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I. Definition Of A "Security"

SURVEY OF 1974 SECURITIES LAW DEVELOPMENTS

I. DEFINITION OF A "SECURITY"

Although many courts in 1974 dealt with the perennial question of what constitutes a "security," no clear definition has yet evolved.[1] However, recent decisions indicate a further liberalization of the four criteria originally enunciated by the Supreme Court in *SEC v. W.J. Howey Co.*[2] In that case, the Supreme Court provided the basic framework for determining the existence of a "security," stating that a transaction involves a "security," or more specifically an "investment contract,"[3] if the transaction is one whereby a person (1) invests his money, (2) in a common enterprise, and (3) is led to expect profits (4) solely from the efforts of others.[4] While recent decisions have refined each of these criteria, no conclusive definition encompassing all four has emerged.[5]

A. "A person invests his money"

The requirement that "a person invest his money" embodies an inherent distinction between investment and commercial activity. Because the securities acts[6] were intended to protect investors, some courts have applied this distinction in attempting to determine

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[1] Both §2(1) of the Securities Act of 1933, and §3(a)(10) of the Securities Exchange Act of 1934 provide similar definitions of a "security." 15 U.S.C. §§77b(1), 78c(a)(10)(1970). Determining whether a particular transaction involves the sale of securities is of great importance since the registration requirements of §5 of the 1933 Act and §12 of the Exchange Act, and the sanctions against fraudulent practices provided in both acts, apply only to securities. 15 U.S.C. §§77e, 78*l* (1970). Most of the litigation involving the meaning of "security," has centered around a definition of the term "investment contract" which is one enumerated example of a "security" under the acts. *See* note 3 *infra*.

[2] 328 U.S. 293 (1946).

[3] Section 2(1) of the Securities Act, and §3(a)(10) of the Exchange Act define a "security" to include the rather broad concept of an "investment contract." *See* note 1 *supra*.

[4] 328 U.S. at 298-99.

[5] One commentator has stated that in defining a security "[W]e are somewhat in the same position as some of the members of the United States Supreme Court when dealing with obscenity: We can generally tell a security when we see one, on a case by case basis, but have been unwilling to attempt to give a generic definition to the term." Long, *Student Symposium on Securities: Introduction*, 6 ST. MARY'S L.J. 95, 96 (1974) [hereinafter cited as *Long*].

[6] Securities Act of 1933, 15 U.S.C. §§77a-77aa(1970); Securities Exchange Act of 1934, 15 U.S.C. §§78a-78hh(1970).

whether a "security" exists, particularly in cases involving promissory notes. Invoking the qualifying language "unless the context otherwise requires," which prefaces the definition of a security in §2(1) of the 1933 Act,[7] courts have held that the circumstances surrounding the execution of a promissory note must be examined to determine the real nature of the instrument. If the note is executed in connection with a commercial transaction it will not be considered a security,[8] but if executed as part of an investment scheme the note will be regarded as a security.[9] A refinement of this basic approach has recently been adopted by the Seventh Circuit.[10] The court has formu-

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[7] *See* note 1 *supra*.

[8] McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 43 U.S.L.W. 3452 (U.S. Jan. 5, 1975) (note and deed of trust resulting from $200,000 loan by bank to a corporation); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1114 (5th Cir. 1974) (note and deed of trust resulting from bank loan to the Bellahs to aid them in developing their livestock business); Avenue State Bank v. Tourtelot, 379 F. Supp. 250, 255 (N.D. Ill. 1974) (note resulting from bank loan to a commercial enterprise). The court in *Tourtelot* stressed that although the note involved was not a security, an agreement by numerous banks to participate in the note transaction ("loan participation agreement") would indicate the investment rather than commercial nature of such a transaction. *Id.* at 254-55.

[9] Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974) (note resulting from plaintiff's loan of funds to defendants to promote a real estate investment corporation); Hall v. Security Planning Serv., Inc., 371 F. Supp. 7 (D. Ariz. 1974) (notes, secured by mortgages and payable to defendant, resulting from the purchase of lots by the makers from the defendant, which defendant then indorsed and sold across the country).

In Safeway Portland Employees' Fed. Credit Union v. C. H. Wagner & Co., 501 F.2d 1120 (9th Cir. 1974), the court considered an entire investment package a security, although part of the package represented a commercial transaction. The plaintiff was induced by defendant to purchase bank certificates of deposit, after having been promised that he would receive from the defendant an added interest rate of ⅝% separate from the bank's normal rate on certificates of deposit of 7-½%. The court considered the certificates of deposit and the bonus together, and held that because the bonus satisfied the elements of a security, the whole package was a security. In reaching its conclusion, the court stressed the importance of analyzing the economic inducement which led the investor to make his investment. *Id.* at 1122-23.

[10] C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., CCH FED. SEC. L. REP. ¶94,938 (7th Cir. Jan. 13, 1975). The court in this case stated:

> [B]uying shares of the common stock of a publicly-held corporation, where the impetus for the transaction comes from the person with the money, is an investment; borrowing money from a bank to finance the purchase of an automobile, where the impetus for the transaction comes from the person who needs the money, is a loan. In between is a gray area which, in the absence of further congressional indication of intent or Supreme Court construction, has been and must be in the future subjected to case-by-case treatment.

Id. at 97,246.

lated an "impetus" test to assist in distinguishing between investment and commercial transactions. When the transaction arises as a result of the borrower's need for cash, the resulting promissory note is not a security. However, if the impetus for the transaction is the investor's desire to "lend" money, the resulting promissory note is a security.

Although primarily applied in promissory note cases, the investment-commercial distinction should be considered whenever the existence of a "security" is in issue.[11] Cases have often been decided by focusing on the other three criteria in the *Howey* formulation without considering this fundamental distinction, as recent decisions involving pyramid schemes and franchise arrangements amply illustrate. While pyramid schemes generally have been held to involve securities,[12] courts have consistently held that franchise arrangements do not fall within that definition.[13] In analyzing both types of arrangements, courts have ignored the investment-commercial distinction and have instead focused on the efforts of the investor in the venture.[14]

The danger inherent in such an approach is that situations may arise in which consideration of the investors' efforts will not result in clear differentiation between pyramid and franchise arrangements. For example, in a recent case the Eastern District of Pennsylvania held that a transaction was a franchise simply because it was termed a franchise in the agreement between the parties.[15] A consideration of the investors' efforts, however, indicated a substantial similarity to arrangements which courts have traditionally regarded as pyramid schemes. Regardless of the decision in this case, the court could have

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[11] One commentator has provided what he terms a definition of a "security by specification" in which he stresses the importance of making the investment-commercial distinction. *Long supra* note 5, at 96.

[12] SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Steed Indus., Inc., CCH FED. SEC. L. REP. ¶ 94,917 (N.D. Ill. Oct. 15, 1974); Davis v. Avco Corp., 371 F. Supp. 782 (N.D. Ohio 1974). The leading case holding that pyramid schemes involve securities is SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

[13] Bitter v. Hoby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974); Plum Tree, Inc. v. Seligson, 383 F. Supp. 307 (E.D. Pa. 1974); L.H.M., Inc. v. Lewis, 371 F. Supp. 395 (D.N.J. 1974). The case most often cited for the proposition that franchise arrangements do not involve securities is Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973).

[14] *See* text accompanying notes 31-40 *infra*.

[15] A.B.A. Auto Lease Corp v. Adam Indus., Inc., CCH FED. SEC. L. REP. ¶94,959 (E.D. Pa. Jan. 9, 1975).

provided a sounder basis for its decision by considering the investment-commercial distinction.[16]

B. *"In a common enterprise"*

The *Howey* formulation also requires that the investors invest their funds in a "common enterprise." However, the ambiguity in this term has led courts to develop two entirely different interpretations of the common enterprise requirement. One interpretation views commonality in a vertical sense by requiring an interdependence between the "fortunes of the investor" and the "efforts and success" of the promoters.[17] The other stresses horizontal commonality, and requires that the fortunes of any one investor be directly related to the success or failure of the other investors.[18]

The conflicting judicial formulations of the commonality requirement recently led two district courts to reach contradictory conclusions as to the nature of discretionary commodity accounts.[19] In *Marshall v. Lamson Bros. & Co.*,[20] the Southern District of Iowa held that such an account was a "security" since the commonality requirement had been met as between the investors and the promoters of the scheme, notwithstanding the lack of any pooling of funds among the

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[16] In El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974), the transaction had all the indicia of a commercial loan yet closer consideration of the facts revealed that the loan was part of a larger investment scheme between the borrower and the lender. *See* text accompanying notes 31-34 *infra*. Although the other three *Howey* criteria presented the court with problems in analysis, a clearer approach could have been adopted through consideration of the investment-commercial distinction.

[17] *See* Rochkind v. Reynolds Sec., Inc., CCH FED. SEC. L. REP. ¶ 95,088 (D. Md. Ja. 8, 1975). In SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974), the Fifth Circuit stated: "The critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts." *Id.* at 478. *See* SEC v. Brigadoon Scotch Distrib., Ltd., CCH FED. SEC. L. REP. ¶94,980 (S.D.N.Y. Feb. 11, 1975).

[18] *See* Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); *Long supra* note 5, at 123-25. This interpretation has led to the requirement that there be a pooling of the investors' funds. *Long supra* note 5, at 123-25.

[19] Commodity futures contracts are not considered securities. *See, e.g.*, Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 253 F. Supp. 359 (S.D.N.Y. 1966). However, the cases here discussed involved discretionary commodity accounts in which investors open accounts with futures commission merchants, using securities or cash, and authorize the merchants to act as their agents (although the agents virtually act on their own) in buying and selling, and otherwise trading in commodities futures contracts on the commodities exchanges.

[20] 368 F. Supp. 486 (S.D. Iowa 1974).

various accounts.[21] In *Hirk v. Agri-Research Council, Inc.*,[22] however, the Northern District of Illinois disagreed with the view taken in *Marshall* and concluded that since commonality among the investors themselves was lacking, the discretionary commodities accounts were not securities. The *Marshall* view is arguably more consistent with the legislative intent underlying the securities acts, since that view protects investors whether or not there is horizontal commonality and pooling of funds.[23]

C. *"Is led to expect profits"*

This element of the *Howey* test involves primarily a determina-

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[21] In recognizing the remedial purpose of the 1933 and 1934 Acts, the court stated:

> At the very least, it is equally as plausible to conclude that the element of a "common enterprise" is satisfied when a single investor commits his funds to a promoter in hope of making a profit as to conclude that the investor protection afforded by the '33 and '34 Acts and the complex regulatory scheme developed thereunder is available only to those hapless capitalists who are not alone in their misfortune.

Id. at 489. *See* note 18 *supra*; SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974). *Cf.* SEC v. Haffenden-Rimar Int'l Inc., 496 F.2d 1192 (4th Cir. 1974); SEC v. Glen-Arden Commodities, Inc., 493 F.2d 1027 (2d Cir. 1974). The latter two cases involved whiskey warehouse receipts in which the investor paid for an identified cask of whiskey, which would be *managed* for him in the whiskey market by the promoters of the investment scheme. The structure of these whiskey investment schemes, which involved no pooling of funds to purchase the whiskey, seems to support the *Marshall* view of commonality.

[22] CCH FED. SEC. L. REP. ¶94,738 (N.D. Ill. June 24, 1974). In rejecting the plaintiff's claim, the court reaffirmed the necessity for the pooling of funds by stating:

> The contractual agreement between the parties makes no reference to any proposed commingling of funds or a joint account with other investors, but speaks solely in terms of a single account, limited to plaintiff's investment. Further, although defendants may have entered into similar discretionary arrangements with other investors, there is no suggestion that the success or failure of those other contracts directly affected the profitability of plaintiff's investment.

Id. at 96,453 (citation omitted).

[23] An important consideration in this regard is the manner in which the investment scheme is represnted to the potential investor. If a pooling of funds is represented although in actuality no pooling occurs, the standards in both the *Hirk* and *Marshall* cases could be satisfied, depending on whether the court considered the representations or the realities of the scheme. *See* text accompanying notes 41-42 *infra*. *But see* Glazer v. National Commodity Research & Statistical Serv., Inc., CCH FED. SEC. L. REP. ¶ 94,978 (N.D. Ill. Sept 5, 1974); Stevens v. Woodstock, Inc., 372 F. Supp. 654 (N.D. Ill. 1974). In both cases, which involved commodities futures contracts, the district court held that the pooling of investors' funds by the defendants, without any authorization from the investors, did not satisfy the commonality requirement due to the lack of a "common purpose."

tion of when there is an expectation of "profits" in a transaction.[24] Various 1974 decisions extended the parameters of the term "profits" to include a broader concept of "benefits."[25]

In *1050 Tenants Corp. v. Jakobson*,[26] the Second Circuit considered whether the "shares" in a housing cooperative were "securities." The court applied the *Howey* test and found that two factors present in the transaction under consideration satisfied the "profit" requirement: (1) the use of rental income to offset and reduce the periodic assessments on the shareholders for the maintenance of the building, and (2) the expectation of capital appreciation on a resale of the shares in the cooperative. In making this determination, the court was implementing a previously established policy treating such tangible benefits as satisfying the "profit" requirement.[27]

In another Second Circuit decision, *Forman v. Community Services, Inc.*,[28] the concept of profits was expanded to include less tangible benefits accruing to shareholders in a cooperative. While no possibility of capital appreciation of the shares held by the "tenants" in the cooperative existed, the *Forman* court concluded that a "security" was present, since other elements of "profit" were present in the housing cooperative scheme. These other elements included the potential tax benefits which would result from the deduction of the shareowner's pro rata share of the mortgage payment from his income, and the rental "savings" by the shareowner as a result of living in the cooperative rather than the more costly neighboring homes.

However, some doubt existed whether the shareowners in *Forman* ever considered these elements "profits."[29] The United States Su-

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[24] This element of the *Howey* test also implies a second consideration previously discussed: that the likelihood of profits *induced* the investor to enter the transaction. *See* text accompanying notes 24-30 *supra*.

[25] Although both terms have approximately the same denotation, "benefits" connotes a broader spectrum of amenities.

[26] 503 F.2d 1375 (2d Cir. 1974).

[27] *See* El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir. 1974); *Long supra* note 5, at 117-19.

[28] 500 F.2d 1246 (2d Cir. 1974), *cert. granted sub nom.*, United Housing Foundation Inc. v. Forman, 43 U.S.L.W. 3140 (U.S. Jan. 20, 1975).

[29] There is no indication that the tenants could have benefitted by the tax deduction, due to the low and low-middle nature of their incomes. 500 F.2d at 1249. Likewise, these tenants probably could not have afforded the other housing in the area, and therefore, it is hardly persuasive to contend that they were actually saving something by living in the cooperative. Furthermore, as in *1050 Tenants Corp.*, the court held that the rental income which offset the carrying charges was also a "profit." However, for a few years previous to the litigation, the carrying charges had been substantially increasing and it seems unlikely that the tenants were aware of any reductions. While

preme Court, in an apparent attempt to limit the expansiveness of the "profit" requirement, recently reversed the Second Circuit decision in *Forman*.[30] Although the Supreme Court concluded that no profits were involved in the *Forman* case,[31] it also stated that the shareowners never expected profits but rather bought the shares to acquire subsidized low-cost living space in the cooperative. "In the present case there can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments."[32] This approach by the Supreme Court is consonant with the current trend of stressing the expectation aspect of the "profit" requirement rather than merely determining if profits or the potential therefore exists.

D. "Solely from the efforts of others"

While the final *Howey* criterion requires that profits *result* from the efforts of persons other than the investors, a recent Ninth Circuit decision, *El Khadem v. Equity Securities Corp.*,[33] rejected the contention that profits must also *vary* with the efforts of others.[34] In that case, pursuant to an agreement, El Khadem supplied Nationwide Investment Corporation with cash, including prepaid interest, and securities as collateral for a loan which she secured from Nationwide. In addition, Nationwide had authority to rehypothecate El Khadem's

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the facts of the case may satisfy an objective interpretation of "profits," it is difficult to believe that these " profits" *induced* the persons to make their investments. *See* note 31 *infra*.

[30] United Housing Foundation, Inc. v. Forman, 43 U.S.L.W. 4742 (June 16, 1975).

[31] The Supreme Court rejected the view that the payment of mortgage interest, with its consequent deductibility for tax purposes, constitutes profit, and also concluded that the rental savings realized by living in the cooperative rather than other housing could in no sense be considered profit. "In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps or other government subsidies." *Id.* at 4748.

Significantly, however, the Court also rejected treatment of the rental income from the leasing of commercial facilities in the cooperative as profit. *See* note 29 *supra*. While the Court conceded that this is the type of profit "traditionally associated with a security investment," it based its conclusion on the observation that "nothing in the record suggests that the facilities *in fact* return a profit in the sense that the leasing fees are greater than the actual cost to Co-op City of the space rented." *Id.* at 4748 (emphasis added). This appears inconsistent, however, with the "expectation of profits" terminology in *Howey* which merely requires the possibility of profit.

[32] *Id.* at 4747.

[33] 494 F.2d 1224 (9th Cir. 1974).

[34] The court analogyzed the situation to that of common stock and corporate bonds; the fact that profits in the latter do not vary does not make them any less securities. *Id.* at 1229.

collateral to the extent of her indebtedness, in furthering its own business purposes. Although the return El Khadem received on the collateral was fixed under the plan, she also "received a tax benefit and investment leverage."[35] The court concluded that although El Khadem received fixed profits, the *Howey* criterion had been met since profits existed and "her risk of loss depended on [the defendant's] management skills."[36]

For purposes of clearer analysis, the requirement of "solely from the efforts of others" can be divided into two distinct elements: "solely" and "from the efforts of others." Cases decided prior to 1974 established that the term "solely" was not to be applied literally.[37] The Ninth Circuit in *SEC v. Glen W. Turner Enterprises, Inc.*,[38] expressed the policy of the courts to view the term realistically in order to encompass those schemes which involve securities in substance if not in form.[39] To formulate a workable standard, the Ninth Circuit required a determination of "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[40] Inherent in this requirement, as evidenced by the use of the word "managerial," is the distinction between investment schemes, in which investors exercise no managerial functions, and commercial ventures which involve substantial managerial efforts on the part of the participants.[41]

The second element of this criterion involves a consideration of the type of efforts provided by persons other than the investors. The court in *Glen Turner* stated that these efforts should be managerial in nature.[42] Nevertheless, in *Miller v. Central Chinchilla Group,*

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[35] *Id.* at 1226.

[36] *Id.* at 1229. It is not clear whether the court intended to imply that either profits or risk must vary with the efforts of others.

[37] *See, e.g.*, SEC v. Glen W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973).

[38] 474 F.2d 476 (9th Cir. 1973).

[39] *Id.* at 481.

[40] *Id.* at 482.

[41] The cases involving franchise arrangements and pyramid schemes illustrate this distinction. *See* notes 12 and 13 *supra*. The franchisee has control over most managerial decisions—hiring, firing, ordering, etc.—and therefore, is involved in a commercial endeavor. In a pyramid scheme, however, the participant leaves the management decisions to others and merely brings potential investors to induction meetings.

[42] In Plum Tree, Inc. v. Seligson, 383 F. Supp. 307 (E.D. Pa. 1974), the court distinguished pyramid schemes from franchise arrangements by stating: "A pyramid sales scheme is found where the investment in the enterprise is made with the expectation of obtaining profits by the sale of the scheme to others rather than by *an on-going involvement with running a business.*" *Id.* at 309 (emphasis added).

Inc.,[43] the Eighth Circuit held that a transaction involved "securities," despite the fact that the investors exercised certain managerial functions. In *Miller*, the defendants had sold a mated pair of chinchillas to the plaintiffs, who were to raise and breed the animals in accordance with certain set procedures. The plaintiffs, in turn, were to sell any mated pairs to the defendants, who would then sell them to other prospective "chinchilla raisers." Although the scheme was initially represented as involving minimal efforts by the plaintiffs, the subsequent development of the project required the plaintiffs to engage in certain managerial activities. Concluding that the representation rather than the realities of the transaction controlled,[44] the Eighth Circuit held that a sale of securities was involved since the efforts provided by persons other than the investors were essentially managerial.

E. Conclusion

In determining whether a particular transaction involves a "security" two points are especially significant. First, the transaction must be carefully scrutinized to determine if it involves an investment or commercial venture. Such an examination will enable courts to determine whether a plaintiff is entitled to relief under the securities acts, or whether his remedy lies in state corporation law. Second, if the manner in which a transaction is represented indicates the existence of a "security," courts will disregard the realities of the situation and base their decision on the representation. This approach reinforces the *Howey* criterion requiring that an individual be "led to expect profits" rather than merely receive the profits.[45]

However, in A.B.A. Auto Lease Corp. v. Adam Indus., Inc., CCH FED. SEC. L. REP. ¶ 94,959 (E.D. Pa. Jan. 9, 1975), a case involving facts similar to those in pyramid schemes, the Eastern District of Pennsylvania recently held that a franchise arrangement existed since it was termed such, and as a result, the court concluded that no security existed. The plaintiffs entered a lease arrangement whereby they provided the defendants with other lessees, and the defendants then consummated and supervised the resulting lease transactions. Although the arrangement was similar to a pyramid scheme the court noted that the plaintiffs were required to spend significant amounts of time and money in setting up and operating an office, and were also required to produce a certain number of leases, under the arrangement. The court concluded that the fact the plaintiff's success or failure depended on their expenditure of substantial time and money was sufficient to remove the arrangement from the definition of a security.

[43] 494 F.2d 414 (8th Cir. 1974).

[44] *Id.* at 416.

[45] *See* Sunriver Properties, Inc., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,691 (SEC Staff Reply Jan. 10, 1974), wherein the SEC stated that the mere