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Introduction Student Symposium - Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations - Introduction.

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INTRODUCTION*

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It is interesting that in the more than 60 years of securities regulation in this country,[1] we still have no clearly accepted definition of a security. In this regard we are somewhat in the same position as some of the members of the United States Supreme Court when dealing with obscenity: We can generally tell a security when we see one, on a case by case basis, but have been unwilling to attempt to give a generic definition to the term. Instead, both the courts and the legislatures have approached the problem of definition by attempting to enumerate those things which they felt were securities rather than trying to isolate those factors which could be considered common to all securities and then re-drafting the definition by specification of these characteristics.

The lack of an adequate definition was apparent from the very beginning. The first securities act did not even contain a defintion of a security, but merely assumed that the word had a common meaning.[2] Subsequent state acts added rudimentary enumerative definitions.[3] The beginnings of

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1. It is generally acknowledged that the first securities act was the Kansas Act of 1911. Kans. Laws 1911, ch. 133 (codified at KAN. STAT. ANN. §§ 17-1201 to 17-1275 (1964)). By 1913, 23 additional states had adopted securities acts by and large based upon the Kansas model. J. MOFSKY, BLUE SKY RESTRICTION ON NEW BUSINESS PROMOTIONS 14 n.35 (1971). In a way it is misleading to refer to these early acts as securities acts because they were more accurately statutes regulating the issuance of securities by investment companies. Probably the first true securities act, in the sense that it attempted to regulate the securities rather than the company issuing them, was the Illinois Securities Act of 1919. Ill. Laws 1919, at 353, *as amended* ILL. ANN. STAT. ch. 121 1/2, §§ 137.1-137.19 (Smith-Hurd 1960). This Illinois Act quickly became the model for "second generation" securities acts and was used by the Uniform Commissioners on State Laws as a model for their Uniform Sale of Securities Act. 1929 HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS OF UNIFORM STATE LAWS AND PROCEEDINGS 131, 173. This statute was withdrawn in 1943 and should not be confused with the more modern Uniform Securities Act which is presently in force in one form or another in 31 states. *See* 1943 HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS OF UNIFORM STATE LAWS AND PROCEEDINGS 81, 305; 1956 HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS OF UNIFORM STATE LAWS AND PROCEEDINGS 182; Uniform Securities Act, 1 CCH BLUE SKY L. REP. ¶ 4901 (1973).

2. Kans. Laws 1911, ch. 133, § 1 provided that investment companies could not sell "any stock, bonds or other securities of any kind or character" without first registering them.

3. The 1913 California statute provided: "The term, 'security,' when used in this act, includes the stock, stock certificate, bonds, and other evidences of indebtedness, other than promissory notes not offered to the public by the maker thereof, of an in-

our modern enumerative definition are found in the Illinois Securities Act of 1919 which provided:

> The word "securities" shall include stocks, bonds, debentures, notes, participation certificates, certificates of shares or interests, preorganizational certificates and subscription, certificates evidencing shares in trust estates or associations and profit sharing certificates.[4]

This 1919 definition foreshadowed the approach that other legislatures were to follow. First, the definition would contain a series of items having rather fixed, generally recognized meanings such as stock, bonds, and debentures. These specific terms were then followed by a series of general terms having no fixed legal meaning, such as profit-sharing certificates[5] and evidences of indebtedness,[6] which were included in an attempt to cover the unusual or irregular securities.

Through the 1920's, as new, irregular investment forms appeared, the legislatures would simply add additional general terms in hopes of plugging the gap.[7] The Securities Act of 1933,[8] however, tended to act as a catalyst

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vestment company." Cal. Stat. 1913, ch. 353, § 2(b), *as amended*, CAL. CORP. CODE § 25019 (Deering Supp. 1974). The 1913 Wisconsin statute similarly provided: "'Security' or 'securities' mean any bond, stock, notes, or other obligations or evidence of indebtedness which constitutes evidence of, or is secured by, title to, interest in or loan upon any or all of the property of such investment company." Wis. Laws 1913, ch. 756, § 1(c), *as amended*, WIS. STAT. ANN. § 551.02 (1971).

4. Ill. Laws 1919, § 2, at 353, *as amended* ILL. ANN. STAT. ch. 121 1/2, § 137.2 (Smith-Hurd 1960).

5. This term still does not have a fixed meaning. Early attempts were made to distinguish it from the other general forms of securities. *See, e.g.*, SEC v. Mining Truth Publishing Co., 1 S.E.C. 469 (E.D. Wash. 1937). However, more recently the tendency has been to treat the term rather interchangeably with the term "investment contract." Professor Loss suggests that the main difference between the two may lie in that a profit-sharing certificate may require a writing in the form of the certificate while an investment contract may not. 1 L. LOSS SECURITIES REGULATION 488 (2d ed. 1961). Very recently courts appear to be attempting to re-establish a distinction between the two categories in an effort to avoid the definition of investment contract established by the Supreme Court in SEC v. W.J. Howey Co., 328 U.S. 293 (1946). *See, e.g.*, SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972) (alternative holding), *aff'd on other grounds*, 474 F.2d 476 (9th Cir.), *cert. denied*, —U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); State *ex rel.* Fisher v. World Mkt. Centers, Inc., 3 CCH BLUE SKY L. REP. ¶ 71,034 (Okla. Dist. Ct., Okla. County, June 2, 1972), *aff'd*, 44 Okla. Bar J. 2218 (Okla. Ct. App. 1973).

6. This term did not have any definition at all in securities law until United States v. Austin, 462 F.2d 724, 736 (10th Cir.), *cert. denied*, 409 U.S. 1048 (1972) where it was held to mean:

> The term "evidence of indebtedness" is not limited to a promissory note or other simple acknowledgment of a debt owing and is held to include all contractual obligations to pay in the future for consideration presently received.

This definition has recently been considered and applied to commodity option contracts in King Commodity Co. v. State, 3 CCH BLUE SKY L. REP. ¶ 71,121 (Tex. Civ. App.—Dallas March 11, 1974). *See also* Hamilton Jewelers v. Department of Corps., 112 Cal. Rptr. 387 (Dist. Ct. App. 1974).

7. Thus the Minnesota Act of 1919 added the now famous category of investment contracts. Minn. Gen. Laws 1919, ch. 105. The 1923 Missouri statute was closely

in this process of definition by enumeration.[9] Congress examined the existing state definitions and combined most of the general phrases into the single enumerative definition now found in Section 2(1) of that Act.[10] It should be noted that several phrases often found in the pre-existing state definitions are conspicuously absent from the definition. These are the phrases "beneficial interests in or title to property or profits" and "interests in foreign real estate."[11] This federal definition has served as the model for most of the modern state enumerative definitions. Professor Loss drew heavily upon that definition when he drafted the Uniform Securities Act[12] which has been substantially adopted by more than 30 jurisdictions.[13]

Lack of an adequate definition has not been a serious problem through much of the history of securities regulation because, by and large, offerings have tended to be of established "regular" forms of securities, such as stock, bonds, and debentures, where there is little question that the instruments come within the regulatory purview of the securities acts. However, there have been certain times when for one reason or another the traditional capital markets have tended to break down.[14] When this occurs, a flock of ir-

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patterned on the Illinois statute but added a number of additional terms such as "certificate of interest in an oil, gas, or mining lease" and "beneficial interest in or title to property or profits." Mo. Laws 1923, § 2(c), at 201, *as amended*, MO. REV. STAT. § 409.020 (1952).

8. 15 U.S.C. § 77a to 77aa (1970).

9. This is not to say that legislatures have not continued to use this device. They have to a limited extent. For example, several states, including Oklahoma, reacted to the abuse created by the widespread sale of unregulated commodity option contracts in 1972 and 1973 by amending the definition of a security to specifically cover these options. *See* OKLA. STAT. ANN. § 2(20)(o) (Supp. 1973). Such an amendment would appear to have been unnecessary. King Commodity Co. v. State, 3 CCH BLUE SKY L. REP. ¶ 71,121 (Tex. Civ. App.—Dallas March 11, 1974). *But see* International Commodity Trust, Inc. v. Fisher, 3 CCH BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Okla. County, May 14, 1973).

10. 15 U.S.C. § 77b(1) (1970).

11. As originally enacted the Securities Act of 1933 did contain as a part of the definition a "certificate of interest in property, tangible or intangible." Act of May 27, 1933, ch. 38, § 2(1), 48 Stat. 74. However, this category was removed in the 1934 amendments "as possibly involving too broad and uncertain application." H.R. REP. No. 1838, 73d Cong., 2d Sess. 9 (1934). The effect of this deletion is discussed in Glen-Arden Commodities, Inc. v. Costantino, [Current Binder] CCH FED. SEC. L. REP. ¶ 94,436 (2d Cir. March 14, 1974).

12. Official Comment to Section 401(1), UNIFORM SECURITIES ACT 7 UNIFORM LAWS ANN. 749 (Master ed. 1970); Uniform Securities Act, 1 CCH BLUE SKY L. REP. ¶ 4931, at 727-30 (1973). See also the drafter's comments, L. LOSS & E. COWETT, BLUE SKY LAW 350 (1958).

13. 1 CCH BLUE SKY L. REP. ¶ 4901, at 701-2 (1973) shows that the Uniform Act has been adopted entirely or in substantial part by 29 states and the District of Columbia and Puerto Rico. Since that date, West Virginia became the 33d jurisdiction to adopt the Uniform Act. SEC. REG. & L. REP. (No. 246), at A-18 (April 3, 1974).

14. My own unscientific observation is that this tends to happen during periods at either end of the economic cycle. In periods of rampant prosperity, investors appear to have more money than the normal capital market can utilize, leaving an opening

regular financing gimmicks, some legitimate, others extremely fraudulent—appears on the scene. This phenomenon occured in the mid- and late 1920's[15] and to a lesser extent in the 1930's.[16] It recurred in the 1960's with the emergence of the founder-membership and Glen Turner-type schemes.[17]

Since 1970 the regulatory agencies and the courts have been inundated with irregular investment devices which they have had to consider and measure against the statutory definitions to determine whether the devices are securities. These opportunities range from the more legitimate condominium and resort membership[18] and lease-back agreements[19] to the often fraudulent sales of commodity options[20] or coins and bullion.[21]

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for unusual marginal operation which the investor does not examine with as great care because he has no great fear of loss. At the other extreme, in a period of depression, there is often a distrust especially among the smaller investors of the established capital markets so that these investors seek to place their money safely outside the established capital framework in the unusual or irregular investment scheme.

15. *See, e.g.*, 1925 IND. ATT'Y GEN. ANN. REP. 154 and 1926 IND. ATT'Y GEN. ANN. REP. 254 outlining a scheme strikingly similar to the founder-membership scheme in State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105 (Hawaii 1971). *See also* 20 WIS. ATT'Y GEN. OP. 176 (1931) and Brownie Oil Co. v. Railroad Comm'n, 240 N.W. 827 (Wis. 1932) for a scheme to finance the building of gas stations through the sale of gas coupon books and attached "good-will" bonds.

16. One of the hot schemes of the late 1930's was the sale of whiskey warehouse receipts. *See* State v. Unger, 296 N.W. 629 (Wis. 1941); 1934 ORE. ATT'Y GEN. OP. 165. This scheme has re-emerged recently with the offer for sale of scotch whisky warehouse receipts. Glen-Arden Commodities, Inc. v. Costantino, [Current Binder] CCH FED. SEC. L. REP. ¶ 94,436, at 95,503 (2d Cir. March 14, 1974); SEC v. Haffenden-Rimar Int'l, Inc., 362 F. Supp. 323 (E.D. Va. 1973); PA. ATT'Y GEN. OP. No. 49, 3 CCH BLUE SKY L. REP. ¶ 71.094 at 67,396 (1973).

17. *See, e.g.*, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105 (Hawaii 1971). Another scheme popular in the 1920's which re-emerged was the sale of fur-bearing animals to be raised and marketed by the seller. *See* Miller v. Central Chinchilla Group, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 94,465, at 95,636 (8th Cir. March 28, 1974); Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967).

18. SEC v. Marasol Properties, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,159 (D.D.C. September 28, 1973); State v. American Campground, Inc., 3 CCH BLUE SKY L. REP. ¶ 71,046 (Ore. Cir. Ct. December 15, 1972); Great W. Campers Ass'n, [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,386 (SEC NAL August 13, 1971); SEC Securities Act Release No. 5347 (January 4, 1973), 1 CCH FED. SEC. L. REP. ¶ 79,163 (1973); Vacations Unlimited (Ore. Corp. Comm'n December 18, 1973); HAWAII ATT'Y GEN. OP. No. 66-12 (March 29, 1966); Grimes & King, *A Look at Condominium Offerings Under Federal Securities Law*, 9 IDAHO L. REV. 149 (1973); Metzinger, *The Condominium as a Security*, 2 COLO. LAW. 19 (May 1973).

19. Hurberman v. Denny's Restaurants, Inc., 337 F. Supp. 1249 (N.D. Cal. 1972); Rice v. Bogart, 272 Ill. App. 292 (Ct. App. 1933); Financial Analytics Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,498 (SEC NAL August 15, 1973); SEC No Action Letter, National Marketing Corp. (January 3, 1974).

20. *In re* Traders Int'l, Ltd., [Current Binder] CCH FED. SEC. L. REP. ¶ 94,529 (D. Nev. 1974); King Commodity Co. v. State, 3 CCH BLUE SKY L. REP. ¶ 71,121 (Tex. Civ. App.—Dallas March 11, 1974); People v. Puts & Calls, Inc., 3 CCH BLUE

Tied to the existing statutory enumerative definitions, both the agencies and the courts have found themselves ill-equipped to handle the task and the results at best are rather spotty.[22] For the most part, the courts have attempted to develop formulas or definitions for the individual general phrases found within the enumerative definition. In doing so all too often there has been little attempt to consider whether the attributes assigned to the individual categories are consistent with the attributes assigned to the other general categories or whether these characteristics are consistent with the general purpose behind the securities act itself.[23]

In 1967, Professor Coffey, realizing the problems of attempting to develop a cohesive definition of a security by enumeration and definition of general terms on a random case by case basis, suggested that there might be certain characteristics common to those things which are generally accepted as coming within the purview of the securities acts.[24] If these char-

SKY L. REP. ¶ 71,090 (Cal. Super. Ct. June 21, 1973); Shapiro v. First Federated Commodity Trust Co., 3 CCH BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct. May 30, 1973); Clayton Brokerage Co. v. Mouer, 3 CCH BLUE SKY L. REP. ¶ 71,125 (Tex. Dist. Ct. April 18, 1974); *In re* Secured Commodities, (Ark. Sec. Comm'n January 22, 1974); Long, *The Naked Commodity Option Contract as a Security*, 15 WM. & MARY L. REV. 211 (1974).

21. State v. International Silver Mint Corp., 3 CCH BLUE SKY L. REP. ¶ 71,066 (Idaho Dist. Ct. July 20, 1972); Interest Coin Exch., Inc., Cease and Desist Order (Ind. Sec. Comm'n October 29, 1973); *In re* American Coin Exchange Determination, Prohibition and Revocation Order (Wis. Sec. Comm'n May 17, 1974). It is my understanding from talking with the Texas Securities Commissioner, Ray Mouer, that the Texas Securities Commission and the Texas Attorney General have filed suits against Secure Monetary Systems, Inc., Southwest Coin Exchange, and Pacific Coast Coin Exchange.

22. For example, the Securities and Exchange Commission, normally considered the leader in the area of regulation, was extremely late in entering the battle against the Glenn Turner-type promotion. It did so only after the state decisions indicated that this type of scheme could be controlled under the existing securities statutes. Even after the Commission had won its test case at the trial level, one of the Commissioners announced to a national meeting of state securities administrators that the federal definition would have to be amended because the Commission's jurisdiction over this type of scheme was highly questionable! Likewise the Commission was slow in coming to grips with the commodity option problem and there is still no satisfactory authority at the federal level on this question. Certainly not all the blame belongs to the regulatory agencies. The courts have made their share of mistakes. *Compare* the extremely narrow decision in Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Civ. App.—Austin 1970, writ ref'd n.r.e.), *with* the very expansive opinion in King Commodity Co. v. State, 3 CCH BLUE SKY L. REP. ¶ 71,121 (Tex. Civ. App.—Dallas March 11, 1974).

23. For an in depth discussion of this problem in connection with the general category of "investment contract," see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

24. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967). Coffey's formula has received judicial recognition as the definition of an investment contract in State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 109 (Hawaii 1971). This started a scramble by many courts to abandon the mechanical interpretations of the general categories in favor of finding what the individual court views as the economic realities of securities.

acteristics could be isolated and identified, then it would become a rather simple matter to determine whether a particular item was a security. All that would be necessary is to measure the factual pattern developed in each case against the general definition by specification to determine whether the common characteristics were present in the device being considered. In 1971, after working with the bewildering and often conflicting morass of case law in connection with an early founder-membership case, I became convinced that Professor Coffey was correct that the only way to provide guidance in the area was to attempt to develop a definition of a security by specification rather than by enumeration.[25]

It is the purpose of this symposium to carry forward the idea that a definition of a "security" by specification is possible. In the remaining portion of this article, I will outline those items that I have come to believe are characteristics common to all generally recognized forms of securities. The student articles to follow will then examine selected specific portions of the present enumerative definition of a "security" which are of current interest. The students will examine in greater detail the existing case law in these areas and will then attempt to test the thesis that a common uniform definition by specification is possible. Only by such an empirical study can the theory be measured against reality and its truth or falsity established.

Before beginning this process, however, the reader should be cautioned about several things. First, since this is a symposium written by a number of different people having differing views of securities regulation and what it should encompass, it is natural that not all the authors will completely agree on all matters. For example, I am of the opinion that the newer decisions bringing devices such as the Glenn Turner-type of scheme and commodity option contracts within the purview of securities regulation is not an expansion of the concept of this regulation, but rather merely a recognition of principles which have been inherent in securities regulation from its inception. In short, there is no real expansion of the extent of securities regulation, merely a recognition of its original scope and its extension to include previously uncontrolled items which fall within that original scope. From this conclusion it follows then that the regulatory agencies are not usurping a new area but merely occupying an area of given regulation which they were not completely occupying before. Reading the student papers, however, it becomes evident that a number of them consider the new developments to be an intrusion into an area not previously within the regulatory authority of the agencies. Certainly there are legal scholars of the first magnitude who would tend to agree with this opinion.[26] The reader is left

25. *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971). *See also* Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974).

26. Professor Loss, for example, initially took the position that the founder-mem-

to form his own opinion on this point.

Second, since there are more than 60 years of case law in this area developed on a case by case basis, it is impossible to reconcile all the cases holding various devices to be securities with the characteristics which will be outlined. This does not mean that we are attempting to start fresh and ignore the existing body of case law. While such an approach is theoretically possible, it s not practical. If our project has any hope of practical success in getting the courts to recognize our approach, it is necessary to show them how our test found recognition in prior decisional law. Obviously then, the reader can find cases which will contain ideas and holdings directly contrary to those outlined here. Again, the reader must decide for himself which he wishes to accept.

Finally, since at present the definition of a "security" is controlled by Congress and the state legislatures and is purely a definition by enumeration, we will see that our common characteristics cannot be applied to some of these definitions.[27] I think that there are two obvious conclusions which the reader can draw from this: Either the legislatures have extended coverage to certain items which conceptually are not securities or the common characteristics which I will outline are not "common characteristics" and therefore our test fails.[28]

Turning our attention now to formulating a definition for "securities" by specification rather than enumeration, the first problem we must consider is the appropriate scope of the securities acts. Although this appears to be the most basic of questions, it is given little actual consideration. Intuitive consideration of this point indicates some difference of opinion as to the appropriate scope of the acts. I think we need to consider this problem from two different aspects. The first consideration is whether the securities acts are intended to cover all investment opportunities or only a certain segment.

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bership schemes were not within the scope of securities regulation. Letter from Louis Loss to James L. Shores, Jr., concerning Alabama Market Centers, Inc., November 27, 1968, on file with the Arkansas Securities Division.

27. It is amazing how few of these there are in view of the legislature's ability to make anything a security merely by inclusion within the statutory definition without regard to the other items also covered. Most of these specific enumerations center around the concepts of "beneficial ownership in real or personal property" and "interests in land located outside the state." There is also some problem with the inclusion of all promissory notes and possibly voting trust certificates. This inclusion suggests that there is in fact a generally understood, if inarticulated, concept of what is a security. The same problem of articulation is true in the torts area. We have a system of tort law which works relatively well as a practical matter, but which is extremely difficult to explain from a conceptual standpoint.

28. We are not suggesting that the courts ignore the statutes as they are written, but rather that they should recognize that the legislature may have mixed apples and oranges in the definition. The courts should deal with items in the definition which are not conceptually securities separately from those items which are conceptually securities.

If we conclude that the securities acts are intended to cover some but not all investments the obvious corollary question is how we identify the ones to be covered and separate them from those investment opportunities which are not to be included. The second aspect of the problem is whether the securities acts are limited to covering only investment opportunities.

Let us now consider each of these points in turn. There is some rather strong historical evidence that the securities acts were intended to have extremely broad coverage and to protect the public against unsound investments of all kinds.[29] The 1919 Minnesota Act added to the growing list of general terms describing a security with the now famous phrase "investment contract."[30] The following year in *State v. Gopher Tire & Rubber Co.*,[31] the Minnesota court was called on to determine exactly what an investment contract was. Having no precedent to rely on, the court turned to the dictionary for a definition of the component words. It defined investment in this manner:

> The placing of capital or laying out of money in a way intended to secure income or profit from its employment in an "investment" as that word is commonly used and understood.[32]

The certificates sold by the defendant for which the investor paid $50 and agreed to "assist by word of mouth and in other ways in the sale of tires and tubes which the defendant will manufacture" in exchange for 10 percent of the price of the goods sold by the defendant's representative in the area for 20 years[33] was held to be a security.

> If defendant issued and sold its certificates to purchasers who paid their money justly expecting to receive an income or profit from the investment, it would seem that the statute should apply.[34]

Read literally, the court would seem to be saying that any contract involving an investment as defined would be an "investment contract." Such an interpretation would mean that almost any investment opportunity would be brought within the securities acts, since all involve a contract of pur-

29. This is somewhat of a misstatement. It is necessary to distinguish the aims of the federal securities acts from those of many of the state blue sky acts. The federal acts are directed toward full disclosure of information and the prevention of fraud. The theory behind them is that a person should be free to make a good or bad investment decision as long as he has the necessary information to make an intelligent decision. On the other hand, many of the state acts are what are referred to in the trade as "fair, just and equitable" statutes. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 581-1 to 581-39 (1964). Under this type of statute the regulatory agency is given authority to prevent the sale of any security which it does not think is "fair, just or equitable" to the investor. Thus, these statutes are built upon the concept of protecting the public from fraudulent or unsound investments.

30. Minn. Gen. Laws 1919, ch. 105.

31. 177 N.W. 937 (Minn. 1920).

32. *Id.* at 938.

33. *Id.* at 937.

34. *Id.* at 938.

chase. Thus the purchase of real estate for speculation would involve an investment contract[35] as would the purchase of commodities or commodity futures contracts purchased for the same purpose.[36]

Apparently this broad view was accepted by a number of state legislatures because the definition of "securities" found in some of the state acts include items not normally thought of as securities. For example, Oklahoma and Wisconsin have included commodity futures contracts generally within the definition,[37] while Florida, Louisiana, and New Hampshire have extended coverage to investments in warehouse receipts of all types.[38] Some five additional states have provisions covering varying interests in real property located outside the state.[39] Other states have or have had other very broad general provisions.[40]

This broad concept of "securities," however, appears to have been rejected in the federal acts as they appeared in final form.[41] The federal acts and the great wealth of decisional law under them almost immediately took a dominant role in the development of securities regulation in this country. As a result, during the three decades since the enactment of the federal statutes, there has been gradual acceptance by most state courts, regulatory agencies, and legal scholars that the state securities acts should also be of a limited scope relatively co-equal to the scope of the federal acts.[42] There-

35. For a recent case taking this position, see Florida Realty, Inc. v. Kirkpatrick, 3 CCH BLUE SKY L. REP. ¶ 71,109, at 67,455 (Mo. March 11, 1974).

36. The Wisconsin Commissioner of Securities took this position. Monthly Bul., Feb. 1968, CCH BLUE SKY L. REP. ¶ 52,707, *cited in* 4 L. LOSS, SECURITIES REGULATION 2504 (Supp. 1969). This position was later confirmed by the Wisconsin legislature when it included commodity futures contracts in the definition of "securities" in the Wisconsin Securities Act of 1968. WIS. STAT. ANN. § 551.02(13)(a) (1971). *But cf.* Glen-Arden Commodities, Inc. v. Costantino, [Current Binder] CCH FED. SEC. L. REP. ¶ 94,436 (2d Cir. March 14, 1974).

37. 71 OKLA. STAT. ANN. § 2(20)(o) (Supp. 1973); WIS. STAT. ANN. § 551.02(13)(a) (1971).

38. FLA. STAT. ANN. § 517.02 (1972); LA. REV. STAT. § 51:701(1) (1950); N.H. REV. STAT. ANN. § 421.2 (1955). *See also* N.C. GEN. STAT. § 78-2(g) (1965) (covering whiskey warehouse receipts).

39. KAN. STAT. ANN. § 17-1252(j) (1964); 15 ME. REV. STAT. ANN. § 32:751 (1965); MO. ANN. STAT. § 409.401(*l*) (Supp. 1974); OHIO REV. CODE ANN. § 1707.01 (B) (Baldwin 1970); TENN. CODE ANN. § 48-1602(J) (1964).

40. The present Ohio statute starts out its definition of a security: "'Security' means any certificate or instrument which represents title to or interest in, or is secured by any lien or charge upon, the capital, assets, profits, property, or credit of any person or any public governmental body." OHIO REV. CODE ANN. § 1707.01(B) (Baldwin 1970). A number of states have or have had definitions containing "beneficial interests in, or title to, property." *See, e.g.*, MISS. CODE ANN. § 75-71-5(c) (1973).

41. *See* note 11 *supra*.

42. Within the last year, however, there have been some decided indications that the states are willing once again to accept a broad role for their securities acts. In State v. Investors Sec. Corp., 209 N.W.2d 405, 410 (Minn. 1973) the court specifically reaffirmed its decision in State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920) as to the broad "paternalistic" scope of the Minnesota act and refused to adopt

fore, for the remainder of this discussion, it will be assumed that the decision has been irreversibly made that the securities acts are not general investment protection statutes, but are intended to protect only investors who purchase certain types of investment opportunities. The test that we propose to develop, then, will be aimed at identifying those investments to be covered from investment opportunities which are to be left to regulation by other statutes or the common law.

The second problem that we must consider before turning to the mechanics of our test is whether an item identified as a security will always be treated as a security so that its disposition will be covered by the securities acts. This problem has become acute in the area of recovery for fraud. One of the primary purposes of all securities acts is the prevention and redress of fraud in connection with transactions in securities. Originally, the state and federal acts were directed at providing a means of recovery for fraud in connection with the sale of securities.[43] However, the Securities and Exchange Commission adopted its famous Rule 10b-5[44] which prohibits the commission of fraud in the *purchase or sale* of securities. It is now well established that this Rule provides an implied civil remedy where such fraud is practiced either in the sale or purchase of securities.[45] There is some indication that state acts will likewise be expanded by interpretation to cover fraud in the purchase of securities.[46]

This development, coupled with the extremely broad definition of "sale" of a security as any disposition for value,[47] has raised the question of

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the federal *Howey* test as the exclusive test for investment contracts. Even more recently the Missouri court in Florida Realty, Inc. v. Kirkpatrick, 3 CCH BLUE SKY L. REP. ¶ 71,109 (Mo. March 11, 1974) rendered an opinion under the portion of the Missouri statute classifying deferred payment or installment contracts on foreign real estate to be a security. The opinion could have treated this provision as an aberration within the statutory definition. Instead, the court went out of its way to suggest that the coverage of this type of item as a security is consistent with the legislative purpose of the securities act.

43. L. Loss & E. COWETT, BLUE SKY LAWS 251-252 (1958).

44. 17 C.F.R. § 240.10b-5 (1973).

45. *See generally* A. BROMBERG, SECURITIES LAW, FRAUD, SEC RULE 10b-5 (1973).

46. Such expansion by implied remedy is not available under the Uniform Securities Act. Mid-Continent Cas. Co. v. McAlester Aircraft, Inc., 349 F.2d 885 (10th Cir. 1965). While section 101 of the Uniform Act closely follows the wording of Rule 10b-5 and does cover fraud in either the purchase or sale of securities, section 410, the civil remedies provision, contains subsection (h) which specifically negates any remedies, express or implied, arising from the Act not provided for in section 410 or section 202(e) dealing with suit on a broker-dealers bond. Recovery under section 410(a) is limited to recovery for fraud in the sale of securities. At least two states, Washington and Nebraska, have omitted subsection (h) when adopting the Uniform Act. NEB. REV. STAT. § 8-118 (Supp. 1973); WASH. REV. CODE ANN. § 21.20.430 (Supp. 1974). As a result the Washington courts have held that a civil remedy may be implied from the Washington version of section 101. Clausing v. DeHart, 515 P.2d 982 (Wash. 1973); Shermer v. Baker, 472 P.2d 589 (Wash. Ct. App. 1970).

47. *See, e.g.*, Uniform Securities Act § 401(j)(1) (1957) which provides: "'Sale' or 'sell' includes every contract of sale of, contract to sell, or disposition of, a security

whether these anti-fraud provisions should be available where the fraud is committed in connection with the sale or purchase of an instrument normally acknowledged to be a security in a non-investment context.

The problem is acutely presented in the case of promissory notes.[48] The present enumerative definitions make clear that a promissory note is a security.[49] Is then the promissory note given by the consumer in the purchase of an automobile, refrigerator, or house, to be considered a security? If so, the person giving the note should be entitled to avail himself of the securities acts to avoid the transaction when he discovers that the item was fraudulently represented to him. Clearly the issuance of the promissory note by the consumer is a "sale" of that note within the definition of sale in the securities acts in that it is a disposition of the note for value. It is now equally clear as a result of the decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[50] that the fraud does not have to relate to the issuance of the security, but merely must have some nexus with the transaction resulting in its issuance. It seems, therefore, that the inescapable answer is that the consumer would be entitled to bring his action under the securities acts, if the promissory note is a security.[51]

This problem of the status of promissory notes has bothered the federal courts on several recent occasions.[52] In *MacAndrews & Forbes v. Ameri-*

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or interest in a security for value." 1 CCH BLUE SKY L. REP. ¶ 4931, at 727 (1973).

48. To a lesser extent the problem is also apparent in the cases of other evidences of indebtedness. *See* Sperry & Hutchinson v. Hudson, 226 P.2d 501 (Ore. 1951) (involving the question of whether green "trading" stamps were a security); Hamilton Jewelers v. Department of Corps., 112 Cal. Rptr. 387 (Dist. Ct. App. 1974) (raising the question of whether a guarantee to repurchase diamonds was a security).

49. Both the Securities Act of 1933 and the Uniform Securities Act specifically list any note as a security. 15 U.S.C. § 77b(1) (1970); Uniform Securities Act § 401(1), 1 CCH BLUE SKY L. REP. ¶ 4931, at 727 (1973).

50. 404 U.S. 6 (1971).

51. The obvious question might be why would he want to do so. There are several answers. First, fraud under the securities acts is much easier to prove than common law fraud, since no intent to defraud needs to be shown. Similarly, securities fraud covers omissions and half-truths often not covered or difficult to prove under common law fraud. The securities acts also give extended liability to persons involved in some way with the fraudulent transactions, but who may not have been a party to the actual fradulent statement. Finally, the person defrauded is entitled under most state statutes to recover his entire consideration, plus interest *from the date of his purchase*, plus court costs and reasonable attorney's fees. *See, e.g.*, Uniform Securities Act § 410, 1 CCH BLUE SKY L. REP. ¶ 4940, at 737-38 (1973). It was once thought that these items of recovery were mandatory. However the Court of Appeals for the Tenth Circuit, construing the Colorado law, has recently held these items to be discretionary with the court. Andrews v. Blue, 389 F.2d 367, 377 (10th Cir. 1973). For a general discussion of the advantages of suing under the securities acts, see Long, *Don't Forget the Securities Acts!* 26 OKLA. L. REV. 160 (1973).

52. *See* Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); McClure v. First Nat'l Bank, 352 F. Supp. 454 (N.D. Tex. 1973); MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972); Janssen v. Tri-Pac Dev. Corp., Civil No. 72-1200 (E.D. Pa., Dec. 1, 1972); Joseph v. Norman's Health Club, Inc.,

can Barmag Corp.[53] the plaintiff corporation owned a textile plant where it processed raw synthetic thread into yarn. The process required the spinning machine to operate within very narrow heat tolerances. Barmag represented that their machine would so operate. Relying on this representation, MacAndrews purchase the machine, paying for it with a series of bills of exchange having varying maturity dates. MacAndrews later discovered that the machine would not perform within these tolerances and sued to have its bills of exchange cancelled, claiming that they were promissory notes and that such cancellation could be had under Rule 10b-5. The defendant moved to strike the allegations on the basis that the bills of exchange here were not securities. The court disagreed holding that they were securities and that Rule 10b-5 was applicable to this type of transaction.[54]

In a similar case, the court in *Janssen v. Tri-Pac Development Corp.*,[55] refused to apply Rule 10b-5. In that case, the plaintiff had purchased a house from the defendant builder. It was later learned that the builder had misrepresented the house in certain respects. The plaintiff sued to cancel his promissory note under Rule 10b-5. The court disagreed and held that the promissory note was not a security.[56]

I would suspect that a vast majority of the readers would agree with the *Janssen* decision over the position taken in *MacAndrews*, yet I doubt that many could give a logical reason for their position. They intuitively believe, as did the court in *Janssen*, that the securities acts should not apply to promissory notes of this type. Yet, a flat, unsupported statement, or an intuitive feeling is poor stuff with which to attempt to override the clear language of the statutory definition.

Fortunately other courts have been more articulate in providing reasons why they felt that this type of promissory note did not come within the acts. Recently the Court of Appeals for the Third Circuit in *Lino v. City Investing Co.*,[57] held that the transaction in which a promissory note was issued to secure the purchase of a franchise agreement was not within the ambit of the securities acts. It pointed out that the definitional sections are pre-

336 F. Supp. 307 (E.D. Mo. 1971). For a discussion of these cases and the problem generally, see Lipton & Katz, *"Notes" Are (Are Not?) Always Securities—A Review*, 29 BUS. LAW. 861 (1974); Comment, *Commercial Notes and the Definition of "Security" Under Securities Exchange Act of 1934: A Note is a Note is a Note?* 52 NEB. L. REV. 478 (1973).

53. 339 F. Supp. 1401 (D.S.C. 1972). For a discussion of this case see Long, *Don't Forget the Securities Acts!* 26 OKLA. L. REV. 160 (1973).

54. MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1401 (D.S.C. 1972).

55. Civil No. 72-1200 (E.D. Pa., Dec. 1, 1972).

56. *Citing* Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307 (E.D. Mo. 1971); Contract Buyers League v. F. & F. Investment, 300 F. Supp. 210 (N.D. Ill. 1969); City Nat'l Bank v. Vanderboom, 290 F. Supp. 592 (W.D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir. 1970).

57. 487 F.2d 689 (3d Cir. 1973).

ceded by the statement that the definitions are to apply unless the context requires otherwise. It then concluded that there had been no "sale" within the definition of "sale" under the act because the commercial context surrounding the issuance of this note required a finding of no sale.

> The commercial context of this case requires a holding that the transaction did not involve a "purchase" of securities. These were personal promissory notes issued by a private party. There was no public offering of the notes, and the issuer was the person claiming to be defrauded. The notes were not procured for speculation or investment. . . .[58]

The courts in *McClure v. First National Bank*[59] and *Joseph v. Norman's Health Club, Inc.*[60] recognized this approach, but also suggested an alternative approach. Instead of applying the "unless otherwise required" language to the definition of "sale," it could be applied directly to the definition of "security." The end result of this process would be to say that the promissory notes issued in certain commercial or consumer transactions are not securities and therefore the securities act has no application.

I submit that this approach is far superior to that taken in the *Lino* case. It should be clear that the initial issuance of stock by the corporation is a sale of that stock within the meaning of the securities act.[61] Under state corporate law the corporation must receive consideration equalling at least the par value of the stock. Further, the Securities Act of 1933 attempts to control only this initial distribution process.[62] As a result, many of the registrations filed with the SEC involve the initial issuance of new shares by the issuing corporation. How then can it be said that the initial issuance of a promissory note is any less a sale of that note than the issuance of the corporate stock is a sale of that stock?

Further, the *Lino* approach is inconsistent with the purpose behind Rule 10b-5. Its anti-fraud provisions are not limited to protecting the investor in the initial distribution of securities. It is equally available to the defrauded purchaser or seller in subsequent secondary or trading transactions involving securities. Thus it is clear that Rule 10b-5 would apply equally to the situation where Mr. Jones fraudulently persuades the XYZ Corporation to issue him some new previously unissued stock as it would if Mr. Jones persuades Mr. Smith to sell him his XYZ stock practicing the same

58. *Id.* at 694-95. These were the grounds for the holding in City Nat'l Bank v. Vanderboom, 290 F. Supp. 592 (W.D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir. 1970) and was an alternative holding in McClure v. First Nat'l Bank, 352 F. Supp. 454 (N.D. Tex. 1973) and Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307 (E.D. Mo. 1971).

59. 352 F. Supp. 454 (N.D. Tex. 1973).

60. 336 F. Supp. 307 (E.D. Mo. 1971).

61. *See* Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974).

62. Most of the state acts on the other hand attempt to regulate both the initial distribution process and the entire secondary or trading market.

fraud. Yet the negotiation of the stock from Smith to Jones differs little from the negotiation of the promissory note in *Lino* or *Janssen*. In all three cases, the seller is induced to give up certain personal property on the basis of fraud. The difference is the classification of the personal property. In our example, the transaction clearly involves a security, while in *Lino* and *Janssen*, the transaction does not.

The difference in the classification of stock and promissory notes lies in the concept of investment. The stock of XYZ corporation represents the tangible evidence of an *investment in the economic capital of the corporation* at some earlier time by Smith or someone from whom he acquired the stock. All subsequent transactions in the stock after this initial investment and the issuance of the stock are essentially commercial transactions, similar to those in *Lino* or *Janssen* in that one person is simply transferring personal property to another. Yet because there was an initial investment in the stock, it became a security and this classification continues regardless of the nature of the transactions in which the stock subsequently becomes involved. Those transactions which involve the disposition of the security for value are "sales" of the securities and Rule 10b-5 is applicable to all sales of securities. Thus, rule 10b-5 would apply equally to the transaction where the stock was bartered to a dealer in exchange for a new car as where the shareholder sold the stock to a purchaser intending to hold the stock for an investment.[63]

If the new car dealer in the last example immediately sells the securities to convert them into cash, the entire transaction becomes nothing more than a means to finance the purchase of an item and is virtually identical to the transaction in the *Lino* and *Janssen* cases. The promissory notes in *Lino* and *Janssen*, however, did not come within the purview of Rule 10b-5 because their issuance resulted from a commercial financing transaction rather than an investment transaction.[64] Thus the promissory notes did not gain the status of a security, and the anti-fraud provisions of the securities acts do not apply.[65]

63. It should be obvious from what has been said that as used here "investment" means the original investment which causes the securities to be issued. and that there can never be more than one investment involved regardless of how many times the security may subsequently change hands. This use of "investment" considers the transaction from the side of the person receiving the consideration rather than the person furnishing the consideration. Examined in this way, the original investment constitutes the placing of money at risk in the hands of the receiver. Subsequent sales merely result in the seller receiving a return of his risked capital in exchange for a transfer of the rights that resulted from the original investment to the purchaser. The purchaser's motive, be it for investment, consumption, or commercial use, is irrelevant.

64. *See* Lipton & Katz, *"Notes" Are (Are Not?) Always Securities—A Review*, 29 BUS. LAW. 861, 866 (1974).

65. This does not mean to say that the promissory notes could not be later combined with other features in such a way that an investment would take place and a security would be created. This is essentially what happened in SEC v. Lake Havasu

I submit that this concept of investment is not restricted to promissory notes, but applies generally to help separate items which fall within one or more of the specific or general categories of the enumerative definitions which are properly classified as securities from similar items within those categories which should not be so classified. Professor Coffey recognized the need for such a distinction when he indicated that the concept of investment is the most important single element in distinguishing a security from other commercial transactions.[66] This point was also recognized by the Oregon court when it held that green "trading" stamps were not securities in *Sperry & Hutchinson v. Hudson.*[67] The court there said:

> The terms "evidence of indebtedness," "certificate of interest or participation in any profit-sharing agreement," and "investment contract" as used in the act refer *only to such of those types as are commonly known as "securities*;" they contemplate the presence of the investment process, that is, "the investment of funds . . . with a view to receiving a profit through the efforts of others than the investor."[68]

At present, it appears that the courts are limited in their attempts to apply this concept to distinguish between those enumerated items which they feel are not true securities to using the escape found in the language "unless the context otherwise requires."[69] It seems clear that our new definition by specification should incorporate a factor which eliminates those instruments arising out of a commercial transaction, while retaining similar instruments arising from or involving an investment transaction.

Estates, 340 F. Supp. 1318 (D. Minn. 1972) and State v. Investors Sec. Corp., 209 N.W.2d 405 (Minn. 1973). In these cases, a development company was selling subdivision plots and taking promissory notes and mortgages to secure payments. These notes, like the notes in *Janssen*, arose out of essentially a commercial purchase and therefore would not meet our test as securities. However, the development company, needing money to finance further development, began selling these notes and mortgages to investors in conjunction with a guarantee and service contract. Both the federal and the state court held that the second sale was the sale of a security. I submit that the discussions are correct. The investor was investing funds in the company in exchange for the company's guarantee of the underlying promissory note. The second transaction then was more than a commercial sale; it involved the investment element and a security was born.

66. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 375 (1967). Coffey's exact words were: "[R]isk to initial investment . . . is the single most important characteristic which distinguishes a security from the universe of other transactions."

67. 226 P.2d 501 (Ore. 1951).

68. *Id.* at 505 (emphasis added).

69. I am afraid that the creation of this escape is the result of a tortured construction of the introductory language. The words "unless the context otherwise requires" suggests that within the later provisions of the statute itself a different meaning than that found in the definitional section may be assigned a word depending upon its surrounding context. This would seem to be a very different thing indeed from altering the basic definition founded upon a particular factual pattern where the question presented is whether the factual pattern fits within the definition. I think that this problem illustrates the particular failing of the definition of securities by enumeration rather than by specification.

Turning now to the formulation of our definition by specification, I think the starting point for the definition should be the test enunciated by the United States Supreme Court in *SEC v. W.J. Howey Co.*[70] for an investment contract. The Court stated its test this way:

> In other words, an 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. . . .[71]

Justice Murphy in formulating this test for the majority disclaimed that he was creating a new test. Instead he indicated that the concept of investment contract was found in the state acts before the enactment of the Securities Act of 1933 and that there was a substantial body of case law establishing the test he enunciated. He felt that Congress was aware of this interpretation of investment contract at the time it included the concept in the federal act and intended to carry forward this definition.[72]

Despite the fact that some of Justice Murphy's precise terms do not appear to have any historical precedent,[73] the basic test itself does find precedent in the earlier cases, not as a definition of an investment contract but as the definition of a security in general.

The test first appeared in the 1923 case of *Lewis v. Creasy Corp.*,[74] involving the Kentucky Securities Act of 1920.[75] In *Creasy*, the Banking Commissioner sought to have the court declare that the statute was broad enough to include any contract which could be used to defraud. The court refused to do this, holding that the statute embraced only "what is ordinarily understood by the term 'security contract' or 'securities.' " The court then went on to define "securities" in this way:

70. 328 U.S. 293 (1946).

71. *Id.* at 298-99. The test was restated in the conclusion of the opinion in this manner: "The test is whether the scheme involves an investment of money in a common enterprise with the profits to come solely from the efforts of others." *Id.* at 301.

72. *Id.* at 298.

73. Two of the concepts, that of "solely" through the efforts of others and that of "common enterprise," do not appear to have any historical antecedent in the cases cited by Justice Murphy. For a detailed discussion of these cases and the *Howey* test itself, see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

74. 248 S.W. 1046 (Ky. 1923).

75. Ky. Laws 1920, ch. 125, § 2, at 581. This Act was basically an investment company act and was patterned closely after the original Kansas Act of 1911. Like the earlier Kansas act, the Kentucky statute did not attempt to define a security, but merely prohibited the sale of "any contract, stock, bonds, or other securities" without their registration. *Id.* § 2, at 581. It is significant that the statute did not contain the phrase "investment contract," this absence leading the court in *Creasy* to specifically reject the *Gopher* definition and other cases involving similar language. Lewis v. Creasy, 248 S.W. 1046, 1049 (Ky. 1923); *see* Standard Home Co. v. Davis, 217 F. 904 (E.D. Ark. 1914); State v. Gopher Tire & Rubber Co., 177 N.W. 937 (Minn. 1920).

> [I]t necessarily means the investment of funds in a designated portion of the assets or capital of a concern, with the view that the latter by using, and operating with, the investment will earn a profit for the investor. In other words, it carries with it the idea that the investor will earn his profit through the efforts of others than his own. It thus includes bonds, stock certificates, shareholder certificates, and other similar investments, but its definition does not include interest income from the lending of money, or the profits which one might make by his own efforts as the result of any ordinary commercial contract which he might enter into.[76]

The court later summarized:

> We, therefore conclude . . . that the primary purpose of Blue Sky Laws is to protect investors from investment in securities whereby a profit is promised and expected without any active efforts on the part of the investor, and which scheme contemplates that the company or individual who receives the investment will employ it himself or itself in such a manner as to reap a profit to the holder of the sold security; and that it was not intended to apply to contracts containing mutual obligations, such as are daily entered into in commercial life, and from which a profit can only be reaped by the uses which the investor alone makes of them.[77]

Finally, the court, based upon this definition, concluded that the contract before it was not a security.[78] This early unsophisticated attempt at for-

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76. Lewis v. Creasy, 248 S.W. 1046, 1048 (Ky. 1923).

77. *Id.* at 1049.

78. *Id.* at 1049; *accord*, Creasy Corp. v. Enz Bros. Co., 187 N.W. 666 (Wis. 1922). I generally agree with the court's definition, if certain clarifications are made, but I tend to question the soundness of the court's conclusion based upon the facts of the particular case. Apparently I am not alone on this later point because the Kentucky Court of Appeals has recently held that *Creasy* will no longer be followed. *See* Scholarship Counselors, Inc. v. Waddle, 507 S.W.2d 138 (Ky. 1974).

The definition is basically sound, but needs clarification in three areas. First, the statement concerning the lending of money is misleading unless read with the statement about ordinary commercial transactions. The court admits that bonds, which involve the lending of money, are securities. Therefore what the court would seem to be saying is that we must exclude those loans which are part of a commercial transaction and do not involve the element of investment. Second, the court refuses to acknowledge that the profits which the investor expects to receive can be other than monetary. We will see later that these profits do not have to be monetary, but merely have to be some benefit which the investor wishes to secure. In Silver Hills Country Club v. Sobieski, 13 Cal. Rptr. 186 (1961), the benefit was the right to use the country club to be built with the investors' funds. *See also In re* Jet Set Travel Club, Notice of Proposed Cease & Desist Order (Ore. Corp. Comm'n April 9, 1974) where the benefit was alleged to be the right to use the club's airplane secured with investor's funds for inexpensive group vacation trips. Finally the court fails to realize that a single contract may have both a commercial aspect and an investment aspect to it. In such a case a security is involved. The founder-membership and Glenn Turner-type of operations are good examples of this. *See, e.g.*, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105 (Hawaii 1971); Scholarship Counselors, Inc. v. Waddle, 507 S.W.2d 138 (Ky. 1974).

These last two points are significant in my objection to the conclusion of the court mulating a definition by specification, along with the Supreme Court's more developed test in *Howey*, reflects principles inherent in securities regulation that are only now being recognized by the courts and regulatory agencies.

The language of the *Creasey* case was picked up by the editors of *Corpus Juris* and incorporated into its definition of a security which read:

> The term "securities," as used in these laws [Blue Sky Laws], means written assurances for the return or payment of money . . . except where special definitions are given by statutes. . . . It means the investment of funds in a designated portion of the assets and capital of a concern, with a view of receiving a profit through the efforts of others than the investor; and in this sense includes what are termed "security" or "investment" contracts or "speculative securities."[79]

It is interesting to note that the *Creasey-Corpus Juris* test did not receive wide acceptance by the state courts prior to the *Howey* case. *Creasey* and *Corpus Juris* were cited in only 10 cases from 1923 until 1946.[80] Therefore it is really difficult to say that this definition was established as the definition of "investment contracts" at the time Congress passed the Securities Act of 1933 as Justice Murphy claimed.

Nevertheless the *Howey* definition gives us a starting point from which to fashion our definition by specification. There are four separate components of the *Howey* definition: (1) the investment of money; (2) in a common enterprise; (3) with the expectation of a profit; (4) to come solely through the efforts of others. We will incorporate these elements in slightly changed form into our suggested definition by specification, however, we must first examine each in some detail to insure that these elements and the possible ramifications of their use are understood.

There are two significant points about the "investment of money" element. Note that it is not referred to as the payment of money but as the "investment" of money. Thus, from the very beginning we have an indication that the concept of security deals not with normal commercial transac-

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on the particular facts of the *Creasy* case. The Creasy corporation was engaged in the wholesale grocery business and was offering a contract to various retail merchants for $300 which granted the purchaser the right to buy wholesale goods from the corporation at a cost plus 5 percent for a period of 20 years. This was basically a commercial transaction as far as the purchase or sale of groceries are concerned. The retailer's profit here will be made from the sale of goods to the public. However, if Creasy was using this $300 as capital in order to be able to supply the groceries, we have an investment in its business and the expectation of a benefit, *i.e.* the right to receive groceries at a discount. These factors would make the contract a security. This same type of hybrid contract is often found in the franchise area where the sale of a franchise is combined with the raising of the capital necessary for the franchisor to fulfill his obligations. *See* CAL. ATT'Y GEN. OPS. No. 66-284, [1961-1971 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70-747 (June 2, 1967); Comment, *Securities: Protecting the Franchisee Through the Securities Laws*, 26 OKLA. L. REV. 604 (1973).

79. 37 C.J. *Licenses* § 168, at 275 (1925).

80. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 152-153 (1971).

tions, but only with those transactions which involve the investment process. This alone is not sufficient to exclude many of the promissory notes discussed earlier, but it is a start in that direction. The second significant term here is the use of the word "money." Why should we limit our definition of security only to those cases involving the payment of money as opposed to other forms of consideration such as property and services? The answer may well be that Justice Murphy in *Howey* was faced with a situation which involved only money investments and therefore he did not think of the ramifications of his choice of words.

I think the following illustration will indicate that we must broaden this element to cover other forms of considerations as well. It is not uncommon for a corporation during its initial process of formation to issue stock for services rendered in forming the corporation or in exchange for machinery, land or other property. Most state *corporate* statutes specifically authorize such an exchange.[81] We have previously seen that the issuance of this stock is just as much a sale of that stock as a sale for cash or a subsequent sale of the stock by the original purchaser to a third party.[82] Furthermore there is no question that the stock is a security. Why then, if we will say that the exchange of stock for consideration other than cash is a sale of a security, should not our definition of security be broadened to recognize that the investment in other forms of securities may come in other forms than cash?

This point has been brought home to several courts dealing with the Glenn Turner-type of pyramid selling scheme where the investor is required to perform certain acts for the corporation as a part of his purchase. The court in *Murphy v. Dare to Be Great, Inc.*,[83] held that the word "money" in the *Howey* definition should mean "anything of value or any considerations, including any benefit to the promisor or detriment to the promisee."[84] More recently the Court of Appeals for the Ninth Circuit made a similar conclusion in *SEC v. Glenn W. Turner Enterprises, Inc.*,[85] where it held that the person investing in a Turner scheme invested three things: his money, his efforts to find other potential purchasers, and whatever it cost him to create the illusion of affluence.[86]

Therefore I submit that we should alter this first element of *Howey* to

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81. *See, e.g.*, OKLA. STAT. tit. 18, § 1.76 (1971).

82. *See* Sargent v. Genesco, 492 F.2d 750 (5th Cir. 1974).

83. 3 CCH BLUE SKY L. REP. ¶ 71,053, at 67,276 (D.C. Super. Ct. September 20, 1972).

84. *Id.* at 67,282. The court then went on to hold that the activities that the prospective enrollee in the Glenn Turner program were required to do, such as attend certain schools and bring pople to meetings fit within this modified definition. *See also In re* Continental Marketing Assoc., Inc., 3 CCH BLUE SKY L. REP. ¶ 71,016 (Ind. Sec. Comm'n October 27, 1969).

85. 474 F.2d 476 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

86. *Id.* at 482.

read "the investment of money or money's worth," so as to recognize the ability of the investment to take other forms than cash. Yet this alteration brings with it situations which up to this point have not been considered within the scope of securities regulation. It has long been recognized as a result of the *Howey* case that the sale of any property coupled with a management contract involves a sale of a security.[87] Further we know from the savings[88] and discretionary account[89] situations that investment may mean nothing more than entrustment of funds to the person promising the return, since there is an expectation that the original money plus the profits will be returned.[90]

These facts together raise the question of what in the *Howey* situation constitutes the sale of the security. Is it the purchase of the original property, is it the entrustment of the property under the management contract, or is it both together? In the vast majority of cases, this question does not need to be answered since the investor both purchases the property and is offered a management contract at the same time. In this case, as the *Howey* court pointed out, there is an offer of a security and this is sufficient to bring the securities acts into play.[91] Furthermore in a large majority of cases most of the purchasers also take the management contract.[92] In those cases, however, where the question has been considered, the courts and agencies have split. There are a number of decisions which stand for the principle that the sale of the property constitutes a sale of a security,

87. *See, e.g.*, People v. Witzerman, 105 Cal. Rptr. 284 (Dist. Ct. App. 1972) (holding that the purchase of cattle with a feeding agreement was a security).

88. There no longer can be any question that a savings account is a security even when represented by nothing more than a pass book. ARIZ. ATT'Y GEN. OP., [1954-61 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,246 (October 26, 1954); 1 OHIO ATT'Y GEN. OP. 572 (Bricker 1933); *cf.* SEC v. First Am. Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973); SEC v. W.L. Moody, [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,619 (S.D. Tex. September 6, 1972). However these securities are normally issued by banks and therefore are usually exempted from the registration requirements, but not the anti-fraud provisions. As a result there is little litigation involving them.

89. Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974); 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); Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967). *But see* Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972).

90. As we will see later neither the return of the original investment nor a monetary profit is the earmark of a security. These factors are found however in the vast majority of securities.

91. SEC v. W.J. Howey Co., 328 U.S. 293, 300-301 (1946). The reason for this is that 15 U.S.C. §§ 77b(3), 77e (1970) makes the act applicable to *both* offers and sales of a security. The same is true under the state acts. *See* Uniform Securities Act § 301, 1 CCH BLUE SKY L. REP. ¶ 4921, at 712 (1973).

92. In the *Howey* case, 85 percent of the land sold was sold with a management contract. SEC v. W.J. Howey CO., 328 U.S. 293, 295 (1946).

if the seller at the time of the sale realizes that the purchaser will, because of his lack of knowledge, equipment, or experience, be forced to retain a third party to manage the property.[93] On the other hand the California Corporation Commission in two recent opinions has indicated that no security is involved when the property is purchased elsewhere and entrusted to the manager.[94] I submit that the California Commission is wrong in this position and that the entrustment of property, just as much as the entrustment of money results in the creation of a security. There are growing indications that the SEC and the courts will adopt my position.[95]

This position raises the question of whether every contract in which another person is hired to manage property is to be classified as a security. I think the answer clearly is no. I don't think, however, that the distinction can be made on the basis that one involves the entrustment of money and the other involves the entrustment of property. Rather, the distinction lies in the control that the owner retains over the property. If he surrenders complete control over the property to the manager and formally or informally agrees that he will not exercise any managerial control or decision making, I submit there is a security involved. On the other hand, if he merely delegates this authority for the sake of convenience and retains practical authority to intervene at any time in the management, then a security is not involved.

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93. Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968); Roe v. United States, 287 F.2d 435 (5th Cir. 1961); SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962). This idea also appears to be present, if unexpressed, in the recent decisions involving scotch whisky. *See* Glen-Arden Commodities, Inc. v. Costantino, [Current Binder] CCH FED. SEC. L. REP. ¶ 94,436 (2d Cir. March 14, 1973); SEC v. Haffenden-Rimar Int'l, Inc., 362 F. Supp. 323 (E.D. Va. 1973); SEC v. M.A. Lundy Assoc., 362 F. Supp. 226 (D.R.I. 1973); PA. ATT'Y GEN. OP. No. 49, 3 CCH BLUE SKY L. REP. ¶ 71,094 July 17, (1973).

94. CAL. CORP. COMM'R OP. No. 72/137C, 4 CAL. CORP. COMM'R CURRENT OPS. (October 10, 1972) (involving the entrustment of trotting horses to be trained and raced by the recipient and a division of the profits between the trainer and the owner); CAL. CORP. COMM'R OP. No. 69/29C, 1 CAL. CORP. COMM'R CURRENT OPS. (April 14, 1969) (involving the management of oil tank cars previously purchased). On the other hand, the commissioner has not been reluctant to hold that a security was present when the property was purchased and a management contract was executed concurrently. CAL. CORP. COMM'R OP. No. 73/46C, 5 CAL. CORP. COMM'R CURRENT OPS. (March 21, 1973); CAL. CORP. COMM'R OP. No. 72/27C, 4 CAL. CORP. COMM'R CURRENT OPS. (March 6, 1972). *See also* Cal. Corp. Comm'r Policy Letters 162C and 167C.

95. SEC v. Development Corp. & Distrib. Co. of America, [197-72 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,358 (W.D. Wash., filed December 1, 1971) (consent injunction subsequently entered); State *ex rel.* Healy v. Development Corp., No. 73460 (Ore. Cir. Ct., Marion County, July 2, 1971) (temporary restraining order); State v. Idea Dev. & Marketing, Inc., No. 9-73-09887 (N.M. Dist. Co., Bernalillo County, filed September 26, 1973); Kentucky Blood Horse, Ltd., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,430 (SEC NAL June 13, 1973) (involving race horse training similar to the California opinion *supra* note 94).

It has also been questioned as to whether a sale is involved in an entrustment situation. The answer to this would seem to be that we have no difficulty finding a sale of the security when money is entrusted in the savings and discretionary account cases, so there should be no difficulty in finding a "sale" in the property entrustment cases. The sale arises in the turning over of the property to a recipient and giving him the right to use that property to generate a return. This right to use is a valuable consideration and can be the consideration for the issuance of the security. We will see this theory being used more and more in the area of corporate marketing of inventor's ideas.[96]

The second element of the *Howey* test is the expectation of a profit. There are a number of things we need to keep in mind here. First is whose expectation of profit. Clearly it is the investor's expectation, not the issuer of the security. Unfortunately, a number of early cases held that a security would not be present if the investor received a return when the issuer did not make a profit.[97] To realize the fallacy of this argument one needs only to remember that a bond or other evidence of indebtedness requires the issuer to pay the return regardless of its own profits as long as it is solvent. Profit here does not mean profits in the sense of profits and losses; it means the payment of any consideration to the investor whether it be in the form of commissions, dividends, interest, or the like.[98]

It should be obvious that in the vast majority of cases the "profits" expected will be some type of monetary return.[99] Yet does our definition of a security demand that this profit be monetary? I submit that it does not. State corporate statutes allow the payment of dividends in stock or in kind as well as in money.[100] Why then could not a profit on other forms of securities be in the form of property or additional securities? Beyond this, does the "profit" even have to be tangible property? I submit that it does not.

The leading case suggesting that the "profits" does not have to be a tangible benefit is *Silver Hills Country Club v. Sobieski.*[101] In that case, the investor was asked to put up money for a membership in a country club

96. *See* cases cited *supra* note 95.

97. Emery v. So-Soft, Inc., 199 N.E.2d 120, 125 (Ohio Ct. App. 1964).

98. State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 109 (Hawaii 1971); *see* Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 238 (1974).

99. This return however may not involve the return of the original consideration. In the Glenn Turner and founder-membership cases, the issuer of the securities got the consideration paid by the purchaser and the "investor" only received the right to a commission for introducing new members into the orgainzation, or, in the case of the founder-membership schemes, an additional commission on sales to people using the cards distributed by the member. The courts have had no difficulty holding that these are securities. *See, e.g.*, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105 (Hawaii 1971).

100. *See, e.g.*, OKLA. STAT. tit. 18, §§ 1.132, 1.134 (1971).

101. 13 Cal. Rptr. 186 (1961).

which was to be built by the promoters. The members were not to receive any ownership interest in the club and their only return on their investment was the right to use the country club facilities. The court had no problem holding this to be a security. It is true that this case was decided under the former California statute which provided that promissory notes of non-profit corporations, whether interest-bearing or not, were securities, lending some credence to an argument that "profits" was not considered a necessary element under California law. The California Corporation Commission has nevertheless continued to apply the *Silver Hills* standard under the present California law which has no such provision.[102] Similarly, the Oregon Corporation Commissioner has used the benefits test in two recent opinions.[103]

Recently the question has been raised whether the extended concept of benefits as opposed to "profits" is a desirable feature in the *Howey* setting, since it would have the effect of making every executory contract into a security.[104] The suggestion was that the extended concept of benefit should be limited to the "risk capital" situation also introduced by the *Silver Hills* case.[105] There is a merit to this argument as it applies to the original *Howey* test. However the definition by specification that we are developing here also will include the risk capital concept[106] and will contain

102. *See*, e.g., CAL. CORP. COMM'R OP. NO. 72/61C, 4 CAL. CORP. COMM'R CURRENT OPS. (May 15, 1972); CAL. CORP. COMM'R OP. NO. 72/73C, 4 CAL. CORP. COMM'R. CURRENT OPS. (June 7, 1972).

103. In Vacations Unlimited, an opinion letter of the Oregon Corporations Commissioner dated December 18, 1973, argued that the purchaser in a time-sharing condominium to be built by the seller received sufficient benefit in the form of the right to occupy the condominium for a fixed period each year to make the sale the sale of a security. More recently, in *In re* Jet Set Travel Club, Notice of Proposed Cease & Desist Order (Ore. Corp. Comm'r April 9, 1974), Commissioner Healy argued that the purchaser of a travel club membership had received a sufficient benefit through the right to use the club's airplane for future vacations to make the membership a security.

104. Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 245 (1974).

105. *Id.* at 245. This argument presupposes that the risk capital test in *Silver Hills* is a completely separate test for investment contracts from that established in *Howey*. This is an open question in both California and Oregon where the "benefits" concept has been applied. The Oregon court of appeals indicated that the risk capital test is an alternative test to the *Howey* test in State *ex rel.* Healy v. Consumer Bus. Sys., Inc., 482 P.2d 549, 554 (Ore. 1971). The problem is more difficult in California. Unfortunately the California court in Silver Hills did not say whether it was creating an additional or replacement test for the *Howey* definition. Earlier the California court, in People v. Syde, 235 P.2d 601 (1951), had adopted the *Howey* definition. This has led the California Corporation Commission to treat the two as alternative tests. *Compare* CAL. CORP. COMM'R OP. NO. 73/42C, 5 CAL. CORP. COMM'R CURRENT OPS. (March 20, 1973), *with* CAL. CORP. COMM'R OP. NO. 73/81C, 5 CAL. CORP. COMM'R CURRENT OPS. (May 31, 1973). The continued validity of this alternative test interpretation may be in question as a result of the recent decision in Hamilton Jewelers v. Department of Corps., 112 Cal Rptr. 387 (Dist. Ct. App. 1974).

106. *See* text accompanying note 149 *infra*.

other provisions designed to eliminate those executory contracts which do not have the appropriate characteristics. Therefore, for the purposes of our definition, it is appropriate to change the *Howey* concept of expectation of "profits" into the broader concept of expectation of "benefit" with the understanding that the benefit can be either tangible in the form of money or property or intangible in the form of a right to use the facilities created or any other benefit which the investor has bargained to receive.

The next element of the *Howey* definition requires that this profit must be generated "solely through the efforts of others." This requirement has spawned a number of problems. First, it is important to distinguish between determining the *amount* of the "profit" and the generation of the fund from which this "profit" is to be paid. This point has recently become very important in the consideration of the commodity option as a security.[107] It should be apparent that the investor participates in the process of determining the amount of his "profit" by the selection of the investment he chooses to make. Thus he can refuse to invest unless the issuer pays him a 8 percent return on his bond, preferred stock, or savings account. The investor determines the amount of his "profit" by deciding how long he will retain his investment. Clearly we cannot mean, when we talk about "profits solely through the efforts of others," this determination of the *amount* of profits because no investment would ever be a security if we did. Therefore, this concept must deal with the generation of the fund from which the "profits" or "benefits" are to come.

The second point that we must consider is the type of "efforts" required. Originally, several courts took the position that any type of effort by the investor would prevent the scheme from being a security.[108] The absurdity of this position can be seen from carrying it to its logical extreme. Under the *Howey* fact situation, this would mean that securities classification could be avoided by a requirement inserted in the management contract that the investor must pick a single orange from his plot.[109] This position has now all but been abandoned.[110] The courts now recognize that "efforts" refer to managerial efforts or to the right to make the decisions which will determine whether the investment is a success or failure.[111]

107. *See* Borton & Abrahams, *Options on Commodity Futures Contracts as Securities in California*, 29 BUS. LAW. 867 (1974); Long, *The Naked Commodity Option Contract as a Security*, 15 WM. & MARY L. REV. 211 (1974).

108. Gallion v. Alabama Mkt. Centers, Inc., 213 So. 2d 841 (Ala. 1968); Georgia Mkt. Centers, Inc. v. Fortson, 171 S.E.2d 620 (Ga. 1969); 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.—Austin 1970, writ ref'd n.r.e.).

109. In fairness to some of the courts taking this position, they did indicate that a *de minimis* effort on the part of the investor would be disregarded. *See, e.g.*, Georgia Mkt. Centers, Inc. v. Fortson, 171 S.E.2d 620, 623 (Ga. 1969).

110. *But see* SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973).

111. *See, e.g.*, SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th

To me this participation in the management of the investment is the key to the entire concept of the securities acts. When an investor is asked to turn over his money or property to another who will then use that money or property to generate a benefit or return, part or all of which will inure to the investor, the investor is undertaking a risk that the investment will not be successful and that he will not receive his benefit. If the investor shares in the management of the project and the decisions which determine whether the investment is a success or failure, then he does not need the protection of the securities acts because he is the master of his own destiny, and his position gives him the right to demand all the information necessary to make the appropriate business decisions. But when he does not have such a right and is dependent on the judgment of another, then he needs protection. Both state and federal securities acts are aimed at providing this protection. The registration provisions attempt to see that the investor receives complete information about both the project in which he is asked to invest and the people who control it and who will be making his decisions concerning the investment. The anti-fraud provisions attempt to insure that this information is accurate. Armed with this accurate information, the investor, in theory at least, will then select only the sound investments, and those containing the type of risk that he is willing to bear. Thus, the securities acts are designed to provide the investor protection when the nature of the interest acquired does not carry with it a right to share in the management of the project. It is important, therefore, to understand that the right to participate in the control or management of the project must stem from the interest acquired, not from some other relationship that the investor may have with the project.

The classic example of this concept is common stock in a corporation. Here the shareholder does not directly control the management or decision-making process of the corporation. This control, by state corporation law,[112] resides in the directors of the corporation, who exercise it through the officers and agents of the corporation. The only right of the shareholders is the indirect right to elect and remove the directors. Thus, the nature of the investment requires that the investor be given protection. Nor should the fact that the shareholder is also an officer or director of the corporation and, in that capacity, participates in the management and control of the corporation, alter the nature or classification of his shares as securities.[113]

Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973); Lino v. City Investing Co., 487 F.2d 689, 692 (3d Cir. 1973); State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., 485 P.2d 105, 111 (Hawaii 1971).

112. *See, e.g.*, OKLA. STAT. tit. 18, § 1.34 (1971).

113. *In re* Continental Marketing Assoc., Inc., 3 CCH BLUE SKY L. REP. ¶ 71,016, at 67,179 (Ind. Sec. Comm'n October 27, 1969). This fact may be significant as to whether the registration procedure is necessary as to this individual and whether the sale to him should be an exempt transaction, however, it should not alter the status of his shares as securities.

Probably the best illustration of an interest that may or may not constitute a security outside of the corporate setting is the partnership. Under the Uniform Limited Partnership Act, the limited partners may not participate in the management of the partnership.[114] Therefore the interest of a limited partner is *always* a security.[115] On the other hand, in the normal general partnership, the partner has the right to participate in the management of the partnership and control partnership affairs. This factor should mean that his interest is *not* a security.[116] There is one important *caveat* to this statement. The rights of the partners are governed by agreement among themselves and, if the partners agree formally in their partnership agreement, or informally that the actual management of the partnership will be left to a managing partner or committee, then interests of the remaining general partners would become securities.[117]

This raises the final question under this element. Should the requirement be that the efforts must come solely through the efforts of others? We have seen earlier that this portion of the *Howey* test finds little support in the state cases which preceded it. Recently, a number of courts looking for a way to avoid the undesirable effect of applying the *Howey* test have adopted the approach that the "solely" part of the test should be changed to "substantially through the efforts of others."[118] Probably the best known example of this approach is *SEC v. Glenn W. Turner Enterprises*,[119] where the court said:

> Strict interpretation of the requirement that profits to be earned must come "solely" from the efforts of others has been subject to criticism. Adherence to such an interpretation could result in a mechanical, unduly restrictive view of what is and what is not an investment contract. It would be easy to evade by adding a requirement that the buyer contribute a modicum of effort. Thus the fact that the investors here were required to exert some efforts if a return were to be achieved

114. Uniform Limited Partnership § 7 (1917). *See generally* J. CRANE & A. BROMBERG, PARTNERSHIPS § 26(c) (1968). This prohibition does not prevent him from working for the partnership or for making decisions concerning the partnership *as an employee* of the partnership. *See, e.g.*, Grainger v. Antoyan, 313 P.2d 848, 853 (Cal. 1957); Silvola v. Rowlett, 272 P.2d 287, 290 (Colo. 1954).

115. Curtis v. Johnson, 234 N.E.2d 566, 573 (Ill. Ct. App. 1968); Reiter v. Greenberg, 288 N.Y.S.2d 57, 61 (1968); N.D. ATT'Y GEN. OP., [1961-71 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,799 (November 15, 1968). These cases are discussed in detail in Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 MO. L. REV. 581, 611-12 (1972).

116. For a discussion of this point, see Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 MO L. REV. 581, 612-15 (1972).

117. Pawgan v. Silverstein, 265 F. Supp. 898, 900 (S.D.N.Y. 1967).

118. This approach was first adopted in State Comm'r of Sec. v. Hawaii Mkt. Center, Inc., [1961-71 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,880 (Hawaii Cir. Ct., October 21, 1970), *aff'd on other grounds*, 485 P.2d 105 (Hawaii 1971). It was later picked up and used in D.M.C. v. Hays, [1961-71 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,897 (Colo. Dist. Ct. February 26, 1971).

119. 474 F.2d 476 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

> should not automatically preclude a finding that the Plan or Adventure is an investment contract. To do so would not serve the purpose of the legislation. Rather we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.[120]

This approach has recently been approved by other federal courts.[121]

This approach is unfortunate. It would be an appropriate test if we were dealing with physical efforts necessary to make the project a success. I submit, however, that once we determine as we have, that the "efforts" refers not to physical activities of the investor but to his right to share in the management or decision-making process in the project, that the "solely" test is the appropriate test. He either has the right to share in these decisions or he does not. We should not attempt to make a qualitative analysis of his right. A partnership example will illustrate my point. We have indicated that the interest of a general partner is not normally a security because he shares in the management process. Let us then contrast the two-partner law firm with the 400-partner national accounting firm. In the case of the law firm, each partner, assuming no partnership agreement to the contrary, would have one vote in partnership affairs. Under the *Glenn Turner* test his "efforts" would clearly be significant and his interest would not be a security. However, in the case of the accountant, again assuming that the partnership agreement has nothing to the contrary,[122] he has a voice in management, albeit his voice is only one in 400. Under the "solely" test as I have outlined it, his interest is still not a security because he shares in management and management is not left "solely" to others. Under the *Glenn Turner* test, I feel that his management voice would be so small that it could not be said to be significant and therefore his interest would be a security. I cannot reconcile the difference in treatment between identical types of interests. Either both are securities or neither are. Our test then should alter the *Howey* "solely through the efforts of others" to read "where the investor has no direct control over the investment or policy decisions of the venture."

The last element of the *Howey* test is the common enterprise test. This element has been giving the courts increasing problems within the last year especially in the areas of commodity option contracts[123] and discretionary

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120. *Id.* at 482 (citations omitted).

121. Miller v. Central Chinchilla Group, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 94,465 (8th Cir. March 28, 1974); Lino v. City Investing Co., 487 F.2d 689, 692 (3d Cir. 1973); Mitzner v. Cardet Int'l, Inc., 358 F. Supp. 1262, 1267 (N.D. Ill. 1973).

122. If management is concentrated into a small management group, then the non-management interests become a security. *See* case cited note 117 *supra*.

123. *See* SEC v. Continental Commodities Corp., Civ. No. CA 3-6976-D (N.D. Tex. April 9, 1973); International Commodity Trust, Inc. v. Fisher, 3 CCH BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct. May 14, 1973); Shapiro v. First Federated Com-

trading accounts.[124]

Presently there are two theories as to what is necessary for a common enterprise to exist. One view, attempting to equate common enterprise with the idea of a joint venture, holds that there must be a pooling of investor funds.[125] Under this theory, if there is only one investor who puts his money in the hands of a person who will manage it, there is no common enterprise between the investor and the manager. Further, if the manager has solicited funds from a number of people to manage, but he does not pool these funds, again there is no common enterprise among the various investors. This view is based upon the fact in the *Howey* case the land was pooled and farmed as a unit.[126] Unfortunately, this view appears to be the predominant view in the federal courts at the moment, at least in the areas of commodity options and discretionary accounts.[127] This fact has caused several state courts to reject the concept of common enterprise completely.[128]

The other view, represented by the Court of Appeals for the Ninth Circuit in *Los Angeles Trust Deed & Mortgage Exchange v. SEC*[129] and *SEC v. Glenn W. Turner Enterprises, Inc.*,[130] is that common enterprise means nothing more than that the fortunes of the investor are interwoven with and dependent upon the efforts and success of either those seeking the investment or of a third party.[131] Under this theory, there is a common enterprise existing between the investor and the person soliciting his funds to manage, as in the case of a discretionary account.[132]

This latter approach is much more sound. Used in this way, I think that it does have an appropriate place in the definition of a security.

modity Trust Corp., 3 CCH BLUE SKY. L. REP. ¶ 71,071 (Md. Cir. Ct. May 30, 1973).

124. Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Stuckey v. DuPont, Glore, Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972).

125. The leading case taking this position is Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

126. This approach, however, ignores the fact that each investor signed an individual management contract.

127. Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Stuckey v. DuPont, Glore, Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972); SEC v. Continental Commodities Corp., Civ. No. CA 3-6976-D (N.D. Tex. April 9, 1973). *But see* Marshall v. Lamson Bros. & Co., 368 F. Supp. 486, 489 (S.D. Iowa 1974).

128. State v. Investors Sec. Corp., 209 N.W.2d 405 (1973); Shapiro v. First Federated Commodity Trust Co., 3 CCH BLUE SKY L. REP. ¶ 71,071, at 67,336 (Md. Cir. Ct., May 30, 1973). It should be remembered that the concept of common enterprise is not found in the state cases preceding *Howey*.

129. 285 F.2d 162 (9th Cir.), *cert. denied*, 366 U.S. 919 (1961).

130. 474 F.2d 476 (9th Cir.), *cert. denied*, — U.S. —, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973).

131. *Id.* at 482-83; Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162, 172 (9th Cir.), *cert. denied*, 366 U.S. 919 (1961).

132. Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974).

It emphasizes again that a security involves a community of effort—one person or group furnishing the capital; another the management or skill necessary to bring about the planned result. However, "common enterprise," as opposed to the concept of "joint venture," does not require, as suggested by *Milnarik v. M-S Commodities,*[133] that the management participants have to share directly in the return or benefit generated. The manager can be strictly a salaried or commissioned manager as in the case of the discretionary account,[134] or he may make his profit from the original sale of the object cared for.[135] It is also important to understand that the concept of "common enterprise" does not mean a single legal entity embracing the entire project. Again the facts of the *Howey* case itself dispel this notion. The land in *Howey* was sold by one corporation, serviced by another, and owner by the investor. While there was a common project among the three, the raising of citrus fruit, they all constituted separate legal entities. In many cases, such as stocks or bonds in a corporation, the enterprise will be embraced by a single legal entity, but the concept of "common enterprise" does not demand it.

The concept of "common enterprise" also serves another very vital function in the definition of a security. It helps to separate certain investments which under current thinking are not securities from those that are. The term "enterprise" suggests that something active is done to bring about the increase in value leading to the "profit" or "benefit" expected.

Professor Loss expressed the idea this way:

> [No security] is involved when a person invests in real estate, with the hope perhaps of earning a profit as the result of a general increase in values concurrent with the development of the neighborhood, as long as he does not do so as a part of an enterprise whereby it is expressly or impliedly understood that the property will be developed or operated by others.[136]

Used in this manner, the concept of "enterprise" illustrates the difference between the buying of a lot for investment purposes in a subdivision where the subdivision owner has a comprehensive plan of development, which would be the purchase of a security,[137] from the purchase of a similar lot

133. 457 F.2d 274 (7th Cir.), *cert. denied,* 400 U.S. 887 (1972).

134. As in the case of Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974).

135. In the *Howey* case itself, the Howey company made its profit from the sale of the land originally. The Howey-in-the-Hills service company received a management fee arising from caring for and cultivating the land, but there was no actual division of the profits resulting from the sale of the fruit produced.

136. 1 L. Loss, SECURITIES REGULATION 491-92 (2d ed. 1961).

137. Hall v. Security Planning Serv., Inc., 371 F. Supp. 7, 14 (D. Ariz. 1974); Johnson v. Suburban Land Inv. Co., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,022 (D.C. Super. Ct. June 1, 1973); HAWAII ATT'Y GEN. OP. No. 70-25, [1961-71 Transfer Binder] CCH BLUE SKY L. REP. ¶ 70,882 (October 15, 1970); Mancini v. GAC Corp., Civ. No. 72-45-TUC-JAW (D. Ariz., filed 1973), *discussed in* Hannan

where no systematic development is planned, which would not be a security. In the first case the investor is looking for the return on his money from a concerted effort which is intended to raise the value of the lot, whereas in the second case he is expecting his profit from the unrelated general development of the area or the historic general increase in land values.

For these reasons we will include the concept of common enterprise in our definition by specification, but because of the confusion that presently surrounds the concept of "common enterprise" I have elected to select the term "venture" to represent the concepts outlined here.

The *Howey* definition appears to be deficient in two areas, both of which have been noted above. First, it does not attempt to distinguish in a meaningful way between those instruments given in a commercial transaction from those arising in an investment one. We have seen that this is a glaring deficiency in the basic definition by enumeration itself. Thus, *Howey* gives us no help in eliminating from securities act coverage the promissory note given for the purchase of an automobile or refrigerator, a transaction we have already concluded ought not to be covered.

Second, the *Howey* test, as modified to include expectation of non-monetary benefits as well as monetary ones, does not eliminate the ordinary contract involving the prepayment for goods to be delivered in the future. Many of these contracts are not securities. One would hardly claim that a contract to buy a new Ford where the purchaser makes payment now and expects the car to be delivered later is a security.[138] On the other hand, there are many prepayment contracts that do involve a security.[139]

Consequently, to make the *Howey* definition as we have modified it into a definition for securities by specification we need to add some additional element to cover these points. These points can be dealt with by the addition of the concept of "risk capital." The concept of "risk capi-

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& Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities,* 25 HASTINGS L.J. 219, 275-76 nn.212 & 213 (1974).

138. The buying of a new Tucker on the other hand is a different story. The SEC held Tucker franchise agreements which required dealers to make deposits toward cars they were to receive were securities. *In re* Tucker Corp., 26 S.E.C. 249 (1947).

139. The borderline problem is well illustrated by CAL. CORP. COMM'R OP. NO. 72/43C, 4 CAL. CORP. COMM'R CURRENT OP. (April 20, 1972). Here the question was asked whether the sale of a publication of the history of Tulare County, California involved a security. The publisher, in order to finance the printing of the history, proposed to sell space for a family biography to the leading citizens of the county. In exchange for the payment they were to receive a copy of the completed book. One of the sponsors had advanced $50,500 of the money necessary to print the book. The remaining cost, some $10,000, was going to come from the sale of the biography space. The California commissioner held that this was not the sale of a security because it was a typical commercial transaction of the type often used in the printing industry. I will not dispute that the contract may be a typical publishing industry transaction, but I am not convinced that this contract is not a security for the reasons to be outlined.

tal" is not new to securities regulation. It finds its roots in the early case of *Brownie Oil Co. v. Railroad Commission*,[140] a concept which did not receive wide attention until expressed by Justice Traynor in his now famous opinion in *Silver Hills Country Club v. Sobieski*.[141] In referring to the scheme to build a country club from money raised from the sale of memberships where the members would have no proprietary interest in the club, but merely the right to use the facilities once constructed, Justice Traynor said:

> We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the *risk capital* with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labeled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.[142]

Later in the opinion Justice Traynor restated the idea of risk capital this way:

> 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.[143]

Let us now see how this risk capital concept can supply the needed elements outlined above. It should be clear that in any case where there is a present payment for goods to be delivered in the future, there is the risk that the person contracted with will not be financially able to perform his obligation. This is a commercial risk inherent in any business contract and should not make the contract a security. This is not the risk however that Justice Traynor is talking about in the *Silver Hills* case. Justice Traynor is concerned rather with a second risk, the investment or enterprise risk.[144] This risk is present in all corporate stocks and bonds. The original investor in these securities turns over to the corporation consideration which the corporation will use to generate a fund from which the promised benefit will be paid. The investor must suffer the risk that his consideration will be dissipated to creditors and others before the corporation has the opportunity to generate the benefit promised and expected. All that Justice Traynor and the court in *Brownie Oil* before him are saying is that whenever this risk is present we have a security—regardless of what name is given to the instrument calling for the investment. Thus, when a person is approached and asked to provide the necessary capital to produce goods by prepaying

140. 240 N.W. 827 (Wis. 1932).
141. 13 Cal. Rptr. 186 (1961).
142. *Id.* at 188 (emphasis added).
143. *Id.* at 188-89.
144. For an excellent discussion of this in the context of commodity option contracts, *see* Ga. Securities Release No. 1, 1 CCH BLUE SKY L. REP. ¶ 14,612, at 10,504 (Ga. Sec. Comm'n September 18, 1973).

for them, he is forced to suffer this investment risk and the contract involves the sale of a security. If, on the other hand, the producer presently has the necessary capital to produce the goods, then prepayment does not result in an assumption of the investment risk, only the normal commercial risk, and no security is involved.

Two further comments need to be made about this concept. First, it should be apparent that I am not using "capital" in the traditional accounting or balance sheet sense of an equity interest in the corporation represented by capital stock and surplus. Rather I am using "capital" in the broad economic sense of the pool of resources necessary to fund a particular project. This economic capital can come from borrowing as well as the sale of equity interest. Both the borrowing and the equity interests can take the traditional forms of promissory notes, bonds, or stock, or more untraditional forms such as the prepayment of memberships in the *Silver Hills* case or the right to receive commissions on future sales as in the Glenn Turner or founder-membership type scheme. Second, while there are some indications that California will so limit it,[145] the risk capital concept should not be limited to original or initial risk capital.[146] It should apply equally to the new company seeking the initial financing to start its business as well as to the old-line, established corporation seeking to raise the capital necessary to start a new line or to extend production under its old business. Additionally, the risk capital classification cannot be avoided by obtaining temporary financing[147] or placing the money taken in escrow for a limited period.[148]

Turning finally to the problem of eliminating the commercial transactions from coverage under the securities acts, this can be accomplished by taking the concept of risk capital and combining it with the concept of venture we developed earlier. The risk capital obtained must be invested in the venture in order that the resulting debt instrument constitute a security. Thus, in the case of the consumer purchase of an automobile or refrigerator or the personal loan from a finance company, the resulting promissory notes would fall outside of the securities act because the promissory note did not result from the investment in the risk capital of a venture. The consumer or the borrower is not going to use the money or property

145. *See, e.g.*, CAL. CORP. COMM'R OP. NO. 72/61C, 4 CAL. CORP. COMM'R CURRENT OPS. (May 15, 1972).

146. State *ex rel.* Parks v. Glenn W. Turner Enterprises, Inc., 3 CCH BLUE SKY L. REP. ¶ 71,023, at 67,202 (Idaho Dist. Ct. March 29, 1972).

147. Thus in the founder-membership situation where the company is going to open a membership department store, the risk capital test cannot be met by the company securing the merchandise to stock the store on consignment or through the process of leased departments. *See* CAL. CORP. COMM'R OP. NO. 73/51C, 5 CAL. CORP. COMM'R CURRENT OPS. (March 22, 1973).

148. CAL. CORP. COMM'R OP. NO. 73/49C, 5 CAL. CORP. COMM'R CURRENT OPS. (March 21, 1973); CAL. CORP. COMM'R OP. NO. 73/19C, 5 CAL. CORP. COMM'R CURRENT OPS. (February 12, 1973); CAL. CORP. COMM'R OP. NO. 72/99C, 4 CAL. CORP. COMM'R CURRENT OPS. (July 31, 1972).

acquired in exchange for his note to generate the money necessary to satisfy the obligation to repay. The funds to pay the promissory note will come from other activities of the consumer borrower, probably from his employment. Admittedly this distinction does not eliminate those commercial transactions or loans where the equipment or money is employed in the generation of the fund used to satisfy the obligation to pay, such as where the refrigerator is used in a restaurant. From the point of view of the purchaser of the goods or the borrower, he is seeking an investment of risk capital in his venture. From the point of view of the seller of the goods or the lender, he may not know or care that the consideration has become part of the risk capital of the venture. But as we have seen earlier, we must nevertheless consider the concept of investment from the side of the recipient, not the investor.[149]

In summary, what is a security? A security is the investment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture.[150]

149. For those who are still concerned whether these transactions should be included within the coverage of the securities act, there is another concept which might be used to eliminate them. We can say that "risk capital" is only that portion of the consideration received for the rights in question, which exceeds the fair value of those rights. This approach was adopted in CAL. CORP. COMM'R OP. NO. 72/76C, 4 CAL. CORP. COMM'R CURRENT OPS. (June 22, 1972) where the commissioner held that the fee prepaid for the use of the campgrounds to be constructed would not substantially exceed the actual benefits realized. However, this approach seems to beg the question. It separates that which can be considered capital from that which can be considered legitimate pre-payment of profits. But the profit has not yet been earned, and the investor has the risk that he will not receive his benefit. The membership fee in the *Silver Hills* case may have represented fair value for the right to use the facilities to be created, but the risk is that the facilities never will be created. This is what makes the interest a security. *See also* Hamilton Jewelers v. Department of Corps., 112 Cal. Rptr. 387 (Dist. Ct. App. 1974).

150. This definition has now been adopted by the Oklahoma legislature as one of the alternative definitions of a security. OKLA. STAT., tit. 71, § 2(19)(P) (Supp. 1973). This definition also closely follows that outlined in Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367 (1967). Coffey's definition served as the basis for the Supreme Court of Hawaii's formulation of a definition of investment contract which combined the liberal interpretation of *Howey* and the risk capital test. The court in State Comm'r of Sec. v. Hawaii Market Center, Inc., 485 P.2d 105, 109 (Hawaii 1971) said:

> [W]e hold that for the purposes of the Hawaii Uniform Securities Act (Modified) an investment contract is created whenever:
> (1) An offeree furnishes initial value to an offeror, and
> (2) a portion of this initial value is subjected to the risks of the enterprise, and
> (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
> (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.