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The Importance of Economic Reality and Risk in Defining Federal Securities

By J. Thomas Hannan*

and

William E. Thomas**

The definition of the term "security," as used in the principal federal securities laws, is for the most part one of the best kept secrets in recent legal history. The Securities Act of 1933 purports to define the term,1 but the definition itself presents a Pandora's box of imposing dimensions. Determination of the issue requires the application of broad statutory language and divergent case law to a seemingly endless succession of new promotional schemes.

Since the inception of the federal securities laws, the Supreme Court has considered the definition of the term "security" on five occasions.2 In each case, the Court found that the challenged transaction constituted a security and rebuked the court of appeals for reading the statutory definition too restrictively. In each of these instances, the Supreme Court dealt principally with only one of the several statutory definitions, namely, "investment contracts." Since 1946 the Court has construed the term "investment contract" in light of a definition given by Justice Murphy in the second of the five decisions, SEC v. W. J. Howey Co.3 Recently, several commentators have

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** A.B., University of California, Santa Barbara; J.D. 1973, University of California, Hastings College of the Law, Member, California Bar.


criticized the rigid "Howey formula" as being ill-suited to meet the issues raised by novel promotional schemes.4

Thus, on the one hand, the Supreme Court has consistently held that the challenged transactions did constitute securities. On the other hand, the continued reaffirmance of a test for the principally litigated definitional terms5 perpetuates a mechanistic and narrow definition in terms of today's promotions. The purpose of this article is to suggest that, despite the formulas and rhetoric, the common thread which winds throughout the forty years of experience with the definition involves an analysis of risk in the light of economic reality

Background

Prior to 1933, securities regulation was the exclusive province of the states. Congress, in defining the term "security," borrowed freely from the earlier Blue Sky laws.6 The final product was drafted "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of security."7 The resulting definition is set forth as follows in the Securities Act of 1933.

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, preorganization certificate or subscription, trans-

4. This article is no exception, if the Howey formula is viewed as a strict limitation upon the definition of the term security. E.g., Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula?, 18 CASE W RES. L. REV. 367 (1967) [hereinafter cited as Coffey]; Long, An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation, 24 OKLA. L. REV. 135 (1971) [hereinafter cited as Long].

5. Not surprisingly, since the Supreme Court has focused on the term "investment contract," lower courts, practitioners and commentators have also done so.

6. The 1933 Act in turn became the model for the definitional section in the Uniform Securities Act, section 401(1), which has been adopted in one form or another in 25 states, the District of Columbia and Puerto Rico. 7 UNIFORM LAWS ANN. 691 (master ed. 1970). Since these subsequent state securities laws have been modeled after the federal statutes, the judicial precedents of either sovereignty may be of assistance in interpreting the various terms. Indeed, the interlocking relationship between these jurisdictions is one of the principal reasons cited by Professor Louis Loss, reporter for the American Law Institute Federal Securities Code Project, for recommending as little revision as possible in the definitional section. ALI FED. SEC. CODE § 297, Comment (Tent. Draft No. 1, April 1972). See note 53 infra. Professor Loss also points out that one must be careful in noting the differences in the specific wording of the various state and federal statutes. 1 L. LOSS, SECURITIES REGULATIONS (2d ed. 1961) 456 [hereinafter cited as Loss].

ferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral right, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.8

This definition has formed the basis for subsequent congressional definitions.9 The definitional sections of the Investment Company Act10 and the Investment Advisers Act11 contain precisely the same definition, but, surprisingly, the definitional section of the Securities Exchange Act of 193412 contains a slightly different definition.13 The terms,


13. The following table sets forth a side-by-side comparison of the definitions in the principal statutes with the differences in each emphasized.

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<td>4. treasury stock,</td>
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<td>5. bond,</td>
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<td>6. debenture,</td>
<td>6. debenture,</td>
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<td>7. evidence of indebtedness,</td>
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<td>8. certificate of interest or participation in any profit-sharing agreement,</td>
<td>8. certificate of interest or participation in any profit-sharing agreement</td>
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<td>10. collateral-trust certificate,</td>
<td>9. or in any oil, gas, or other mineral royalty or lease,</td>
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<td>11. preorganization certificate or subscription,</td>
<td>10. any collateral-trust certificate,</td>
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“stock,” “treasury stock,” “bond” and “debenture” which appear in each of the statutes are reasonably precise and have not resulted in great confusion. Certain of the remaining definitions, however, have perplexed both the courts and the commentators. This article addresses itself primarily to a portion of this residuum.

The differences in the definitions contained in the 1933 Act and the 1934 Act at first appear substantial. There is a variation, for example, in the language relating to oil, gas and mineral interests. Furthermore, with respect to the clause in the 1933 Act, “or, in general, any interest or instrument commonly known as a ‘security’,” one notes that the 1934 Act omits the reference to “any interest.” This omission would presumably limit that section to interests embodied in a docu-

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<td>investment contract,</td>
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<td>voting-trust certificate,</td>
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<td>15.</td>
<td>certificate of deposit for a security,</td>
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<td>16.</td>
<td>fractional undivided interest in oil, gas or other mineral rights,</td>
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<td>17.</td>
<td>or, in general, any interest or instrument commonly known as a “security”,</td>
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<td>18.</td>
<td>or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing,</td>
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<td>19.</td>
<td>but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.</td>
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14. There is a body of jurisprudence surrounding each of these terms, their differences and similarities, which is beyond the scope of this article. It was argued in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) that the more specific terms ought to prevail over the more general terms. The Court, in rejecting this *ejusdem generis* argument, said, “We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as [a] matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as ‘investment contracts,’ or as ‘any interest or instrument commonly known as a security.’” *Id.* at 351.
ment. However, the most glaring omission in the 1934 Act is the complete absence of the term “evidence of indebtedness.” Utilization of this language in an action founded upon Rule 10b-5 might thus be inhibited. Nevertheless, the Supreme Court, in *Tcherepnin v Knight*, attached no significance to the omission of the term “evidence of indebtedness” from the 1934 Act. In this case the transaction constituted a security, as measured by other definitional terms, and the court of appeals had wrongly construed the transaction as constituting an evidence of indebtedness. Significantly, however, the court also emphasized that the 1933 Act precedents are generally applicable to interpretation of the 1934 Act. Accordingly, it may be unavailing to seek to establish technical differences between the definitions contained in the two acts.

**The Supreme Court and Investment Contracts as Securities**

Most courts have defined securities as “investment contracts,” an often-litigated term which appears both in the federal and in most state securities laws, but which the statutes do not explain further. Consequently, it has devolved upon the courts to identify those schemes which can be characterized as investment contracts within the purview of the acts. The term has been the focal point in dealing with the proliferation of new and ingenious forms of public financing designed to

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17. *Id.* at 344.
18. *Id.*
19. *Id.* at 336. Professor Alan Bromberg correctly cautions however that: “Full equivalence of the 1933 and 1934 Act definitions does not necessarily follow. There is some reason to interpret ‘security’ more broadly for antifraud purposes (now primarily a 1934 Act matter) than for registration purposes (primarily a 1933 Act matter). It is easier to justify a remedy for an investor who has been defrauded in a borderline ‘security’ than to give him an automatic remedy per SA [Securities Act of 1933] Section 12(1) because the security was not registered under the 1933 Act. This kind of distinction might well be made in areas of traditional public trading (like commodity futures) or public offerings (like franchises and oil or real estate interests) without registration. It should be noted that the Supreme Court, in *Tcherepnin*, was dealing with (1) an interest exempt from the 1933 Act registration requirements by SA § 3(a) (5), and (2), a suit under 10b-5, and therefore was not faced with a self-executing right of recovery for failure to register.” 1 A. BROMBERG, SECURITIES LAW • FRAUD, § 4.6, at 82.2 (1971). So far, however, the cases have not expressly recognized this distinction and in Bromberg's view, it does not appear that Congress intended such a distinction. *Id.*
20. See note 6 supra.
evade the letter, if not the spirit, of the securities acts. The jurisprudence surrounding the definition of the term “investment contracts” appears to be experiencing a reappraisal. To appreciate this process fully, this section begins by tracing the development of landmark United States Supreme Court decisions, as modified by current legal trends.

Ten years after the promulgation of the 1933 Act, the Supreme Court, in *SEC v C. M. Joiner Leasing Corp.*,\(^2\) issued its first opinion on the interpretation of this definitional language. The case involved a campaign to sell oil leases, accompanied by representations that defendants would drill a test well which would prove the productivity of the vendee’s acreage. In response to defendant’s argument that this was merely the offer of “naked leasehold rights,” Justice Jackson perceptively observed:

> The drilling of this well was not an unconnected or uncontrolled phenomenon to which salesman pointed merely to show the possibilities of the offered leases. The exploration enterprise was woven into these lease-holds, in both an economic and a legal sense; the undertaking to drill a well runs through the whole transaction as the thread on which everybody’s beads were strung.\(^2\)

Justice Jackson emphasized the underlying purpose of the Securities Act:

> It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that defendants were selling and gave to the instruments most of their value and all of their lure. The trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end.\(^3\)

In reversing the lower court, Justice Jackson refused to be bound by a specific formula in defining the term “investment contracts.” Rather, he followed the lead of prior state and federal decisions and chose to place his holding on general policy grounds, suggesting a case-by-case analysis.

> The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters’ offerings be judged as being what they were represented to be.\(^4\)

Three years later the Supreme Court decided the often cited case of *SEC v W J Howey Co.*\(^5\) Justice Murphy, speaking for the

\(^{21}\) 320 U.S. 344 (1943).
\(^{22}\) Id. at 348.
\(^{23}\) Id. at 349.
\(^{24}\) Id. at 352-53.
\(^{25}\) 328 U.S. 293 (1946).
majority, chose to isolate the elements which in his opinion were the
distinctive features of an investment contract. The fact situation in-
volved the sale of citrus acreage accompanied by an option to pur-
chase service contracts which would obligate an affiliated corporation
to cultivate and market the fruit. As in Joiner, it was impractical for
the purchasers to participate in the development of their own land be-
cause of their lack of sophistication, absenteeism and the economic dif-
ficulties of piecemeal forming. Noting that Congress had been in-
fluenced by the prior Blue Sky laws, Justice Murphy purported to
rely upon state decisions to fashion a test which, he concluded, was con-
sistent with statutory aims:

[A]n investment contract for purposes of the Securities Act means
a contract, transaction or scheme whereby[(1)] a person invests
his money [(2)] in a common enterprise and [(3)] is led to ex-
pect profits [(4)] solely from the efforts of the promoter or a
third party, it being immaterial whether the shares in the enter-
prise are evidenced by formal certificates or by nominal inter-
ests in the physical assets employed by the enterprise.

This sentence quickly became a magic four-part standard for
judging whether a particular transaction involved an "investment con-
tract." Later decisions have rarely, if ever, construed this term without
considering, if not relying upon, the Howey formula. Indeed, this
formula has become so revered that it has prompted many members
of the legal community to call for a major reassessment of its under-
lying strengths and weaknesses.

Like many "black letter" phrases, the Howey formula contains the
seeds of its own destruction. Predictably, clever lawyers and promot-
ers have found means to circumvent the black letter; they always
have and always will, no matter now thoughtful the mechanical rub-
ric. In fairness to Justice Murphy, however, it should be pointed out
that many of the criticisms directed at the test are the result of

26. Id. at 298-99.
27. Id. at 298-99.
28. Many refer to Howey as a three-pronged test. This is accomplished by com-
bining the last two factors as one. Because this article deals with these two concepts
separately, they are segregated herein and Howey is referred to as a four-factor test.
29. Some writers claim the Howey decision rests upon a weak precedential foun-
dation. In a very thoughtful article, Professor Joseph Long concludes: “Justice Mur-
phy was in error when he claimed to be restating a definition which had received uni-
versal acceptance by prior cases and the effect of the Howey case was to perpetuate
a test which was misleading and did not accurately reflect the policy behind securities
regulation. What makes the Howey test even more tragic is the ill-chosen language
used to frame the test and the fact that the test was totally unnecessary to the dispo-
sition of the case.” Long, supra note 4, at 177. See also Coffey, supra note 4.
considering the test apart from the remaining opinion. Justice Murphy specifically recognized that congressional intent augured against restrictive or rigid interpretations. "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." Indeed, the Howey decision was in reaction to the Fifth Circuit's overly narrow reading of the definition.

The Supreme Court subsequently has considered "investment contracts" on three occasions. In each instance the transaction in question was found to involve an investment contract. SEC v Variable Annuity Life Insurance Co. of America dealt with the issue of whether so-called "variable annuity" contracts were required to be registered under the 1933 Act. Conventional life insurance and annuity contracts are expressly exempted from the 1933 Act by virtue of section 3(a)(8), the sole regulatory power being lodged with the states pursuant to the McCarran-Ferguson Act. While variable annuity contracts contain many features of classical insurance, they are distinguishable because they guarantee no fixed monthly or yearly amount. Premium payments are made in consideration of a pro rata interest in a securities portfolio. Therefore, the amount due to the

30. 328 U.S. at 301.
31. A more thorough discussion of this issue is reserved for the section "An Analytic Framework," infra.
33. "Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities: [a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia." Securities Act of 1933, § 3(a)(8), 15 U.S.C. § 77(c)(a)(8) (1970).
34. Section 2(b) provides, "No act of Congress shall be construed to invalidate, impair, or supercede any law enacted by any State for the purpose of regulating the business of insurance " 15 U.S.C. § 1012(b) (1970).
35. "[P]ayments are made periodically; they continue until the annuitant's death or in case other options are chosen until the end of a fixed term or until the death of the last of two persons; payments are made both from principal and income; and the amounts vary according to the age and sex of the annuitant. Moreover, actuarily both the fixed-dollar annuity and the variable annuity are calculated by identical principles. Each issuer assumes the risk of mortality from the moment the contract is issued. That risk is an actuarial prognostication that a certain number of annuitants will survive to specified ages. Even if a substantial number live beyond their predicted demise, the company issuing the annuity—whether it be fixed or variable—is obligated to make the annuity payments on the basis of the mortality prediction reflected in the contract." SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 70 (1959).
36. The principal appeal of variable annuity contracts is their purported ability to function as a hedge against inflation.
annuitant is variable, being subject to the success or failure of the offeror's investment policy.

The companies that issue these annuities take the risk of failure [prognostication of mortality]. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor.\textsuperscript{37}

The Court divided five to four and held that the insurance exemption did not apply. The dissenters stressed the strong policy in favor of state regulation of the insurance industry. For the purposes of this discussion, however, that policy question is less important than the consideration of the test used by the Court to determine whether insurance was in fact involved. In the view of Justice Douglas, speaking for the majority, that issue turned on an analysis of the allocation of risk.

The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a \textit{pro rata} share of what the portfolio of equity interest reflects—which may be a lot, a little or nothing. . . . \textit{[T]he concept of 'insurance' involves some investment risk-taking on the part of the company.}\textsuperscript{88}

In Justice Brennan's concurring opinion, this concept of investment risk was more finely detailed, and was keyed to the disclosure philosophy of the act.

\textit{[O]ne of the basic premises of state regulation would appear to be that in one sense the investor in an annuity or life insurance company \textit{not} become a direct sharer in the company's investment experience; that his investment in the policy or contract be sufficiently protected to prevent this. But the situation changes where the coin of the company's obligation is not money but is rather the present condition of its investment portfolio. . . . Prescribed limitations on investment and examination of solvency and reserves become perfectly circular to the extent that there is no obligation to pay except in terms measured by one's portfolio. . . . Where the nature of the obligation assumed is such, the federally protected interests in disclosure to the investor of the nature of the corporation to whom he is asked to entrust his money and the purposes for which it is to be used become obvious and real. The contract between the investor and the organization no longer squares with the sort of contract in regard to which Congress in 1933 thought its "disclosure" statute was unnecessary.}\textsuperscript{89}

This delicate mixture of risk and policy was explored more care-

\textsuperscript{37} 359 U.S. at 71-72.
\textsuperscript{38} Id. at 71.
\textsuperscript{39} Id. at 78.
fully eight years later in *SEC v United Benefit Life Insurance Co.*  

The defendants were engaged in the sale of "Flexible Fund" annuities. These contracts resembled the variable annuities in *VALIC* in that purchasers' premiums were invested in defendants' managed fund. However, in *VALIC* the contracts contained no element of fixed return, whereas these defendants guaranteed a minimum cash value ranging from 50 percent of net premiums the first year to 100 percent after ten years. The issue was squarely presented: How much risk must the insurer assume to qualify for exemption pursuant to section 3(a)(8) of the 1933 Act?

The Court, speaking through Justice Harlan who had authored the dissent in *VALIC*, held that despite defendants' guarantee, a substantial part of the investment risk still remained with the policy-holder, not the insurer. "The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized."

The *United Benefit Life* case represented the fourth occasion on which the Supreme Court had reversed and criticized the lower court for drawing an overly rigid interpretation of the definition of a security.

In considering *VALIC* to have turned solely on the absence of any substantial investment risk-taking on the part of the insurer there, we think that the Court of Appeals in the present case viewed that decision too narrowly.

The opinions in *VALIC* and *United Benefit Life* present a notable contrast to the four-factor approach of *Howey*. By examining risk to the investor in terms of public policy, the Court suggested a more flexible standard. It is possible to maintain that these decisions are sui generis, and are limited to determining the breadth of the insurance exemption. On the other hand, it is significant that the Court is speaking in terms of risk allocation. It is submitted that the policy of investor protection is inextricably interwoven with the concept of risk allocation. When a scheme is designed to shift all or substantially all of the investment risk to the purchaser, public policy weighs heavily in favor of disclosure of these material facts.

The Supreme Court's most recent pronouncement on the definition of a security was in *Tcherepnin v Knight*, decided under the 1934 Act, unlike prior precedent. The case holds that withdrawable capital shares in a savings and loan association fall within a number of statutory

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41. *Id.* at 211.
42. *Id.* at 210.
43. 389 U.S. 332 (1967).
niches, the closest being the classical investment contract (tested under the Howey criteria). Once again the Court refused to accept the picayune restrictions placed upon the definition of a security by the appellate court. "We have little difficulty fitting the withdrawable capital shares held by the petitioners into that expansive concept of security."45

_Tcherepnin_ was a classic _Howey_ situation, so there was no need to re-examine Justice Murphy's four-pronged test. The _Tcherepnin_ decision was particularly interesting, however, in that the Court recognized other definitional pegs, such as "certificates of interest or participation in any profit sharing agreement," "stock," and "transferable shares."46 The contention of the court of appeals that the definitional term "instruments commonly known as a 'security'" was a limitation on the other definitional pegs was rejected.47 The notion that the omission of the term "evidence of indebtedness" from the 1934 Act is significant was likewise rejected.48 It is possible that all of the _Tcherepnin_ opinion is dicta, other than the holding that the interests were investment contracts. Yet, even if it is dicta, it seems very significant. The Court appears to be saying unanimously: (1) do not ignore the other definitional pegs in analyzing securities transactions; (2) the legislative history of the 1933 and 1934 Acts may be read together to afford broad coverage in the definition of the term security; and (3) with an eye toward federal policy, look to substantive economic realities to determine as a matter of federal law whether these realities constitute a security.49

44. See text accompanying notes 223-251 _infra_ for a discussion of other definitions of a security.
45. 389 U.S. at 338.
46. _Id._ at 339-40.
47. _Id._ at 343.
48. _Id._ at 344.
49. With respect to ascertaining what kinds of transactions involve securities for the purposes of civil antifraud litigation, the following question is raised: Are the same definitions of the term "security" to be used in this instance? The answer appears to be yes. _Tcherepnin_ was a private implied civil antifraud action. Chief Justice Warren, speaking for an unanimous Court, in determining that withdrawable capital shares of an Illinois savings and loan association were securities under the 1934 Act, reviewed the legislative history of the 1933 Act and found that an exemption from registration had been sought by the United States Building & Loan Association and granted by Congress in section 3a(5) of the 1933 Act. Thus fact was taken to indicate that Congress intended the securities of these associations to be a "security" within the definition of the 1934 Act. In _Tcherepnin_, the Court was not squarely asked to consider any dichotomy between private and regulatory actions under the antifraud provisions of the 1933 Act. Indeed, it was not until Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. (1971) that the Court expressly recognized the validity of
Where does that leave us today? The Supreme Court has been silent since 1967 on this question and the composition of the Court has changed during that period. There are two different types of activity in the forefront which could provide further assistance. First there is a series of decisions by other courts, both before and after 1967, which make eventual Supreme Court review likely; second, a blue ribbon panel of experts is drafting and debating a proposed model Federal Securities Code.

To date, the second avenue has been a great disappointment to those who had hoped for some resolution of the definitional questions. Many of the nation's foremost securities experts have simply thrown up their hands and left future developments in this area to be determined by the courts on a case-by-case basis. While a black letter formula would be undesirable for the reasons set forth above in the implied private civil antifraud action under Rule 10b-5. Nevertheless, although Tcherepnin was a private 10b-5 action, the Court did consider the effect of an exemption from registration and did conclude that the history of the exemption was useful in defining the term "security" in an implied private civil action. Thus, it may very well be that the definitions for the purposes of registration and antifraud considerations are identical and that no distinction is to be drawn between the definitions to be applied in implied civil remedy actions, express civil remedy actions, and regulatory enforcement. A different result may obtain if the Supreme Court should accept the "context" statutory construction argument discussed in the text accompanying notes 216-221 infra.

50. There is also a third possibility, namely, the SEC no action interpretive letters which are now publicly available. However, this seems an unlikely source of further definition for various reasons. First, the interest of the SEC is different in granting no action status with respect to registration than it is with respect to its antifraud enforcement. Second, the format of the no action letter is such that the applicant's counsel makes the best argument he can for exemption and the SEC response is often to the effect that if the transaction is as characterized by the applicant, it will recommend no action. There is some analogy between this procedure and the action of the Justice Department in reviewing competitive mergers in the antitrust field in which a favorable review is clearly not a bar to subsequent antimerger suits.


53. "This section [definition of security] should be changed as little as possible, both because there is now a considerable body of jurisprudence and because it was substantially followed in the Uniform Securities Act, so that there is now a degree of uniformity at both state and federal levels. On the other hand, there are a number of defects in the language, none of which affects the terms, 'investment contract' and 'certificate of interest or participation in a profit-sharing agreement,' which have been the subject of most of the litigation." Id. § 297, at 52, Comment.
discussing Justice Murphy's *Howey* test, some analytic guidance would be helpful. Perhaps that guidance may yet be forthcoming since the code is now only in its second tentative draft. This article will focus upon the developing judicial treatment of the term "security."

**Two Important Decisions of Other Courts**

There are a great many decisions of state and federal courts dealing with the term security. Two of these decisions are reviewed here, as they assume current importance for purposes of analyzing the Supreme Court's prior decisions.

**Silver Hills Country Club v. Sobieski**

The Supreme Court of California, in an opinion by its distinguished jurist Roger Traynor, made the first major departure from the solidly entrenched *Howey* doctrine. *Silver Hills Country Club v. Sobieski* involved a partnership which sought to fund the development of a golf and country club by offering "memberships." A membership included rights, revocable only for misbehavior or failure to pay dues, to the use of club facilities. The venture was grossly undercapitalized. The promoters provided a down payment of $400 under a contract to purchase a $75,000 ranch, and proposed to raise an additional $165,000 for construction costs through this mode of outside financing. Realizing that the risk of loss was certain to rest almost exclusively on the public, John Sobieski, then the California commissioner of corporations, issued a desist and refrain order for failure to comply with the California corporate securities code. The plaintiffs sought judicial review, alleging that the memberships were not securities because they conveyed no rights in the assets or income of the club, and because they were purchased, not as an investment, but for the personal enjoyment of the vendee. Applying *Howey* literally, the plaintiffs were correct. Even though the public had invested the money and remained in passive reliance on the efforts of the promoters, there was no expectation of *profit*.


55. "They plan to sell a total of 200 'charter memberships' for $150 each, thereby raising $30,000; 300 memberships for $200 each, thereby raising $60,000; and 500 memberships for $250 each, thereby raising $75,000 [sic]." *Id.* at 812-13, 361 P.2d at 907, 13 Cal. Rptr. at 187.

56. CAL. CORP. CODE § 25514 (West 1955). "Whenever in the opinion of the commissioner the further sale of any securities by any company would be unfair, unjust or inequitable to the purchasers of the securities, the commissioner may order the company to desist and to refrain from the further sale of its securities."
Instead of making technical distinctions, Justice Traynor treated the issue as one of first impression. He found that the membership fitted within the literal definition of a “beneficial interest in title to property,” but more importantly he concluded that the scheme fell within the regulatory purpose of the Blue Sky law.

[The corporate securities code] objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.

This terse statement contains two revolutionary concepts: expectation of a nonmaterial benefit and risk capital. By emphasizing the regulatory purpose of the Blue Sky law, the Silver Hills court felt comfortable in easing the traditional requirement that investment contracts contain an element of pecuniary return. Significantly, the court was aided in reaching this conclusion by the language of the California statute, which includes noninterest bearing debt instruments of nonprofit corporations within the definition of a security.

The act extends even to transactions where capital is placed without expectation of any material benefits. Thus from its exemption of securities of certain nonprofit companies, the act specifically excepts “notes, bonds, debentures, or other evidence of indebtedness, whether interest-bearing or not.”

This language, which some suggest is dicta, certainly repre-

58. 55 Cal. 2d at 815, 361 P.2d at 909, 13 Cal. Rptr. at 189.
59. Whether these concepts are truly “revolutionary” in a strictly legal sense is probably open to debate. Some writers believe this was a radical departure. “Until Silver Hills, with one exception [Davenport v. U.S., 260 F.2d 591 (9th Cir. 1958) (fraud conviction)], every state and federal, case which considered whether a membership or interest in property constituted a security, found either an expectation of profit to the investor or evidence of an indebtedness.” Note, Franchise Regulation under the California Corporate Securities Law, 5 SAN DIEGO L. REV. 140, 151 (1968). “Silver Hills is apparently a case of first impressions not only in California, but in the entire nation.” 50 CALIF. L. REV. 156, 158 (1962); accord, 14 HASTINGS L.J. 181 (1962). But see Long, supra note 4, at 168-70, wherein the author concludes that the roots of the risk capital concept date back to Browne Oil Co. v. Railroad Comm’r, 207 Wis. 88, 240 N.W. 827 (1932).
60. Except as expressly provided below, the California Corporate Securities Code is inapplicable to the following classes of securities:
“(a) Any security (except evidences of indebtedness, whether interest bearing or not) of an issuer (1) organized exclusively for educational, benevolent, fraternal, religious, charitable, social, or reformatory purposes and not for pecuniary profit, if no part of the net earnings of the issuer inures to the benefit of any private shareholder or individual.” CAL. CORP CODE § 25100 (West Supp. 1973).
61. Silver Hills Country Club v. Sobieski, 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188 (court’s emphasis).
62. It has been suggested that Silver Hills did contain an element of expected
resents a departure from the language contained in over thirty years of state and federal decisions. It should be clear, however, that "profit motive" is not irrelevant; it is still an indication of a security. What *Silver Hills* does say, however, is that the absence of a profit motive does not provide a shield for the unscrupulous promoter who seeks to finance his operation by public solicitation of risk capital. *Silver Hills* thus represents a departure from the *Howey* formula with respect to the profit prong of the test. At the same time, the type of promotional scheme in question was not dissimilar to the one in *Howey*. The country club in *Silver Hills* was to be a profit making venture for the promoters with the venture to be financed through the use of money gained from the uninformed and unsophisticated public, as with the citrus groves in *Howey* and the oil leases in *Joiner*. This concept of financing through the obtaining of risk capital from the public is particularly important where the transaction involves a benefit other than a pecuniary return.

**SEC v. Glenn W. Turner Enterprises, Inc.**

SEC v. Glenn W. Turner Enterprises, Inc., involved an enterprise commonly known as a pyramid operation. In *Glenn Turner*, defendants purported to market self-improvement courses through a multilevel network of independent distributors. The substance of defendants' scheme, however, was the sale of distributorships, not goods. The purchase of a distributorship entitled the investor to a commission or finder's fee for each new distributor he was able to recruit. These payments would multiply geometrically as the new recruit in turn recruited additional salesmen. Because of the basic instability and mathematical impossibility of a pyramid operation, the structure ultimately collapses, benefiting only those at the top of the pyramid. The most pernicious aspect of this operation is the recruiting program. Prospective salesmen, aroused by the prospect of easy money, are persuaded to attend "adventure meetings." These gatherings take on the profit in the form of an "entrance privilege." Coffey, supra note 4, at 402-03.

Although the lawyer-like quality of this argument cannot be denied, it is highly unlikely that either the litigants or the court conceived of the scheme in this light. Justice Traynor spoke directly to the threshold issue of nonpecuniary benefits.

63. See text accompanying notes 81-86 infra.

64. 474 F.2d 476 (9th Cir.), cert. denied, 42 U.S.L.W. 3189 (U.S. Oct. 9, 1973). Defendant Glenn Turner purported to market a line of self-improvement courses known as "Dare to be Great" ("DARE"). To avoid confusion, the reader should be cognizant of the fact that the court refers variously to defendants as "Glenn Turner," "Dare to be Great," and "DARE."
evangelistic characteristics of old religious revival meetings. Sharp practices are utilized to pressure predominantly poor and unsophisticated individuals into parting with their meager savings.\textsuperscript{65} Although this type of fraud has been uniformly condemned by the courts,\textsuperscript{66} the question facing the Ninth Circuit was whether or not this scheme involved a security.

The investor in \textit{Glenn Turner} was not wholly passive. As the court observed,

\begin{quote}
[The purchaser] must himself exert some effort if he is to realize a return on his initial cash outlay. He must find prospects and persuade them to attend Dare Adventure Meetings, and at least some of them must then purchase a plan if he is to realize that return. Thus it can be said that the returns or profits are not coming "solely" from the efforts of others.\textsuperscript{67}
\end{quote}

Since "solely from the efforts of others" is an integral part of the \textit{Howey} test, a literal interpretation would have precluded the finding of an investment contract. Nevertheless, the Ninth Circuit refused to allow the defendants to hide behind this language.

We hold, however, that in light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities.\textsuperscript{68}

The court went on to note that several state courts\textsuperscript{69} had recently considered similar transactions and had chosen to criticize the mechanical interpretation of "solely" in favor of enjoining the pyramid

\textsuperscript{65} Id. at 478-80.

\textsuperscript{66} For example, in a case based on nearly identical facts, the district court observed: "In reviewing the record in this case, it is plain that defendants' program is a get-rich-quick scheme in the worst sense. Poor, unwary persons have been induced by high-pressure sales tactics to part with their money, and a very few have harvested the large returns they were led to believe were common for those participating in the program. Gross, intentional fraud may well be involved. Nonetheless, the court is not entirely convinced that defendants' operation, outrageous as it may be, actually involves the sale or offer of sale of securities within the meaning of the federal Acts.” SEC v. Koscot Interplanetary, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 93,960, at 93,845 (N.D. Ga. Apr. 19, 1973).

\textsuperscript{67} 474 F.2d at 482.

\textsuperscript{68} Id.

operation. Finally, the Ninth Circuit announced that henceforth the efforts of others would be construed in a qualitative sense: "[W]e adopt a more realistic test, 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."70 Even though the investor was an active participant in this scheme, the court cogently observed that what he invested in was a "share in the proceeds of the selling efforts of DARE."71 In other words, instead of analyzing the problem simply in terms of investor participation, the court examined how meaningful the investor's efforts were designed to be with reference to the scheme.

Those efforts [DARE's] are the **sine qua non** of the scheme; those efforts are what keeps it going; those efforts are what produces the money which is to make him rich. In essence, it is the right to share in the proceeds of those efforts that he buys. In our view, the scheme is no less an investment contract merely because he contributes some effort as well as money to get into it.72

As will be seen in testing other commercial transactions, this change in emphasis from the quantum of effort to the lack of significant control is particularly important. Thus, in two key cases, two prongs of the *Howey* test have come under attack. In *Silver Hills*, as a matter of state corporate securities law, the profit prong was eliminated in favor of a risk analysis and the reaping of a material benefit other than profit. In *Glenn Turner* the "solely from the efforts of others" prong was redefined through a balancing process.

A reasonable argument can be advanced that these decisions go far to recall the *Joiner* decision, whereby rekindled policy considerations will provide little comfort to the purveyors of worthless promises. The use of the risk capital concept and of policy considerations hopefully has nurtured the continued growth of a broad, flexible doctrine capable of being adapted to evolving investment schemes.

**An Analytic Framework**

Having reviewed two encroachments upon the *Howey* formula, together with the indication of the Supreme Court that the definition of the term security should not be narrowly construed, the question becomes: How does one analyze a promotional scheme to determine whether it involves a security?

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70. 474 F.2d at 482 (emphasis added).
71. Id.
72. Id.
The following is an appraisal of the fundamental concepts underlying those promotional schemes which are likely to involve securities. These concepts are compared and contrasted with the current state of the law for the purpose of understanding the direction the definition may take in the future.

The problem with the Howey formula is not that it is wrong, but that it is often applied restrictively without recognizing that it is merely a statement of a result based upon the facts in the Howey case. The following analytic framework is based partly upon a Howey-type analysis, together with a recognition of post-Howey developments, without any direct attempt to limit the analysis strictly to "investment contracts." The framework consists of seven questions. There is no magic in that number, nor are the questions intended to be exclusive. They are at best a starting point.

1. **What is the participant asked to contribute to the enterprise?**

The investor must supply some consideration; Howey spoke of money, presumably cash. There seems to be no analytic reason, however, to suggest that Justice Murphy purposely excluded the investor who furnishes property or services. Any distinction based upon conditions which may accompany the property or services goes to the nature of the expectation of return, or to the control exercised, not to the furnishing of valuable consideration. Perhaps this is an academic point, because promoters are generally interested in money. Sometimes, however, the transaction requires two steps. For example, the investor may be required to purchase a shipping container which is then turned over to the promoter to be managed with others under his common control. Such a purchase would be the price of admission and the furnishing of the container would be the substantial equivalent of supplying money.

2. **Is there in substance a common enterprise?**

Common enterprise should be liberally construed to mean any type of concerted effort whereby the investor's financial interests are "inextricably interwoven" with those of the promoter or third party.

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73. Professor Long thoughtfully deals with this topic under the heading of "Money or Money's Worth." See Long, supra note 4, at 161-62.

74. This phrase derives from the Ninth Circuit's opinion in Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1961).

75. For an excellent discussion of common enterprise, see Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967).
In other words, the element of commonality is vertical between buyer and seller—not horizontal—among investors similarly situated, as some courts have interpreted the Howey decision. Thus, in Maheu v. Reynolds & Co. the court held that a discretionary commodities account, managed and supervised solely by defendants, constituted an investment contract, notwithstanding the fact that plaintiff’s account was not pooled with that of other investors.

Likewise, common enterprise should not be confused with the requirement of Federal Rule of Civil Procedure that class actions must involve common questions of law and fact. In other words, a class action theory might be thwarted if a promoter offered a different scheme to different investors. In that case, the investors’ claims would lack commonality. This failure, however, would not preclude each individual investor from maintaining a securities claim on his own behalf, since a separate common enterprise would exist between each investor and the promoter.

It is also important to note that common enterprise is not limited to a single legal entity. The gist of common enterprise is the interweaving of economic interests. Thus, the presence or absence of a legal entity or a number of legal entities is irrelevant in determining the existence of a common enterprise.

3. Is the participant led to expect a profit?

The Howey opinion speaks in terms of the expectation of “profits.” While this term has been severely criticized when relied upon as a nindispensable attribute of investment contracts (and rightly so if rigidly construed), it is submitted that there is evidentiary and analytic meaning in that term. As Professor Coffey states:

78. "The joint account may constitute a security even if there was no pooling arrangement or common enterprise among investors." Id. at 429. The "pooling" problem may be more imagined than real. The Maheu decision is typical of and in accord with the clear weight of authority. See 1 Loss, supra note 6, at 489 n.86.
79. "Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class." FED. R. CIV. P. 23(a) (emphasis added).
80. For a more detailed discussion, see Long, supra note 4, at 163-64.
The requirement seems sound; securities regulation does not appear to be necessarily appropriate for all types of transactions in which the buyer's initial value is subjected to the risk of an enterprise. For example, the SEC has indicated that it would not ordinarily consider the term "security" to embrace trading stamps, streetcar tokens, meal tickets, Christmas gift certificates, box tops, or theater tickets.82

The term "profits" should not be construed restrictive. It is apparent from decisions subsequent to Howey that the return promised for the use of the investors' money may be something other than a share of the profits of an enterprise in a narrow accounting sense. It is true that Howey dealt with a situation where the investor had the equivalent of an equity interest in the common enterprise, but where the investment offered is of a different nature, the promised return will necessarily vary. For example, market price appreciation in value, though not profit in a commercial sense, was the significant factor in the investment contract recognized by the Supreme Court in SEC v. Variable Annuity Life Insurance Co. of America83 and SEC v. United Benefit Life Insurance Co.84 The profits involved in Los Angeles Trust Deed & Mortgage Exchange v SEC85 consisted of interest payments received on notes secured by trust deeds. Furthermore, the existence of a security does not necessarily depend upon the investor having an interest in the enterprise as a whole. Indeed, in Joiner86 the Supreme Court held that a security existed where each investor was sold a specific interest in oil leases, an interest which was not owned in common with other investors or promoters. Since the profit expected by each individual investor was the appreciation in the market price of his individual acreage, there was no identity of his profits with those of the promoters. Therefore, in understanding the term "profits" reference can be made to distributions which are fixed, variable, conditioned upon, or unrelated to the profits as reflected in the balance sheet of the enterprise.87

4 How does the promoter characterize his promotion?

Promoters represented by competent counsel are not likely to make their offerings sound like securities. Although from a sales

82. Coffey, supra note 4, at 399 (emphasis added). See also Sperry & Hutchinson Co. v. Hudson, 190 Ore. 458, 226 P.2d 501 (1951) (ordinary retail trading stamps were held not to constitute securities under the state securities statute).
84. 387 U.S. 202 (1967).
85. 285 F.2d 162 (9th Cir. 1960).
86. 320 U.S. 344 (1943).
87. However, the profit element may not be required if the scheme is a risk capital scheme. See discussion of risk capital in text accompanying notes 87-118; infra.
standpoint there is a great incentive to do so, such a characterization runs directly into the often cited language of Justice Jackson in SEC v. C. M. Joiner Leasing Corp.:'88

The test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that the promoters' offerings be judged as being what they were represented to be.89

Despite the broad sweep of this language, it is submitted that promotional representations should be construed solely as an evidentiary matter. In other words, if the seller represents something as a security which is clearly not a security, federal jurisdiction cannot be founded upon his erroneous conclusion. By the same token, if the seller should color his promotions of a security with representations that it is not a security, he has done nothing to put himself beyond the reach of the securities laws. This position is best illustrated by employing an analogy to the familiar declaration against interest exception to the hearsay rule. For example, in United Benefit Life, Justice Harlan recited the above mentioned paragraph in Joiner and added:

Contracts such as the "Flexible Fund" offer important competition to mutual funds . . . and are pitched to the same consumer interest in growth through professionally managed investment. It seems eminently fair that a purchaser of such a plan be afforded

88. 320 U.S. 344 (1943).
89. Id. at 352-53 (emphasis added).

Professor Loss has suggested that this is closely analogous to the more recent and more publicized Supreme Court holding in Ginzburg v. United States, 383 U.S. 463 (1966). 4 Loss, supra note 6, at 2497 (Supp. 1969). In Ginzburg, the Court stated: "We agree that the question of obscenity may include consideration of the setting in which the publications were presented as an aid to determining the question of obscenity, and assume without deciding that the prosecution could not have succeeded otherwise." 383 U.S. at 465-66.

The Ginzburg opinion dealt with "pandering" and the means used to promote obscenity. Without regard to the wisdom of the test as applied to the obscenity laws, it is an appropriate device in analyzing whether the scheme constitutes a security.

Professor Loss states that "this analysis is invited by the reference in section 2(1) to 'any interest or instrument commonly known as a "security"'" 4 Loss, supra note 6, at 2497 (Supp. 1969).

There is no question the courts place heavy emphasis on the promoter's representations. See Farrell v. United States, 321 F.2d 409, 415-16 (9th Cir. 1963); Roe v. United States, 287 F.2d 435 (5th Cir. 1961); SEC v. Royal Hawaiian Management Corp., [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,982, at 96,338 (C.D. Cal. 1967); cf. 1 Loss, supra note 6, at 511-12 (forged securities). See also Seeman v. United States, 90 F.2d 88 (5th Cir. 1937).
the same advantages of disclosure which inure to a mutual fund purchaser under Section 5 of the Securities Act.\textsuperscript{90}

Justice Harlan is not suggesting that bald sales representations were a sufficient basis for finding an investment contract. The thrust of his statement is that the defendants were taking a contrary position in court to the position which they had previously taken in their sales literature. In determining whether or not a security was involved, these earlier statements against their present interest were considered as "some evidence" against them. On the other hand, if defendants had represented their "Flexible Fund" as a stable and secure annuity, it is doubtful that this would have had a material effect in defending against the SEC's position. That is, although both kinds of representations should be considered as evidence, their relative weight is substantially different. The point is that as with a declaration against interest, the courts are likely to find sufficient trustworthiness in a statement which makes the promotion sound like a security to swing a close case against the promoter.\textsuperscript{91}

The terms of the offer are extremely important for another reason. The 1933 Act speaks in terms of offer or sale of a security\textsuperscript{92} Thus, if the investor has been offered, alternatively, either active managerial control over his investment, or a merely passive interest, both Howey and Joiner indicate that there has been an offer of an unregistered security. This is true notwithstanding the fact that the investor chose to purchase the active alternative which would itself not constitute the sale of security.

\textsuperscript{90} 387 U.S. at 211.

\textsuperscript{91} SEC Securities Act Release No. 5347 (Jan. 10, 1973) provides an excellent example of the strong weight given to the promoter's representations. The release offers guidelines with respect to the applicability of federal securities laws to the offer and sale of condominiums or other units in a real estate development. In many situations, condominiums are offered with collateral arrangements such as a rental pool, exclusive rental agents, or restrictions on occupancy and rental so that in substance the offeror is offering an opportunity through which the purchaser may earn a return on his investment through the managerial efforts of the promoters or a third party in their operation of the enterprise. Noting the wide variety of these arrangements, the SEC has stated that 'condominiums, coupled with a rental arrangement, will be deemed to be securities if they are offered and sold through advertising, sales literature, promotional schemes or oral representations which emphasize the economic benefits to the purchaser to be derived from the managerial efforts of the promoter or a third party designated or arranged by the promoter in renting the units.' Id.

\textsuperscript{92} "The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value. The term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 15 U.S.C. § 77b(3) (1970).
5. Where does the risk of loss from the transaction fall?

The risk of loss concept is central to an understanding of the securities concept. Too often this principle is overlooked as a result of overemphasis on the "expectation of profit" language in the Howey opinion. One need only look to the earlier Joiner decision to recognize that the case turned not so much on the promoters' representations of profit as on the economic reality that the risk of loss had been placed on the shoulders of the investors.

By selling from 1,000 to 2,000 acres at $5.00 to $15.00 per acre, he [Joiner] could fulfill his obligation to drill the well, recoup his incidental expenses and those of the selling intermediaries, and have a thousand acres left for the gamble, with no investment of his own; and if he sold more, he would have a present profit. *Without the drilling of the well, no one's leases had any value, and except for that undertaking they [the leases] had been obtained [by Joiner] at no substantial cost.* The well was necessary not only to fulfill the hopes of purchasers but apparently even to avoid the forfeiture of the leases.

... It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that the defendants were selling and gave to the instruments most of their value and all of their lure. The trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end.93

As Professor Coffey observed of the *Joiner* opinion, "The Court's concern is clearly focused on the relationship between the success of the enterprise and the preservation or deterioration of the value which the buyer originally furnished in the alleged security transaction."94 Similarly, the Supreme Court's concern in *VALIC* and *United Benefit Life* was clearly directed at the insurer's attempt to shift all or a substantial portion of the risk of loss to the investor.95 Therefore, in determining whether or not a security is involved in a particular transaction, analysis of the type, character, and allocation of the risk of loss provides a reliable barometer.96

93. 320 U.S. at 349 (emphasis added).
94. Coffey, *supra* note 4, at 381 (partial emphasis added).
95. See discussion of these decisions in text accompanying notes 32-42 *supra*.
96. This is so because risk analysis involves a broadly based inquiry which includes a consideration of the economic realities. For example, the scope of the risk is contingent to a great degree on the quality of investor control over his investments. The more dependent the investor becomes on another, the less able he is to protect his investment and the greater the risk. Additionally, the existence of a common enterprise, the presence or absence of a profit motive, and the representations made by the promoter are factors to be considered in analyzing the risk. Thus, the term risk is
Risk analysis is also helpful in distinguishing between normal "commercial" risks, which lie outside the purview of the acts, and investment type risks, which fall within the definition of the term security.

The reality of our market place is that nearly all businesses ultimately finance themselves by obtaining public finds through the sale of goods or services. Whenever some future performance is promised to the customer of an enterprise, there is the commercial risk that the promisor will not perform or that the intervening insolvency of the promisor will prevent or delay the performance. These types of "normal" commercial risks, without more, do not shift the principal risk to the customer. How, then, does one differentiate between various enterprises in which the public provides consideration to determine which enterprises fall within the definition of the term security? The answer lies in an analysis of risk as a matter of economic reality. Whether the transaction looks like the sale of a finished product (variable annuities, withdrawable capital shares, dealerships, club memberships) or an interim product in a larger scheme (oil leases, undivided interests in an orange grove) is less important than is the determination of who, in reality, bears the principal risk of loss.

There is no magic formula for determining the principal risk, but a similar analysis is required to be made within an analogous area of the securities laws. Section 4(2) of the 1933 Act provides an exemption from registration for "private offerings" without further guidelines for ascertaining what transactions fall within the scope of that exemption. In a landmark decision, SEC v Ralston Purina Co., the Supreme Court indicated that the exemption from registration was not capable of being reduced to a numerical formula. The Court in a six to two decision by Justice Clark reversed the court of appeals and stated:

[T]he statute would seem to apply to a "public offering" whether to a few or many. It may well be that offerings to a substantial number of persons would rarely be exempt. Indeed, nothing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a

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quantity limit on private offerings as a matter of statutory interpretation.

... Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable. ... Agreeing, the court below thought the burden met primarily because of the respondent's purpose in singling out its key employees for stock offerings. But once it is seen that the exemption question turns on the knowledge of the offerees, the issuer's motives, laudable though they may be, fade into irrelevance. The focus of inquiry should be on the need of the offerees for the protections afforded by registration.\(^9\)

The SEC relying on *Ralston Purina*, issued a release providing guidelines for ascertaining the availability of the private offering exemption. The release states: "Whether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering."\(^10\) Similarly, as a matter of defining a security, the location of the principal risk is a question of fact to be determined by reference to all the surrounding circumstances.

One is often able to gain a greater insight into the economic realities of the transaction by focusing on how and for what purpose the scheme was designed. For instance, the recent increase in the price of gold on the world market prompted some Americans to attempt to participate indirectly in the price increase by purchasing large quantities of the cheaper varieties of rare gold coins. Coin dealers who operate as a brokerage medium and nothing more in these transactions are probably not in violation of the securities laws. In other words, so long as these dealers act as a mere "conduit" without more, and simply "pass on" the investment risk of the world gold market to the public, they have done nothing to alter or reallocate the risk of loss.

On the other hand, if an undercapitalized entity should interpose itself in the midst of the investment risk which emanates from the marketplace, and offer, for example, unhedged ninety-day options on twenty dollar gold pieces, the risk of loss would be fundamentally altered. No longer would the coin buyer's investment be subject merely to the exigencies of the marketplace; rather, the investor's risk of loss would be

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99. *Id.* at 125-27 (emphasis added).
fully contingent upon the changing fortunes of his optionor, much as if he had purchased stock in the enterprise. Utilizing risk analysis, and taking into account all the facts and circumstances, it would appear that since the scheme was designed for the purpose of obtaining venture capital from the public and was operated in such a manner that the risk of loss was shifted to the public, the erstwhile investor became the financier of the enterprise and was entitled to the protection of the securities laws. In other words, where the principal risk has been allocated to the public as it was in *Joiner*, *VALIC*, and *United Benefit Life*, reference to the *Howey* formula should be unnecessary

6. *Is the participant's contribution risk capital?*

Risk capital is a specific kind of risk analysis relating to the providing of venture capital by the participants. *Silver Hills*, the genesis of the risk capital concept, is different from *United Benefit Life* in that the concern of the California Supreme Court was with the capitalization of the country club, while the United States Supreme Court in *United Benefit Life* was concerned not with the provision of capital for the venture, but with the undisclosed risk of loss to the participants in the variable annuity plan. *Joiner* and *Glenn Turner* each display elements of both risk and risk capital analysis. In *Joiner*, the promotion of the leaseholds was the vehicle by which venture capital would have been raised to drill the oil well. The investors were therefore directly responsible for financing the enterprise and would bear the risk of loss. In *Glenn Turner*, insufficient capitalization from an endless chain and risk of loss at the ever-extending base of the pyramid were both present. *Glenn Turner* is difficult to analyze as a risk capital case because the amount of capital required for the endlessly expanding pyramid was elusive, if not illusory. From a risk standpoint, however, the risk was clearly on the investor at the bottom of an inverted funnel which drew money to those at the top.

In *Silver Hills*, Justice Traynor refined the risk capital concept by specifically limiting his analysis:

> As a general rule, the sale of 'securities' that is condemned by the courts involves an attempt by an issuer to raise funds for a business venture or enterprise; an indiscriminate offering to the public at large where the persons solicited are selected at ran-

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101. On the other hand, should the scheme encompass the four factors of *Howey*, at this late date there is little doubt that an investment contract exists without reference to risk.
dom; a passive position on the part of the investor; and the conduct of the enterprise by the issuer with other people's money.\footnote{102}

In other words, the securities acts are designed in part to operate in situations amounting to venture capital offerings. This is the gravamen of the risk capital concept. In these situations, the investment return requirement may be relaxed.

This relationship is extremely important because a major mistake of many writers\footnote{103} and a prospective trap for many courts is the erroneous assumption that \textit{Silver Hills} stands for the proposition that the unqualified expectation of a valuable benefit alone is sufficient to constitute an investment contract and thereby to circumvent the profit element of \textit{Howey}. The reason that this analysis must fail is easily seen once \textit{Howey} absent the profit element is extended to its logical conclusion. As discussed previously, whenever a customer of an enterprise has been promised some future performance, the fulfillment of that promise necessarily rests upon the willingness and capability of the promisor to perform. If the valuable benefit concept were indiscriminately adopted, it would be tantamount to extending the securities acts to virtually every executory contract. Importantly, \textit{Silver Hills} did not involve every risk contingency found in executory contracts, but was limited to venture capital offerings.

Thus construed, the valuable benefit concept and the risk capital theory are not separate and distinct; \textit{they are, in fact, two sides of the same coin.}\footnote{104} Severing "benefit" from "risk capital" drains the via-

\begin{footnotes}
\item[102] 55 Cal. 2d at 814, 361 P.2d at 908, 13 Cal. Rptr. at 188, citing Dahlquist, \textit{Regulation and Civil Liability Under the California Corporate Securities Act}, 33 CALIF. L. REV. 343, 360 (1945). While \textit{Silver Hills} speaks of "public offerings," that matter is handled within the Federal Securities Laws by an exemption from registration, section 4(1) of the 1933 Act, rather than by the definition of the term "security." Thus an investor in a "private offering" could still assert a federal securities claim pursuant to the antifraud sections.

\item[103] "The third part of the \textit{Howey} test was the expectation of profits. The proposed rule makes clear that the benefit is intended to be to the investor and by using the general word 'benefit' eliminates any possibility of narrow interpretation. Beyond this it recognizes the idea developed by the \textit{Silver Hills} case that the benefit does not have to be either tangible or material. The \textit{Howey} test of profits, if used in a general sense, and properly applied to the return to the investor, will cover a large portion of securities cases. The proposed test merely expands and clarifies it so that all securities are covered. Long, \textit{supra} note 6, at 175-76.

\item[104] Professor Coffey hints at this relationship: "Nevertheless, two generalities may safely be stated about the relationship between risk to initial value and the reasonable expectation of 'profit'. First, both factors are necessary in most securities transactions. Second, as the degree of risk to initial value increases, the need for a well-defined 'profit' motive lessens; \textit{i.e.}, the elements of risk to initial value and reasonable expectation of profits are on a sliding scale of inverse proportionality." Coffey, \textit{supra} note 6, at 401.
\end{footnotes}
bility of each. However, employed in tandem, the twin concepts offer a potent weapon against those who would hide behind neat distinctions in the language of Howey. This fire power is not supplied out of judicial craftsmanship; rather, it is derived from the fundamental legislative policy of protecting individuals from being victimized by venture capital offerings in whatever form they may be clothed. As Justice Traynor noted:

The purchasers' risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.

The next crucial inquiry is whether federal law can be rationalized together with Silver Hills. It is possible, of course, for state and federal law to co-exist in irreconcilable disharmony. For instance, a reasonable argument can be made that under the paternalistic "fair, just and equitable" standard, California, through its corporations commissioner, has the right to protect California citizens from operations financed on a shoestring whether they know it or not. On the other hand, the federal full disclosure type of statute does not permit the luxury of segregating schemes which are bad bargains from those which are good bargains. Admitting the substantiality of that argument, one could still contend that no definitive answer has yet been issued at the federal level. However, a careful reading of the two Supreme Court variable annuity cases, VALIC and United Benefit Life, shows that the Court was making an analysis which is analytically similar to a risk capital analysis. In these cases, the risk of success or

105. "Silver Hills has considerably expanded the concept of 'securities' in California. In de-emphasizing the 'profit motive' test, the Supreme Court has consequently emphasized that the nature of the investment interest, and the liberal purpose of the Corporate Securities Act, can be used exclusively in protecting investment ventures.

106. 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.
107. CAL. CORP CODE § 25140(a) (West Supp. 1973). For a general discussion of the contrast between full disclosure and the "fair, just and equitable" standard, see Long, supra note 6, at 159-60.
110. At first blush it might appear that a contrary argument could be made, based upon the language in Tcherepnin v. Knight, 389 U.S. 332 (1967) and SEC v. W.J. Howey Co., 328 U.S. 293 (1946). In Tcherepnin, the Court stated: "As was
failure fell upon the purchasers. Although there is a profit incentive in the variable annuity cases, it is entirely consistent to view venture capital promoters such as Silver Hills under the same basic risk analysis. It is submitted that where the promoter in substance is conducting his business with other people's money at their risk, the courts can find an expressed federal policy of the securities act to protect the investor from this type of venture capital offering, notwithstanding the absence of a conventional profit motive.

The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion . . ."111

Some evidence of this policy is apparent in an example previously noted. Professor Coffey was quoted above112 as expressing approval of the SEC's decision to cull from the securities concept such instruments as trading stamps, streetcar tokens, and Christmas gift certificates. In these situations there is generally no expectation of profit. Significantly, the commission has left open the question of whether a security is involved when a company uses retail trading stamps as a method of financing its operations.113

Howey and Silver Hills are therefore complementary decisions. Where the expectation of profit is present, both reach the same result. Where the investment return takes the form of a valuable but nonmate-

observed in Howey, 'it is immaterial whether the enterprise is speculative or non-speculative.'" 389 U.S. at 345. The argument does not appear meritorious. The context of the quote from Howey is: "If that test [the Howey test] be satisfied, it is immaterial whether the enterprise is speculative or nonspeculative or whether there is a sale of property with or without intrinsic value." 328 U.S. at 301.

Thus, the Court in Howey did not purport to eliminate inquiry into risk, but only stated that it was unnecessary when the Howey test was satisfied. Likewise, in Tcherenepin, the Supreme Court did not cite its abbreviated quotation as a general proposition, but used it in reaction to the court of appeal's argument that "the petitioners' withdrawable capital shares are not within the purview of the 1934 Act because their value normally does not fluctuate and because they normally are not traded in securities exchanges or over the counter." 389 U.S. at 345. Since the Court found the capital shares to pass muster under Howey, such speculative inquiry was irrelevant.

A credible argument could be advanced that a distinction must be drawn between speculation and risk capital. Whereas risk capital refers to the substantive reality of a disguised venture capital offering, speculation is akin to gambling. The two terms are not synonymous.

112. See text accompanying note 82 supra.
rional benefit, the substance of the scheme determines if it violates an express public policy. Where the purpose of promotion is the procurement of venture capital with the risk of failure allocated substantially to the public, the Silver Hills argument is appropriate. However, where the scheme contains none of the characteristics of investment return, as for example in the case of ordinary retail trading stamps, neither case law nor policy considerations will sustain a securities theory. Such is the theory; in practice, how does one make such distinctions?

Some writers question whether it is judicially practicable to make these distinctions, and whether such distinctions are compatible with federal law. Justice Traynor would have the court focus on the substance of the scheme, almost from a materiality standpoint. If the type of risk and the degree to which it is allocated to the investor are such that "those who risk their capital" are not afforded "at least a fair chance of realizing their objective," disclosure of these facts is warranted. Reasonable men may differ as to whether this inquiry is too indefinite for judicial discernment. Howey has the apparent benefit of certainty and definiteness, but the problem is that the real world is not as simple as the Howey formula or any other formula. Therefore, the courts have been forced to resort to devices nearly as clever as those of the entrepreneurs in order to fit the schemes within the "test." It is likely that greater predictability will result as courts increasingly turn to a risk analysis. It is true that ultimately risk analysis will be a mat-

114. Federal recognition of this interrelationship between risk capital and the profit element of Howey is evident in the recent case of Forman v. Community Services Inc., [Current Binder] CCH Fed. Sec. L. Rep. 1 94,139, at 94,586 (S.D.N.Y. Sept. 6, 1973). Judge Pierce faced the very difficult issue of whether a share of a state financed and supervised nonprofit cooperative housing corporation is a security within the meaning of the federal securities laws. Since the restrictions on the shares prohibited gain or loss on the disposition of the shares and barred the payment of dividends, it was difficult to find the requisite profit motive. The plaintiffs argued that the definition of profit should be expanded to include savings of money that might otherwise have gone for more expensive housing. The court, however, chose to construe this hedge against rising real estate costs not as a profit, but as an economic benefit, thereby, failing the Howey test. The court was cognizant of the argument that monetary return is not essential in a risk capital case. However, the court found this argument unavailing since the project was financed by New York State, and thereby the resultant capital risk was zero.

Without reference to the result of the case, that the shares in the cooperative association were not securities, Forman might be considered authority for the proposition that where there is little risk to the investor the courts will consider the elements of Howey in a more restrictive fashion.

115. E.g., Note, Franchise Regulation under the California Corporate Securities Law, 5 San Diego L. Rev. 140, 151 (1968).

116. 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.
ter of subjective judgment. In reaching that judgment, however, courts may rely on certain objective criteria. Factors such as capitalization, experience, sophistication, and proven track records are all very helpful in determining whether the investor needs protection. In other areas of federal law, counsel and the courts have successfully undertaken such a task. For example, in the antitrust field, the courts have developed an extensive body of law delineating what is an “unreasonable restraint of trade.”  

In advising clients on proposed promotions, counsel would be well advised to treat the matter as if there were a rebuttable presumption that the promotion involved a security, and that the burden is on the promoter to prove that his promotion falls within the fair risk variety.

7. Who is in control of the venture?

The securities acts were designed to protect those who are not in a position to protect their investments. People who put their money in other people’s hands are usually powerless to control what is done with the money. Under these circumstances it is appropriate for the promoter to disclose the risks of the enterprise, so that the investor can make an informed judgment. However, if the investor has the right to determine how his capital is to be utilized, the policy underlying statutory protection disappears. The emphasis, however, must be on the quality of the investor’s participation. As was seen in Glenn Turner, using the term “solely” in the literal sense merely emasculates the purposes of securities regulation. An unscrupulous promoter may seek to evade the law by designing a scheme which utilizes some physical activity on the part of the investor. No longer is there sole reliance on the efforts of others, but neither is the investor any less dependent upon the promoter.

117. This kind of analysis has been suggested with respect to franchises. See Note, Franchise Regulation under the California Corporate Securities Law, 5 SAN DIEGO L. REV. 140, 170 (1968). It should also be noted that these kinds of considerations are also utilized in construing the private offering exemption of the 1933 Act. The analogy is not complete. The degrees of risk analysis is far broader in scope than the private offering exemption.

118. See, e.g., Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918).

119. See text accompanying notes 99 supra.

120. 474 F.2d 476 (1973).

121. The phrase “solely from the efforts of others” really contains two problematic terms: solely and efforts. In Glenn Turner, the court holds that solely should not be used in the strict arithmetic sense and that efforts should be distinguished on the basis of being discretionary or ministerial. Since the test for both terms is a qualitative one, the two terms will be considered in concert.

122. There is a somewhat analogous body of jurisprudence which has developed
There is considerable support for the view that "solely" did not spring from prior judicial precedent. None of the state cases cited in Justice Murphy's opinion even use the word. Indeed, *State v Gopher Tire & Rubber Co.*, apparently the principal source of Murphy's definition, placed no such limitation on investment contracts. An investment contract was there held to mean a contract or scheme for "placing of capital or laying out of money in a way intended to secure income or profits from its employment." \(^{124}\)

In a subsequent decision, the Supreme Court of Minnesota, relying on *Gopher Tire*, affirmed a criminal conviction for selling investment contracts in a franchise-like situation. The vendee had advanced $1,000 as part payment for a motor bus which he agreed to operate for guaranteed ratable wages; he was to have a share of the profits and, eventually, stock in the busline organization. The court noted:

The operator was helping finance the organization. He was not merely a money lender. He was not working merely for wages. He was not a copartner. He was to participate in profits as the result of his investment, and eventually they were to be evidenced by corporate stock. He invested with a view of making profits, and the "operator's agreement" was the contract. It was quite as much an investment contract as those involved in *State v Gopher Tire & Rubber Co* \(^{125}\)

As for the prior federal cases cited by Justice Murphy, they "show an inadvertent and unplanned acceptance of the 'profit through the efforts of others' test as a condition for an investment contract." \(^{126}\) Even subsequent to *Howey*, there has been no strict uniformity of interpretation of this term. \(^{127}\) It is noteworthy that Justice Murphy indicated his appreciation of the importance of managerial control.

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concerning the participation of limited partners in limited partnerships. However, it would be shortsighted to suggest that the same standards apply in considering the type of control which will remove the transaction from the protection of the securities laws.

123. 146 Minn. 52, 177 N.W. 937 (1920).
124. *Id.* at 56, 177 N.W. at 938.
126. Long, *supra* note 4, at 158.
127. An excellent example is Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), wherein the court, faced with a *Howey* type situation, thought it irrelevant that the investors gave binding marketing instructions with respect to the produce harvested from their particular tract of land. In *SEC v. Koscot Interplanetary, Inc.* [Current Binder] CCH FED. SEC. L. REP. ¶ 93,960, at 93,844 (N.D. Ga. Apr. 19, 1973) the district court concluded that *Glenn Turner*-type pyramid scheme (indeed, Koscot was owned by Turner) contained too much investor participation.
A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of return on their investments.

Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise.\textsuperscript{128}

Judge Duniway's analogy between \textit{Glenn Turner} and \textit{Howey} is particularly apposite.

The essential nature of the scheme, however, would be the same. He would still be buying, in exchange for money, trees and planting, a share in what he hoped would be the company's success in cultivating the trees and harvesting and marketing the crop... Regardless of the fact that the purchaser here must contribute something besides his money, the essential managerial efforts which affect the failure or success of the enterprise are those of Dare, not his own.\textsuperscript{129}

It is thus apparent that the term "solely" creates a nightmare if literally construed. Furthermore, such a construction conflicts with the policy basis of the \textit{Howey} decision. The Ninth Circuit, coming to grips with these dilemmas, determined that no quantum of physical effort will render the investor any less impotent if he has no meaningful decision making power over his money. Their decision represents a rational approach, and their test of "essential managerial efforts" should find a favorable reception.

With respect to investor control, \textit{Howey}, as interpreted by the Ninth Circuit in \textit{Glenn Turner}, is analytically complementary to a risk capital test. Both cases underscore the economic reality that the investor is entitled to disclosure if he relinquishes control of his capital and is therefore dependent upon the promoter or a third party for realization of an investment return. The apparent difference between the two tests is not in the analysis of control but rather in the factual setting giving rise to the transaction. The \textit{Howey} test is a general shorthand for investment contracts, whereas in \textit{Silver Hills} the risk capital concept operated in the specific situation where the transaction amounted to a disguised venture capital solicitation. The so-called "double investment"\textsuperscript{130} analysis is a good illustration. This concept is founded upon the proposition that one may examine a transaction in terms of

\textsuperscript{128} 328 U.S. at 300 (emphasis added).
\textsuperscript{129} 474 F.2d at 483.
\textsuperscript{130} See text accompanying notes 158-191 infra.
separate business risks. For example, if an individual purchases a franchise over which he is to exercise managerial control, it is difficult for him to take the position that he is relying "solely on the efforts of others." However, if his franchisor designs the sale of franchises as a means of obtaining the venture capital to launch the enterprise, it can be argued that there is a separate business risk apart from the franchisee's risk of operating his business.

The analysis does not stop there. The solicitation of venture capital must still be examined in terms of the quality of investor control. If, for example, the franchisee, in addition to operating his franchise, occupied a decision making capacity with respect to the sale of the franchises, say as a joint venturer with the franchisor, then he would be in a position to protect his investment, and therefore, the risk capital test would not be met.

The Oregon Supreme Court, in *State ex rel. Healy v Consumer Business System, Inc.*, a pre-Glenn Turner decision, correctly utilized the double investment approach in a risk capital setting to find a security under the Oregon statute, notwithstanding the fact that the franchisee exercised managerial control over his franchise. The court correctly held that "the Howey test was not exclusive" and that a prima facie case could be established under the risk capital theory if a franchisor obtained a substantial portion of his initial capitalization by selling franchises to the public. Perhaps because the investors were passive with respect to the disguised venture capital offering, the court stated generally:

[Under the Silver Hills theory, the courts are not concerned so much with whether the investor derives his profit solely or substantially from the efforts of others, but rather with whether the franchisor is depending on the investor for a substantial portion of the initial capital needed to start the enterprise.]

This statement is true with respect to the first aspect of the double investment analysis (the disguised venture capital transaction), but it would not be correct to conclude that an inquiry into control of the capital raising venture is foreclosed.

The main point is that investment contracts as defined in *Glenn Turner* and in the risk capital test are consistent. Qualitative analysis

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131. See text accompanying notes 142-145 infra.
132. See text accompanying notes 159 infra.
133. 5 Ore. Ct. App. 19, 482 P.2d 549 (1971).
134. ORE. REV. STAT. § 59.005 et seq.
135. 5 Ore. Ct. App. at 29, 482 P.2d at 554.
136. Id. at 32, 482 P.2d at 555.
of investor control is common to each. As the double investment concept demonstrates, the inquiry as to which analysis to use is dependent upon the economic realities of the particular facts of the case.

The Significance of the Answers

What significance do the answers to the above questions have? First and foremost, they provide a means for determining the substance of the transaction under analysis. The questions are not written on tablets of stone and may prompt other questions which will likewise be helpful. Second, they should provide the framework for comparing a transaction with the emerging case law. With this second aspect in mind, a review of current areas of developing interest is in order.

Analysis of Some Currently Litigated Areas

The following is a review of several major areas of litigation where questions have arisen as to whether the promotions involve "securities," together with an analysis of these promotions in terms of the above framework.

The Emerging Franchise Cases

It is likely that Justice Murphy never had the occasion to dine at a McDonald's or to stay overnight at a Howard Johnson's or a similar franchise when he authored his famous opinion. If he had, he would have been amazed by the sheer magnitude of this postwar phenomenon. Indeed, the proliferation of the franchise concept is a perfect example of changing economic realities. The idea really embraces the original spirit of American capitalism. It enables an individual who is long on ambition but short on money and experience to become an independent businessman by drawing upon the expertise and financial backing of the corporate leadership. The other side of this coin is the fact that bunko artists thrive in an environment where unsophisticated people try to realize their economic dreams. The role of securities laws in redressing such abuses is an open-ended topic of intense contemporary debate. This article is not a comprehensive study of this field; that would be a treatise in itself. It is felt, however, that modern day litigation in this area is putting the definitional concepts to perhaps their toughest test.

Franchise cases to date have at least paid lip service to Howey. By their very nature, all franchises involve a common enterprise, since the continuing success of each party to the enterprise is dependent
upon the efforts and success of the others. Likewise, there is generally no problem in finding an investment of "money" with the "expectation of profit." Leaving the risk analysis aside for the moment, the only difficulty in applying Howey to franchises is the requirement that the profits be derived solely from the efforts of others. In the world of franchising, the investor-franchisee can be found at every point along the spectrum of "participation." This creates the insolvable riddle of how inactive is "passive." Bernard Goodwin, a leading expert in this field, tersely summarizes the unique features of this commercial arrangement:

The business of franchising is basically an alternative to the orthodox system of marketing and distribution. The franchisor exchanges a salable product or service, with management know-how, for the outlet of the franchised small business distributor or retailer, while retaining financial and operative control, plus some important legal controls, of the common enterprise franchise system. The franchisees share the risks of establishing a new business, but do not acquire either the ownership interest of stockholders or the security interest of bondholders, whereas the franchisor does not dilute his ownership control or hazard losing control to a lender.

The terms of this relationship are made formal in the franchise agreement. Typically, it provides that the franchisor will construct and equip the outlet and train the franchisee and designated third parties in the art of successful operation of the enterprise. In return, the franchisee covenants to pay a franchise fee for the exclusive right to sell under the franchisor's name in a certain territory. He also promises to maintain certain uniform standards of quality, to protect the franchisor's trademark and trade name, and, in many instances, to purchase supplies exclusively from the franchisor or his designate. The contract is enforced by periodic inspection. Violation of the terms of the agreement is grounds for termination, in which event the franchisor pockets the fee and the franchisee incurs the debts. Whether a court approaches this problem from a qualitative or quantitative standpoint, the result is mere sophistry if it attempts to reconcile its finding of a security with the word "solely." This is a clear example of a situation in which the traditional Howey formula, as construed by many lower courts, suffers from arthritis. As might be expected, the rec-

ord has been a patchwork of inconsistent decisions. The longevity of the traditional rule is probably due in part to the dearth of franchise-type cases dealing squarely with this issue. There have been some cases, both before and after Howey (although not directly concerned with franchises), which have rejected a restricted interpretation.\textsuperscript{139} It is fair to say, however, that for the most part, "solely" meant "solely" in the minds of most federal court judges. Nevertheless, by the 1960's the courts had begun to draw some basic guidelines.

In \textit{United States v. Herr},\textsuperscript{140} the Seventh Circuit affirmed a criminal conviction for selling distributorship agreements that offered a choice of an active or an inactive role. The court rejected the argument that this was simply a vendor-vendee relationship.

\textquoteleft\textquoteleft\textit{It was not the intention of either the defendants or the investors that the latter, themselves, were to actually resell the merchandise. They were described as and were actually \textit{inactive}. They were led to believe that they could expect profits solely from the efforts of others.}\textsuperscript{141}

This case, of course, fits neatly into the \textit{Howey} formula, since the court found complete passivity Where operations and control are lodged entirely in the hands of a promoter or a third party, and the investor merely contributes money, the courts have had little difficulty finding an investment contract.

On the other hand, in \textit{Chapman v. Rudd Paint & Varnish Co.},\textsuperscript{142} the Ninth Circuit held that no security existed where the agreement contemplated an active role and the franchisee admitted that he was depending primarily upon his own efforts for the success or failure of marketing the product. The hiatus formed by these two opinions is considerably more problematic. In many cases, the promoter directs his advertising to unsophisticated people having little money and no experience in the management or operation of the enterprise. Consequently, from the outset, they are almost entirely dependent upon the franchisor. These prospective franchisees expect to contribute no more than their money and routine labor. They rely completely on the franchisor for management decision making and other assistance

\textsuperscript{139} For cases decided prior to \textit{Howey}, see State v. Bushard, 164 Minn. 455, 205 N.W. 370 (1925); Stevens v. Liberty Packing Corp., 111 N.J. Eq. 61, 161 A. 193 (1932); subsequent to \textit{Howey}, see Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), discussed \textit{supra} note 127. \textit{See also} SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961) (contribution of some effort to the enterprise).

\textsuperscript{140} 338 F.2d 607 (7th Cir. 1964), \textit{discussed in Comment, Franchise Sales: Are They Sales of Securities?}, 34 \textit{ALBANY L. REV.} 383, 387-88 (1970).

\textsuperscript{141} 338 F.2d at 610.

\textsuperscript{142} 409 F.2d 635 (9th Cir. 1969).
in turning the business into a success. Once under way, the franchisee is tightly circumscribed by strict enforcement of "quality control." Indeed, any maverick ambitions are suppressed by the prospect of termination. Thus, the overt display of actual physical participation is really only a disguised ministerial straightjacket.143

The franchisee has no more freedom to chart the course of his business than a salaried manager in an establishment owned by the franchisors. In fact, franchisors themselves feel that they have more control over a franchisee than over a salaried manager. Yet a manager of a single branch of a large chain owning stock in that chain would be protected by the securities laws.144

Certainly the law should protect the franchisee from the fraudulent promoter. Whether the securities laws are the proper vehicle for this purpose is open to legitimate question,145 but it is submitted that in those instances where the economic reality is such that the substantive control of the venture viewed as a whole is in the hands of the promoter, the securities laws are designed to provide a remedy to the franchise purchaser.

Multilevel Distributorships

The breakthrough appears to have come in the aftermath of Silver Hills with a series of state and federal decisions dealing with the most flagrantly fraudulent of all franchising practices—the sale of multilevel distributorships. These schemes are typically of two types: founder-membership programs and pyramid sales plans.146

The founder-membership plan involves soliciting capital (typically for an overpriced product) from a finite number of "founders." The funds are to be used to construct a retail store. In return, the "founder" receives identification cards which he distributes to prospective customers. When the store opens, the founders receive commis-

144. Id. at 237, accord, Goodwin, supra note 138. It may be surprising to some that in Mr. Softee, Inc. v. Oil Workers Union, 162 N.L.R.B. 354 (1966), a franchisee qualified as an "employee" under the terms of the National Labor Relations Act by virtue of the constraints placed upon him by his franchisor. But see Coleman, A Franchise Agreement: Not a "Security" Under the Securities Act of 1933, 22 BUS. LAW 493 (1967).
sions on sales made to those persons with the identification cards. Usually, by recruiting additional founder-members, the founder earns an additional finder's fee and an override commission if his recruit should subsequently enlist a new distributor. A variation of this scheme is to sell consumer goods to the buyer at more than fair market value, in return for which the buyer is entitled to commissions on a referral arrangement.

The pyramid schemes, described above in the discussion of Glenn Turner, involve a company which purports to market a line of products but in reality leads the prospective participants to believe that they will profit by recruitment of other participants. These investors do not expect to assume any of the significant functional responsibilities which normally attend the operation of a franchise. The pyramid schemes are doomed to failure because the scheme is based upon the erroneous assumption that growth can be infinite. These schemes emphasize the riches which await the successful recruiter, while obscuring the fundamental relationship created between the participants and the offeror. The issue is whether these schemes embody sufficient investor participation, in terms of distribution of cards or recruitment of distributors, to vitiate an investment contract theory.

A number of cases applied the rigid formula and found no investment contract. While some of these courts pointed out that the buyer was not participating in the "profits" of the selling corporation, the striking parallelism of these cases was in their unanimous vindication of the "solely" rationale. Typical is the language of a Texas court:

It does not appear that Owens was to play the passive role of an investor only. Management was in the hands of the company but profits were not to be realized by Owens without his actual and continued participation. The role was not "minimal" or a

147. See text accompanying notes 64-72 supra.


mere walk-on, but one that occupied the center stage for most of the play. The expectation of financial return to the complaining witness might have been raised by hopes falsely induced, but since the "agreement" contemplates his active and actual participation, we cannot conclude, viewing the transaction as a whole, that it constitutes an "investment contract" within the meaning of the Texas Securities Act.150

Other courts, however, have found these schemes too repugnant to warrant such benign tolerance. In sweeping fashion, the Supreme Court of Hawaii held that a founder-membership plan constituted a security:

[I]t is irrelevant to the remedial purposes of the Securities Act that an investor participates in a minor way in the operations of the enterprise. The courts should focus on the quality of the participation. In order to negate the finding of a security the offeree should have practical and actual control over the managerial decisions of the enterprise. For it is this control which gives the offeree the opportunity to safeguard his own investment, thus obviating the need for state intervention.151

This crack in the franchise facade allows a new concept to slip through; within "solely" lies a distinction between mere active participation and meaningful managerial control over one's investment. This distinction was seized upon by the district court in SEC v Glenn W

151. State ex rel. Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 651-52, 485 P.2d 105, 111 (1971). This is possibly the most progressive case in the nation with respect to the definition of a security. Indeed, it adopts the revised test of Professor Coffey:

"A 'security' is: (1) A transaction in which (2) a person ('buyer') furnishes value ('initial value') to another ('seller'); and (3) a portion of initial value is subjected to the risks of an enterprise, it being sufficient if—

(a) part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or

(b) any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property, or

(c) part of initial value is furnished for property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise, even though the buyer has no legal relationship with the enterprise; and

(4) at the time of the transaction, the buyer is not familiar with the operations of the enterprise or does not receive the right to participate in the management of the enterprise; and (5) the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise." Coffey, supra note 4, at 377

Hawaii Market Centers represents one of the finest examples of a court boldly coming to grips with modern economic reality. However, it is submitted that as thoughtful as Professor Coffey's formula is, it suffers the same flaw as the Howey formula. Clever entrepreneurs will wind a path around the black letter and force courts back to analysis rather than mechanics.
Once the court found as a matter of fact that the investor’s efforts were ministerial, and not discretionary, the result followed quite easily. The Ninth Circuit, bound by this finding of fact, affirmed the decision on the ground that the investor lacked essential managerial control to affect the success or failure of the enterprise.\textsuperscript{153}

\textit{Glenn Turner} has not achieved universal acceptance, however. Recently, Judge Smith of the Northern District of Georgia, concluded that no security existed under almost precisely the same facts as in \textit{Glenn Turner}.\textsuperscript{154} The judge noted that there may be room to discount \textit{de minimus} efforts on the part of the investor: “But, even so, this court sees the distributor’s efforts in the Koscot program as fundamental and substantial, not token. Accordingly, broad reading will not help the Commission in this respect.”\textsuperscript{155}

Taking cognizance of the Ninth Circuit’s opinion, Judge Smith stated that:

[T]he Court of Appeals for this Circuit, as well as the Supreme Court, has repeatedly stated the “solely” test as the standard for an investment contract. This district court sees no freedom to coin a new, different and more expansive standard in light of these binding higher court decisions.\textsuperscript{156}

Judge Smith’s opinion highlights a difference which the Supreme Court may ultimately resolve. The federal courts may be embroiled in what amounts to a quibble. The Ninth Circuit will continue to make nice distinctions between participation which is “ministerial” and that which is “discretionary.” Concurrently, the Fifth Circuit may continue to label analogous efforts “fundamental and substantial.” The

\begin{itemize}
\item \textsuperscript{152} 348 F. Supp. 766 (D. Ore. 1972).
\item \textsuperscript{153} 474 F.2d 476 (9th Cir. 1973).
\item \textsuperscript{154} SEC v. Koscot Interplanetary, Inc. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 93,960, at 93,844 (N.D. Ga. Apr. 19, 1973). Representing that the facts were similar is somewhat of an understatement. Both Glenn Turner Enterprises and Koscot Interplanetary were pyramid sales schemes owned and operated in an almost identical manner by Glenn Turner.
\item It should be noted also that Judge Smith is no stranger to this issue. \textit{See} Cobb v. Network Cinema Corp., 339 F. Supp. 95 (N.D. Ga. 1972).
\item \textsuperscript{155} [Current Binder] CCH Fed. Sec. L. Rep. ¶ 93,960, at 93,846.
\item \textsuperscript{156} \textit{Id.} Judge Smith goes on to say that “[n]ot every get-rich-quick scheme is a ‘security’ within the meaning of federal law, and neither the number or the nature of the participants nor possible fraud will transmit the sale of an opportunity to participate actively in a distributorship recruiting program into a ‘security’ if, in its legal and economic effects, the thing sold is not a ‘security’.” \textit{Id.} at p. 93,845.
\item Utilizing risk analysis, it may well be that most get-rich-quick schemes embrace an element of unreasonable risk allocation on the investor and thereby constitute a \textit{prima facie} argument that the economic reality of the scheme is a security.
\end{itemize}
franchise arrangements encompass a variety of participatory levels. Trying to draw lines between ministerial and discretionary participation may well prove as difficult as determining the meaning of the word "solely." For example, a reasonable argument could be made that a McDonald's franchise is an investment contract. McDonald's is so successful that all investors owe unquestioned allegiance to the franchisor. The operators and workers are trained at McDonald's schools, and the site is prearranged. In effect, the argument would be that these hamburger stands are nothing more than cages of trained monkeys.\(^1\)

One might ask, is there any meaningful distinction between the Glenn Turner distributors and the franchisee who operates the "Golden Arches?" Certainly they project different appearances. One man is out hustling his fellow man and the other is a "productive citizen" housed in a commercial structure, selling legitimate goods, and paying wages and taxes.

After first blush, the distinction begins to fade. Both rely almost entirely upon the promotional efforts of their franchisor. Neither contemplates a decision-making role with respect to his investment dollars. Their profit making activity consists mainly of physical labor and following the rules. Viewed in this light, both roles seem equally ministerial. The distinction, if any, is that one is engaged in more socially desirable activity than the other.

The foregoing abstraction is not meant to imply that all McDonald's franchises are or are not securities; it is merely to indicate that the obvious differences may find judicial recognition. More importantly, this is in no way directed at upsetting the legal wisdom of the Ninth Cir-

\(^{157}\) This is certainly the thrust of Goodwin's article. "With this in mind, the Courts, especially the United States Supreme Court, when properly presented with the problem, can logically say that a franchisee could not exist without the success of the entire common enterprise franchise system, which is operated and controlled solely by the franchisor, and, furthermore, that the franchisee's profits depend thereon. The Courts, in dissecting the modus operandi of the standard franchise system, will readily appreciate that the real functions of the franchisee comprise mostly ministerial rather than discretionary activities, when considered in relation to the franchise system as a whole, virtually making franchisees employee managers cloaked with the dignity of ownership." Goodwin, supra note 138, at 1319 Franchise industry spokesmen, however, disagree: "The franchisee's success depends almost entirely upon his desire to do a job adhering to the policies, the regulations, and the systems of the parent company; and his benefits are tied to his own ability to do this job which was prespecified and which he accepted as his responsibility. This is completely opposite from the theory of purchasing securities. An individual purchasing a security of a corporation depends upon the management of the corporation for his return on his investment. He has nothing to say about the policies, the type of business, or the direction of this corporation in which he has invested." Thomas J. Murphy, The Publisher Speaks, Continental Franchise Review, April 6, 1970.
The purpose is simply to illustrate how hamstrung the federal courts have become in trying to engraft the Howey criteria onto every modern financing concept. The judicial infatuation with the word "solely" is only the most obvious indication of the problem.

A second issue raised by franchising is the application of risk and risk capital analysis. This problem is encountered when the franchisor attempts to finance his operation from the fee of the franchisee. If the franchisee is to play a passive or ministerial role, there is no difficulty in satisfying the Howey rationale as modernized by Glenn Turner. On the other hand, if the franchisee has discretionary functions, the nature of the risk to the public may be sufficient to permit separation of the active management of the franchise from the initial funding of the franchisor's operation. With respect to the latter the investor is totally passive, thereby falling squarely within the purview of Howey.

Apparently, the California Attorney General first introduced this "double investment" concept.\footnote{158. 49 Op. Cal. Att'y Gen. 124 (1967).}

The risk capital... is provided by the franchisee to the franchisor to enable the franchisor to supply the franchisee with certain goods and services. This latter aspect seems to us to be a separate business risk apart from the success or failure of the franchisee's conduct of the franchised business... Following this reasoning, it would seem that the franchised business operated by the franchisee and the franchisor's business of supplying the franchisee with goods and services are separate "business ventures" and that the venture in which the franchisee participates is not the same venture for which he supplies the risk capital. The fact that these two "business ventures" are contained in the same franchise agreement should not obscure this distinction.\footnote{159. Id. at 129.}

The double investment analysis has been attacked as a legal fiction. The crux of the argument is that the franchise agreement is an integrated whole, not two separate ventures. For example, one writer asks,

Why should the franchisee be concerned with what the franchisor intends to do with the money received from the sale of the franchise? Naturally, the franchisee would be interested in the ability of the franchisor to continue to provide the necessary goods and services, but this is one of the normal risks of the franchised business, not a separate risk as suggested by the Attorney General.\footnote{160. Note, Franchise Regulation Under the California Corporate Securities Law, 5 San Diego L. Rev. 140, 161 (1968).}

Further, critics assault the assumption that the speculative nature...
of an enterprise is subject to objective determination.\(^{161}\) This argument stems from the attorney general's statement that "[I]t is not clear what degrees of under-capitalization by the franchisor will cause the fees paid by the franchisee to be characterized as 'risk capital' within the Silver Hills rule."\(^{162}\) The attorney general goes on to allude to a "degree of risk" analysis suggested by one writer.

A venture in its promotional stages, financed on a shoestring, as in Silver Hills, would seem to fit easily into a high degree of risk to the investor category. On the other hand, an established country club or other organization having a sound financial standing would seem clearly to fall outside the "degree of risk" rule.\(^{163}\)

Many feel that distinguishing between high and low risk is simply too subjective an exercise for the courts. Finally, one commentator wonders why the theory is limited to initial capitalization.

If the purpose of the Corporate Securities Law is to protect the investing public against spurious schemes, why does the Attorney General not define risk capital to include schemes to raise capital for an existing but unproven business, as well as schemes to raise initial capital?\(^{164}\)

These are valid comments. It is very difficult to answer these questions by using the cumbersome language of Howey, or by simply uttering the term "risk capital." By utilizing the principles discussed in this article, however, these arguments may be answered in an orderly manner, and, in addition, the economic realities of which Justice Murphy spoke in Howey may be exposed. The first criticism is the alleged fictitious distinction between two separate business risks within one franchise agreement. Why should the franchisee care what happens to his money, so long as he receives the desired goods and services? Here, the error is one of perspective. In testing investment contracts, the examiner must stand principally in the shoes of the promoter. The franchisor did not design his scheme as a single contract for business services; he sought financing. "The franchisor has done a brilliant thing. Though he has neither given up equity nor incurred any debt in his franchising business, he still raises capital to launch the business."\(^{165}\)

This is not a fictitious distinction. There is a great difference

\(^{161}\) 50 Calif. L. Rev. 156, 160 (1962).
\(^{163}\) Id. citing 50 Calif. L. Rev. 156, 160 (1962).
\(^{164}\) Note, Franchise Regulation Under the California Corporate Securities Law, 5 San Diego L. Rev. 140, 164 (1968).
between paying a franchise fee to Conrad Hilton for the right to operate a hotel and turning over the money to a fly-by-night promoter with a great story. The investor always assumes the risk of future delivery, but in the latter case he does not expect to be directly responsible for starting the franchisor's enterprise. Several states have recognized this difference and accordingly have protected the investor in an initial capitalization.

Finally, some writers argue that the California Attorney General has unreasonably restricted the double investment concept to start-up operations as opposed to established enterprises. This is a valid point. It is difficult to discern any reason why all disguised forms of public financing should not fall within the purview of the risk capital analysis. It is true that the start-ups are the easiest to spot, and at first blush it may seem to make more sense to protect the public from a scheme which has just been planned rather than from an enterprise which has a long track record. When an existing business launches a new venture, however, the opportunity for abuse is equally pronounced. In these situations, courts are probably on firm ground in utilizing a risk analysis or risk capital theory.

Much of the analytical difficulty could be alleviated by recognizing that the policy requiring disclosure of risk in schemes designed to secure financing is an independent basis for invoking the aegis of the securities laws. With respect to public offerings, merely subjecting the public to unreasonable risk may be sufficient basis for finding a security. Acknowledgement of this argument would preclude much of the gamesmanship required to fit risk capital into the test of Howey.

In recent years some courts have candidly discussed the theories involved in ascertaining what constitutes a security. One of the more thorough analyses was given in a case which found that the scheme did not involve a security. *Mr. Steak, Inc. v. River City Steak, Inc.* is cited by some for the proposition that no security is involved when the franchisee operates and controls his own business. However, the case is much more subtle. Without regard to the correctness of the specific result, the court's analysis is helpful. The court noted: "[W]ho exercised actual control over the restaurant is not determinative. Rather, it is merely a factor to consider."

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166. *See id.* at 253.
167. The additional argument that too much certainty is sacrificed by such analysis is discussed in text accompanying notes 115-118 *supra*.
168. *See text accompanying notes 104-118 supra*.
170. 324 F. Supp. at 644.
The court then proceeded to focus upon the *quality* of the investor participation. The opinion did not mechanically propose that every franchisee who operates his own business is precluded from raising an investment contract or other securities argument. Quite to the contrary, the court focused upon economic reality and found that where a franchisee did *not* own and operate his own business he still may not have purchased an investment contract. This type of analysis of the catch phrase “solely from the efforts of others” was discussed with approval by the district court in *Glenn Turner* 171 “The court [in *Mr Steak* weighted] the relative participation in the control of the franchised restaurant before determining that the substantial degree of authority held by the franchisee was inconsistent with a securities transaction.”172

The facts in *Mr Steak* involved the sale of a “turn-key” distributorship to a sophisticated franchisee. The agreement called for unlimited financial participation by an experienced franchisee who was well acquainted with the nature of the enterprise. In this setting, the typical franchisor—franchisee relationship was reversed. Even though the franchisee delegated control of the restaurant to the franchisor, the court presumably found that the decision to delegate by the franchisee was a discretionary function contemplated by the franchise agreement which vested the power of managerial control in the franchisee.

[T]he role of the franchisee was envisioned as a flexible one, depending upon the business expertise and inclination of the franchisee. That River City Steak delegated performance of those duties and ignored daily operations does not affect the nature of its powers, nor change the essential fact that River City Steak abandoned what rights of control and participation it did have.173

It is difficult to tell from the opinion whether Judge Arraj was analyzing the problem from the standpoint of the franchisor or the franchisee. While the result may be the same, the method is important. There is a vast difference between denying the existence of an investment contract on the ground that the franchisor sold to informed purchasers whom he knew would be in a position to decide how to manage the day-to-day chores, and finding no security because the agreement

was signed by sophisticated people who theoretically do not need the protection of the act. The former goes to the ability to control the investment; the latter involves the element of reliance. The distinction is highlighted by section 17(a) of the 1933 Act which prohibits fraud in the offer as well as the sale of securities. If courts were to consider the subsequent activities of the purchaser in defining the term security for the purposes of a sale, a needless dichotomy might be created since those activities would hardly be considered with reference to an offer of sale.

Under the classic Howey analysis, the court's job is now over. Having studied the efforts of the franchisee, and having found them to be meaningful, most courts would foreclose the possibility of an investment contract. To Judge Arraj's credit, not only did he undertake a liberal analysis of the efforts of the franchisee, but in addition he undertook the first clear attempt in a federal court to apply a risk capital analysis.

One salient feature of most cases finding an investment contract has involved the solicitation of funds for speculative, poorly-financed business ventures or emergent industries. In these instances the investor, even if he can participate in or control some phase of the enterprise, is gambling "risk capital," where there is less than an even chance of success, against the opportunity for large profits. Because of the substantial risk of loss, to include such operations within the purview of the 1933 Act would fulfill the purpose of protecting passive investors by compelling disclosure of the disquieting aspects of a scheme. Under this approach, once the requisite risk is shown there would be no compelling reason to exclude a franchise operation from the Act's coverage.

The judge is thus expressing the long standing policy of extending the protection of the securities acts to venture capital situations. This interpretation draws support from the court's subsequent discussion of Silver Hills. The court cautiously read this case as applying strictly to initial capitalization. "The court implies by this holding [in Silver Hills] that where an ongoing business is involved, there is no imperative need for the protections of security acts, and those businesses should not be included."


177. Id.
Accordingly, this court would consider the California attorney general's double investment concept too extreme. Judge Arraj would limit the theory to situations "where exceptionally high risk, speculative franchises are involved. In other situations, we consider the risk undertaken by the franchisee as incident to the conduct of his business."

The court completed its discussion by analyzing the risk of the venture in question and concluded:

River City Steak, Inc.'s investment in plaintiff's business comprised the purchase of the Mr. Steak name and method of doing business. Any "risk" to River City Steak created by that purchase is an unsubstantial and legitimate risk of doing business. That risk does not warrant investor protection, and so under our analysis, no security interest subject to registration and regulation under the 1933 Act has been created.

Except for the emphasis upon the activities carried out by the franchisee, this methodology is consistent with the type of analysis suggested in this article. First, the court took a close look at what role the franchisor contemplated the franchisee playing. Looking through form to substance, the court found it to be substantial and discretionary despite the facade of absentee delegation. Next, it turned to a risk capital analysis to see whether the scheme was disguised as a public offering, and thus whether the policy of the securities acts should be invoked. The case is particularly valuable in that it demonstrates the use of a reasoned analysis, as opposed to the simple application of a mechanical test.

When using general terms such as "efforts of others," "control," "risk," etc., it is far too easy to begin equating tung trees and chin-chillas with Howard Johnsons.

Franchising is unique because the
franchisor must insist on certain uniform standards to maintain his national image and reputation. If he does not properly police his franchisees, he runs the risk of losing his trademark and trade name under the Lanham Act.\textsuperscript{182} This is an economic reality which must be considered along with others, but which would not be determinative by itself.

\textit{Wieboldt v. Metz}\textsuperscript{183} is a more recent application of a similar analysis. \textit{Metz} dealt with a typical franchise where the franchise agreement contemplated active participation by the franchisee (who did in fact control and operate the franchise). The issue was whether the franchisee’s active participation was negated by his dependency on his franchisor. The court held that it was not, finding no investment contract. Judge Lasker stated:

\begin{quote}
[I]t is only necessary that the franchisee exercise policy-making power over his unit of the enterprise, since to require control over the franchisor’s entire system is incompatible with the franchising method and would make all franchises investment contracts.\textsuperscript{184}
\end{quote}

Analytically, the court approached the matter correctly. First, the court examined the transaction in light of the traditional \textit{Howey} rule. Finding no security under this rule (in fact the plaintiff conceded this point) the court went on to consider a “liberalized and broadened concept”\textsuperscript{185} of investment contract. Following the same path as \textit{Mr. Steak}, the court noted that pursuant to \textit{Silver Hills}, an investment contract should be found if the agreement amounted to an initial capitalization.

The theory behind the test is that, under those circumstances, the profit-making potential of his investment is essentially realized by the franchisor and the \textit{Howey} test that “profits [are] to come solely from the efforts of others” is satisfied.\textsuperscript{186}

This theory was perforated by the fact that this franchisor had been in operation for ten years prior to the agreement.\textsuperscript{187} The statement of facts also discloses that the situation did “not involve numerous, scattered, ignorant investors”\textsuperscript{188} since the defendant sold only
eight franchises of the type offered to plaintiffs. The argument could be made that this arrangement hardly amounted in substance to a disguised solicitation of venture capital. In considering the application of Glenn Turner to the Metz facts, the court agreed that an investment contract would be present if the franchisee did not have "meaningful control" over his enterprise.

This review of Mr Steak and Metz is not intended as an endorsement of the results in those cases, but rather as an approval of the analytic methods employed by those courts. The decisions appear conservative in viewing most franchises not to be securities, a conservatism which has not in the past been supported by the Supreme Court in its review of investment contracts. The results may represent a viable line of demarcation, but until the Congress or the Supreme Court endorses the result, practitioners would do well to be extremely cautious in this area. There also appears to be no compelling policy reason why large, well-established franchises should not be subjected to the antifraud provisions of the federal securities laws and/or be required to register their investment opportunities as securities.

189. It is important not to confuse the private offering exemption from registration with the broader scope of the risk analysis in situations amounting to a disguised venture capital offering.

190. Id. at 260.

191. Recent cases lend increasing support to methods and conclusions reached by the courts in Glenn Turner, Hawaii Market Centers, and Metz. In Lino v. City Investing Co., [Current Binder] CCH Fed. Sec. L. Rep ¶ 94,124, at 94,505 (3rd Cir. Aug. 20, 1973), the Third Circuit stated, "The reasoning of the Supreme Court, the Ninth Circuit, the SEC [Securities Act Release No. 5211 (Nov. 30, 1971)] and Supreme Court of Hawaii leads us to hold that an investment contract can exist where the investor is required to perform some duties, as long as they are nominal or limited and would have 'little direct effect upon receipt by the participant of the benefits promised by the promoters.'"

Although the Third Circuit found the above authorities persuasive, the court reversed the district court and held that no investment contract existed where the franchisee controlled his franchise and was "required to make significant efforts." Id. at 94,505.

Similarly, in Nash & Associates, Inc. v. Lum's, Inc., [Current Binder] CCH Fed. Sec. L. Rep ¶ 94,126, at 94,513 (6th Cir. Sept. 5, 1973), the Sixth Circuit stated, "We find the general concept of a less restrictive approach attractive in view of the broad remedial purposes of the federal legislation and the importance of flexibility as stressed in Howey." Id. at 94,515.

After considering Glenn Turner, Silver Hills, Mr Steak, and Hawaii Market Center, the court concluded along the same lines as the Metz decision. Since the franchisor was adequately capitalized and the franchisee had invested in his own business and was in control of his own business, the court held that the franchise agreement had none of the traditional qualities of a security.

Importantly neither decision speaks in terms of "managerial efforts" as did the Ninth Circuit, rather they held that "solely" should not be construed literally. It is
Naked Commodity Options

A storm of controversy is currently brewing over a new type of promotion recently conceived by ingenious promoters. These are the naked commodities option cases.

The case of SEC v. Goldstein Samuelson, Inc. ("GSI") is typical of a number of recent federal actions brought to restrain speculative option trading in the commodities market. The basic operation is quite simple. For a specified premium, the investor receives an option to buy or sell (or both) a specified commodities futures contract from or to GSI during a specified period at a fixed price. The options are termed "naked" because GSI does not purchase the futures contract to which the customer's option relates. One attraction of these options is that the investor's risk of loss is limited to the amount of the premium. On the other hand, the amount of profit is based in theory upon the investor's timing in exercising the option at a favorable price in the face of a fluctuating commodities market. The contingencies surrounding payment of the investor's claim, however, form the gravamen of the lawsuit. GSI is not obligated to use the investor's premium to purchase a futures contract to cover the risk created by selling the option. Instead, the money is diverted to general corporate purposes. Therefore, the GSI's risk of loss is based upon: (1) The risk of price fluctuation in the underlying futures contract; (2) The investor's ability to take advantage of favorable price movement; and (3) most important, GSI's own success in generating sufficient additional capital, through the employment of investor's premiums, to enable GSI to pay off incoming option claims. "GSI regards its obligations to its customers as essentially general unsecured obligations of the firm and the customer takes the risk of GSI's continued ability to meet its obligations." see also Mitzner v. Cardet Int'l, 358 F Supp. 1262 (N.D. Ill. 1973) which demonstrates increasing judicial acceptance of the analysis set forth in Mr. Steak, Glenn Turner and Metz, and also offers a middle ground with respect to quasi-Glenn Turner type franchises.


In this case, the money making efforts of twenty-eight year-old Harold Goldstein, chairman of GSI, were somewhat less than successful. Although GSI had grown from nothing to a $25 million per month business in less than two years, when bankruptcy was declared on April 30, 1973, its liabilities, including profits owed to its customers, were estimated to be in the neighborhood of $76 million, compared with unconfirmed assets of around $17 million. Concurrently Mr. Goldstein was indicted and pleaded guilty to three counts of mail fraud in connection with the issuance of fraudulent financial statements and a letter claiming that a surety bond, which was in fact non-existent, underwrote the options. In March of 1973, when the above facts began to surface, the SEC filed suit seeking a preliminary injunction and the appointment of a receiver. District Judge Kelleher had before him a record of fraudulent activity which included the falsification of financial records, the attempted diversion of assets out of the United States, the concealment and destruction of corporate records, and the concealment of the company's insolvent condition while Goldstein continued to seek funds from public investors. Judge Kelleher refused to sustain the preliminary injunction and ordered the action to proceed to trial on the merits. Contemporaneous with the SEC action, California Corporations Commissioner Van Camp filed for similar relief under state law against Puts and Calls Inc., a firm with operations similar to GSI. The state court ruled that a preliminary injunction was the proper remedy and appointed a receiver. One may wonder why two courts faced with similar records of outrageous fraud came to opposite conclusions. The answer is purely jurisdictional; the state court found Puts and Calls Inc. to be selling securities while the federal court thought the issue was too close to justify extraordinary relief.

Historically, commodities futures contracts (agreements for the delivery of a specified quantity of a commodity at any day in a given future month) have been excluded from the definition of a security. The rationale is that the elements of common enterprise and reliance on the efforts of others are absent. There is said to be no interlocking of common interests since the purchaser acquires "the power to exercise absolute dominion and control over the specified commodities." Likewise the facts of future delivery and speculative motives

194. Id., citing Receiver's Report at 5.
196. See 1 Loss, supra note 6, at 491-92.
do not constitute reliance upon the "continuing efforts of another."
"In the words of the Supreme Court [the investor has] been left to [his] own devices for realizing upon [his] rights." 198

Congress recognized the strong resemblance between futures contracts and traditional securities. Both are traded on regular markets; the investor can buy on margin and hold long or short positions, and many of the transactions are placed through the same brokerage houses. Accordingly, the Commodities Exchange Act 199 was promulgated. This act authorizes the Commodity Exchange Authority, operating out of the Department of Agriculture, to regulate the various commodities exchanges. Section 6(b) 200 has been construed as according to private investors an implied claim for relief for fraudulent practices. The difficulty, however, is that section 2 201 of this counterpart to the securities acts regulates only a finite number of commodities. There is no federal claim available to the investor in unregulated futures. 202 (GSI's options, of course, were strictly limited to unregulated commodities.) It is clear, however, that certain arrangements involving commodities may come within the ambit of the securities acts. For example, in Maheu v. Reynolds & Co., 203 the court had no difficulty finding an investment contract where the investor placed his money in a discretionary commodities account which was managed and supervised solely by defendants. GSI was thus selling commodities which the SEC conceded were not in and of themselves securities.

In GSI the defense argued that because the options take the character of the underlying instrument or interest, no securities are involved. The SEC met this argument by analogizing the GSI scheme to the familiar investment contract precedents dealing with silver foxes and orange groves. 204 They contended:

The purchase or sale of GSI options has no direct relationship to commodities future contracts or actual commodities. Option purchasers do not contemplate the acquisition of commodities or futures contracts. GSI has no obligation to any investor to buy (or sell) commodities or commodities futures and may, if it chooses,

198. Id. at 367.
204. See note 181 supra.
devote the funds received to any unrelated purpose as it sees fit. Whether a payment can or will be made to investors is dependent upon the success of GSI and the management of the pooled investors’ funds which have been committed to it.205

In short, the SEC argued that the investor’s efforts and choices are inconsequential unless GSI successfully generates profits on its own. In this profit-generating enterprise, the interests of all GSI option holders are common with those of GSI. The defense replied that this confuses factors which lead to the realization of profits by a GSI customer with those factors which lead to payment of that profit. With respect to the former, the investor is left to his own devices. With respect to the latter, the defendants conceded that payment depends entirely upon GSI’s willingness and capability to respond to customer claims. However, the defense argued that the ability to pay is not a securities issue. Rather, insolvency is a fact of commercial life and every creditor assumes this risk.

The GSI situation provides an obvious example of what may result from a mechanical application of the Howey test. Ostensibly, GSI would seem to have a colorable argument. Upon closer scrutiny, the alleged distinction between realization of profit and payment is patently fallacious. By examining how effective the investor’s efforts were allowed to be with reference to the promotional scheme, it is obvious that GSI was designed in such a way that any “profit generation” on the part of the investor was illusory. It is true that the investors were led to believe that they must exercise discretionary judgment in order to assert a claim against GSI. However, the economic reality was that any realization of profit would result only from the giant “match game” which GSI was playing.

G.S.I., as the seller of commodity “options,” can offer investors a limited risk only by assuming an unlimited market risk itself. Because G.S.I. failed to cover its market risk with commodities futures contracts, or purchase of actual commodities, the investor was dependent on the efforts of G.S.I. to generate profits from the solicited premiums of the investors. Thus, the investor merely purchases a share in the proceeds of the selling efforts of G.S.I. in raising money from other investors.206

This is an excellent example of a situation in which “form [must be] disregarded for substance and emphasis placed upon economic

In substance, GSI operated in such a way that the distinction between realization of profit and payment was artificial. The most pernicious aspect of the scheme was the concealment of the substance of the transaction and its attendant risks. Thus the optionees, without their knowledge or consent, were channeled into a common enterprise whereby any profit they would obtain would be contingent on the changing fortunes of GSI. Viewed in this light, the SEC has made a strong argument that the scheme falls within the four corners of Howey.208

Applying a risk analysis, an even stronger case is made against GSI, and the analysis is far less cluttered with red herring issues such as payment. Utilizing the Silver Hills doctrine, the California court had little difficulty determining that GSI was a disguised venture capital offering of the most speculative variety. The investor's risk was not lessened merely because these interests were labeled "options." As in Silver Hills, the risk of loss was allocated to the public and not to the promoter. Thus, GSI's options fell squarely within the regulatory purpose of the Blue Sky Law.

Whether the same analysis would carry the day at the federal level requires the consideration of an additional issue, the profit element of Howey. GSI is a law professor's dream because it trains the spotlight on the subtle tension between the "profit motive" of Howey and the "valuable benefit" doctrine of Silver Hills. To be sure "profits" should not be restrictively interpreted as a share in the balance sheet of the promoter's company, but it does connote a species of pecuniary investment return. The most difficult aspect of GSI is the determination of whether this option constitutes the expectation of pecuniary investment return. It could be argued that GSI affirmatively represented these options as a way to get rich quickly. As such, GSI seems to be offering all of the affirmative economic inducements which the acts were designed to redress. If the promoter's scheme and representations led the buyer to expect "profits" through the employment of his investment capital, then it is not inappropriate for the offering to be judged as it was represented to be. That interpretation, however, would be a strained legal fiction. The better view is that in promising the investor an option GSI has not promised a "profit." What GSI has

208. This was the conclusion of Hon. Hugh M. Caldwell, referee in bankruptcy, on facts substantially identical to GSI. To date, this is the only federal authority on this issue. See In re Traders Int'l Ltd., Civil No. 7350 (D. Nev., filed Aug. 23, 1973).
done is to promise a valuable benefit, the opportunity to play the commodities game. GSI is thus a risk capital case which squarely indicates the need for a risk capital analysis in order to effectuate the policy of the acts.\textsuperscript{209}

Within the ambit of "risk capital," GSI is a good example of the salutary effect of the initial capitalization concept. Presumably, if Merrill, Lynch, Pierce, Fenner & Smith, Inc., a financially responsible entity, offered the same options and underwrote them with its assets, the degree of risk would be greatly lessened. In that situation, leaving aside the question of whether commodities and thus commodities options should be independently classified as securities or instruments commonly known as securities, no security would result under the risk capital analysis.

\section*{Land Sales Financing}

A classic image of investment fraud is that of the hapless man from Minnesota who is fast-talked into a "bargain" purchase of sunny Florida swamp land or Arizona desert. For years the real estate industry has played host to some of the most outrageous charlatans in the annals of American swindling. Such fraud usually takes the form either of the promotion of physically inferior property or of the employment of sharp practices aimed at selling acreage through marketing techniques similar to those used in the securities industry and wholly unlike those normally used in the sale of real estate. Nowhere is this combination of evils more apparent than in the nationwide marketing of raw "investment" acreage in the "planned communities of tomorrow." Although it may seem strange to some that a securities theory is used as the legal assault on these unscrupulous developers,\textsuperscript{210} one will recall that both \textit{Joiner} and \textit{Howey} involved land transactions. In other words, it is not what you sell, but how you sell it, or as Professor Loss put it:

\begin{quote}
[N]o "investment contract" is involved when a person invests in real estate, with the hope perhaps of earning a profit as the result of a general increase in values concurrent with the development of the neighborhood, \textit{as long as he does not do so as part of an}\
\end{quote}

\textsuperscript{209} See text accompanying note 111 supra.

\textsuperscript{210} Many of these practices have been regulated since April 29, 1969 (the effective date) by the Interstate Land Sales Full Disclosure Act, 15 U.S.C. § 1701-20 (1970). The Land Sales Act, however, is not an exclusive remedy and will, of course, include many typical land sales other than those disguised as public offerings. Thus there is an overlap with the securities laws, but not a usurpation.
enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others.\textsuperscript{211}

Although there is an enormous variety of possible land sales operations, the typical transaction looks something like this: A developer will purchase a large parcel of unimproved land at prices comparable to surrounding unimproved property. The developer will then “subdivide” the property and make minimal improvements in order to showcase the property. Lots in the new community are then sold through a high-priced marketing program featuring low down payments and monthly payments over a substantial period of time. Improvements which would allow “occupancy” of the land are generally deferred. Although on the surface, this may appear to be an innocent business, the economic reality is to the contrary.

The cost of building a new community is enormous. In comparison to this cost, the initial capital supplied by the developer is minimal and the risk of the venture falls upon members of the public who purchase “lots.” In order to make the venture profitable, the developer must sell the lots at a price sufficient to pay for future improvements, sales costs, debt service and land costs \textit{plus} his profit. The resulting price is thus wholly unrelated to the normal market pricing of comparable undeveloped real estate.

For example, one developer is alleged to have purchased Arizona desert acreage at an average price of about \$61 per acre. Lots were laid out and improvements were installed after which its own appraiser estimated the value of the land to be \$175 per lot (the cost of usable and unusable land to the developer had by then increased to \$100 per acre.) The developer than sold lots to the public at an average price of \$5,000, not per acre, but per average quarter-acre lot. The plaintiffs allege that the sales price was computed by an overall formula taking into account the minimal cost of the land, the cost of engineering, the estimated cost of development including debt service, the cost of selling the land, and to all this adding a profit of 30 percent of the \textit{total gross}.\textsuperscript{212} Because this type of development can only be marketed through an extensive sales program, the cost of selling the lots runs from 30 percent to as much as 50 percent of the sales price. The economic reality is, therefore, that the funds to finance

\textsuperscript{211} 1 Loss, \textit{supra} note 6, at 491-92 (emphasis added).
\textsuperscript{212} These facts are based upon those alleged by plaintiffs to be true in Mancini \textit{v. GAC Corp.}, Civil No. 72-45-TUC-JAW (D. Ariz., 1973), in which co-author, J. Thomas Hannan appears as one of the counsel of record for the plaintiffs. The case is considered in more detail in note 213 \textit{infra}. 
the development of the new community are coming from the public through installment land purchase payments. This technique may be described as an inverted pyramid, with respect to value, wherein the value of the lots when sold is nowhere near the sales price, but in theory the value goes in while the purchaser provides the capital through installment payments.

Most of these developments have been sold to the public so far by means of a marketing program which represents the product largely as a profit opportunity. Thus, the courts may apply a traditional Howey analysis in finding the investment of money (cash) in a common enterprise (the development as a whole since the individual lots are not in the normal sense unique) with the expectation of a profit (upon subsequent resale because “land” values and real estate are alleged always to appreciate) solely from the efforts of the promoter or third persons (the success of the community development in reality depends upon the promoter).

The first reported case holding a land sales financing transaction to be a security under the 1933 act is Johnson v Suburban Land Investment Co. The case is a classic Howey situation in which the promoter sold land to the public under an agreement whereby the purchaser would subordinate the land to the control of the promoter for the purposes of constructing a new residential subdivision. The analysis of the court followed the Howey rationale. The court was not troubled by language in the contracts which provided that the investors would control the land improvement, because the economic reality

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213. [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,022, at 94,100 (Sup. Ct. D.C. June 1, 1973). Two other class actions in which securities acts violations are alleged have been certified under Rule 23 of the Federal Rules of Civil Procedure. In Tober v. Charnita, Inc., 58 F.R.D. 74 (M.D. Pa. 1973), a class action was certified in which the federal claim arose under the 1933 and 1934 Acts. While such a certification does not constitute a finding that the transactions in question are securities, the court found there are sufficient common questions of fact and law as required by Rule 23(a)(2) and devoted considerable discussion to the reliance issue in federal securities cases. This at least indicates a sufficiently serious belief that the issue is raised in order to gear-up the machinery of the federal courts to handle a substantial class action. At the same time, the court also certified as a class action Hoffman v. Charnita, Inc., 58 F.R.D. 86 (M.D. Pa. 1973), arising under the Interstate Land Sales Full Disclosure Act.

The second case wherein the issue has been raised is Mancini v. GAC Corp., Civil No. 72-45-TUC-JAW (D. Ariz., 1973). Mancini has been certified as a class action under the 1934 Act and the Interstate Land Sales Full Disclosure Act. The defendants' motion for summary judgment asserting that the sale of subdivision lots could not be a security under the facts of the case was denied. See text accompanying note 212 for a discussion of the general factual situation.
was that only the developer had the expertise required to carry out the planning and construction of a new community. In that regard, the court stated:

The economic reality of Suburban Land's activities was this: Investors, ignorant of the intricacies of the construction business, provided Suburban Land with the necessary capital to proceed with the construction project by purchasing the parcels of Virginia real estate and executing the contracts for services in the implementation of the plan for the construction of a new community. As in Howey, these investors were attracted to the 'Suburban Concept' 'solely by the prospects of a return on their investment.' For the investors here to involve themselves in an intricate plan to construct a new housing development which requires a plethora of expertise would not only have vitiated the feasibility of such an investment from the investor's viewpoint, but also would have prevented Suburban Land from seriously proceeding with its plans.214

The promoter thus receives his financing and the purchasers bear all the risk. The price premium over the present value of the lot represents the amount of risk capital. That is, return on those dollars is contingent solely upon the success of the developer in completing the projects.

Developers are now getting the message, and are beginning to look for holes in the classic Howey formula. Previously, they have argued that land is unique, that each participant could improve his own land, and that therefore the "solely" language of Howey precluded the finding of an investment contract. These arguments have generally been unavailing.215 The current thrust appears to be to water down the "profit" representations; yet, it is submitted that application of the risk and risk capital analyses forecloses this exit where in substance the new community is financed in such a fashion that the principal risk falls upon the public. This may be the next area in which the Silver Hills approach will find acceptance under the federal securities laws.

Other Problems of Definition

Statutory Construction

As we have seen, the Supreme Court has not encouraged attempts to limit the definition of the term security.216 There is, however, one limitation some lower courts, the SEC and Professor Loss seem to en-

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215. See notes 213-214 supra.
216. See text accompanying notes 20-53 supra.
dorse. That limitation stems from the introductory phrase to the definitional sections of the principal federal securities statutes.

The introductory phrase reads in essence: \(^{217}\) "When used in this [title or sub-chapter], unless the context otherwise requires [the definitions including security mean]." That phrase might appear to mean that the definition is as set forth in the definitional section unless the language surrounding the term elsewhere in the act indicates otherwise. It would be most difficult to find such language, yet Professor Loss understands the statement as explicit recognition of an old principle of construction. Quoting Justice Holmes, he notes that the same word may have different meanings within the same act. Thus, he concludes that congressional intent may be used as a guide in applying the term to the various provisions of the act.\(^{218}\)

The SEC has adopted this rationale with respect to the definition of the term "sale" for the purposes of section 5 of the 1933 Act and in so doing has specifically pointed out that the definition adopted for the purposes of Rule 133 did not apply to the antifraud provisions of the 1933 and 1934 Acts.\(^{219}\) The Supreme Court endorsed that view in \textit{SEC v National Securities, Inc.},\(^{220}\) wherein the Court stated:

Although the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen, ordinary rules of statutory construction still apply. The meaning of particular phrases must be determined in context. Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context otherwise requires." We must therefore address ourselves to the meaning of the words "purchase or sale" in the context of § 10(b).\(^{221}\)

It is therefore possible that the term security may have a different meaning for different purposes (for example, registration as opposed to antifraud or perhaps even implied antifraud actions). Without predicting what differences, if any, there may be,\(^{222}\) this realization should


\(^{218}\) 4 Loss, \textit{supra} note 6, at 2485 (Supp. 1969).


\(^{221}\) \textit{Id.} at 466.

\(^{222}\) See note 19 \textit{supra}. 
lessen the expressed and unexpressed concern of courts that the ramifications of decisions in one area may be devastating in other areas.

*Other Definitional "Pegs"

This article has been principally concerned with analysis in the light of case development and the policy underlying the securities acts. Most of the development has involved or been related to investment contracts. Nevertheless, the Supreme Court has given a clear indication that practitioners should not limit their analysis to investment contracts or their equivalent in considering what may be a security. It is beyond the purview of this article to consider exhaustively all transactions which may involve securities. It is appropriate, however, to touch upon some of the other definitional pegs which are available.

It may be that any note is within the definition of a security under the federal securities laws when they are read literally. Though the protection of the securities laws is designed to be broad, the possibility of including all of the possible interpretations of all of the terms included in the statutory definitions would vastly expand the reach of the acts. Some lower courts are beginning to fashion another limitation with respect to certain all-encompassing terms in the definition such as "note" or "evidence of indebtedness." This limitation, as discussed above, is based upon the introductory phrase to the definitional sections of the 1933 and the 1934 Acts.

Both acts specifically include the word "note," although the phrase "evidence of indebtedness" is absent from the 1934 Act. Taken together, the literal import of these terms would seem to extend the coverage of the securities acts to nearly every personal loan or credit purchase. Many courts infer that such may be the case.

As recently as June of 1972, the Seventh Circuit announced: "[A]ny note, regardless of its nature, terms or conditions, is fully subject to whatever antifraud provisions are included in the five acts." In that case, the court held that promissory notes offered to the public

223. See text accompanying notes 45-49 supra.
224. See text accompanying notes 217-222 supra.
225. See text accompanying note 17 supra.
226. Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 991-92 (5th Cir. 1969) (emphasis added).
with a maturity not exceeding nine months did not come within the statutory exclusion of the 1934 Act.\textsuperscript{228} The exclusionary language was strictly limited to apply

\begin{enumerate}
\item only to (1) prime quality negotiable commercial paper
\item of a type not ordinarily purchased by the general public, that is,
\item paper issued to facilitate well recognized types of current operational business requirements and
\item of a type eligible for discounting by Federal Reserve banks.\textsuperscript{229}
\end{enumerate}

Likewise, the phrase "evidence of indebtedness" has been given an expansive reading. In June of 1972, the Tenth Circuit upheld a criminal conviction pursuant to the 1933 Act for the floating of a bogus loan commitment letter. The court stated: "The term 'evidence of indebtedness' is not limited to a promissory note or other simple acknowledgement of debt owing and is held to include all contractual obligations to pay in the future for consideration presently received."\textsuperscript{230}

In \textit{Movielab, Inc. v Berkey Photo, Inc.},\textsuperscript{231} Judge Mansfield demonstrated his awareness of these broad precedents. In that case, the plaintiff corporation issued notes to defendant corporation, both publicly held, for $10.5 million payable over a twenty year period in exchange for assets of the defendant corporation. Judge Mansfield reluctantly agreed that these notes appeared to constitute securities.

Try as we may, we fail to detect in the 1934 Act any grant of discretionary power to the court to construe the term "security" as including certain types of notes but not others. Congress apparently decided that it would pass a sweeping prohibition rather than attempt to draw such distinctions. We are bound by that decision.\textsuperscript{232}

Impelled by that mandate, the judge shared an uneasiness over where the line is to be drawn.

If instruments used in every private loan transaction qualified as securities under the federal statutes, our jurisdiction could be invoked with respect to any claim of fraud in connection with the issuance of a check or note, no matter how small the transaction

\textsuperscript{227} Sanders v. John Nuveen & Co., 463 F.2d 1075, 1078 (7th Cir. 1972).
\textsuperscript{228} "[B]ut [the term 'security'] shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." Securities Exchange Act of 1934, § 3(10), 15 U.S.C. § 78c(a)(10) (1970).
\textsuperscript{229} Sanders v. John Nuveen & Co., 463 F.2d 1075, 1079 (7th Cir. 1972).
\textsuperscript{230} United States v. Austin, 462 F.2d 724, 736 (10th Cir. 1972). In reaching this conclusion, the court borrowed from the interpretation given to the phrase "evidence of indebtedness" in the Stolen Property Act, 18 U.S.C. § 2311 (1970).
\textsuperscript{232} \textit{Id.} at 809.
(e.g., the purchase of an automobile or refrigerator), provided the mails or some other instrumentality of interstate commerce were used. Furthermore, the maker of the note or check as well as the payee would be entitled to sue. We do not view this as the type of situation that prompted the enactment of the federal securities laws.233

The answer may come from the context analysis previously discussed. That type of analysis was applied by Judge Woodward in the recent case of McClure v. First National Bank.234 The issue was whether the execution of promissory notes and the fraudulent misapplication of the funds obtained thereby stated a claim for relief pursuant to section 10(b) of the 1934 Act. The court held that it did not. The court felt that a private loan transaction which was a matter of internal corporate management did not fall within the coverage of the act. To sustain this view, Judge Woodward strained to reconcile the legion of precedent that would seem to oppose him. He began by citing the language in Lehigh Valley Trust that "almost all notes are held to be securities."235 By logical deduction then, there are some notes which do not constitute securities. Since the statutory language states that the act covers "any note... unless the context otherwise required" the judge set out to delineate under what circumstances Congress intended to extend federal protection. The court concluded:

... the Act was designed primarily and almost exclusively to curb abuses involved in 'trading for speculation or investment.' Thus the Act is designed to deal with substance over form and to regulate and prohibit fraud involved in the sale of promissory notes where such notes are sold or traded for purposes of speculation or investment in the same way that stock, bonds, or debentures might be traded, sold or exchanged. Such an interpretation of the "any note" provision of the statute is consistent with the 'dominating general purpose' of the Act and specifically of 15 U.S.C. § 78j(b).236

Thus Judge Woodward endeavored to circumscribe the application of "note" to include only those transactions which are the technical equivalent of a public offering or issuance of stock. In contrast, where the transaction is merely a garden variety commercial loan, the judge contended that no policy of the securities act is invoked. The broad language of Judge Mansfield is distinguished on the grounds that the

233. Id. at 808.
236. Id.
transaction involved in *Movielab* was equivalent to a merger by the sale of assets. “In *Movielab* Corporation A merely issued a note in place of its stock.”

Similarly, the court in *McClure* distinguished *United States v Austin* on the basis that the letter of commitment did not constitute an ordinary commercial loan. Although Judge Woodward disagreed with the broad language of the Seventh Circuit in *Sanders v John Nu-veen & Co.*, nevertheless, in his view, that case did support his policy distinctions.

*Sanders* does provide, however, a useful and cogent distinction between two different kinds of notes: commercial (not covered by the Act, in the view of this Court) and investment (covered by the Act). The former is created “when a prospective borrower approaches a bank for a loan and gives his note in consideration for it.” The latter is created when a person “seeks to invest his money and receives a note in return for it.”

The court cited *SEC v Addison*, as a perfect example of a situation in which a note transaction constituted a securities violation. There, “defendants needed money to get into operation and in order to finance such operations, they were soliciting unconditional unsecured loans of money from members of the general public. Such defrauding of public investors is precisely within the purview of the Act.”

Whether or not the result in *McClure* is correct, this type of analysis is likely to be repeated in future cases, although probably with a more thorough risk analysis. That approach seems to be the only sensible way to achieve a workable result. One must be cognizant,}

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237. Id. at 93,968. Judge Mansfield's opinion might be so read since it stated: “[I]t must be conceded that notes of the type issued here are frequently discounted, purchased for investment, hypothecated, or otherwise made the subject of dealings in the market place.” *Movielab*, Inc. v. Berkey Photo, Inc., 321 F Supp 806, 809 (S.D.N.Y 1970).

Further, the appellate court, in affirming the *Movielab* decision below on an interlocutory appeal, stated: “[A]ppellants strenuously urge that claims of fraud in connection with the issuance of notes in every private loan transaction cannot be within the scope of the Securities Exchange Act of 1934 We need not deal with the hypothetical situation.” *Movielab*, Inc. v. Berkey Photo, Inc., 452 F.2d 662, 663 (2d Cir. 1971), *per curiam* (emphasis added).

238. 462 F.2d 724 (10th Cir. 1972).

239. 463 F.2d 1075 (7th Cir. 1972).


243. In the recent case of *Lino v. City Investing, Inc.* [Current Binder] CCH FED.
however, of the Supreme Court’s caution about reading the definitions too restrictively.\textsuperscript{244}

Another area in which the “note or evidence of indebtedness” definitions should apply is that of land sale financing. Coffey and Welch recognized this when they wrote:

As for the so-called installment lot transactions, the testimony revealed that buyers were actually acquiring very little more than creditors’ claims against the developers under the guise of multi-payment conditional sales contracts . . . . It is difficult to characterize the purchaser’s payments as much more than a loan to the developer. In essence, the developer is selling a debt instrument coupled with a specious commitment to repay by means of specific property. Such a transaction differs considerably from the installment sale of a residence, where the purchaser takes possession of the property, and the entire deal is viewed as a loan by the seller to the purchaser, with the vendor retaining title as security for payment.\textsuperscript{245}

Although the Supreme Court has focused principally upon investment contracts, it has also mentioned other definitions. In \textit{Joiner} for example, the Court mentioned that the transaction constituted an “interest or instrument commonly known as security.”\textsuperscript{246} Justice Brennan, concurring in \textit{VALIC}, thought that variable annuity interests were possibly also “certificates of interest or participation in a profit-sharing agreement”\textsuperscript{247} and in \textit{Tcherepnin} the Court mentioned several alternative terms.\textsuperscript{248}

The District Court in \textit{SEC v. Glenn W. Turner Enterprises, Inc.}\textsuperscript{249} took heed of this opening only to have the Ninth Circuit limit its affirmance to an investment contract definition. Nevertheless, Judge Skopil’s opinion is an excellent example of the use of other definitional pegs and of the analysis which supports them. The judge concluded on the basis of a risk capital theory that the scheme involved an instrument “commonly known as a security” and that the Dare To

\textsuperscript{244} See text accompanying notes 2-44 \textit{supra}.
\textsuperscript{246} 320 U.S. at 351.
\textsuperscript{247} 359 U.S. at 74 n.4.
\textsuperscript{248} 389 U.S. 332 (1967).
Be Great franchises fell within that definitional peg. Likewise, the court found the franchises to be "certificates of interest or participation in profit-sharing agreements." Significantly, Judge Skopil pointed out that the mechanical rubric of Howey is not to be viewed as a limitation upon these other terms even if it were a limitation upon investment contracts (a limitation he rejects).

There is thus sufficient precedent for those counseling clients to look at transactions carefully to ascertain whether another definitional peg may be applicable. Litigators should be particularly aware of these pegs where a transaction "feels" as though it involves some kind of security, yet is not within the classic Howey test.

Conclusion

Not unlike the United States Constitution, the definitional sections of the federal securities laws were designed to be broad and dynamic, and thus capable of dealing with a developing commercial society. With forty years of experience behind us, it appears that one of the principal applications of the federal securities laws has been to foster disclosure of risk to investors. It is the term risk, together with economic reality, which underlies this article more than any other. In analyzing the countless ventures one may participate in, the case law generally focuses in one fashion or another upon economic reality and risk in ascertaining whether the venture is one Congress intended to encompass within the securities laws. That premise is not always articulated, but it clearly underlies three of the five Supreme Court decisions construing the term security and is arguably a factor in the other two.

250. "The spread of the risk capital theory from the state in which it was first applied to other states and the favorable comment with which it has been received make it an appropriate test to look to for determining what is 'commonly known as a security.' There probably have been few schemes devised that more closely meet the test than does the defendants' promotion. In the opinion of the Court, both the letter and the purposes of the statutes are satisfied by holding, therefore, that defendants are offering and selling contracts which are commonly known as securities within the meaning of the federal statutes." Id. at 774. The opinion includes a list of jurisdictions adopting the risk capital theory.

251. "It should be recalled that the 'solely from the efforts of others' test is part of the definition of investment contract, not of the definition of security. More specifically, the Supreme Court has not said that in order for a transaction to constitute a certificate of interest or participation in a profit-sharing agreement it must contemplate no effort on the part of the investor." Id. at 776.


253. There is no suggestion in SEC v. W.J. Howey Co., 328 U.S. 293 (1946) that there was a lack of financial responsibility on the part of either the Howey Com-
Thus, where the risk is shifted to the participant there will likely be a security. It does not, however, follow that a security may not be found under the Howey formula or otherwise where the risk is not shifted.

There has been a tendency in most of the cases to discuss only investment contracts when dealing with nonobvious securities (unlike stocks and bonds). That tendency has been fostered largely by the Supreme Court's focus upon "investment contracts," although the Court has plainly encouraged the use of other definitional pegs including the very flexible "interest commonly known as a security."

In this era of class actions combined with securities litigation, public and private, one can expect a substantial volume of cases exploring the parameters of the securities laws. It is imperative that future cases closely examine the economic reality to ascertain where the risk of the venture is allocated. The analytic framework set forth in this article may be helpful in making an analysis of future transactions.

pany or the Howey-in-the-Hills Service, Inc., yet the risk of loss was upon the public as to the undivided interests sold. Tcherepnin v. Knight, 389 U.S. 332 (1967) is the least risk oriented case. The opinion of the court of appeals shows that there was little risk of loss to the investors since the shares (deposits) were insured by the Federal Savings and Loan Insurance Corporation up to $15,000. The risks were thus withdrawable on shares in excess of a total of $15,000 and upon the nonpayment of dividends. Tcherepnin v. Knight, 371 F.2d 374, 379 (7th Cir. 1967).

Addendum: The case of SEC v. Goldstein Samuelson cited in note 192 has been settled without trial, leaving the important securities issue unresolved. On October 29, 1973, Goldstein Samuelson, Inc. and Harold Goldstein stipulated to a consent decree whereby the defendants admitted the jurisdiction of the district court and agreed to the entry of a permanent injunction prohibiting the defendants from engaging in the naked commodity option business. On November 9, 1973, District Judge E. Avery Crary sentenced Harold Goldstein to 15 years in federal prison on three counts of mail fraud subject to further review upon completion of a 90 day psychiatric examination. With the company in receivership, the issuance of a permanent injunction, and the chair of the board in jail, the S.E.C. would appear to have won a clear-cut victory in the case. What the S.E.C. did not achieve, however, was binding judicial precedent holding that naked commodity options are securities and therefore within the jurisdiction of the S.E.C. and the federal courts. Since dealers in naked commodity options are continuing to spring up throughout the nation, it is highly unlikely that this consent decree has laid these difficulties to rest.