DISCRETIONARY TRADING ACCOUNTS IN COMMODITY FUTURES ARE NOT SECURITIES ABSENT HORIZONTAL COMMONALITY

Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216 (6th Cir. 1980), *cert. granted,* 101 S. Ct. 1971 (1981)

In the current split of authority over the scope of the federal securities laws, the Sixth Circuit Court of Appeals in *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[1] sided with those courts holding that a discretionary trading account[2] in commodity futures[3] is not a security.[4]

Plaintiffs invested in a discretionary[5] trading account program that

1. 622 F.2d 216 (6th Cir. 1980), *cert. granted,* 101 S. Ct. 1971 (1981) (certiorari limited to issue of whether an implied private right of action exists under the Commodity Exchange Act).

2. "Typically, a customer trading in a discretionary commodity account gives the broker authority to buy and sell at the broker's discretion, without prior consultation with the customer. Discretionary accounts are more common for commodities where fast trading is required due to sharp movement in prices . . . ." 622 F.2d at 221. For a discussion of discretionary trading accounts, see H. BINES, THE LAW OF INVESTMENT MANAGEMENT 3-47 to 3-48 (1978).

3. "A commodity future is a standardized contract for the purchase and sale of a fixed quantity of a commodity to be delivered in a specified future month at a price agreed upon when the contract is entered into." 622 F.2d at 220 (citing A. BROMBERG, SECURITIES LAWS § 4.6 at 82.181 (1975)).

4. Section 2(1) of the Securities Act of 1933 defines security as follows:

> The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1976) (emphasis added).

Section 3(a)(10) of the Securities Exchange Act of 1934 defines security in similar terms:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (1976) (emphasis added). *See also* Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(36) (1976); Investment Advisors Act of 1940, 15 U.S.C. § 80b-2(a)(18) (1976).

5. Merrill Lynch claimed that the account was in fact non-discretionary, but conceded that for purposes of the appeal it must be viewed as discretionary. 622 F.2d at 220. Courts are in general agreement that non-discretionary trading accounts are not securities. *See, e.g.,* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 485 (5th Cir. 1974); E.F. Hutton & Co. v. Burkholder,

had certain unique elements.[6] After losing a substantial amount of money, plaintiffs filed suit under both state and federal securities laws charging Merrill Lynch with violating the registration requirements of the Securities Act of 1933,[7] and the antifraud provisions of the Securities Exchange Act of 1934,[8] SEC rule 10b-5,[9] and the Michigan Uniform Securities Act.[10] They claimed that the account program was an investment contract and qualified as a security under the Securities Act[11] and the Securities Exchange Act.[12]

The Sixth Circuit affirmed the district court's partial summary judgment[13] for defendants and *held*: A discretionary trading account in commodity futures is not a security absent a pooling of investor's interests.[14]

The rapid growth[15] of the commodity futures market has led to a significant increase in the number of dissatisfied investors seeking redress.[16] Many of these cases state causes of action under the federal

413 F. Supp. 852, 860 (D.D.C. 1976); Berman v. Dean Witter & Co., 353 F. Supp. 669, 671 (C.D. Cal. 1973); McCurnin v. Kohlmeyer & Co., 340 F. Supp. 1338, 1341 (E.D. La. 1972), *aff'd,* 477 F.2d 113 (5th Cir. 1973). *See* L. Loss, SECURITIES REGULATION 491-92 (temp. student ed. 1961).

6. 622 F.2d at 220. Specifically, Merrill Lynch's "Guided Commodities Account Program" involved three significant elements: (1) the investors could not withdraw from the program for eighteen months, (2) a single broker would direct the trading for the entire group of accounts, and (3) the effect on the market of having control over all the accounts in the program would be greater than if trading was based only on individual accounts. For the significance of these elements, see notes 78-81 *infra* and accompanying text.

7. 15 U.S.C. § 77e (1976).

8. 15 U.S.C. § 78j (1976).

9. 17 C.F.R. § 240.10b-5 (1980).

10. MICH. COMP. LAWS § 451.501 (1970).

11. 15 U.S.C. § 77b(1) (1976).

12. 15 U.S.C. § 78c(a)(10) (1976).

13. 622 F.2d at 236-37. The court affirmed the partial summary judgment and reversed and remanded the order staying plaintiff's fraud claims under the Commodity Exchange Act. Subsequently, the United States Supreme Court granted certiorari on the issue of whether an implied private right of action exists under the Commodity Exchange Act. 101 S. Ct. 1971 (1981). For a review of the Sixth Circuit's reasoning on the implied right of action issue, see 22 WM. & MARY L. REV. 579 (1981).

14. 622 F.2d at 222. *See* note 55 *infra* and accompanying text.

15. Trading volume in commodity futures contracts rose from 32.2 million contracts in 1975 to 42.09 million in 1977. S. REP. No. 850, 95th Cong., 2d Sess. 1, 13, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 2087, 2101. Since 1977 the volume of trading in commodity futures has nearly doubled. For fiscal year 1980, 82.7 million futures contracts were traded. COMMODITY FUTURES TRADING COMM'N ANN. REP. 88 (1980) [hereinafter cited as CFTC ANN. REP.].

16. In fiscal 1978 the number of reparations complaints docketed by the Commodity Futures Trading Commission totaled 312, compared with 1,401 for fiscal 1980. CFTC ANN. REP. 140 (1978).

securities laws because the investor protection is broader and violations are easier to prove[17] than under the Commodity Exchange Act of 1933, as amended by the Commodity Futures Trading Commission Act of 1974.[18] When seeking a remedy under the securities laws, an investor injured through a discretionary trading account must show that the account is an investment contract subject to the securities laws.[19] The

17. 15 U.S.C. § 77e (1976). *See, e.g.,* Hirk v. Agri-Research Council, Inc. 561 F.2d 96, 99 (7th Cir. 1977); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 686 (5th Cir. 1971); Swank Fed. Credit Union v. C.H. Wagner & Co., 405 F. Supp. 385, 387-88 (D. Mass. 1975). *See generally* Bromberg, *Commodities Law and Securities Law—Overlaps and Preemptions,* 1 J. CORP. L. 217 (1976).

18. 7 U.S.C. §§ 1-22 (1976 & Supp. IV 1980). If the federal securities laws covered discretionary trading accounts in commodity futures, a prima facie violation of the registration requirements would allow the investor to recover the amount of his investment. *See generally* Bines, *Regulating Discretionary Management: Broker-Dealers as Catalysts for Reform,* 16 B.C. INDUS. & COM. L. REV. 347, 356 (1975).

19. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Goldman, 593 F.2d 129 (8th Cir.), *cert. denied,* 444 U.S. 838 (1979); Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978); Moody v. Bache & Co., 570 F.2d 523 (5th Cir. 1978); Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Hector v. Wiens, 533 F.2d 429 (9th Cir. 1976); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); Glen-Arden Commodities, Inc., v. Costantino, 493 F.2d 1027 (2d Cir. 1974); Commercial Iron & Metal Co. v. Bache & Co., 478 F.2d 39 (9th Cir. 1973); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972); Wiggin v. Kohlmeyer & Co., 446 F.2d 792 (5th Cir. 1971); Booth v. Peavey Commodity Servs., 430 F.2d 132 (8th Cir. 1970); Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), *cert. denied,* 391 U.S. 905 (1968); Jenny v. Shearson, Hammill & Co., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,911 (S.D.N.Y.); Walsh v. Int'l Precious Metals Corp., 510 F. Supp. 867 (D. Utah 1981); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225 (S.D.N.Y. 1981); Christensen Hatch Farms, Inc. v. Peavey Co., 505 F. Supp. 903 (D. Minn. 1981); Meredith v. Conticommodity Services, Inc., [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,701 (D.D.C.); Sennett v. Oppenheimer & Co., 502 F. Supp. 939 (N.D. Ill. 1980); Gonzalez v. Paine, Webber, Jackson & Curtis, Inc., 493 F. Supp. 499 (S.D.N.Y. 1980); Mullis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 492 F. Supp. 1345 (D. Nev. 1980); Berman v. Bache, Halsey, Stuart, Shields Co., 467 F. Supp. 311 (S.D. Ohio 1979); Hofmayer v. Dean Witter & Co., 459 F. Supp. 733 (N.D. Cal. 1978); Plunkett v. Francisco, 430 F. Supp. 235 (N.D. Ga. 1977); Jones v. International Inventors Inc. East, 429 F. Supp. 119 (N.D. Ga. 1977); Consolo v. Hornblower & Weeks-Hemphill, Noyes, Inc., 436 F. Supp. 447 (N.D. Ohio 1976); Securities Investor Protection Corp. v. Associated Underwriters, Inc., 423 F. Supp. 168 (D. Utah 1975); Ramsey v. Arata, 406 F. Supp. 435 (N.D. Tex. 1975); Swank Fed. Credit Union v. C.H. Wagner & Co., 405 F. Supp. 385 (D. Mass. 1975); SEC v. Brigadoon Scotch Distribs., 388 F. Supp. 1288 (S.D.N.Y. 1975); Rochkind v. Reynolds Securities, Inc., 388 F. Supp. 254 (D. Md. 1975); Glazer v. National Commodity Research & Statistical Servs., 388 F. Supp. 1341 (N.D. Ill. 1974), *aff'd,* 547 F.2d 392 (7th Cir. 1977); Golding v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 385 F. Supp. 1182 (S.D.N.Y. 1974); Stevens v. Woodstock, Inc., 372 F. Supp. 654 (N.D. Ill. 1974); Marshall v. Lamson Bros., 368 F. Supp. 486 (S.D. Iowa 1974); Arnold v. Bache & Co., 377 F. Supp. 61 (M.D. Pa. 1973); Stuckey v. DuPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd mem.,* 491 F.2d 752 (3d

securities laws contain no statutory definition of "investment contract." Thus, the courts must interpret the term.[20]

In *SEC v. W.J. Howey Co.*,[21] the Supreme Court defined an investment contract as a transaction in which the person invests in a "common enterprise" with the expectation that profits will result solely from the efforts of a broker or promoter.[22] The Court did not elaborate on the requirement of a "common enterprise;" consequently, sharp differences of opinion exist as to what the term means.[23]

The courts have posited two approaches to the *Howey* commonality test.[24] One approach[25] is that discretionary trading accounts[26] are se-

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Cir. 1973), *cert. denied,* 416 U.S. 994 (1974); Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764 (D. Minn. 1972); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968); Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967); Sinva Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 253 F. Supp. 359 (S.D.N.Y. 1966); SEC v. Wickham, 12 F. Supp. 245 (D. Minn. 1935).

20. SEC v. W.J. Howey Co., 328 U.S. 293 (1946). "By including an investment contract within the scope of § 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by . . . prior judicial interpretation." *Id.* at 298.

21. *Id.* at 293.

22. *Id.* at 298-99. International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979), and United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975), reaffirmed the definition used in *Howey.*

The Supreme Court had confronted the issue of defining a security prior to *Howey* in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943). In that case, the Court reasoned that the scope of the securities laws was not limited to 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.

23. Bonnett, *How Common Is a "Common Enterprise"?,* 1974 ARIZ. ST. L.J. 339, 341.

24. California and Hawaii, in decisions under similarly written state securities statutes, adopted a third approach that rejects the *Howey* test. The "risk capital" theory focuses on the person bearing the burden of risk in the investment arrangement. *See, e.g.,* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P. 2d 105 (1971). For a general overview of the "risk capital" theory in relation to the recent Supreme Court decision in *United Hous. Found., Inc. v. Forman,* see Deacon & Prendergast, *Defining a "Security" After the* Forman *Decision,* 11 PAC. L.J. 213 (1980).

25. Courts using the vertical commonality approach have relied primarily on *Joiner* and *Howey* as precedent. For an overview of state and federal cases defining "investment contract" prior to the enactment of the Securities Act and Securities Exchange Act, see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation,* 24 OKLA. L.REV. 135, 146-59 (1971). *See also* Note, *Discretionary Commodity Accounts as "Securities": Applying the* Howey *Investment Contract Test to a New Investment Medium,* 67 GEO. L.J. 269, 283-85 (1978) (discussion of state court decisions cited in *Howey*). The state court decisions relied on in *Howey* support the argument that it is not essential for an investment contract to include an actual pool-

curities if a vertical commonality requirement is met.[27] The District Court for the Southern District of New York in *Maheu v. Reynolds & Co.*[28] was the first to apply the vertical commonality approach. The *Maheu* court, citing *Howey* in support of its conclusion, considered the "vertical" relationship between investor and broker as determinative.[29] The court held that even without a pooling of funds or common enterprise among investors, a joint account qualified as a security.[30] In 1973 the Ninth Circuit adopted the vertical commonality approach, defining a common enterprise as an investment in which the investor depends on the efforts of the broker for its success.[31] The Fifth Circuit subsequently adopted this definition in *SEC v. Koscot Interplanetary, Inc.*[32]

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ing of funds. *See, e.g.,* State v. Evans, 154 Minn. 95, 191 N.W. 425 (1922); State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920). *See generally* Note, *supra*.

26. Courts are in general agreement that a commodity futures contract itself is not a security. *See, e.g.,* Moody v. Bache & Co., 570 F.2d 523 (5th Cir. 1978); SEC v. Commodity Options Int'l, Inc., 553 F.2d 628 (9th Cir. 1977); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974); Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972); Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 253 F.Supp. 359 (S.D.N.Y. 1966).

27. *See, e.g.,* Hector v. Wiens, 533 F.2d 429 (9th Cir. 1976); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973); Marshall v. Lamson Bros., 368 F. Supp. 486 (S.D. Iowa 1974); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967). The vertical commonality approach would allow a relationship between a single investor and a broker to satisfy the common enterprise requirement without a showing of pro-rata profit sharing or pooling of funds. *See, e.g.,* Marshall v. Lamson Bros., 368 F.Supp. 486 (S.D. Iowa 1974). *See also* Bonnett, *supra* note 23, at 365-66; Note, *Discretionary Trading Accounts as Securities:* Howey *Revisited,* 16 TULSA L.J. 334, 340 (1980). *See also* Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Goldman, 593 F.2d 129 (8th Cir.), *cert. denied,* 444 U.S. 838 (1979); Moody v. Bache & Co., 570 F.2d 523 (5th Cir. 1978); Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974); Commercial Iron & Metal Co. v. Bache & Co., 478 F.2d 39 (10th Cir. 1973), *cert. denied,* 440 U.S. 914 (1979); Jenny v. Shearson, Hammill & Co., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,911 (S.D.N.Y.); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225 (S.D.N.Y. 1981); Christensen Hatch Farms, Inc. v. Peavey Co., 505 F. Supp. 903 (D. Minn. 1981) (by implication); Troyer v. Karcagi, 476 F.Supp. 1142 (S.D.N.Y. 1979).

28. 282 F. Supp. 423 (S.D.N.Y. 1967).

29. *Id.* at 426.

30. *Id.* at 429. Seven months after the decision in *Maheu*, the court reaffirmed its reasoning in Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968).

31. SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973). *Accord,* Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764 (S.D.N.Y. 1972); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967).

32. 497 F.2d 473 (5th Cir. 1974). The case involved a pyramid scheme similar to the one

and *SEC v. Continental Commodities Corp.*[33] Noting the purposes of the Securities Act and the Securities Exchange Act,[34] the *Koscot* court stated that a literal reading of the *Howey* test would frustrate these acts' remedial purposes.[35] In *Continental Commodities* the court stated that the inquiry should focus on whether the success of the investment is dependent upon the expertise of the broker.[36]

A significant number of courts reject the vertical commonality approach and require horizontal commonality among investors before treating a discretionary trading account as a security.[37] The Seventh Circuit Court of Appeals decided in *Milnarik v. M-S Commodities, Inc.*[38] that the discretionary trading account in question was not a security subject to the registration requirements[39] of the Securities Act.[40] The court held that the element of commonality required by the *Howey* test was absent[41] in an account in which the broker traded for commodity futures on margin.[42] Although the investment broker in *Milnarik*

dealt with by the Ninth Circuit in SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973). *See generally* Note, *Pyramid Schemes: Dare to be Regulated,* 61 GEO. L.J. 1257 (1973).

33. 497 F.2d 516 (5th Cir. 1974) (involving commodities options). *See* Note, *Discretionary Accounts,* 32 U. MIAMI L. REV. 401, 408 n. 41 (1977).

34. The legislative history of the securities laws clearly indicates the remedial purposes behind their enactment. *See* SENATE COMM. ON BANKING & CURRENCY, SECURITIES REGULATION, S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933). *See also* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 223 (6th Cir. 1980), *cert. granted,* 101 S. Ct. 1971 (1981).

35. SEC v. Koscot Interplanetary Inc., 497 F.2d 473, 480 (5th Cir. 1974).

36. SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974).

37. *See, e.g.,* Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972); Sennett v. Oppenheimer & Co., 502 F. Supp. 939 (N.D. Ill. 1980); Berman v. Bache, Halsey, Stuart, Shields Co., 467 F. Supp. 311 (S.D. Ohio 1979); Glazer v. National Commodity Research & Statistical Servs., 388 F. Supp. 1341 (N.D. Ill. 1974), *aff'd,* 547 F.2d 392 (7th Cir. 1977); Stevens v. Woodstock, Inc., 372 F. Supp. 654 (N.D. Ill. 1974); Arnold v. Bache & Co., 377 F. Supp. 61 (M.D. Pa. 1973); Stuckey v. du Pont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd mem.,* 491 F.2d 752 (3d Cir. 1973).

38. 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972).

39. 15 U.S.C. § 77e (1976).

40. 457 F.2d at 279.

41. *Id.* at 276.

42. A margin account is the security industry's method of extending credit to customers. Under this practice, the customer—investor—purchases a specified amount of stock from the securities firm by advancing only a portion of the purchase price, while the brokerage firm extends credit for the balance due on the stock's purchase price. The firm holds the stock as collateral for

represented a group of investors, each contract between the broker and the individual investor was independent of any other contract.[43] The *Milnarik* court insisted that a pooling of funds and a pro rata distribution of profits among the several investors was necessary to establish a common enterprise.[44]

In 1977 the Seventh Circuit reaffirmed *Milnarik* in *Hirk v. Agri-Research Council, Inc.*[45] Rejecting the argument that a strict commonality requirement is inconsistent with the remedial purposes of the securities laws,[46] the court stated that even if the broker had treated the investors' funds "as if commingled," an actual pooling must occur to satisfy the common enterprise requirement.[47] The *Hirk* court explained that without actual pooling, the success or failure of each account was independent of the other accounts, and therefore a common enterprise did not exist.[48]

In *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[49] the Sixth Circuit confronted a discretionary trading account similar to the one involved in *Milnarik*. Using the three-part *Howey* definition of an in-

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the loan. *See* BLACK'S LAW DICTIONARY 871 (5th ed. 1978). The amount of credit that can be extended by the broker is regulated under section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g (1976).

43. 457 F.2d at 277. "In essence, this contract creates an agency-for-hire rather than constituting the sale of a unit of a larger enterprise." *Id.* (quoting from the district court's opinion, 320 F. Supp. 1149, 1151 (N.D. Ill. 1970)).

44. 457 F.2d at 278.

45. 561 F.2d 96 (7th Cir. 1977).

46. *Id.* at 100.

47. *Id.* at 101.

48. *Id.* "[Plaintiff's] effort to sidestep [the unitary nature of each account] by stressing . . . that substantially similar transactions were made in all accounts and that profits or losses ebbed or flowed uniformly also fails because the necessary pooling remains unshown." *Id.*

Relying primarily on the reasoning of the Seventh Circuit in *Milnarik*, the Third Circuit Court of Appeals also has required horizontal commonality. *See* Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd mem.*, 491 F.2d 752 (3d Cir. 1973). "As in *Milnarik*, nothing in the instant complaint suggests the type of common enterprise or pooling of funds for a common purpose required to convert the discretionary account plaintiffs had . . . into a statutory security." *Id.* at 1069. Plaintiffs in *Wasnowic* claimed, *inter alia*, that the broker fraudulently commingled the investors' funds and that this satisfied the common enterprise requirement. *Id.* at 1070. The court held that a unilateral fraud, in view of what the parties had originally intended, did not constitute an investment contract subject to the securities acts. *Id.* at 1070-71.

49. 622 F.2d 216 (6th Cir. 1980), *cert. granted*, 101 S. Ct. 1971 (1981). Although Senior Circuit Judge Phillips concurred in part and dissented in part, he concurred with the majority in the issues discussed in this Comment. He dissented on the issue of the existence of an implied private right of action under the Commodity Exchange Act. *See* note 13 *supra*.

vestment contract,[50] the *Curran* court affirmed the district court's application of horizontal commonality as posited by the Seventh Circuit in *Milnarik*. The court, expressly rejecting the Fifth Circuit ruling in *SEC v. Continental Commodities Corp.*,[51] reasoned that a mere showing of vertical commonality between investor and broker is inconsistent with the *Howey* common enterprise requirement.[52] The court agreed with the conclusion reached by the Southern District of Ohio[53] that without a finding of horizontal commonality the common enterprise requirement of *Howey* is "effectively excise[d]."[54] The *Curran* court insisted that in addition to vertical commonality, a relationship must exist between the investors themselves such that each investment is tied to the success of the group enterprise.[55]

The court recognized a significant distinction between the factual allegations in *Milnarik* and those in *Curran*. Plaintiffs in *Curran* claimed that Merrill Lynch fraudulently promised to place their investments in a common enterprise with other accounts in the program.[56] They argued that the unfulfilled promise was sufficient to bring this account within the definition of a security.[57] The court rejected the argument because each customer knew from the outset that their individual return would depend only on a "one-to-one" vertical relationship with

50. *Id.* at 221. "It is universally recognized that the *Howey* test is comprised of three basic elements: (1) an investment of money, (2) in a common enterprise, with (3) profits to come solely from the efforts of others." *Id.* Some commentators have preferred to use a four-part test requiring the following: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of the promoter or a third party. *See, e.g.,* 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATION LAW § 2.04, at 2-14 (1974); Bonnett, *supra* note 23, at 341; Coffey, *The Economic Realities of a "Security": Is there a More Meaningful Formula?,* 18 CASE W. RES. L. REV. 367, 373 (1967); Long, *supra* note 25, at 142.

51. 497 F.2d 516 (5th Cir. 1974). *See* note 33 *supra* and accompanying text.

52. 622 F.2d at 224.

53. Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311 (S.D. Ohio 1979).

54. *Id.* at 319. *Cf.* Bonnett, *supra* note 23, at 365-66 (the author approves of the elimination of the requirement).

55. 622 F.2d at 224. Although the court did not explain precisely the nature of the required relationship, the implication is that an actual pooling of investors' funds (with a corresponding pro-rata share of profits) is necessary. *See* note 44 *supra* and accompanying text.

56. 622 F.2d at 224.

57. *Id.* The *Milnarik* court did not make clear whether an allegation of fraudulent broker conduct would have resulted in a more favorable disposition of the case for plaintiffs. At least one court, addressing a similar issue, held that the broker's unilateral fraud in handling accounts was not sufficient for a finding of the required common enterprise. *See* note 48 *supra* and accompanying text. Nevertheless, plaintiffs in *Curran* claimed that the fraudulent promise by the broker to form a "common enterprise" was sufficient to find an investment contract security.

the broker rather than on a horizontal relationship between their account and those of other investors.[58] The court thus required an actual pooling of investor capital.[59] An unfulfilled promise by the broker[60] to pool investor capital did not suffice to qualify the account as an investment contract in a common enterprise.[61]

The current split of authority as to whether commodity trading accounts satisfy the *Howey* test calls for a response from the Supreme Court[62] or clarifying legislation.[63] Sound arguments exist for both the vertical and the horizontal commonality approaches. The vertical commonality approach, which emphasizes the need for a resilient standard, finds indirect support in several Supreme Court decisions.[64] Furthermore, the remedial purposes underlying the federal securities laws and the need for greater investor protection[65] are persuasive reasons to apply a flexible standard.

The horizontal commonality approach, on the other hand, adheres

58. 622 F.2d at 225.

59. *See* note 55 *supra*.

60. The deposition of a customer account executive at Merrill Lynch stated that although plaintiff's account may have been handled independently of other accounts in the program, the description of the program given to plaintiffs was such that an expectation of a common enterprise on their part was understandable. 622 F.2d at 225.

61. *Id.*

62. Two commentators contend that the present uncertainty among the courts could "open the door to a system of securities regulation based on judicial pick-and-choose." Tew & Freedman, *In Support of* SEC v. W.J. Howey Co.: *A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser,* 27 U. MIAMI L. REV. 407, 447 (1973). *See also* Note, *supra* note 27, at 346. *But see* Deacon & Prendergast, *supra* note 24, at 232 (arguing that the *Forman* decision, in conjunction with *Howey*, provides a sufficiently clear framework for the courts).

63. *Compare* letter from William T. Bagley, Chairman, CFTC, to Senator Herman E. Talmadge (May 1, 1978) *with* letter from James T. McIntyre, Jr., Director, Office of Management and Budget, to Senator Herman E. Talmadge (April 18, 1978), S. REP. No. 850, 95th Cong., 2d Sess. 1, 405, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 2087, 2129-34. *See generally* Bines, *supra* note 18, at 390; Note, *supra* note 33, at 414.

64. *See, e.g.,* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 (1979) ("[The] test is to be applied in light of the '. . . economic realities of the transaction . . .' "); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975) ("Congress intended the application of [the Securities Acts] to turn on the economic realities underlying the transaction"); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) ("form should be disregarded for substance"); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943) ("the reach of the [Securities] Act does not stop with the obvious and commonplace").

65. *See generally* Hudson, *Customer Protection in the Commodity Futures Market,* 58 B.U. L. REV. 1 (1978) (protection offered under the CFTC). *See also* Bromberg, *supra* note 17; Note, *supra* note 33.

more closely to the test enunciated in *Howey*.[66] The requirement of an actual pooling of funds and pro-rata profit-sharing provides a clear cut rule for determining the existence of a security.[67] In addition, courts adopting horizontal commonality[68] have noted correctly the increasing scope of protection offered by the Commodity Exchange Act and the Commodity Futures Trading Commission Act.[69]

Commentators have suggested, however, that a close reading of the *Howey* opinion reveals faults inherent in both standards.[70] The flexibility of the vertical approach depends on a de-emphasis, if not actual elimination, of the common enterprise requirement.[71] The restrictive requirement of horizontal commonality fails to provide needed protection for investors in a rapidly expanding and increasingly complicated market.[72] The pyramid scheme cases confronted by the Fifth and Ninth Circuits[73] illustrate the susceptibility of unsophisticated investors to imaginative and potentially disastrous investment schemes.[74]

Until the Supreme Court clarifies its position or Congress enacts ap-

66. *See, e.g.,* Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972). *See also* Bines, *supra* note 18 (author contended that logic underlying vertical commonality is strained). *But see* Bromberg, *supra* note 17, at 225-26; Note, *supra* note 33, at 411-14.

67. *See* Tew & Freedman, *supra* note 62, at 448. "*Howey* has certain superior qualities, one of which is *certainty*." *Id.*

68. *See* cases cited at note 37 *supra*.

69. *See, e.g.,* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 103 n.8 (7th Cir. 1977). *Cf.* Booth v. Peavey Co. Commodity Servs., 430 F.2d 132, 133 (8th Cir. 1970) (the court adopted the vertical commonality approach but recognized that a private right of action exists for violation of § 6d of the Commodity Exchange Act). *See also* Note, *supra* note 25, at 272 n.24.

70. *See, e.g.,* Bonnett, *supra* note 23, at 366. Referring to the horizontal commonality approach, the author stated that "[p]roviding a simple checklist of elements that make up an investment contract is counterproductive." *Id. But see* Note, *supra* note 27, at 340-41. "[One] problem with [the vertical commonality] approach is that such an interpretation [of *Howey*] presupposes the idea that the common enterprise element of the test is mere surplusage and need not be treated as a distinct element." *Id.*

71. *See* Bonnett, *supra* note 23, at 366.

> [I]t seems sufficient to recommend that courts confronted with common enterprise arguments should avoid a dogmatic four-part checklist approach to the necessary factual analysis. If the other parts of the *Howey* test are present, *the lack of a "common enterprise" should rarely defeat the finding of an investment contract.*

Id. (emphasis added). Thus, the author favorably viewed the virtual elimination of the common enterprise requirement of *Howey*.

72. *See, e.g.,* Bromberg, *supra* note 17.

73. *See* note 32 *supra*.

74. SEC v. Koscot Interplanetary, Inc. 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973). *See generally* Note, *supra* note 32.

propriate legislation, courts must pay particular attention to the factual elements peculiar to each case.[75] Failure to account for subtle but significant differences in the various investment agreements may result in an excessively rigid application of the *Howey* test.[76] The *Howey* court recognized and warned against the potential results associated with failing to appreciate the remedial nature of the securities laws.[77] The uncertainty in the courts is the necessary result of inadequate definitions in both *Howey* and the securities acts.

The Sixth Circuit's strict application of *Milnarik* is misplaced. The *Curran* plaintiffs, unlike those in *Milnarik*, alleged that Merrill Lynch promised to place their investments in a common enterprise.[78] Because plaintiffs were unable to withdraw their investments for a specified period of time, an ostensible, if not actual, pooling of funds occurred. Merrill Lynch's plan for using this arrangement was to allow the broker's trading to have a greater effect on the market than if each account was fully independent. To a certain extent, therefore, the fortunes of the investors were tied to each other,[79] for the greater the effect on the market, the greater the possibility for success (or failure) of the group as a whole. The court, however, failed to adequately address this issue[80] by insisting on an actual pooling of investor capital.[81] A less rigid approach would recognize that if the inducements offered for investing in such an arrangement are fraudulent, then the remedies afforded under the securities acts are more appropriate than those under the amended Commodity Exchange Act.

The *Curran* opinion fails to provide an analysis of important aspects

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75. *See, e.g.,* Long, *supra* note 25, at 139.

76. *See, e.g.,* notes 78-81 *infra* and accompanying text.

77. SEC v. W.J. Howey Co., 328 U.S. 293 (1946). "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic or irrelevant formulae." *Id.* at 301. *See also* Long, *supra* note 25, at 139-46.

> [I]n spite of the admonishments of the early courts and even the Supreme Court itself against the crystallization of irrelevant formulas, the courts have created a fixed and arbitrary definition of investment contract which they are showing great reluctance to abandon in the face of increased evidence of the need for public protection which an expanded definition could afford.

Id. at 139-40 (footnotes omitted).

78. 622 F.2d at 224.

79. *Id. See* Maheu v. Reynolds & Co., 282 F. Supp. 423, 429 (S.D.N.Y. 1967). "The joint account may constitute a security even if there was no pooling arrangement or common enterprise among investors." *Id.*

80. *See* Note, *supra* note 33, at 411 n.53.

81. 622 F.2d at 222-24.

of the current debate over whether a discretionary trading account in commodity futures qualifies as a security. *Curran* merely adds to the conflict among the courts on this important issue.

R.E.T.