bank to secure advances under a line of credit to a third business constituted a security.[133] In measuring the risk involved, the court listed a number of considerations

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[125] *See also* Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974); Lino v. City Investing Co., 487 F.2d 689 (3rd Cir. 1973).

[126] 562 F.2d 645 (10th Cir. 1977). Although the Tenth Circuit did not explicitly state that it was using the "risk capital" approach, the court's use of the "commercial-investment dichotomy" indicates an acceptance of such an analysis. The court phrased this issue in terms of whether the transaction was of a kind in which stock is often given. *Id.* at 647; *see* Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974). Rather than abandoning the *Howey* test, however, the Tenth Circuit incorporated the "risk capital" approach into the "efforts of others" criteria. 562 F.2d at 647. More appropriately, however, the court could have used the commercial nature of the transaction to find that there had been no "investment" of money as required by *Howey.*

[127] *Id.* at 647-48.

[128] *Id.* at 646. The loan commitment was an agreement by First of Denver representing that it was "ready, willing, and able" to provide construction financing to the plaintiff upon certain conditions. *Id.* One such condition was that a permanent loan commitment be obtained from defendant, B.F. Saul Advisory Co. This commitment was an irrevocable promise to loan a specific amount to the plaintiff. *Id.*

[129] 562 F.2d at 647.

[130] *Id.*

[131] *Id.*

[132] 557 F.2d 1351 (9th Cir. 1977).

[133] *Id.* at 92,057. The notes issued by the borrowing business as part of the agreement matured in one month. *Id.* at 92,061. These notes would fall under exceptions in the Acts which exclude short-term commercial paper from coverage since this type of paper is generally not of an investment nature. *See* note 10 *supra*; Sanders v. John Nuveen & Co., 463 F.2d 1075, 1079-80 (7th Cir.), *cert. denied,* 409 U.S. 1009 (1972); 15 U.S.C. §§ 77c(a), 78c(10) (1976); Comment, *The Commercial Paper Market and the Securities Acts,* 39 U. CHI. L. REV. 362, 380-85 (1972).

including time, collateralization, form of obligation, circumstances of issuance, the relationship between the amount borrowed and the size of the borrower's business and the contemplated use of funds.[134] Applying these criteria to *THC Financial*, the Ninth Circuit emphasized that the finance company had extensive knowledge of the third party's fiscal makeup, that the agreement was to last only six months, and that the finance company felt little risk was involved.[135] Therefore, the court held that this situation was similar to a "risky loan" associated with commercial transactions, and not "risk capital", funds risked to a degree greater than generally associated with typical commercial investment situations.[136]

Unlike the Tenth Circuit in *McGovern Plaza*, the Ninth Circuit did not apply the *Howey* test, even though the result in *THC Financial* could have been reached by use of the older standard. Central to the "risk capital" approach is the theory that as the risk increases so does the investors dependence on the "efforts of others."[137] When the *Howey* "efforts of others" criteria is applied to the facts of *THC Financial*, the agreement cannot be considered a security. The success of the third business did not affect the finance company's profit. As long as the business remained solvent, the finance company was assured it would not lose its gain acquired from the cost of the agreement to the business. The only profit making activity from the finance company's point of view was its own ability to secure a good credit risk. Since the person claiming the protection of the Acts was also the person controlling the profit making activity, the *Howey* "efforts of others" test was not met.

Since the *Forman* opinion indicates the Supreme Court's preference for the *Howey* test, the "risk capital" approach should be used only to supplement this standard. Inasmuch as the *Howey* test as written requires an "investment of money," the nature of the risk analysis illustrated by *McGovern Plaza* can be used to determine if an "investment" has occurred. The "degree of risk" aspect can be used as part of the "profit from efforts of others" analysis. Such an intertwining of the two approaches helps refine the *Howey* standard by utilizing the "risk capital" analysis.

The *Forman* opinion indicates both a reaffirmation of the *Howey* test and a policy of tempering the expansion of the scope of securities law. Only in compelling circumstances should the coverage of the Acts be extended. Such circumstances are illustrated by the *Daniel* opinion extending the Acts to pension funds, an area pervaded by fraud and of utmost importance to American labor.[138] Typically, the *Howey* criteria should be read strictly to avoid expansion of the Act. Thus in discerning what is a

[134] [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,125, at 92,061; *see* Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1254-55 (9th Cir. 1976).

[135] [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,125, at 92,061.

[136] *Id.*

[137] *See* Pollock, *Notes Issued in Syndicated Loans—A New Test to Define Securities*, 32 BUS. LAW. 537, 544 (1977); *Definition of a "Security," supra* note 13, at 877.

[138] *See* text accompanying notes 76-79.