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I. WHAT IS A "SECURITY"?

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . .[1]

In the twenty-five years following that statement by the Supreme Court in *SEC v. W.J. Howey Co.*,[2] the test announced adequately protected the investing public and, with few exceptions, endured without major revision. The last three years, however, have brought an onslaught of criticism from courts and legal commentators, and the result has been a steady, but now accelerating, erosion of the 1946 definition. The four elements of that definition, (1) investment of money, in a (2) common enterprise, with the (3) expectation of profit, (4) solely from the efforts of the promoter or a third party, have been subjected to such judicial expansion that they no longer furnish a reliable guide for courts faced with the problem of distinguishing between similar transactions to determine which are within the ambit of the federal securities laws. At the same time, however, the courts have been reluctant to depart from the words of the Supreme Court.

This reluctance to examine new formulations after *Howey* has prevented the development of an analysis based on the functional realities and policy implications presented by a particular transaction.[3] These

1. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).
2. 328 U.S. 293 (1946).
3. Judicial adherence to the *Howey* language in defining both "security," *see* text accompanying note 17 *infra*, and "investment contract" is ironic in light of the Court's

realities can be discerned from one central question: Does the investor in the transaction need the special protections of the securities acts?[4] This question can be divided into two seperate questions: (1) Are the enforcement and regulatory mechanisms of the Securities and Exchange Commission (SEC) designed to control the abuses associated with the transaction? and (2) Even if the SEC is capable of exercising control, should that function be assigned to other enforcement and regulatory mechanisms?[5] Before examining what part these functional

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admonition that the definition "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. at 299.

4. *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 373 (1967) [hereinafter cited as Coffey]. For an analysis of the Coffey approach, see notes 31-38 *infra* and accompanying text.

5. This kind of analysis has been present at the SEC for the past few years. *See, e.g.*, Sommer, *Introduction*, 25 HASTINGS L.J. 213, 214 (1974):

> Someone has suggested that, instead of stretching the meaning of "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934 to meet the new creations of promoters, perhaps Congress should create a new agency which would have regulatory and enforcement authority over "dirty tricks" regardless of the form they take. This agency would field those inflictions upon the public which somehow or other fall outside the jurisdiction of the Federal Trade Commission, the SEC and such other agencies as have concerns with protecting the individuals of the nation against being put upon. Thus it would not be necessary to engage in intricate reasoning to find that a pyramid scheme or a membership in a country club was a security, thus sharing a concept with common stocks and bonds.

While, as Commissioner Sommer suggests, this approach toward intricate promotion schemes may be novel, it is precisely the kind of analysis that the SEC and the Supreme Court have used in decisions on annuity plans and insurance regulation. In SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959), in which the Court held that variable annuities were subject to regulation under the federal securities acts, Justice Douglas expressed the Court's concern with the appropriateness of federal involvement:

> We start with a reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements. When the States speak in the field of "insurance," they speak with the authority of a long tradition. For the regulation of "insurance," though within the ambit of federal power . . . , has traditionally been under the control of the States.

Id. at 68-69. *See also* Dorsey, *The Place of "Variable Annuities" in Law and Economics*, 34 NOTRE DAME LAW. 489 (1959); Mearns, *The Commission, the Variable Annuity, and the Inconsiderate Sovereign*, 45 VA. L. REV. 831 (1959); 20 OHIO ST. L.J. 688 (1959); 38 TEXAS L. REV. 248 (1959). The SEC has since attempted to define the exact parameters of its jurisdiction. In November 1971, two insurance associations petitioned the SEC for an exemption from registration under § 6 of the Investment Company Act of 1940, 15 U.S.C. § 80a-6 (1970). In January 1973, the SEC replied that while variable annuities are "securities," companies offering them did not have to register under the Act. *See* SEC Securities Act Release No. 5360 (Jan. 31, 1973). In a questions have played in the recent attenuation of *Howey*, it is necessary to discuss in detail the analysis employed by the Supreme Court and the critical comment it engendered.

A. *The Supreme Court Decisions*

Three years before *Howey*, the Court was presented in *SEC v. C.M. Joiner Leasing Corp.*[6] with its first opportunity to define the scope of the term "security"[7] as used in the Securities Act of 1933 (1933 Act).[8] An oil promoter had formed a corporation and acquired oil and gas leaseholds in Texas. In order to finance the drilling of a test well, he sold assignments of the leasehold to investors all over the country. No parcel assigned was larger than twenty acres. The literature given the investors emphasized that they would realize a profit if the promoter were successful with his test well. The Court held that the scheme involved a security. Justice Jackson, writing for the majority, rejected the promoter's contention that he was selling only a naked leasehold right, and instead emphasized the "enterprise" aspect of the transaction:

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later release, however, the SEC took the position that any variable annuities registered under § 6(a) of the Securities Act of 1933, 15 U.S.C. § 77f(a) (1970) [hereinafter cited as 1933 Act], must receive approval from the appropriate state insurance commissioner prior to registration. *See* SEC Securities Act Release No. 5413 (Aug. 2, 1973). Thus, the SEC has also recognized the effect on its jurisdiction of other possible means of regulation, and their capabilities in the field. *See generally* Blank, Keen, Payne & Miller, *Variable Life Insurance and the Federal Securities Laws*, 60 VA. L. REV. 71 (1974).

6. 320 U.S. 344 (1943), *noted in* 17 S. CAL. L. REV. 324 (1944).

7. All the acts relating to the regulatory functions of the SEC contain similar definitions of the term "security." *See* 1933 Act § 2(1), 15 U.S.C. § 77b(1) (1970); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970) [hereinafter cited as 1934 Act]; Investment Company Act of 1940 § 2(36), 15 U.S.C. § 80a-2(36) (1970); Investment Advisers Act of 1940 § 202(a)(18), 15 U.S.C. § 80b-2(a)(18) (1970). For the purposes of the analysis in this Note, the definitions contained in the 1933 and 1934 Acts will be treated as equivalent. The 1934 Act definition is:

> 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.

8. 15 U.S.C. §§ 77a-aa (1970).

> The drilling of this well was not an unconnected or uncontrolled phenomenon to which salesmen pointed merely to show the possibilities of the offered leases. The exploration enterprise was woven into these leaseholds 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.[9]

The Court also rejected the lower courts' reliance on the real property character of the documents on the ground that the *policy* of the securities acts clearly indicated that the leases should be included within its regulatory scope.[10] The Court asserted that no specific test was necessary; courts should decide issues by a case-by-case method:

> In applying acts of this general purpose, the courts have not been guided by the nature of the assets back of a particular document or offering. 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.[11]

Thus, in its first attempt to define the term "security," the Court emphasized the functional and policy aspects of the transaction, namely, whether the plan of distribution presented the abuses that the securities acts were designed to correct.

The Court's second opportunity to address the question of the definition of "security" produced the now-famous *Howey* formulation. W.J. Howey Company owned large tracts of citrus acreage in Florida, managed by the commonly held Howey-in-the-Hills Service, Inc. Customers were offered small amounts of citrus acreage accompanied by an option to purchase service contracts with Howey-in-the-Hills. The Court held that the transfer of acreage, represented by a land sales contract and warranty deed, with the service contract constituted an "investment contract," and thus fell within section 2(1) of the 1933 Act. Justice Murphy, writing for the majority, again rejected the defense that only sales of property were involved. Noting that the in-

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9. 320 U.S. at 348.

10. *Id.* at 349:

> 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.

11. *Id.* at 352-53 (footnote omitted).

vestors were predominantly business and professional people who were not interested in managing the acreage, the Court concluded that this was a scheme for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment."[12] Then, after surveying previous state blue sky decisions, the Court adopted the four-step investment contract definition.[13]

Two characteristics of the *Howey* opinion should be emphasized. First, the Court, as it had done three years previously in *Joiner*, relied heavily on the policy implications of the transaction. After announcing its definition, the Court said:

> [The definition] permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." H. Rep. No. 85, 73d Cong., 1st Sess., p. 11. It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.[14]

Moreover, the functional reality of the situation was that the "purchasers" lacked both the desire and expertise to develop the land; they were "attracted solely by the prospects of a return on their investment."[15] Indeed, individual development of the plots was not "economically feasible" due to their small size.[16]

The second aspect of the *Howey* decision that has been overlooked by both supporters and critics of the four-step definition is that the Court was attempting to define the term "investment contract," and not the generic term "security." Certainly, the Court would consider an employee stock-option plan a "security," even though such a plan would not fit into the rigid "profit solely from the efforts of another"

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12. 328 U.S. at 298, *quoting* State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920).

13. *See* text accompanying note 1 *supra*. One commentator has analyzed the state decisions relied on by the Court, 328 U.S. at 298 n.4, and concluded that none contain the *Howey* definition and, moreover, that they are very contradictory. *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 177 (1971) [hereinafter cited as Long]. *See also* 30 MICH. L. REV. 1113 (1932).

14. 328 U.S. at 299. This legislative purpose is again emphasized in the opinion's concluding sentence: "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Id.* at 301.

15. *Id.* at 300.

16. *Id.*

portion of the *Howey* "investment contract" definition. Thus, those courts and commentators who consider *Howey* to be the Supreme Court's fundamental analysis of what constitutes a security are misreading the Court's intention.[17]

There has been one other major Supreme Court attempt to define the contours of the federal securities jurisdiction. In *Tcherepnin v. Knight*[18] holders of withdrawable capital shares in an Illinois savings and loan association brought a class action for rescission based on fraud. The shares entitled their holders to a dividend based on the association's profits. Thus, the holders "participated" in a plan whose success depended on the skill of the association's management in making profitable loans. The Court held the shares to be securities, "most closely resembl[ing] investment contracts,"[19] and based its decision squarely on policy considerations:

> [W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities . . . . [I]n searching for the meaning and scope of the word "security" in the Act, form should be disregarded for substance and the emphasis should be on economic reality.[20]

Although the savings and loan association was regulated by the state of Illinois, the Court, quoting a dissenting opinion of the court of appeals, concluded that the Securities Exchange Act of 1934 (1934 Act)[21] was a better vehicle for protecting the investors' interests:

17. Other attempts have been made to limit the effect of the *Howey* language. For instance, it has been suggested that the Court was trying to produce the most narrow holding to cover the facts in *Howey*. *See* Comment, *What is a Security?* Howey, Turner Enterprises, *and Franchise Agreements*, 22 KAN. L. REV. 55, 59 (1973). There is some merit to this proposition, since the state decision most relied on by the Court, State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920), involved a scheme in which the investor was required to expend some effort to produce a profit.

18. 389 U.S. 332 (1967).

19. *Id.* at 338. Withdrawable capital shares constituted one of the two ways Illinois banks were allowed to raise capital. ILL. ANN. STAT. ch. 32, § 761(a) (Smith-Hurd 1970). Each holder of a share was a member of the association and entitled to one vote per $100 invested, *id.* §§ 741(a)(2), 742(d)(4), and to receive the dividends, *id.* § 778(c).

20. 389 U.S. at 336 (footnote omitted).

21. 15 U.S.C. §§ 78a-jj (1970).

"The investors . . . were less able to protect themselves than the purchasers of orange groves in *Howey*. . . . Because savings and loan associations are constantly seeking investors through advertising . . . the SEC's present tender of its expert services should be especially beneficial to would-be savings and loan investors as a shield against unscrupulous or unqualified promoters."[22]

B. *The Criticisms of* Howey

Justice Murphy's four-pronged test for "investment contracts" adequately explains most of the decisions involving sales-management contracts.[23] In 1961, however, the California Supreme Court, in an opinion by Justice Traynor, rejected the *Howey* formulation and proposed a new definition of "security" in *Silver Hills Country Club v. Sobieski.*[24] The promoters had contracted to purchase a 22-acre ranch for $75,000. Only $400 was put down; the rest of the purchase price was to come from the sale of memberships in a country club to be constructed on the ranch. The California Corporations Commission demanded that the offer of memberships be registered under the state's blue sky law; the promoters maintained that they were merely selling the right to use the club's facilities. The court held that the memberships were "securities,"[25] although members were not to par-

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22. 389 U.S. at 345-46, *quoting* 371 F.2d 374, 384-85 (7th Cir. 1966) (Cummings, J., dissenting).

23. *See, e.g.*, Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974) (chinchillas); Ahrens v. American-Canadian Beaver Co., 428 F.2d 926 (10th Cir. 1970) (beavers); Continental Mktg. Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967) (beavers); Blackwell v. Bentson, 203 F.2d 690 (5th Cir. 1953) (citrus groves); Ascher v. United States, 143 F.2d 592 (6th Cir. 1944) (vending machines); Penfield Co. v. SEC, 143 F.2d 746 (9th Cir. 1944) (bottling contracts); Schillner v. H. Vaughan Clarke & Co., 134 F.2d 875 (2d Cir. 1943) (distillery stock certificates); Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964) (archery range); SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962) (citrus groves); SEC v. Payne, 35 F. Supp. 873 (S.D.N.Y. 1940) (foxes); SEC v. Gilbert, 29 F. Supp. 654 (S.D. Okla. 1939) (motor boats); Hollywood State Bank v. Wilde, 70 Cal. App. 2d 103, 160 P.2d 846 (1945) (chinchillas; state statute); State v. Lorentz, 221 Minn. 366, 22 N.W.2d 313 (1946) (cemetery lots); State v. Robbins, 185 Minn. 202, 240 N.W. 456 (1932) (muskrats; state statute); Stevens v. Liberty Packing Corp., 111 N.J. Eq. 61, 161 A. 193 (Ch. 1932) (rabbits; state statute). *See generally* Annot., 3 A.L.R. FED. 592 (1970).

24. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

25. Ch. 384, § 1, [1949] Cal. Laws 699, *as amended*, CAL. CORP. CODE § 25019 (Deering Supp. 1974) contains a definition of "security" that is identical to the 1933 Act definition in all material respects. Throughout the remainder of this Note, state court decisions should be assumed to have been based upon statutory language similar to the federal acts unless otherwise indicated.

ticipate in the club's profits: "We have here nothing like the ordinary sale of a right to use existing facilities. [The promoters] are soliciting the risk capital with which to develop a business for profit."[26] Although some language in the opinion suggested that the blue sky policy of "fair, just, and equitable" regulation was a factor in the decision,[27] the court's reasoning was based primarily on the functional similarity of solicitation of capital for new ventures, whether through an offering of stock or club "memberships."

The approach of the *Silver Hills* court has been designated the "risk-capital" theory. Although the theory is not without its problems and critics,[28] its importance lies not in its utility as a formula but in its role as the first major attempt to avoid the mechanical use of the *Howey* test and employ an analysis grounded in an emphasis on the economic

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26. 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

27. Ch. 384, § 1, [1949] Cal. Laws 709, *as amended*, CAL. CORP. CODE § 25140 (Deering Supp. 1974). The paternalistic blue sky standard permits greater intervention by state authorities to prevent the registration of securities that are found not to be in the public interest. *See* UNIFORM SECURITIES ACT § 306. *See generally* L. LOSS & E. COWETT, BLUE SKY LAW 327-30 (1958); Edwards, *California Measures the Uniform Securities Act Against Its Corporate Securities Law*, 15 BUS. LAW. 814 (1960). The *Silver Hills* court noted that the California definition contained language indicating that "any note, any evidence of indebtedness whether interest-bearing or not," Ch. 384, § 1, [1949] Cal. Laws 699, *as amended*, CAL. CORP. CODE § 25019 (Deering Supp. 1974), was a security and thus discounted the "profit" requirement. It then said:

> Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its 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.

55 Cal. 2d at 815, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89. Despite the repeal of this statutory provision, the California Corporations Commission still uses the *Silver Hills* definition. *See* Long, *Introduction*, 6 ST. MARY'S L.J. 96, 118 & n.102 (1974).

28. The major problem with the risk-capital theory of *Silver Hills* is that the court never adequately defined what it meant by "risk-capital." It could mean (1) capital used to promote a previously nonexistent project, (2) capital invested in a risky chance or venture, or (3) capital with a very risky chance of return. *See* Note, *Franchise Regulation Under the California Corporate Securities Law*, 5 SAN DIEGO L. REV. 140 (1958) [hereinafter cited as *California Franchise Regulation*]. *See also* Note, *Franchisor Liability Under Securities Law*, 13 WASHBURN L.J. 68 (1974).

Risk-capital has been criticized as being too subjective a concept. Some commentators have suggested that acceptance of this theory would necessitate a day-by-day evaluation of an enterprise to determine whether enough risk existed to classify the investment as a security. *See California Franchise Regulation* 155; 24 VAND. L. REV. 638 (1971). Other criticisms are that the theory's emphasis on risky ventures would seriously impede the necessary flow of capital to innovative enterprises, and that abuses can occur in the most solidly established corporations. *See generally California Franchise Regulation.*

and policy realities behind the transaction. As Justice Traynor stated,

> [A]s 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 random; a passive position on the part of an investor; and the conduct of the enterprise by the issuer with other people's money.[29]

Six years after *Silver Hills*, Professor Coffey published the first rigorous attempt to analyze the economic realities of a "security." Coffey initiated his inquiry by addressing a "master policy question," namely, "What characteristics or features of a transaction necessitate its being subject to the rather specialized anti-fraud protection afforded by the securities laws?" His answer was the formulation of a five-part test:[30]

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 under-

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29. 55 Cal. 2d at 814, 361 P.2d at 908, 13 Cal. Rptr. at 188, *citing* Dahlquist, *Regulation and Civil Liability Under the California Corporate Securities Act*, 33 CALIF. L. REV. 343, 360 (1945).

30. Coffey 377 (footnote omitted).

> standing 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.

The first two elements follow the *Howey* definition, except that Coffey indicates that the initial investment can consist of value other than money.[31] The heart of Coffey's analysis, that "risk to initial investment . . . is the single most important economic characteristic which distinguishes a security from the universe of other transactions,"[32] is expanded in item (3) of the test. The first sub-item, (3)(a), covers the situation in which the risk of return on the initial investment is entirely dependent upon the success of the enterprise—that is, an unsecured interest.[33] The second situation, explained in (3)(b), covers the traditional sales-management cases; for example, when an animal is sold to the investor and recommitted to the promoter for training or breeding.[34] The final section, (3)(c), has become the most important in recent judicial attempts to characterize transactions as "securities." Basically, this section covers referral-sales schemes in which property is sold to the investor with an overcharge. The overcharge becomes subject to the risks of the enterprise, since it enables the buyer to receive payments dependent on the future success of the enterprise.[35]

To this point, Coffey's analysis is similar to Justice Traynor's opinion in *Silver Hills*, which also emphasized the functional similarity of all securities offerings—that is, a promoter soliciting value with the risk of loss on the investor.[36] Coffey carries the policy argument one step fur-

31. There seems to be little analytical justification for reading Justice Murphy's opinion in *Howey* to require money for the initial investment. It is true, as some commentators have pointed out, that most promoters are more interested in money than in labor or property. *See* Hannan & Thomas, *The Importance of Economic Realtiy and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974) [hereinafter cited as Hannan & Thomas]; Long 161-62.

32. Coffey 375.

33. Coffey cites *Joiner* to support this proposition. *Id.* at 381-82. While it is true that the investors in *Joiner* purchased a property right, its value was entirely dependent on the success of the test well. *See* text accompanying note 9 *supra.*

34. *See, e.g.*, Continental Mktg. Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967).

35. *See* Coffey 394-95.

36. There is also some support for this concept in the Supreme Court insurance decisions. *See* note 5 *supra.* Justice Douglas analyzed the variable annuity presented in SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959), in terms of risk allocation:

> 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.

ther, however, by stressing the requirement in item (4) that the buyer be unsophisticated or denied participation in the management of the enterprise. In other words, there are certain factors, such as investor participation or sophistication, that take the instrument out of the ambit of the securities acts by reducing the possibility of fraud in the transaction.[37]

The fifth item in Coffey's analysis attempts to correct the *Howey* reliance on expectation of pecuniary return. Coffey's contention is that, as in *Silver Hills,* the return on the investment may be tax benefits or rights to use facilities. Moreover, as the risk to the initial value increases, the 1933 Act policy of protection of investors requires less expectation of return.[38]

The Coffey analysis has been approved by commentators[39] and at least one court.[40] It offers the most thorough analysis of the elements

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> The holder gets only a *pro rata* share of what the portfolio of equity interest reflects—which may be a lot, a little, or nothing . . . . [T]he concept of "insurance" involves some investment risk-taking on the part of the company.

Id. at 71. Similarly, in SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967), the decision turned on whether a variable annuity which was 50% fixed return and 50% dependent on investment success constituted a "security." Justice Harlan, writing for the majority, held that a substantial risk remained with the investor, and thus a "security" was involved. *Id.* at 211. *See also* Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir. 1974), where the court held that the risk-of-loss factor distinguished a commercial loan from a security. *See generally* Hannan & Thomas 241-42; notes 237-42 *infra* and accompanying text.

37. Coffey is able to cite *Howey* for support of this position, since Justice Murphy repeatedly stressed the lack of expertise and experience of the *Howey* investors. *See* text accompanying note 15 *supra.* For a fuller discussion of this requirement, see note 126 *infra* and accompanying text.

38. Coffey cites an SEC opinion to the effect that trading stamps, meal tickets, subway tokens, and box tops are not securities since there is no expectation of "profit." The release goes on to state, however, that these items may be considered "securities" if "they are used as a method of corporate financing." SEC Securities Act Release No. 3890 (Jan. 21, 1958). *See also* Hannan & Thomas 247-48. One commentator has suggested that this distinction, while it may be correct, is not capable of judicial use. *See California Franchise Regulation* 148-51.

39. *See generally* Hannan & Thomas; Long.

40. *See* State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971). The case was a securities prosecution against a founders contract scheme. *See* text accompanying note 41 *infra.* The court, in rejecting *Howey* and adopting the Coffey analysis, said:

> Thus courts become entrapped in polemics over the meaning of the word "solely" and fail to consider the more fundamental question whether the statutory policy of affording broad protection to investors should be applied even to those situations where an investor is not inactive, but participates to a limited degree in the operation of the business.

of the functional question posed earlier in this discussion, namely, whether the enforcement and regulatory mechanisms of the SEC are designed to control the abuses associated with the transaction. Coffey's analysis highlights those elements that call for the extensive disclosure and antifraud remedies of the securities acts.

The remainder of this discussion will examine the demise of the *Howey* test in four separate areas and the failure of the courts to recognize the functional and policy realities that can serve as effective guides in those areas. The Coffey analysis will be used to answer the first question derived from the central policy question; the second question, whether the SEC should be assigned the task of regulating the transaction, will be examined by reference to other attempts at regulation. Finally, an analysis will be made of one area in which courts, freed from the restraints of a *Howey*-type definition, have been more successful in developing a meaningful approach based upon the policy realities of the transaction.

C. *Judicial Application of the* Howey *Test*

1. *Multilevel Distributorships: The "Solely" Requirement*

One man is perhaps most responsible for the recent intense judicial and scholarly attention to the meaning of the term "security." The man is Glenn W. Turner, and his contribution consisted of one of the largest frauds of the past decade, the "multilevel distributorship." The scheme presented a direct challenge to both state and federal regulatory authorities, and their responses have changed the shape of the law.

There are two principal types of multilevel distributorship schemes. The first, Turner's "pyramid" scheme, consists of selling a product or service through a multilevel network of independent distributors. The purchase of a distributorship entitles the investor to recruit other investors and earn a finder's fee for each new participant. Obviously, it becomes much more profitable to recruit investors than to sell the product. The recruits are enticed by promises of easy wealth delivered in high-pressure recruiting sessions which closely resemble revival meetings. The second type of scheme, the founders contract, evolves from the same principle. The originator recruits investors by selling cards to be used at a store that he will build. The purchaser

52 Hawaii at 647, 485 P.2d at 108 (footnote omitted). *See also* 18 WAYNE L. REV. 1141 (1972).

of the cards also buys the right to sell other people the cards and to earn direct and override commission fees for every card sold. Most of the time, no store is ever built.

The major abuse associated with these schemes is obvious. Just as in a chain-letter, the investors who come in late find that the market is already saturated.[41] Moreover, the prime targets for these schemes are the poor and uneducated who are coerced into parting with their savings by the high-pressure tactics of the successful salesman.[42] By the time most of these people realize that there is no market for their products, the promoters have departed, leaving behind only an under-capitalized corporate shell.[43]

Although these organizations are not new,[44] it was not until the mid-1960's that they became a serious consumer-fraud problem.[45] Largely due to the success of Turner and his various organizations,[46] by the end of 1972 there were 150 different pyramid operations in ex-

41. A predecessor to Turner, Holiday Magic Distributors, promised its investors that they would make a profit if they could get five new investors each month. At first glance, this does not seem difficult, but the SEC has calculated that if each investor accomplished it, there would be 305,175,780 people selling at the end of one year. *See* SEC v. Holiday Magic Distrib., BNA SEC. REG. & L. REP. No. 211, at A-5 (N.D. Cal. July 18, 1973) (complaint of SEC). *See also* TIME, July 16, 1973, at 51; N.Y. Times, Apr. 3, 1973, at 45, col. 1 (late city ed.). Congress has specifically attempted to protect the investing public from chain-letter schemes through the Mail Fraud Act, 18 U.S.C. § 1341 (1970).

42. *See* SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 478-80 (9th Cir. 1973).

43. *See Hearings on the Role of Small Business in Franchising Before the Subcomm. on Minority Small Business Enterprises and Franchising of the House Permanent Select Comm. on Small Business*, 93d Cong., 1st Sess. 171 (1973) (testimony of Neal McCoy, Chief Counsel, Division of Corporation Finance of the SEC):

> The New York state attorney general has in the past indicated that only 79 out of 1,600 distributors in Koscot Interplanetary, Inc. [a Turner pyramid] made more than $5,000 through sales of Koscot in 1970. Only 10 made an excess of $20,000. We have also been told that in Pennsylvania, during a 5-month period ending February, 1972, of 845 people enrolled in Dare-To-Be-Great [another Turner pyramid], only 72 recouped more than their investment and 656 failed to get any return whatsoever.

See also Comment, *supra* note 17.

44. For an early case involving pyramid operations, see Twentieth Century Co. v. Quilling, 130 Wis. 318, 110 N.W. 174 (1907). *See also* United States v. Herr, 338 F.2d 607 (7th Cir. 1964) (mail fraud conviction).

45. As early as 1966, the Better Business Bureau ranked pyramid schemes third on its list of the ten most serious consumer frauds. *See* 51 TEXAS L. REV. 788, 803 (1973).

46. Turner had two principal plans. First, he sold "motivational courses" through Dare To Be Great, Inc. Second, he sold cosmetics through Koscot Interplanetary, Inc.

istence with a combined investment of over $300 million.[47] Finally, state attorneys general began to look for a way to stop the multi-million dollar chain-letter that Turner was heading.[48] Although other remedies were tried,[49] most states turned to the securities laws. The result was that about one-half of the states found on various grounds that the Turner plan involved a "security",[50] while the other half rejected the securities claim on the basis of the *Howey* definition.[51] There was no difficulty with *Howey*'s first three elements, investment in a common enterprise with the expectation of profit. The problem arose with the fourth element, "solely from the efforts of another," since the investor was required to solicit more purchasers if he was to make a profit. Most of the *Howey*-influenced courts recognized that some government control over these schemes was necessary, but felt bound by the Supreme Court definition.

Thus, there was a sharp split in the states when the federal courts were first presented with the question under the 1934 Act. The District Court of Oregon, however, in *SEC v. Glenn W. Turner Enterprises,*

47. *See* Comment, *supra* note 17.

48. Turner attempted a counter-attack by suing twenty-six state attorneys general, charging a massive conspiracy to violate his civil rights. The action was dismissed in Turner v. Baxley, 354 F. Supp. 963 (D. Vt. 1972), *appeal dismissed,* Civil No. 73-1272 (2d Cir., June 5, 1973).

49. *See* notes 78-90 *infra* and accompanying text.

50. *See, e.g.,* Hurst v. Dare To Be Great, Inc., 474 F.2d 483 (9th Cir. 1973) (interpreting Oregon law and risk-capital); Frye v. Taylor, 263 So. 2d 835 (Fla. App. 1972) (profit-sharing element used); State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971) (using Coffey formula); State *ex rel.* Park v. Glenn Turner Enterprises, Inc., CCH BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Mar. 29, 1972) (adopting risk-capital); Mahoney v. Andresen, CCH BLUE SKY L. REP. ¶ 71,093 (Kings County, N.Y., Civ. Ct., Jan. 3, 1973) (adopting risk-capital); State *ex rel.* Fisher v. Glenn W. Turner Enterprises, Inc., CCH BLUE SKY L. REP. ¶ 71,059 (Okla. Dist. Ct., Jan. 10, 1973) (adopting risk-capital); State *ex rel.* Healy v. Consumer Business Sys., Inc., 482 P.2d 549 (Ore. App. 1971) (adopting risk-capital).

51. *See, e.g.,* Gallion v. Alabama Mkt. Centers, Inc., 282 Ala. 679, 213 So. 2d 841 (1968); Georgia Mkt. Centers, Inc. v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969), *noted in* 21 MERCER L. REV. 715 (1970); Brown v. Computer Credit Sys., Inc., 128 Ga. App. 429, 197 S.E.2d 165 (1973); Fidelity Credit Co. v. Bradford, 177 So. 2d 635 (La. App. 1965); Emery v. So-Soft of Ohio, Inc., 30 Ohio Op. 2d 226, 199 N.E.2d 120 (Ct. App. 1964); Commonwealth v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964); Bruner v. State, 463 S.W.2d 205 (Tex. Crim. App. 1970); Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Civ. App. 1970). *See generally* Note, *Pyramid Scheme Regulation: The Evolution of Investment Contracts as a Security Under the Federal Securities Law,* 25 SYR. L. REV. 690 (1974).

Inc.,[52] had no difficulty in deciding that the pyramid sales scheme fit into three categories of "security."[53] Instead of following the "solely" test, the court substituted a new formula based on whether the investor "has substantial power to affect the success of the enterprise."[54] Moreover, if the success of the venture requires professional or managerial skill, the investor must possess enough sophistication to be able to supply those skills, and not be forced to turn to others for them.[55] The decision was affirmed by the Ninth Circuit,[56] which, although it also held that an "investment contract" was involved, modified the lower court's test for "solely": "[The test is] 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."[57]

There are two important characteristics of the *Turner* case beyond its modification of *Howey*'s fourth element. First, the Ninth Circuit implicitly recognized a distinction advanced by some commentators[58] that becomes an important factor in the area of franchising.[59] Besides finding that the investors' efforts in *Turner* were not "essential" enough to negative the existence of a security, the court characterized them as part of the "initial" investment required to capitalize the operation at the outset. Secondly, both *Turner* courts returned to the original policy analysis of the *Joiner* Court. The district court emphasized that the promoters had represented their scheme as an investment to the objects of their sales efforts.[60] And the circuit court rested its decision squarely on the policy discussions of the Supreme Court:

52. 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

53. The court held that the pyramid scheme was "commonly known as a security," relying on state court decisions finding Dare To Be Great, Inc., to be a security. *Id.* at 772. It ignored the contrary results. The court without elaboration also found that the plan involved a "certificate of interest in a profit-sharing agreement." For a more complete discussion of these contentions, see note 63 *infra*.

54. 348 F. Supp. at 775.

55. *Id.* This portion of the opinion closely resembles the discussion of the *Howey* unsophisticated investor. *See* text accompanying note 15 *supra*.

56. 474 F.2d 476 (9th Cir. 1973). Because it found the scheme to be within the "investment contract" definition of the 1933 Act, the appellate court found it unnecessary to review the district court's alternative grounds for finding a "security." *See* note 53 *supra*.

57. 474 F.2d at 482.

58. *See* Goodwin, *Franchising Law Matures*, 28 BUS. LAW. 703 (1973); Note, *Regulation of the Franchise as a Security*, 19 J. PUB. L. 105 (1970).

59. *See* notes 104-07 *infra* and accompanying text.

60. 348 F. Supp. at 772.

[I]n 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.[61]

In *SEC v. Koscot Interplanetary, Inc.*[62] the Fifth Circuit adopted the Ninth Circuit test in reversing a district court opinion based primarily on the precedential force of *Howey*.[63] The appellate court had no difficulty satisfying the first three elements of *Howey*, but was forced to discuss the "solely" requirement more fully. The court twice mentioned its determination to apply a "functional" approach to avoid frustrating the remedial purposes of the 1933 Act.[64] Moreover, the court questioned literal adherence to the "solely" language in view of the *Howey* Court's reliance on state court decisions that did not specifically use the word "solely."[65] Finally, the court noted that the trend among the circuits was to liberalize the strict reliance on the language of *Howey*.[66]

Although the courts in both *Turner* and *Koscot* undoubtedly reached the correct result, it is unfortunate that their opinions followed the rigid categories of *Howey*. The courts based their decisions primarily on the

61. 474 F.2d at 482. For detailed studies of the Ninth Circuit's opinion, see 6 CREIGHTON L. REV. 450 (1973); 52 N.C.L. REV. 476 (1973); 51 TEXAS L. REV. 788 (1973).

62. 497 F.2d 473 (5th Cir. 1974), *rev'g* 365 F. Supp. 588 (N.D. Ga. 1973).

63. The district court admitted that Koscot, part of the Turner pyramid, represented a "get-rich-quick" scheme in the worst sense, but felt compelled by stare decisis to hold that it was not a security. 365 F. Supp. at 590. The court was more convincing in its discussion of the "commonly known as" and "profit-sharing agreement" arguments. As to the former, the court demanded a uniform and proper standard. Noting that the expert witness at the trial, a securities analyst, had denied that most experts would consider the scheme to be a security, the court concluded that the industry view was not uniform. Also, the state courts that had considered the question had split. *See* sources cited notes 50-51 *supra*. Similarly, no security was found under the "profit-sharing agreement" category. The court reasoned that the money received by the investors was "commissions" and not "profits." For a discussion of the profits/commissions distinction, see Commonwealth v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964). For the Internal Revenue Service's definition of "profit-sharing," see INT. REV. CODE OF 1954, §§ 401, 404, *construed in* Mississippi River Fuel Corp. v. Koehler, 266 F.2d 190 (8th Cir. 1959). *See generally* 48 TULANE L. REV. 738 (1974).

64. 497 F.2d 473, 480 (5th Cir. 1974).

65. *See* note 5 *supra*.

66. 497 F.2d 473, 481-82 (5th Cir. 1974).

policy of preventing a massive fraud; it only serves to confuse the issue to try to fit a transaction into the formalistic confines of the *Howey* language. As the Fifth Circuit correctly observed, recent cases have all but eliminated the conventional "investment contract" analysis. Instead of mechanical test-matching, courts should acknowledge the role played by functional and policy realities. The pyramid scheme easily fits within the Coffey analysis. There is a transaction in which the investors furnish value that is subjected to the risks of the enterprise. If the parent corporation folds, there will be no "product" to sell to other investors. Moreover, the buyer is purposely kept uninformed[67] and does not receive the right to participate in the management of the pyramid operation. His only job is to attract other investors; he is given no decision-making authority. Finally, he is solicited by promises of great wealth.[68] There is no question that this sort of transaction presents abuses similar to those found in many stock promotions of new ventures. Thus, the SEC policy of disclosure, as contained in the 1933 Act registration requirements and the 1934 Act antifraud sanctions, is relevant to the problem.[69] In addition, pyramid schemes

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67. *See id.* at 476:

> The Koscot Manual describes the reasoning behind the approach and its operation in the following manner: "DON'T GO INTO DETAILS. Never explain the program to a prospect before bringing him to an Opportunity Meeting. Do not mention Kosmetics or give any particulars, as many people will prejudge the program and decide it is not for them before they see the presentation."

68. The "opportunity meetings" are carefully orchestrated to present an illusion of wealth. Salesmen are encouraged to borrow money so that they can impress potential "investors" with their expensive clothes and cars. Salesmen are also instructed to tell an investor that they have "discovered a wonderful financial opportunity that will fit him like a glove!" *Id.* at 475-76.

69. *See* SECURITIES AND EXCHANGE COMM'N, DISCLOSURE TO INVESTORS (1969) (Wheat Report) (disclosure aspects of the securities laws). Some commentators have argued that disclosure is an ineffective tool against this kind of fraud. *See* Comment, *Pyramid Sales: Dare To Be Regulated,* 61 GEO. L.J. 1257, 1263 (1973); Note, *Federal Regulation of Pyramid Sales Schemes,* 1974 U. ILL. L.F. 137, 145. Indeed, one attorney has said about pyramid schemes: "We explain to people that it's a fraud, that they'll probably lose money, that they'll wind up cheating their friends and when we get through, they still say 'I'm going to try it.'" N.Y. Times, Apr. 3, 1973, at 39, col. 1. *See also* Whitford, *The Functions of Disclosure Regulation in Consumer Transactions,* 1973 WIS. L. REV. 400, 410-20, for an empirical study of the Truth-in-Lending Act's disclosure requirements. The author of that study concludes that most low-income consumers rely on their personal relationship with the salesman rather than on the facts disclosed. The argument against the effectiveness of SEC regulation through full disclosure overlooks a number of significant points. First, the SEC is moving toward a policy of warning potential investors against worthless schemes. *See, e.g.,* SEC Securities Act Release No. 5396 (June 1, 1973) ("poison paragraph" requirement for new

and other frauds affect the securities markets by draining capital away from legitimate business.[70]

The SEC has indicated on some occasions that it believes special legislation is needed to curb pyramid schemes,[71] and it has taken the position that it should be given authority to regulate in the area.[72] In November 1971, the SEC published a release stating its intention to consider multilevel distributorships to be securities.[73] The release rejected the literal *Howey* definition and, concentrating on the policy discussion in *Joiner, Howey,* and *Tcherepnin,* adopted the Coffey analysis.[74]

Although the pyramid scheme possesses those characteristics of a security that signal the need for securities law protections, it is also necessary to consider whether regulation by some other method is more appropriate. The first possibility is through common law deceit actions.[75] There are, however, no reported cases using deceit to allow recovery against pyramid schemes. The probable reason is that the required strict proof of the elements of deceit is too difficult to sustain, especially when there is the possibility of a rule 10b-5 action.[76]

A more successful approach has been realized under consumer protection legislation. The pyramid scheme has been held to violate state

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issues). Second, the expense, delay, and detail required in the prospectus may deter potential violators. Third, the finding of a "security" for federal law purposes also means that the states may regulate under their blue sky laws, using their "fair, just, and equitable" standard to prevent registration or suspend solicitation. Finally, it is difficult to imagine a case involving pyramid sales that does not present a claim under SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1974).

70. *See, e.g.,* Casey, *Corporate Responsibility as Seen from the S.E.C.,* BUS. & SOC'Y REV., Spring 1972, at 24, 27 (stressing the importance of efficient use of the limited available venture capital).

71. *See* [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,367 (May 9, 1973) (report of address by SEC Chairman Cook before the Society of American Business Writers).

72. *See* Letter from William Casey, SEC Chairman, to Senator Harrison A. Williams, Jr. and Representative John E. Moss, Sept. 4, 1972, *reprinted in part in* BNA SEC. REG. & L. REP. No. 168, at A-3 (Sept. 13, 1972).

73. SEC Securities Act Release No. 5211 (Nov. 30, 1971); *see* SEC Securities Exchange Act Release No. 9387 (Nov. 30, 1971).

74. The SEC credited the Hawaiian Supreme Court for the definition used, but, as has been seen, the analysis is based on Coffey's article. *See* note 40 *supra.*

75. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS 683-736 (4th ed. 1971).

76. The elements of deceit are reliance, scienter, causation, misrepresentation of a material fact, and damages. *Id.* For a discussion of the difference between securities law fraud and common law deceit, see 3 L. LOSS, SECURITIES REGULATION 1430-45 (2d ed. 1961) [hereinafter cited as LOSS].

laws against both "deceptive practices"[77] and "deceptive advertising."[78] The problem is that this approach depends on vigorous enforcement by public law-enforcement agencies, and, as some commentators have suggested, those agencies are too understaffed and overworked to provide adequate investigation and enforcement.[79] Moreover, it is necessary to adopt a very broad reading of the typical consumer statute to reach pyramid-type schemes.[80]

A few cases[81] have held that pyramid schemes violate federal lottery laws,[82] since the investor's prospects of profit are dependent on the "chance" that his purchasers will provide him with override commissions. This approach has been criticized on a number of grounds.[83] First, there does not really appear to be the kind of "chance" in a pyramid that exists in a lottery.[84] Secondly, courts are reluctant to construe penal statutes broadly. Thirdly, a criminal action does not adequately provide for compensation of the defrauded investor.[85]

At least two bills have been introduced in Congress to deal with the pyramid problem. One would have amended the 1933 Act specifically

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77. *See* Kugler v. Koscot Interplanetary, Inc., 120 N.J. Super. 216, 293 A.2d 682 (Super. Ct. Ch. 1972) (based on N.J. REV. STAT. §§ 56:8-1, -2-8 (1964)); State v. ITM, Inc., 52 Misc. 2d 39, 275 N.Y.S.2d 303 (Sup. Ct. 1966) (based on N.Y. EXEC. LAW § 63(12) (McKinney 1951)).

78. *See* People *ex rel.* Kelley v. Koscot Interplanetary, Inc., 37 Mich. App. 447, 195 N.W.2d 43 (1972) (based on MICH. COMP. LAWS §§ 445.801-.803 (1967)).

79. *See* Lorenz, *Consumer Fraud and the San Diego District Attorney's Office,* 8 SAN DIEGO L. REV. 47 (1971); Comment, *Private and Public Remedies for Fraudulent Business Practices in California: The Importance of a Strong Public Role,* 6 LOYOLA (L.A.) L. REV. 312 (1973).

80. *See* 27 RUTGERS L. REV. 220 (1973).

There are also state securities statutes in the area, but they have been criticized because their penalties are so minor as to make prosecution "hardly worth the effort." Wall Street J., Dec. 8, 1972, at 22, col. 1.

81. *See, e.g.,* Zebelman v. United States, 339 F.2d 484 (10th Cir. 1964); Sherwood & Roberts Yakima, Inc. v. Leach, 67 Wash. 2d 630, 409 P.2d 160 (1967).

82. 18 U.S.C. §§ 1301-06 (1970, Supp. IV, 1974).

83. *See* Comment, *Trade Regulation: Examination of Games of Chance and Referral Selling on Sales Promotional Devices,* 17 KAN. L. REV. 668 (1969). *See generally* Note, *supra* note 69.

84. The elements of a lottery are (1) a prize, (2) awarded by chance, (3) for a consideration. *See, e.g.,* M. Lippincott Mortgage Inv. Co. v. Childress, 204 So. 2d 919, 921 (Fla. App. 1967). Some courts have held that no "chance" is involved in a lottery. *See* First Discount Corp. v. Cua, 117 Ohio App. 105, 190 N.E.2d 695 (1962); Yoder v. So-Soft of Ohio, Inc., 202 N.E.2d 329 (Ohio C.P. 1963).

85. *See, e.g.,* VA. CODE ANN. §§ 959.1-67.1 to -67.3 (1973); WIS. STAT. ANN. § 5.122 (1970).

to include the pyramid scheme within the definition of investment contract.[86] The other bill, introduced by Senator Mondale would have created criminal sanctions against pyramids.[87] Neither bill made it out of committee. Moreover, the Mondale proposal has been criticized because it had definitional problems and its criminal sanctions would apply to the small investor who solicits as well as the man at the top of the pyramid.[88]

The most reasonable alternative to SEC regulation is Federal Trade Commission (FTC) action. The FTC has moved against some pyramid operators[89] on the basis of an "unfair practice" claim under section 5 of the Federal Trade Commission Act.[90] The difficulty is that the FTC has, until recently, been restricted to case-by-case adjudication, an extremely inefficient regulatory tool.[91] Moreover, the delay[92] inherent in the ad hoc method is hardly effective against the pyramid scheme, which has a planned limited life span. The FTC does publish industry-wide guides,[93] but they are not binding as rules of law; the FTC must still prove a section 5 violation in court.[94] Moreover, until early 1975, there was only limited judicial authority for the proposition that the FTC had rulemaking authority.[95] And while the 1975 amendments to the Federal Trade Commission Act give the Commission authority

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86. S. 3983, 92d Cong., 2d Sess. (1972) (introduced by Senator Tower).

87. S. 1939, 93d Cong., 1st Sess. (1973). The bill had been introduced the previous year, also by Senator Mondale. S. 4043, 92d Cong., 2d Sess. (1972).

88. *See* Note, *Regulation of Pyramid Sales Ventures,* 15 WM. & MARY L. REV. 117 (1973). The same problem occurs with the SEC approach. In its Release No. 5211, *supra* note 73, the SEC warned that anyone selling the scheme would be considered a broker or underwriter. Conceivably, as in the Mondale proposal, the net would be cast so wide that one would catch the very people whom the regulation is trying to protect. The only answer to this problem is that the SEC has not, and is not likely to, move against the small investor, although that does not prevent the possibility of a private action.

89. *See, e.g.,* Bestline Prods. Corp., 3 TRADE REG. REP. ¶ 20,350 (FTC June 13, 1973); Holiday Magic, Inc., 3 TRADE REG. REP. ¶ 20,372, at 20,261 (FTC May 31, 1973); Koscot I, 2 TRADE REG. REP. ¶ 20,019 (FTC May 24, 1972).

90. 15 U.S.C. § 45(a)(1) (1970).

91. *See* K. DAVIS, ADMINISTRATIVE LAW TEXT 151 (3d ed. 1972).

92. *See* Johnson, *Consumer Rights and the Regulatory Crisis,* 20 CATH. U.L. REV. 424, 438 (1971).

93. *See* FTC General Procedure, 16 C.F.R. § 1.5 (1975).

94. *See, e.g.,* FTC v. Mary Carter Paint Co., 382 U.S. 46, 48 (1965).

95. *See* National Petroleum Refiners Ass'n v. FTC, 482 F.2d 672 (D.C. Cir. 1973).

to make rules governing unfair or deceptive acts or practices,[96] it is not certain that the Commission will vigorously exercise its power in the field of pyramid schemes. Finally, there is considerable question whether consumers can obtain monetary redress through the actions of the FTC.[97]

Although the FTC may prove to be an effective regulator in this area,[98] it seems more efficacious that the SEC, with experience and success in the field, take the lead in regulation. It has been seen that pyramid schemes present the types of abuses that the securities acts were intended to correct; it now appears that the SEC is the most appropriate vehicle of regulation as well.

2. *Franchise Agreements: "Solely from the Efforts of Another"*

One of the fastest growing forms of business organization during the 1960's was the franchise. It was estimated in 1969 that 150 new franchises were opened every working day of the year.[99] In 1970 a Senate panel found that franchises accounted for over $100 billion in sales, almost ten percent of the gross national product.[100] The early 1970's however, witnessed a drop in the popularity of franchises[101] as the abuses associated with them became apparent.

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96. Act of Jan. 4, 1975, Pub. L. No. 93-637, § 202(a), 88 Stat. 2193 (codified at 7 U.S.C.A. § 57(a) (Supp. I, 1975)), *amending* 15 U.S.C. § 57 (1970).

97. The traditional view has been that there is no private remedy. *See* FTC v. Klesner, 280 U.S. 19, 25 (1929): "Section 5 of the Federal Trade Commission Act does not provide private persons with an administrative remedy for private wrongs. The formal complaint is brought in the Commission's name; the prosecution is wholly that of the Government . . . ." Many commentators have urged, however, that Justice Brandeis' comment was careless dictum and have asserted that a private right does exist. *See, e.g.*, Jones & Boyer, *Improving the Quality of Justice in the Marketplace: The Need for Better Consumer Remedies*, 40 GEO. WASH. L. REV. 357 (1972); Sebert, *Obtaining Monetary Redress for Consumers Through Action by the Federal Trade Commission*, 57 MINN. L. REV. 225 (1972). The FTC has recently indicated that it has the power to seek restitution on behalf of victims of deceptive practices, but only in very limited circumstances. *See* Curtis Publishing Co., No. 8800 (FTC June 30, 1972).

98. The American Bar Association has severely criticized the FTC:

> The recurrent flaws of FTC enforcement—failures of detection, undercommitment of resources to important projects, timidity in instituting formal proceedings and failure to engage in an effective compliance program—tend to outweigh its occasional successes.

ABA COMMISSION TO STUDY THE FTC, REPORT 9 (1969).

99. *See* Wall Street J., Sept. 10, 1969, at 36, col. 1.

100. *See* S. REP. No. 1344, 91st Cong., 2d Sess. 1 (1970).

101. *See* Goodwin, *supra* note 58.

There are two basic types of franchise organization.[102] Under the "product and service" system, the franchisor licenses the distribution of his manufactured products under his name and trademark. Common examples are gasoline and automobile companies. The second type of franchise is the "trademark license," in which the franchisee purchases the right to sell goods and services he produces under the franchisor's name. The best example of this type is the fast-food business.

Although there were early attempts to bring the franchise within the purview of the securities acts,[103] it was not until the late 1960's that an attempt was made to develop a consistent theory. Since the fourth element of *Howey* was obviously not met in the case of an active franchisee, an alternative theory was needed. The first attempt was the result of Justice Traynor's risk-capital approach in *Silver Hills*. The California Attorney General constructed three hypothetical franchise situations that raised the issue of whether a security existed.[104] The first, when the franchisee participates only nominally in the enterprise, was clearly a security under a liberal reading of *Howey*. The second, where the franchisee actively participates in the enterprise and the franchisor provides goods and services, was construed to fall outside the securities acts. The third, where the franchisee actively participates but the value he furnishes constitutes risk value, was a difficult question. The Attorney General reasoned that in the third situation the franchisee was in reality investing in two separate business ventures. One was the operation of the franchised business, and the other was the enterprise conducted by the franchisor financed by the franchisee's risk capital. Two years later, the Georgia Attorney General adopted the California "dual-investment" theory, although he argued that its application should be limited to situations in which the franchisor was so undercapitalized that he needed the franchisee's investment to produce the

102. *See* J. CURRY, PARTNERS FOR PROFIT (1966); E. LEWIS & R. HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION (1963). *See also* Note, *Franchisor Liability Under Securities Law*, 13 WASHBURN L.J. 68 (1974).

103. *See, e.g.*, Belhumeur v. Dawson, 229 F. Supp. 78 (D. Mont. 1964) (retail stores held security); Drug Management, Inc. v. Dart Drug Corp., [1962-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,293 (D.D.C. 1963) (drug stores held no security); *In re* Tucker Corp., 26 S.E.C. 249 (1947) (auto franchise held evidence of indebtedness). *See generally* Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Securities Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311 (1969).

104. 49 CAL. OP. ATT'Y GEN. 124 (1967).

necessary products.[105] These theories have been severely criticized by commentators. The major focus of their attack has been on the subjective nature of the test, the characterization of the risk that the franchisor's enterprise will be successful as an investment risk and not an ordinary business risk, the limitation of the term "security" to risky ventures, and the fear that new venture capital will be impeded.[106]

While the virtues and defects of the California "dual-investment" theory as an alternative to *Howey* were being debated,[107] a federal district court in *Mr. Steak, Inc. v. River City Steak, Inc.*[108] held that a restaurant franchise arrangement was not a "security" within the meaning of section 2(*1*) of the 1933 Act. The franchise agreement provided that the franchisor, a national restaurant chain, would have the right to control the operations of the restaurant, including daily financial affairs and the activities of the manager, whom the franchisor was to select. The franchisee, a sophisticated investor, retained the right to terminate the manager's employment and generally was contemplated to "play an active, if severely circumscribed, role in the conduct of the restaurant."[109] After considering in detail both the contractual rights of the parties and the actual method of operating the restaurant, the court concluded that the exercise of control over the franchised operation was not determinative; since the franchisee exercised some control, and had delegated or abandoned other powers under the agreement, the franchise was a "business which the [franchisee] *could* control and included the normal risks incident to opera-

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105. 1969 GA. OP. ATT'Y GEN. 661, 664-65:

> [T]his test essentially recognizes the fact that if a franchising system is in its infancy to such a degree that the individual franchisee might realistically be held to have provided risk capital in the enterprise as a whole to the extent that its success or failure will necessarily depend upon the success or failure of every other individual franchisee as well as the franchisor, then his investment constitutes an investment contract . . . .
>
> Thus . . . promoters undertaking to establish a new franchise system will fall within the ambit of securities regulation if the franchisor is so thinly or under-capitalized as to require franchisees in order to meet its obligations to furnish goods and services to its franchisees . . . .

106. *See California Franchise Regulation*; 24 VAND. L. REV. 638 (1971). For an interesting discussion of new venture capital financing and the inherent difficulties, see Cronson, *Venture Capital Financing—Legal and Financial Considerations,* 48 NOTRE DAME LAW. 614 (1973).

107. The California approach was certainly not without its supporters. *See* Goodwin, *supra* note 58; Note, *supra* note 58.

108. 324 F. Supp. 640 (D. Colo. 1970), *modified,* 460 F.2d 666 (10th Cir. 1972).

109. *Id.* at 645.

tion of any enterprise."[110] Thus, because the investor in *Mr. Steak* was informed as to the nature of the investment and had the right, if largely unexercised, to effect the investment's success, the transaction failed to satisfy the "solely" requirement of the *Howey* formula.[111]

Federal courts since *Mr. Steak* have uniformly[112] held that franchises are not "securities" within the meaning of the federal acts. Some courts have routinely considered the *Howey* "solely" language in reaching this result,[113] while others have used the Ninth Circuit *Turner* test.[114] These latter courts have stressed the kinds of duties for which the franchisees were responsible and, although purportedly applying the more liberal "essential managerial" test of *Turner*,[115] have found that these duties take the arrangement outside the protection of the securities laws.

One area seldom discussed in the cases is the potential for abuse that is inherent in the franchise field. First, there is generally a gross disparity of economic power between the franchisor and franchisee,[116] and the former has not been unwilling in some cases to abuse

110. *Id.* (emphasis added). For a discussion of this "turn-key" agreement, where the franchisee is given a choice whether to participate or not, see Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635 (9th Cir. 1969). *See also* Continental Mktg. Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968).

111. Although the court could have stopped there, it went on to discuss the possible application of the risk-capital approach. While the court suggested that the dual-investment theory was "too extreme," it expressed approval of the *Silver Hills* approach so long as it "limit[s] the 1933 Act to situations where exceptionally high risk, speculative franchises are involved." 324 F. Supp. at 647.

112. In two cases, courts characterized the sellers as franchisors, but a close reading of the facts indicates that their operations were much closer to multilevel distributorships than to legitimate franchises. *See* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262 (N.D. Ill. 1973).

113. *See, e.g.*, L.H.M., Inc. v. Lewis, 371 F. Supp. 395 (D.N.J. 1974); Schuler, Inc. v. Better Equip. Launder Center, Inc. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,074 (D. Mass. 1973); Beefy Trail, Inc. v. Beefy King Int'l, Inc., 348 F. Supp. 799 (M.D. Fla. 1972); Cobb v. Network Cinema Corp., 339 F. Supp. 95 (N.D. Ga. 1972).

114. *See, e.g.*, Bitter v. Hoby's Int'l, Inc. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,562 (9th Cir. 1974); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); Nash & Associates, Inc. v. Lumis of Ohio, Inc., 484 F.2d 392 (6th Cir. 1973); Wieboldt v. Metz, 355 F. Supp. 255 (S.D.N.Y. 1973). *See generally* Hannan & Thomas 268.

115. *See* text accompanying notes 52-57 *supra*.

116. *See* Gellhorn, *Limitation on Contract Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465.

that power.[117] Second, the use of the names of celebrities[118] and high-pressure sales tactics tends to block investor access to vital information.[119] Third, the costs of obtaining a franchise are sometimes hidden from the franchisee under the designation "miscellaneous fees" or "advertising charges."[120] Fourth, the franchisor often fails to disclose the profits he receives in the form of kickbacks from suppliers.[121] Fifth, undue pressure is often brought against the franchisee by threats of termination.[122] Finally, the effect on the securities markets is substantial. Many of the companies that fueled the "hot-issue" craze of the late 1960's were franchising ventures.[123]

Most of these abuses could be controlled by a system of stringent disclosure such as is provided by the securities laws. The SEC has indicated that it does not consider itself to be without power in the field.[124] Moreover, the franchise would probably fit into the Coffey formula. There is a transaction in which a buyer furnishes initial value to the seller. That value is subject to the risk of the enterprise, since it is to some extent dependent on the continued good will of the franchised name.[125] Furthermore, the franchisee is induced to invest in the enterprise with the expectation of economic benefit.

It is the fourth element of the Coffey analysis which presents difficulties. In most franchises, the buyer is not familiar with the operations of the parent enterprise. Secondly, he is led to expect profits from his management of the enterprise, as well as profits from the future success of the parent enterprise in generating nationwide

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117. *See, e.g.*, C. Robert Ingram, Inc. v. Chrysler Corp., 256 F.2d 684, 687 (10th Cir. 1958).

118. *See* Goodwin, *The Name of the Franchising Game is: The Franchise Fee, The Celebrity, or Basic Operations?*, 25 BUS. LAW. 1403 (1970).

119. *See* Axelrad, *Franchising—Changing Legal Skirmish Lines or Armageddon?*, 26 BUS. LAW. 695 (1971); Lefkowitz, *Franchising Abuses—One State's Approach*, 75 CASE & COM., July-Aug. 1970, at 14.

120. *See* H. BROWN, FRANCHISING: TRAP FOR THE TRUSTING 10 (1969).

121. *Id.* at 14-16.

122. *Id.* at 22.

123. In August 1969, there were 173 fast-food operations alone that had either gone public or were in registration. *See* Elliott, *Speculative Bellyache?*, BARRON'S, Aug. 25, 1969, at 11.

124. *See, e.g.*, SEC Securities Act Release No. 5211, *supra* note 73.

125. This factor was overlooked by the court in Bitter v. Hoby's Int'l, Inc., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,562 (9th Cir. 1974). The court rejected the risk-capital approach in franchising cases by stating that the franchisee's success is totally independent of the success or failure of the franchisor. That contention is contrary to the whole theory of franchising.

recognition. It is the very nature of a franchise, its fundamental distinguishing feature, that part of the return on the franchisee's investment is dependent upon the success of the parent enterprise. Moreover, a functional analysis of the "typical" franchise agreement reveals that the franchisor retains control of the profit-generating business decisions, such as initial purchase, site selection, daily operating plan, marketing, and accounting.[126] Thus, the franchisee is basically in the same position as the investor who relies on the securities acts for protection against unscrupulous promoters; he needs full disclosure to make an informed judgment about an enterprise upon which he is dependent for a return on his investment.

The securities laws also provide the most appropriate means of regulation. Although some courts have held against the franchisor on the basis of common law fraud,[127] this does not seem to be a promising remedy for the same reasons it was unsuitable in the pyramid scheme cases.[128] The major difficulty with any contract action is that the franchise relationship may be characterized as a "sale," an "agency," or something between the two.[129] Nevertheless, at least one commentator[130] has urged that the principle of unconscionability[131] be expanded to cover the franchise situation. The problem is that this approach may be useful in pursuing an individual remedy, but it cannot serve a prophylactic function.

Two bills regulating franchising were introduced in the Senate in 1967.[132] Neither bill passed, and both were criticized for definitional vagueness.[133] Further, the bills only related to the termination provisions of the franchise agreement, and did not purport to cover the problem of undisclosed profits and costs. Finally, Congress has not been extremely successful in its only other attempt to regulate fran-

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126. For an empirical study confirming this analysis, see Comment, *The Franchise Agreement: A Security for Purposes of Regulation*, 1970 U. ILL. L.F. 130. It does not appear necessary to adopt the approach that characterizes the labor of the franchisee as part of the initial investment in the enterprise.

127. *See, e.g.*, Venture Inv. Co. v. Schaefer, 478 F.2d 156 (10th Cir. 1973).

128. *See* text accompanying notes 75-76 *supra*.

129. *See, e.g.*, Des Moines Blue Ribbon Distrib., Inc. v. Drewry's Ltd., 256 Iowa 899, 906-07, 129 N.W.2d 731, 736 (1964).

130. *See* Gellhorn, *supra* note 116.

131. *See* UNIFORM COMMERCIAL CODE § 2-302 (1972).

132. S. 2507, 90th Cong., 1st Sess. (1967) ("Franchise Distribution Act of 1967"); S. 2321, 90th Cong., 1st Sess. (1967) ("Franchise Competitive Practice Act of 1967").

133. *See* H. BROWN, *supra* note 120, at 88.

chises.[134] California has adopted a comprehensive franchise law,[135] but it is too early to judge how effective it will be.

Once again, the FTC has taken some steps[136] to enter the franchise regulation field. Even before the Commission had obtained rulemaking authority in the area of unfair or deceptive acts or practices,[137] it had proposed a disclosure rule for franchising.[138] It seems ironic that the federal agency with the most experience in effective disclosure, the SEC, should be prevented from exercising its jurisdiction, while another agency, a neophyte in the field of rulemaking,[139] should be assigned the task.

The area of franchising does differ from the pyramid sales area in that there are many legitimate businesses operating in the field. These businesses are already under close regulation because of antitrust problems in the areas of price fixing,[140] tying arrangements,[141] and location restrictions.[142] It has been the philosophy of the American securities laws, however, that the interests of these legitimate operations must bow to the interests of the investor.

134. Automobile Dealer Franchise Act, 15 U.S.C. § 1221 (1970), *discussed in* Note, *The Judicial Treatment of the Automobile Dealer Franchise Act*, 62 MICH. L. REV. 310 (1963); Note, *The Automobile Dealer Franchise Act: A "New Departure" in Federal Legislation*, 52 NW. L. REV. 253 (1957).

135. CAL. CORP. CODE. § 31000 *et seq.* (Deering Supp. 1974). The law provides for both full disclosure of offered franchises, *id.* §§ 31110-24, and prohibition of fraudulent sales, *id.* §§ 31200-03, 31210-11. *See* Augustine & Hrusaff, *The California Franchise Investment Law*, 46 J. STATE BAR CAL. 50 (1971); Damon, *Franchise Investment Law*, 2 PAC. L.J. 27 (1971).

136. The FTC has won consent decrees against franchisor misrepresentation. *See* Meal or Snack Sys., Inc., 75 F.T.C. 497 (1969); Mercury Electronics, Inc., 74 F.T.C. 548 (1968).

137. *See* source cited note 96 *supra* and accompanying text.

138. 36 Fed. Reg. 21,607 (1971). For an analysis of the proposed rule, see Rosenfield, *A Look at the Proposed F.T.C. Rule on Franchising*, 27 BUS. LAW. 907 (1972).

139. Indeed, the proposed regulations have been attacked as vague, burdensome, and difficult or impossible to perform. *See* Zeidman, *Regulation of Franchising by the Federal Trade Commission: A Critique of the Proposed Trade Regulation Rule*, 28 BUS. LAW. 135 (1972).

140. *See* United States v. Parke, Davis & Co., 362 U.S. 29 (1960). *See also* Comment, *Resale Price Maintenance, Refusals to Deal, and the Gasoline Retailer—A Search for Alternative Remedial Deterrants*, 18 VILL. L. REV. 648 (1973).

141. *See* Times Picayune Publishing Co. v. United States, 345 U.S. 594 (1953). *See also* Day, *Exclusive Dealing, Tying, and Reciprocity—A Reappraisal*, 29 OHIO ST. L.J. 539 (1968).

142. *See* United States v. Sealy, Inc., 388 U.S. 350 (1967). *See generally* Comment, *Franchising and the Antitrust Laws: An Overview*, 41 TENN. L. REV. 535 (1974).

3. *The Commodities Game: "Common Enterprise" or Not*

The commodity futures contract has been defined as an agreement to purchase some fixed amount of a commodity at a future date for a fixed price.[143] There is, however, usually no intent to take delivery of the commodity; most commitments are offset by acquiring a corresponding offer to sell at the time of delivery.[144] While the organized trading of futures has valuable benefits,[145] it can also be a vehicle for investor speculation.[146] Regardless of their purpose, many people are now actively trading on the commodity exchanges.[147]

The question whether the ordinary futures contract is a security was convincingly answered in the negative by a federal district court in *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[148] Sinva, a foreign financing and investment company, sued its broker for alleged mishandling of its commodity account. The court, applying the *Howey* test, reasoned that there was no "common enterprise to realize a profit" between Sinva and its broker; there was simply a broker-client relationship, with the latter in complete charge of deciding whether to accept the commodity or offset in another trade.[149] Further, the court noted that the SEC should not be granted jurisdiction in light of a clear congressional intent to regulate the commodities market through another agency.[150]

Sinva and subsequent decisions[151] have established that the ordinary

143. Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 47 (1955).

144. By most estimates, less than 1% of the contracts are actually consummated by delivery. *See* Note, *Federal Regulation of Commodity Futures Trading,* 60 YALE L.J. 822, 825 (1951).

145. The trading aids in price determination, assists in the handling of after-harvest movement, makes hedging possible, provides quotations which can be widely disseminated, facilitates a continuous market, and results in some changes of ownership. *See* Irwin, *Legal Status of Trading in Futures,* 32 ILL. L. REV. 155 (1937).

146. *See* Campbell, *Trading in Futures Under the Commodity Exchange Act,* 26 GEO. WASH. L. REV. 215, 219 (1958).

147. The Senate reported in 1968 that trading for the previous year in the principal agricultural products was at a record level of $75 billion annually with about 16 million transactions. S. REP. No. 947, 90th Cong., 2d Sess. 3 (1968).

148. 253 F. Supp. 359 (S.D.N.Y. 1966).

149. *Id.* at 366.

150. *Id.* at 367. The Commodity Exchange Authority had regulatory authority in the field, pursuant to the Commodities Exchange Act, 7 U.S.C. §§ 1-17a (1970), *as amended,* Act of Oct. 23, 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified at 7 U.S.C.A. §§ 1-22 (Supp. I, 1975)).

151. *See* Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974); Golding v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [current] CCH FED.

futures contract is not a security. Under certain circumstances, however, an option to buy or sell a future contract is a security. This conclusion is a result of another get-rich-quick promotion scheme.[152] In this scheme, the "naked" commodity option, the investor purchases an option to buy or sell (or both) a particular futures contract from (or to) the promoter during a specified period at a fixed price. The options are "naked" because the promoter does not purchase the contract to which the customer's option relates. Instead, he invests the purchasers money to generate additional capital. The investor profits when he correctly guesses the position of the market at the future time and exercises his option with the promoter. The investor loses if he misreads the market, or if the promoter is unable to raise the capital to pay his claim when the option is exercised. Unfortunately, the promoters of the "naked" commodity option have been less than successful in raising the capital.[153] Not surprisingly, the securities commissioners of several states[154] asserted jurisdiction for the purpose of stopping the "naked" option game.

While other courts[155] have litigated the question of whether the naked option is a "security" under the blue sky laws, the major decision in the area came from the California courts in *People v. Puts & Calls, Inc.*[156] The defendant in that case relied on three principal arguments. First, it was contended that an option takes on the character of its underlying instrument. Therefore, since *Sinva* had established that futures are not securities, the option to purchase could not be one either. Second, the defendant argued that there was no element of

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SEC. L. REP. ¶ 94,896 (S.D.N.Y. Dec. 5, 1974); Berman v. Dean Witter & Co., 353 F. Supp. 669 (M.D. Cal. 1973); McCurnin v. Kohlmeyer & Co., 340 F. Supp. 1338 (E.D. La. 1972); Schwartz v. Bache & Co., 340 F. Supp. 995 (S.D. Iowa 1972).

152. *See* Hannan & Thomas 269.

153. One such promoter, Harold Goldstein, declared bankruptcy after only two years at the business with $17 million in assets but $76 million in liabilities. *Id.* at 270.

154. *See* 1 CCH BLUE SKY L. REP. ¶ 9722 (May 22, 1973) (Colorado Securities Commissioner); 2 CCH BLUE SKY L. REP. ¶ 28,651 (May 29, 1973) (Missouri Securities Commissioner); 3 CCH BLUE SKY L. REP. ¶ 41,358 (Mar. 27, 1973) (Pennsylvania Securities Commissioner); 3 CCH BLUE SKY L. REP. ¶ 47,655 (Mar. 16, 1973) (Utah Securities Commissioner).

155. *See* Shapiro v. First Federated Commodity Trust Corp., 3 CCH BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct. May 30, 1973) (finding "security"); International Commodity Trust, Inc. v. Fisher, 3 CCH BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct. May 14, 1973) (finding no "security"), *overruling In re* Goldstein, Samuelson, Inc., 3 CCH BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Order Feb. 23, 1973).

156. 3 CCH BLUE SKY L. REP. ¶ 71,090 (Cal. Sup. Ct. June 21, 1973).

"common enterprise" since the success or failure of the individual investor in reading the market is the significant factor in realizing a profit. Third, profit is not "solely" dependent on the efforts of a third party.[157] The *Puts & Calls* court had little difficulty with the three arguments. On the first defense, the court reasoned that more than a sale of options was involved; there was also a sale of an investment contract. As to the other defenses, the court reasoned that the "profit" of the investor was solely dependent on the ability of the third party to raise additional capital by investing the commingled account of investors' payments. Strangely enough, the California court used the *Howey-Turner* analysis and rejected a risk-capital[158] or public policy[159] approach.

Between the ordinary futures contract and the naked commodity option lies the discretionary commodities account. Under this plan, the investor entrusts his money in a joint account, expecting profits solely from the investment success of the broker. As the description indicates, three elements of *Howey*, investment of money with the expectation of profit solely from the efforts of another, are met. The problem lies with the "common enterprise" requirement.

The first major attempt to define "common enterprise" came from the Ninth Circuit in *Los Angeles Trust Deed & Mortgage Exchange v. SEC.*[160] Purchasers received notes secured by a second deed of trust on property managed by the seller. The money was pooled and reinvested, the purchasers relying on the advertised expertise of the seller. There was little question that this was a "common enterprise," since

157. These defenses are discussed in Borton & Abrahams, *Options on Commodity Futures Contracts as Securities in California*, 29 BUS. LAW. 867 (1974).

158. This type of investment fits perfectly into the *Silver Hills* risk-capital analysis. The investors were primarily furnishing capital in a speculative, high-risk venture. Moreover, the *Turner* approach is not too valuable here. As one commentator has suggested, the idea that the "common enterprise" and "solely" elements are satisfied by relying on the fact that promoter solvency was necessary for a payoff confuses the two separate risks involved in *Puts & Calls*. The speculative risk purchased by the investor was that he could guess the market; he did not intend to purchase the business risk that the promoter would be able to pay. *See* Bloomenthal, *Calls, Puts and Commodity Options*, 2 SEC. REG. L.J. 101 (1974).

159. The court at one point said:

> I'm acutely aware of the fact that simply because there may be a crying need for regulation—and I think the evidence amply shows that—does not of itself necessarily mean that there is to be regulation.

3 CCH BLUE SKY L. REP. ¶ 71,090, at 67,385.

160. 285 F.2d 162 (9th Cir. 1960).

many investors were solicited and their capital pooled; in making this finding, the court stated that the crucial element was that the "economic welfare of the purchasers was *inextricably woven* with the ability of [the seller] to meet its commitments."[161] Thus, the court made it clear that the "common enterprise" requirement was satisfied by *either* a pooling of interests *or* a commonality of interest between purchaser and seller. This contention has been accepted in numerous[162] situations; it is strange that it has caused so much trouble in the commodities area.

There was no indication in the early cases involving discretionary accounts that the "common enterprise" element might not be satisfied. In *Maheu v. Reynolds & Co.*[163] the court rejected the contention that there was no common enterprise by relying upon prior cases[164] and an analysis of *Howey*. The lower court in *Howey* had reasoned that there was no element of common enterprise since each owner looked to his own individual citrus grove for profit.[165] The *Maheu* court thought it significant that the Supreme Court reversed the lower court decision, and held that a common enterprise existed.[166] The cases that followed *Maheu*[167] routinely held that a discretionary account was a security until the federal district court decision in *Milnarik v. M-S Commodities, Inc.*[168] In that case, an investor sued on the basis of his

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161. *Id.* at 172 (emphasis added).

162. *See* notes 175-79 *infra* and accompanying text.

Further, this has never been a problem in the sale-leaseback arrangement. This method of financing involves a sale by the promoter to the investor and a lease-back to the promoter. The terms of the lease usually provide for a fixed rent plus a percentage of sales. The courts have uniformly held this to involve a security. *See, e.g.*, Huberman v. Denny's Restaurants, Inc., 337 F. Supp. 1249 (N.D. Cal. 1972). *See generally* Bruck, *Investment Contracts: To Qualify or Not to Qualify?*, 49 L.A. BAR BULL. 179 (1974); Note, *The Expanding Definition of "Security": Sale-Leasebacks and Other Commercial Leasing Arrangements*, 1972 DUKE L.J. 1221.

163. 282 F. Supp. 423 (S.D.N.Y. 1967).

164. SEC v. Payne, 35 F. Supp. 873 (S.D.N.Y. 1940); SEC v. Wickham, 12 F. Supp. 245 (D. Minn. 1935); *see* 1 Loss 489.

165. *See* 151 F.2d at 715-17.

166. Although this result is probably correct, the court's argument is very weak. The Supreme Court did reverse the lower court in *Howey*, but it based the decision of common enterprise on the fact that the capital invested by others helped Howey in its efforts at successful management. 328 U.S. at 298.

167. *See, e.g.*, Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764 (S.D.N.Y. 1972); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968).

168. 320 F. Supp. 1149 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

broker's alleged failure to register his discretionary commodities account as a security under the 1933 Act. The *Milnarik* court purported to accept the argument that the contract constituted a security; it based its holding for the broker on the private-offering exemption.[169] The holding was, however, at least partially based on the court's theory that there was no "common enterprise" involved in the offering. Rather, the court stated, the broker was simply selling individual agency-for-hire contracts.[170] Although there was considerable doubt about the validity of the court's exemption holding,[171] the Seventh Circuit, on appeal, compounded the error by holding that there was no offering of a "security." In so deciding, the court quoted extensively from the district court's dicta about the agency-for-hire relationship and observed that, although the broker had many accounts, there was no commingling of assets.[172]

The *Milnarik* opinion has been followed in two other cases.[173] There is a good policy argument that application of the 1933 Act would be inappropriate in *Milnarik*,[174] but the opinion, forced into the narrow confines of the traditional *Howey* elements, relied on the wrong rationale—the restrictions placed on the "common enterprise" element are inconsistent with the prevailing views of the courts. One example, the scotch whiskey warehouse cases, makes this clear. Courts have re-

169. 1933 Act § 4(2), 15 U.S.C. § 77d(2) (1970).

170. 320 F. Supp. at 1151.

171. The court did not properly apply the private offering exemption test from SEC v. Ralston Purina Co., 346 U.S. 119 (1952). Evidently, the broker had solicited money on a nationwide scale. *See* 320 F. Supp. at 1150. If each contract was a security, as the court indicated, the offering was to a large group of people, most of whom were not possessed of investment sophistication.

The decision also misapplied policy considerations. The court felt that the disclosure requirements of Schedule A of the 1933 Act would not be appropriate. Nonetheless there was considerable need for disclosure about the broker's expertise in the commodities markets, which was the inducement for the contract.

172. 457 F.2d at 277.

173. Stuckey v. duPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasabwic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972).

174. The SEC has never really determined the amount of regulation it wishes to pursue in the case of commodities accounts and related devices such as puts and calls. For instance, in E.F. Hutton & Co., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,007 (SEC 1973), the SEC took no position on whether a discretionary commodities account was a security, but "suggested" that E.F. Hutton register it. *But see* Hayden, Stone, Inc. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,262 (SEC 1973) (computer-operated commodities account did not have necessary element of commonality).

cently addressed the question whether an investment in which a broker sells raw whiskey to an investor and, after three years of aging, resells the alcohol, constitutes a "security."[175] As in the case of the discretionary commodity account, there is no pooling of investments and, indeed, there is not even a requirement of other investors. Nonetheless, mindful of the abuses[176] that are associated with the transaction, courts,[177] the SEC,[178] and blue sky commissioners[179] have uniformly held that the investments are securities.

Because the *Milnarik* court was so concerned with *Howey*, it failed to analyze adequately the policy question.[180] Unlike the areas of franchising and pyramid schemes, there is a federal agency that has been given authority over the commodities field. The Commodity Exchange Act was passed by Congress to regulate brokers who regularly trade on the commodity exchanges.[181] It contained provisions which regulated excessive speculation, the financial responsibility of brokers, and the handling of customer accounts, as well as a general antifraud section.[182] The latter was construed to support a private right of ac-

175. The first whiskey warehouse craze occurred in the 1940's. *See* Penfield Co. v. SEC, 143 F.2d 746 (9th Cir. 1944); SEC v. Bourbon Sales Corp., 47 F. Supp. 70 (W.D. Ky. 1942). There has recently been a revival of interest and court activity. *See* Glen-Arden Commodities, Inc. v. Costantino, 493 F.2d 1027 (2d Cir. 1974); SEC v. Haffenden-Rimar Int'l, Inc., 362 F. Supp. 323 (E.D. Va. 1973); SEC v. M.A. Lundy Associates, 362 F. Supp. 226 (D.R.I. 1973).

176. The problem is that the investor is totally dependent on the broker, since there are no published prices in the field. Some brokers overcharge their investors and fail to disclose that overproduction of whiskey is now a factor. *See* BUSINESS WEEK, Feb. 17, 1973, at 81; NEWSWEEK, May 21, 1973, at 82; TIME, May 21, 1973, at 92.

177. *See* note 175 *supra*.

178. *See* SEC Securities Act Release No. 5018 (Nov. 4, 1969); SEC Securities Exchange Act Release No. 8733 (Nov. 4, 1969).

179. *See, e.g.*, [1973] PA. ATT'Y GEN. OP. No. 49.

180. In fact, the court found it "unnecessary to comment on any question of policy in order to dispose of this appeal." 457 F.2d at 277 n.5.

181. Ch. 369, 42 Stat. 998 (1922), codified at 7 U.S.C. §§ 1-17a (1970), *as amended*, Act of Oct. 23, 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified at 7 U.S.C.A. §§ 1-22 (Supp. I, 1975)). *See* S. Rep. No. 947, 90th Cong., 2d Sess. (1968).

182. 7 U.S.C. § 6(a) (1970), *as amended*, Act of Oct. 23, 1974, Pub. L. No. 93-463, §§ 403-04, 88 Stat. 1389 (codified at 7 U.S.C.A. § 6(a) (Supp. I, 1975)) (regulation of excessive speculation); *id.* § 6(d), *as amended*, Act of Oct. 23, 1974, Pub. L. No. 93-463, § 103(a) (codified at 7 U.S.C.A. § 6(a) (Supp. I, 1975)) (regulation of handling of customer accounts); *id.* § 6(f), *as amended*, Act of Oct. 23, 1974, Pub. L. No. 93-463, § 103(a) (codified at 7 U.S.C.A. § 6(f) (Supp. I, 1975)) (regulation of brokers' financial responsibility).

tion,[183] but the major regulation was done by the Commodity Exchange Authority.[184] Although there were cases under the antifraud section, most concerned "churning" or market manipulation.[185] One case rejected a securities claim premised on rule 10b-5 on the ground that a futures contract is not a security, while another allowed a section 16(b) claim.[186]

There were, however, serious problems with this mode of regulation. First, the Act covered only a limited number of commodities.[187] Secondly, although the commodities market was theoretically subject to the same type of regulation as the securities market, there were practical difficulties of manpower and resources. As one writer has said:

> The Authority, however, as it itself has noted, cannot continue the fine job it has done to date, much less assume broader powers, under present appropriations and staff-size limitation. It cannot be expected to fully oversee a 60 billion dollar industry with an annual appropriation of 1.5 million dollars. The SEC has a budget ten times as large as the Authority's to regulate an industry one-eighth the size.[188]

In response to the need for a stronger and more expansive regulatory scheme, Congress recently enacted the Commodity Futures Trading Commission Act of 1974,[189] which transferred the authority vested in the Secretary of Agriculture, the Commodity Exchange Commission, and the Commodity Exchange Authority under the Commodity Ex-

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183. Goodman v. H. Hentz & Co., 265 F. Supp. 440 (N.D. Ill. 1967).

184. This body could revoke the license of a broker, 7 U.S.C. § 8(a) (1970), *as amended*, Act of Oct. 23, 1974, Pub. L. No. 93-463, §§ 103(a)-(c), 88 Stat. 1389 (codified at 7 U.S.C.A. § 8(a) (Supp. I, 1975)), and issue cease and desist orders, *id.* § 13(a). The authority could initiate complaints and hold hearings. *See* 17 C.F.R. § 0.53 (1974). *See generally* Vogelson, *Tightened Regulation for Commodity Exchanges*, 55 A.B.A.J. 858 (1969).

185. See Cargill v. Hardin, 452 F.2d 1154 (8th Cir. 1971), *noted in* 57 MINN. L. REV. 1243 (1973) (market manipulation); Booth v. Peavey County Community Servs., 430 F.2d 132 (8th Cir. 1970) (churning); Johnson v. Arthur Espy, Shearson, Hammill & Co., 341 F. Supp. 764 (S.D.N.Y. 1972) (churning); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968) (churning).

186. McNurnin v. Kohlmeyer & Co., 340 F. Supp. 338 (E.D. La. 1972) (claim allowed); Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 253 F. Supp. 359 (S.D.N.Y. 1966) (futures contracts not securities).

187. *See* 7 U.S.C. § 2 (1970), *as amended*, Act of Oct. 23, 1974, Pub. L. No. 93-463, §§ 101(a)(1), 201-02, 88 Stat. 1389 (codified at 7 U.S.C.A. § 2 (Supp. I, 1975)).

188. Wolff, *Comparative Federal Regulation of the Commodities Exchanges and the National Securities Exchanges*, 38 GEO. WASH. L. REV. 223, 263-64 (1969).

189. Act of Oct. 23, 1974, Pub. L. No. 93-463, §§ 101, 103-409, 411-18, 88 Stat. 1389, *amending* 7 U.S.C. §§ 1-17a (1970) (codified at 7 U.S.C.A. §§ 2, 4, 4a, 6-6g, 6i-9a, 11-13, 15-16, 18-22 (Supp. I, 1975)).

change Act to the newly formed Commodity Futures Trading Commission. The Act operates essentially in four ways: (1) it substantially expands the subject matter regulated, (2) it broadens fraud protection and gives the Commission power to control excessive speculation, (3) it provides for the registration and regulation of floor brokers, futures commission merchants, commodity trading advisors, and commodity pool operators, and (4) it empowers the commission to regulate boards of trade and to designate them as contract markets.[190]

There is no question that a discretionary commodity account has the potential for abuse that is present whenever one person gives money to another to manage and make a profit. The danger of nondisclosure and fraud is just as great for the individual when his money is segregated as when it is pooled. It is unfortunate that unthinking reliance on the *Howey* terminology can blind a court to the essential policy ramifications of the transaction involved.

4. *The Housing Boom: Expectation of "Profit"*

One of the defenses offered in *Howey* was that the investors were merely purchasing valuable property in the hope of "profiting" from an increase in land values. The Supreme Court clearly saw through the argument; the profit was to come through the management expertise of Howey-in-the-Hills, not through a general appreciation in land value. Subsequent courts also have had little difficulty with the defense so long as the land's value is dependent upon the efforts of the promoter and the only return expected is monetary.[191]

A more difficult case is presented by the condominium.[192] The purchaser of a condominium does buy something of present value, and he may expect no monetary return at all—he may just be buying a

190. *Id.*

191. *See* Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973); SEC v. Lake Hauser Estates, 340 F. Supp. 1318 (D. Minn. 1972), *noted in* 5 LOYOLA L. REV. 417 (1972); State v. American Campground, Inc., 3 CCH BLUE SKY L. REP. ¶ 71,064 (Ore. Sup. Ct. 1972); Dellico, Rudolph & Grant, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,882 (SEC 1972). *See generally* Note, *Regulation of Real Estate Syndications: An Overview*, 49 WASH. L. REV. 137 (1973).

192. It has been estimated that three out of every five new housing starts in Detroit involves condominiums. NEWSWEEK, Aug. 20, 1973, at 58. It has also been stated that over 75% of new construction in Florida involves condominiums. BUSINESS WEEK, Nov. 4, 1972, at 82. *See generally* Note, *Securities: Another Way to Regulate the Resort Development Boom*, 27 OKLA. L. REV. 104 (1974).

residence. Under these circumstances, it is difficult to see why the securities laws should be involved. If, however, the purchaser is buying an investment—something that he expects will return a profit—there is every reason to want the protection of the securities acts.

Thus, the crucial task in the area is to distinguish between the investment and the residence. At first, the SEC pursued a case-by-case method. One of the first elements that was held to signal the existence of a security was "rent-pooling."[193] Under this arrangement, the owner rents his unit during the year, but does not receive the return from that unit alone. Instead, the rent from all units is pooled and the individual owners receive a percentage. It is not too difficult to see that the investment promise of rental profits outweighs the residential aspect of the arrangement.[194] The second element to be isolated was a sale coupled with a long-term management contract.[195] The arrangement looks more like the traditional *Howey* situation and less like the purchase of a home. The agreements also frequently contain restrictions on times of owner occupancy. The third element that was isolated was the effect of advertising. Condominiums may become securities if they are offered and sold through promotional efforts that emphasize the economic benefits for the purchaser to be derived from the managerial efforts of the promoter.[196] This kind of analysis, first discussed by Justice Jackson in the *Joiner* case,[197] has been employed frequently by the SEC in other areas.[198] It implicitly recognizes that a promoter may be *offering* a security even if the investor *accepts* something less.[199]

These factors were finally consolidated in an SEC release stating the

193. *See* SEC Securities Act Release No. 4877 (Aug. 8, 1967).

194. *See* San Diego-Maui Group, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,444 (SEC 1972) (comments on rent-pooling in refusal to grant no-action letter).

195. *See, e.g.*, Edward S. Jaffry, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,395 (SEC 1972).

196. *See* SEC v. Royal Hawaiian Management Corp., [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,982, at 96,338 (M.D. Cal. 1967).

197. *See* text accompanying note 9 *supra*.

198. In Longines Symphonette Soc'y, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,151 (SEC 1972), the SEC stated that it would refuse a no-action letter on an offering of commemorative medallions until investment language was removed from the sales literature.

199. *See generally* Hannan & Thomas 239-40. For a general discussion of these factors, see Note, *supra* note 192.

guidelines for distinguishing between a security and a residence.[200] The significance of the SEC response to condominiums is the approach that was used. Instead of attempting to distinguish between the "profits" expected by the purchaser of a security and of a residence within the *Howey* framework, the Commission adopted a more functional analysis, identifying those factors that make the transaction look more like one that presents abuses that could be corrected by the securities acts. With this approach, the SEC,[201] blue sky commissioners,[202] and commentators[203] have had little difficulty in identifying a security in this area.

The *Howey* element of "expectation of profit" has, however, caused some difficulty in one facet of the housing area, the cooperative housing association. In a typical arrangement, the developer buys the land, builds units, and organizes an association composed of unit-owners. The association elects officers and then purchases the development from the promoter. Thus, there are securities aspects to the transaction (ownership of "shares" in an association) and residential aspects

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200. SEC Securities Act Release No. 5347 (Jan. 4, 1973). *See also* SEC Securities Act Release No. 5382 (Apr. 9, 1973) (containing reminder that sales literature on condominiums constitute illegal offers if offering is not registered).

201. The SEC is still presented with the necessity of case-by-case adjudication. Nevertheless, it does have the option of issuing general guidelines releases. *See* Kaiser Aetna, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,471 (SEC 1973); Tahoe Donner Ski Bowl, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,440 (SEC 1973); Innisfree Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,398 (SEC 1973).

Moreover, many developers seem to be unaware of the SEC action. As of August 1, 1973, 59 resort condominium registrations had been filed. It has been estimated that between 500 and 700 more qualify as securities, but remain unregistered. Of course, the developer may just be wary of the time and expense involved. Of the 59 registrations on file, the price of registration has ranged from $4000 to $25,000 and the time of review from 32 days to one year. *See* Ellsworth, *Condominiums Are Securities?*, 2 REAL ESTATE L.J. 694, 698 (1974).

202. *See, e.g.*, 2 CCH BLUE SKY L. REP. ¶ 38,759 (1973) (Ohio Securities Commissioner); 2 CCH BLUE SKY L. REP. ¶ 41,341 (1973) (Pennsylvania Blue Sky Commissioner). A few states have handled the condominium/securities problem through registration. *See, e.g.*, N.Y. GEN. BUS. LAW. § 352-e (McKinney 1968, Supp. 1973). *See also* HAWAII REV. STAT. § 485-6(14) (Supp. 1973) (sale of condominium exempt transaction).

203. The literature on condominiums is quite extensive. Recent articles include Clurman, *Condominiums as Securities: A Current Look*, 19 N.Y.L.F. 457 (1974); Dickey & Thorpe, *Federal Securities Regulation of Condominium Offers*, 19 N.Y.L.F. 473 (1974); Grimes & King, *A Look at Condominium Offerings Under the Federal Securities Laws—For the Idaho Lawyer*, 9 IDAHO L. REV. 149 (1973).

(the cooperatives are intended to be full-year residences with no rental arrangements).

The District Court for the Southern District of New York, in *Forman v. Community Services, Inc.*,[204] was recently faced with a difficult decision in this area. The cooperative involved was a non-profit corporation financed with state aid. In holding that participation in the corporation did not constitute a security, the court had to address two theories for finding jurisdiction, sale of "stock" and "investment contract." The court disposed of the first argument by pointing out that the plaintiffs had no right to an apportionment of tangible profits, a normal incident of "stock" ownership.[205] The second claim was caught in the inflexible throes of the *Howey* analysis, and the "expectation of profits" language. It was argued that the tax and social benefits that inured to the purchasers constituted "profit" within the meaning of *Howey*. The court rejected the tax-benefit theory on the basis that tax advantages were merely an incident of real estate ownership, and not a result of securities ownership.[206] Secondly, the court reasoned, indirect social benefits of cooperative housing, such as quality housing for minimal expense, do not constitute "profit"; the securities acts were intended to protect those who invest with the expectation of *monetary* profit.[207]

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204. 366 F. Supp. 1117 (S.D.N.Y. 1973), *rev'd*, 500 F.2d 1246 (2d Cir. 1974), *rev'd sub nom.* United Housing Foundation, Inc. v. Forman, 95 S.Ct. 2051 (1975).

205. *Id.* at 1126-27.

206. *Id.* at 1129 n.35. The tax benefit claimed in *Forman* was in the form of deductions from each shareholder's individual federal income tax under INT. REV. CODE OF 1954, § 216, for amounts paid to the housing cooperative to the extent they represented the shareholder's "proportionate share (based on the total shares outstanding) of the real estate taxes and mortgage interest allowable as a deduction to the cooperative." Eckstein v. United States, 452 F.2d 1036, 1038 (Ct. Cl. 1971). Section 216 was designed to place tenant-stockholders of housing cooperatives on the same tax footing as homeowners, *see* INT. REV. CODE OF 1954, §§ 163, 164; S. REP. No. 1631, 77th Cong., 2d Sess. (1942), rather than apartment renters, *see* INT. REV. CODE OF 1954, § 262.

Many commentators have urged that tax benefits be considered "profit." *See, e.g.*, Coffey 399; Long 161-62; Zammit, *Securities Law Aspects of Cooperative Housing*, N.Y.L.J., Jan. 8, 1973, at 1; Note, *Cooperative Housing Corporations and the Federal Securities Laws*, 71 COLUM. L. REV. 118 (1971); Note, *Cooperative Apartment Housing*, 61 HARV. L. REV. 1407 (1948).

207. 366 F. Supp. at 1130-31. The court quoted extensively from the legislative history of the Act. *See* H.R. REP. No. 1418, 88th Cong., 2d Sess. 11 (1964); H.R. REP. No. 1382, 73d Cong., 2d Sess. 3-5 (1934); H.R. REP. No. 85, 73d Cong., 1st Sess. 2, 11 (1933); *Hearings on H.R. 6789, H.R. 6793 & S. 1642 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 88th Cong., 1st & 2d Sess., pt. 2, at 855-65 (1963-1964).

On appeal, the Second Circuit reversed the *Forman* trial court and held that shares in the cooperative were "investment contracts."[208] The court reasoned that there were three possible benefits which could accrue to purchasers. First, the success of the association[209] could mean lower maintenance fees for the tenants. Secondly, the tax benefits were viewed by the Second Circuit as an incident of securities ownership, as the court analogized to investment tax shelters for the rich. Thirdly, the court accepted the argument that the opportunity to buy quality housing for a lower charge constituted a profit to the shareholders.[210]

Recently, the Supreme Court approved the trial court's view that participation in the corporation involves neither the sale of "stock" nor an "investment contract" and therefore, was not subject to the securities laws.[211] Purporting to examine the substance of the transaction in light of economic reality, the Court maintained, notwithstanding the name attached to the interest, that the shares did not possess the "characteristics traditionally associated with stock . . . ."[212] Since the shares were not accompanied by (1) the right to receive dividends out of profits, (2) the potential for appreciation in value, (3) proportional voting rights, and (4) the right of unrestricted alienability, the improbability that purchasers desiring residential accommodations believed they were acquiring securities simply by virtue of a nametag precluded finding securities.[213] In effect, the plaintiffs were unable to convince the Court that the purchase decisions were motivated by expectations of profits.

Similarly, the expectation of profits requirement, and particularly the nature of those profits, proved to be the hurdle that prevented the finding of an "investment contract":

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208. 500 F.2d 1246 (2d Cir. 1974).

209. In this case, the association leased its common ground to retail establishments, and the income from that rent determined the amount of carrying charges to the shareholders/tenants.

210. The same issue was recently presented to the same two courts in 1050 Tenants Corp. v. Jakobson, 365 F. Supp. 1171 (S.D.N.Y. 1973), *aff'd*, 503 F.2d 1375 (2d Cir. 1974), in which the district court distinguished its own decision in *Forman* on the grounds that the *Jakobson* cooperative was not a non-profit organization and that the members had the right to resell their shares for a profit.

211. United Housing Foundation, Inc. v. Forman, 95 S.Ct. 2051 (1975).

212. *Id.* at 2060.

213. *Id.*

> By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds . . . .[214]

The Court then proceeded to analyze the benefits accruing to participants in the development. First, the trial court's tax benefit analysis was reiterated. Second, whatever benefits the plaintiffs received by occupying low-priced, high-value living units were neither dependent upon the managerial efforts of others nor capable of liquidation into cash. Finally, whatever income might result from commercial rentals in the development was "far too speculative and insubstantial to bring the entire transaction within the Securities Acts."[215] The Court felt the crucial distinction to be between "an investment where one parts with his money in the hope of receiving profits from the efforts of others, and where he purchases a commodity for personal consumption or living quarters for personal use."[216]

While the SEC has taken a somewhat equivocal position on this matter,[217] a policy analysis without rigid reliance on *Howey* would indicate that shares in a housing cooperative constitute a security, notwithstanding the Court's decision in *Forman*. First, the scheme presents the same types of abuses that affect other securities offers.[218] Secondly, there is little reason to confine the securities acts to situations in which an actual monetary return is expected. Certainly, as the Coffey analysis suggests, there is an expectation of a "valuable benefit" from the enterprise. A more serious question is whether the securities laws are the appropriate vehicles of regulation. There are a number of state statutes that purport

214. *Id.*

215. *Id.* at 2062.

216. *Id.* at 2063. The dissent essentially agreed with the circuit court, and disputed the majority's interpretation of (1) the nature of profits, (2) the de minimus aspect of commercial rental profits, (3) the nature of the tax benefit, and (4) the importance of the efforts of others to the success of the development. *Id.* at 2064-67.

217. SEC rule 235(a), 17 C.F.R. § 230.235(a) (1974), may indicate SEC willingness to consider cooperative shares to be securities. The rule exempts from registration, under certain conditions, "stock or other securities representing membership in any cooperative housing corporation." *See* United Housing Foundation, Inc. v. Forman, 95 S.Ct. 2051, 2063-64 n. 24 (1975).

218. The major abuses presented in the cooperative area are promoter self-dealing, misrepresentation, misuse of deposit money before the association election, and threats of evictions to get votes. *See* Note, *Florida Condominiums—Developer Abuses and Securities Law Implications Create a Need for a State Regulatory Agency*, 25 U. FLA. L. REV. 350 (1973).

219. *See* FLA. STAT. ANN. §§ 711.13, 711.24 (1971); N.J. REV. STAT. § 3-27 *et seq.* (1970); N.Y. GEN. BUS. LAW. § 352-e (McKinney 1968, Supp. 1973).

to regulate the condominium field,[219] but their inadequacies have been fully documented.[220] Housing presents intricate problems in real estate financing and insurance, and may be beyond the competence of securities examiners. The solution may be a limited exemption from securities registration, with a continued availability of the securities antifraud remedies.[221]

5. *Notes: Freedom from* Howey

Although the *Howey* definition of "investment contract" has dominated recent developments in the determination of the meaning of "security," one area of activity has centered on the language, "any note . . . or evidence of indebtedness," in the statutory definitions. After a false start, the courts have had little difficulty in developing a formula based on functional realities and policy implications. The false start was the result of dictum in a Fifth Circuit opinion, *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville.*[222] The court held that a share in a loan participation agreement was a security, but added that almost *all* notes were securities as well.[223]

This language apparently formed the basis of holdings in two later cases. In *Movielab, Inc. v. Berkey Photo, Inc.*[224] the court held that promissory notes given in payment for corporate assets were "securities" under the 1934 Act. The court was concerned that if all "notes" were securities, the "instruments used in every private loan transaction" might invoke federal jurisdiction under the securities acts, but felt compelled to follow the plain meaning of the statutory language, "any note."[225] There is some justification for this holding, since the case

220. *See* Note, *Cooperative Housing Corporations, supra* note 206; Note, *supra* note 218, at 358-59.

221. The Second Circuit in *Forman* specifically rejected a defense that the association was regulated by another agency in New York. 500 F.2d at 1256.

222. 409 F.2d 989 (5th Cir. 1969).

223. The court did have some precedent for its statement. *See, e.g.*, Prentice v. Hsu, 280 F. Supp. 385, 386 (S.D.N.Y. 1968) (promissory note for personal loan held security); *cf.* Olympic Capital Corp. v. Newman, 276 F. Supp. 646, 653 (M.D. Cal. 1967) (personal note given for loan; neither party questioned whether security involved). *But see* SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 38 (S.D.N.Y. 1968) (notes of personal loans not securities, without discussion); Beury v. Beury, 127 F. Supp. 786 (S.D.W. Va. 1954) (personal note not security, without discussion).

224. 321 F. Supp. 806 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971).

225. *Id.* at 808. The court continued,

> [O]ur 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 (e.g., the purchase of an automobile or refrigerator), provided the mails

involved fraud in connection with a sale of corporate assets, a situation which suggests the application of the securities laws. In *MacAndrews & Forbes Co. v. American Barmag Corp.*[226] the court held that a bill of exchange for the purchase of a texturizing machine constituted a security. A combination of the *Tcherepnin* "broad reading"[227] language and the canon of strict construction led to the result.

At the same time, two other district courts were taking a contrary position. In *Joseph v. Norman's Health Club, Inc.*[228] plaintiffs executed promissory notes to defendant in exchange for lifetime memberships in a health club. When the club failed, plaintiffs, sued under rule 10b-5. The court, citing the "unless the context otherwise requires" language that precedes the definitional section of the 1934 Act, held that the securities acts were not intended to cover ordinary consumer transactions.[229] The same analysis was applied in *McClure v. First National Bank of Lubbock, Texas.*[230] The court held that a promissory note secured by a deed of trust was not a "security" since the 1934 Act was intended to cover only transactions "in which there is common trading for speculation or investment,"[231] while these loans were "ordinary commercial loans."[232]

A corporate mismanagement case, *Rekant v. Desser*,[233] provided a key to analyzing the note problem. A stockholder filed a derivative suit against the corporation's president on the ground that the president had compelled the corporation to issue a note in exchange for overvalued farm land that the president owned, in violation of rule 10b-5. The court, in holding that the note was a "security," stated:

> 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.

226. 339 F. Supp. 1401 (D.S.C. 1972).

227. *See* text accompanying note 20 *supra.*

228. 336 F. Supp. 307 (E.D. Mo. 1971).

229. The court relied heavily on City Nat'l Bank v. Vanderboom, 290 F. Supp. 592 (W.D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970), in which the court held that a bank loan was not a security, but merely a commercial transaction.

230. 352 F. Supp. 454 (N.D. Tex. 1973), *aff'd*, 497 F.2d 490 (5th Cir. 1974), *noted in* 5 TEXAS TECH. L. REV. 200 (1973).

231. 352 F. Supp. at 457, *quoting* SEC v. C.M. Joiner Leasing Co., 320 U.S. 344, 350-51 (1943).

232. 352 F. Supp. at 457.

233. 425 F.2d 872 (5th Cir. 1970).

> That [the corporation] may have chosen to pay for the land by the issuance of its note as opposed to the issuance of some other form of security should have no bearing on the coverage of the Rule since the Rule prohibits fraud in connection with the sale of *any* security.[234]

Thus, the court in effect suggested that the finding of a security should be linked to the function that the note plays in the transaction. The *Rekant* analysis was refined in *Zeller v. Bogue Electric Manufacturing Corp.*,[235] another 10b-5 derivative suit. The court held that a series of open-account, no interest loans from a subsidiary to its parent corporation were "securities" when replaced by an interest-bearing promissory note. The court cautioned, however:

> It does not follow . . . that every transaction within the introductory clause of Section 10, which involves promissory notes, whether of less or more than nine months maturity, is within Rule 10b-5. The Act is for the protection of investors, and its provisions must be read accordingly. . . . But we see no reason to doubt that [the subsidiary] stood in the position of an investor, although perhaps an involuntary one, with respect to [the parent].[236]

Thus, the key under this analysis is to distinguish between ordinary commercial loans and investment loans. If notes are issued to obtain financing, they call for the special protection of the securities acts. If there is one note issued in the context of a consumer loan, the securities acts are inappropriate.[237] Two recent cases apply this test effectively. In *Davis v. Avco Corp.*[238] investors' participation in one of Turner's pyramid schemes was financed through notes. The court held that this was not an ordinary commercial loan, but rather was part of a financing operation which "call[ed] into play the antifraud protection and remedies of the securities laws."[239] In *Bellah v. First National*

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234. *Id.* at 878 (emphasis original).

235. 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

236. *Id.* at 800.

237. The *Zeller* court emphasized this distinction by reasoning that merely because a note had a maturity of less than nine months—and thus was apparently excluded from the definition of "security" in § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1970)—"did not take the case out of Rule 10b-5, unless the note fits the general notion of 'commercial paper' reflected in [*SEC Securities Act Release* No. 4412 (Sept. 20, 1961)]." *Id.* *See* Anderson v. Francis I duPont & Co., 291 F. Supp. 705 (D. Minn. 1968); H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933); A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 § 4.6(317) (1969), *cited in* Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 800 (2d Cir. 1973).

238. 371 F. Supp. 782 (N.D. Ohio 1974).

239. *Id.* at 787.

Bank[240] the Fifth Circuit retreated from its *Lehigh Valley* dicta and held that an ordinary bank note to secure a debt was only a commercial loan and did not require the protection of the securities acts. *Davis* and *Bellah* demonstrate an awareness of policy considerations that is generally absent in the *Howey* determination. The ordinary consumer loan situation is covered by the federal Consumer Credit Protection Act,[241] while the Uniform Commercial Code is intended to give states jurisdiction over commercial transactions. There is little reason to introduce the SEC into the field unless the notes are part of a finance capital situation with possibilities of fraud in the issuance.[242]

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240. 495 F.2d 1109 (5th Cir. 1974).

241. 15 U.S.C. § 1601 *et seq.* (Supp. IV, 1974). There is some indication that Congress felt that commercial transactions and securities were two different things. Thus, Congress delineated transactions outside the purview of the Act. This list included "credit transactions . . . for business or commercial purposes" *and* "transactions in securities." *Id.* § 1603.

242. Most commentators agree with this test. *See, e.g.*, Lipton & Katz, *"Notes" Are (Are Not?) Always Securities—A Review*, 29 BUS. LAW. 861 (1974); Comment, *Commercial Notes and Definition of "Security" Under the Securities Exchange Act of 1934: A Note is a Note is a Note*, 52 NEB. L. REV. 478 (1973); 5 TEXAS TECH. L. REV. 200 (1973).

One reason the courts have taken a careful look at the note as a security question is that it has arisen in the context of two other difficult securities questions. First, the decision often involves a consideration of the rule 10b-5 purchaser-seller problem. For instance, it is difficult to see how a fraudulent defendant "purchases" a "security" when a plaintiff buys something on time. *See* Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); Ross v. Longchamps, Inc., 336 F. Supp. 434 (E.D. Mo. 1971). Secondly, there is a problem with the short-term note exemption of § 3(a)(10) of the 1934 Act. *See* note 237 *supra.* There is some controversy over whether this exemption was meant to apply to ordinary commercial situations. *See* United States v. Rachal, 473 F.2d 1338 (5th Cir.), *cert. denied*, 412 U.S. 927 (1973); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972), *noted in* 26 VAND. L. REV. 874 (1973); United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969). *See generally* Note, *The Commercial Paper Market and the Securities Act*, 39 U. CHI. L. REV. 362 (1972).