
Maura K. Monaghan
NOTES

AN UNCOMMON STATE OF CONFUSION: THE COMMON ENTERPRISE ELEMENT OF INVESTMENT CONTRACT ANALYSIS

MAURA K. MONAGHAN

INTRODUCTION

The threshold question in any securities litigation is whether the instrument at issue is a security. An investor seeking relief in court requires an affirmative answer to this question before invoking the protections of the Securities Acts. An issuer or offeror of a security may have a more urgent need to know if a particular transaction falls within the purview of the Acts because failure to register a qualifying security gives rise to potential liability even in the absence of fraud or some other wrongful act. The applicability of the federal securities laws also may determine the parties' access to the federal courts. Many important consequences, therefore, flow from the critical determination of whether a given instrument is a security.

With so much at stake, it is unfortunate that neither Congress nor the courts have been able to arrive at a simple, easy-to-apply litmus test on this question. The difficulty faced by Congress and the courts stems from a paradox: To be applied consistently, the test of what constitutes a security should be relatively simple and the outcome capable of accurate prediction so that effective business planning is possible. On the other hand, because neither Congress nor the courts can


2. Accordingly, § 77e(a) of the 1933 Act states:

   Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

   (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise . . . .


3. 28 U.S.C. § 1331 provides: “The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States.” 28 U.S.C. § 1331 (1988). In Osborn v. Bank of the United States, 22 U.S. (9 Wheat.) 738 (1824), Chief Justice Marshall interpreted the constitutionally permissible jurisdiction of the federal courts as follows: “If . . . the title or right set up by the party, may be defeated by one construction of the constitution or law of the United States, and sustained by the opposition construction,” federal jurisdiction may properly be asserted. Id. at 822. Thus, if the rights of the parties are determined by application of the Securities Acts, the case is properly within the jurisdiction of the federal courts.
possibly foresee the entire multitude of schemes that people's profit seeking ingenuity might devise, an overly simple test would be susceptible to easy evasion or might not be flexible enough to cover instruments designed in the future.\(^4\)

The 1933 and 1934 Acts represent a Congressional compromise between these extremes. While acknowledging that some guidance is necessary, Congress recognized that the remedial purposes underlying the Acts might be undermined by an overly restrictive definition of a security. The Acts therefore do not provide any comprehensive definition of the term "security." Rather, they provide a laundry list of the most common securities instruments, including catch-all categories such as "investment contract" designed to offset any omissions from the list.\(^5\) Section 2(1) of the Securities Act of 1933, for example, provides:

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights . . . or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.\(^6\)

Section 3(a)(10) of the Securities Exchange Act of 1934 tracks this definition with one change.\(^7\) The 1933 and 1934 Act definitions, however, are considered to be functionally equivalent.\(^8\)

\(^4\) In Reves v. Ernst & Young, 494 U.S. 56 (1990), the Supreme Court noted:
An approach founded on economic reality rather than on a set of per se rules is subject to the criticism that whether a particular note is a "security" may not be entirely clear at the time it is issued. Such an approach has the corresponding advantage, though, of permitting the SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition.

\(^5\) Id. at 63 n.2.

\(^6\) See Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985) ("As we have observed in the past, this definition [of "security"] is quite broad, and includes both instruments whose names alone carry well-settled meaning, as well as instruments of 'more variable character [that] were necessarily designated by more descriptive terms,' such as 'investment contract' and 'instrument commonly known as a security.'" (alteration in original)(citations omitted) (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943)).


\(^8\) "The term 'security' . . . shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 15 U.S.C. § 78c(a)(10) (1988).

\(^8\) Tcherepnin v. Knight, 389 U.S. 332, 342 (1967).
This Note is concerned with only one of the many listed instruments, the investment contract. Although Congress included the term "investment contract" in its laundry list of securities instruments, it provided no more precise definition of the term, leaving further interpretation to the courts. The Supreme Court has interpreted this instrument broadly to reach "[n]ovel, uncommon, or irregular devices, whatever they appear to be." In effect, the investment contract has evolved into a safety net category, designed to capture those transactions that might not otherwise qualify under the Acts, but that have the potential to expose the public to investment fraud.

The Supreme Court has made it clear that the mere characterization of a particular transaction is not conclusive, noting that "[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." The courts must therefore examine each scheme before them to determine whether its economic realities make application of the Securities Acts appropriate.

The guiding principle for this examination was set forth in the seminal case SEC v. W.J. Howey Co. In Howey, the Supreme Court defined an investment contract as "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." While the Howey test provides a meaningful framework for courts in their analysis of investment contracts, the test also has raised significant controversies regarding the satisfaction of its individual elements.

One of these elements, the "common enterprise" element, has been the source of great disagreement among the courts. Today, nearly fifty years after the Howey decision, three distinct interpretations of what constitutes a common enterprise exist, each of which has been adopted by certain of the circuit courts of appeals. Some courts have required "horizontal commonality," which focuses on the relationship among multiple investors whose assets are pooled in the inves-
ment fund and who receive profits based on a pro-rata allocation.\textsuperscript{16} Other courts have adopted "narrow vertical commonality,"\textsuperscript{17} which examines the relationship between a promoter and an investor whose fortunes are mutually dependent.\textsuperscript{18} Still other courts have looked for "broad vertical commonality," which focuses not on the economic relationship between the investor and promoter, but on the investor's dependence on the promoter's expertise.\textsuperscript{19}

The situation is further complicated by the fact that some circuits have not adopted any one of the three tests to the exclusion of the others. Therefore, there are splits within individual circuits, as well as the long-standing split among the courts of appeals.

This Note will examine the differing approaches to commonality and will compare the strengths and drawbacks of each approach, evaluated in light of the legislative history underlying the Securities Acts and the purposes behind the \textit{Howey} decision. Part I briefly analyzes the legislative history and purposes underlying the Securities Acts and discusses the Supreme Court's construction of other instruments contained within the 1933 and 1934 Acts' list of securities. Part II introduces a general outline of the \textit{Howey} test, including a brief discussion of each of its elements. Part III details the three views of the common enterprise prong with case illustrations from the various courts following each view. This part also includes a discussion of the strengths and shortcomings of each approach. Part IV examines the confusion still plaguing the courts at mid-decade. Part V argues that the Supreme Court must resolve this issue so that both promoters and investors are freed from the current uncertainty as to the applicability of the Securities Acts. Finally, Part V outlines the proposal for a new, hybrid test. This Note concludes that a hybrid test, embodying the analytical strengths of the existing tests while avoiding undue restriction, should be applied by every federal court to ensure that investors are not left without the protection mandated by Congress.


\textsuperscript{17} The vertical forms of commonality focus on the relationship between the investors and promoter in the scheme, who are in unequal positions.

\textsuperscript{18} See, e.g., Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978) (applying the narrow vertical commonality test and finding that the success or failure of Bache as a brokerage house did not correlate with the individual investor's profit or loss and that therefore the case did not present a common enterprise).

\textsuperscript{19} See, e.g., SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974) (applying the broad vertical commonality test and holding that the key factor in the determination of whether a case presents a common enterprise is the effect of the promoter's expertise on the investor's decision).
I. THE HISTORY AND LEGISLATIVE INTENT UNDERLYING THE SECURITIES ACTS

To understand the underlying purpose of the Securities Acts, it is necessary to examine the climate in which they were enacted.\(^{20}\) Unfortunately, this task is made difficult by the scarcity of the available legislative history and the speed with which Congress enacted the statutes.\(^{21}\)

Prior to 1933, securities regulation was a matter of state law, with so-called blue sky laws\(^{22}\) existing in most states.\(^{23}\) Despite these regulations, abusive practices abounded in securities transactions.\(^{24}\) Typical schemes included lack of full and fair disclosure,\(^{25}\) blatant fraud in news accounts,\(^{26}\) manipulative short sales,\(^{27}\) insider trading,\(^{28}\) and wash sales.\(^{29}\) These deceptive practices and the lack of effective en-


\(^{21}\) See Thomas Roe Frazer II, Comment, Catch-All Investment Contracts: The Economic Realities Otherwise Require, 14 Cumb. L. Rev. 135, 140 (1984); see also Landreth Timber Co. v. Landreth, 471 U.S. 681, 694-95 n.7 (1985) (acknowledging that the legislative history was silent as to whether Congress had contemplated any particular type of transaction when enacting the Securities Acts).

\(^{22}\) See State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920) (defining the state laws as having application to “speculative schemes having no more basis than so many feet of blue sky”); see also Nathan W. Drage, Comment, Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act, 18 Pac. L.J. 125, 129 (1986) (explaining that state securities laws are referred to as blue sky laws because the purpose of the statutes was to protect farmers from buying a piece of the blue sky).


\(^{24}\) Joel Seligman, The Transformation of Wall Street 16 (1982). Some commentators, including Professor Seligman, have suggested that the blue sky laws never had a chance to succeed because of the interstate nature of securities transactions.

\(^{25}\) See id. at 28.

\(^{26}\) See id. at 16-17. For example, over a 10 year period one publicist received over $280,000 for deliberately planting hyperbolic news stories to raise the prices of several stocks. Id.

\(^{27}\) See id. at 9. A person selling short is counting on the stock price dropping. Stock is sold to a purchaser by a person who does not own the stock, but instead borrows it from a broker to deliver to the purchaser. If the price of the share drops, the short seller profits by purchasing replacement shares at the lower price to return to the lending broker. Id. at 9 n.*.

\(^{28}\) See id. at 34. For example, one firm offered stock to preferred insiders at a cost lower than the price for public trading, guaranteeing the favored investors a profit. Id.

\(^{29}\) See id. at 17. A wash sale occurs when shares of stock are bought and sold by the same person or pool of persons to create the illusion of activity in a particular issue. The trading volume may entice new investors to trade in the security, driving up the stock prices. Id. at 17 n.*.
forcement of the state laws were instrumental in artificially inflating share values during the 1920s.\textsuperscript{30}

The belief that these inflated values would continue to rise influenced the behavior of many investors, who borrowed in reliance on the steady climb and became dangerously leveraged. This continuing rise, in turn, resulted from "the vested interest in euphoria [that] leads men and women, individuals and institutions to believe that all will be better off, that they are meant to be richer and to dismiss as intellectually deficient what is in conflict with that conviction."\textsuperscript{31} The market, however, could not long sustain the feverishly inflationary trend resulting from deceptive practices, and inevitably, it crashed.\textsuperscript{32} The link between the fraudulent and unethical practices that were rampant in the securities industry and the economic catastrophe that resulted is clear. When the inflationary trend came to its crashing halt, half of the new securities issued in the 1920s proved to be utterly without value.\textsuperscript{33} The infamous stock market crash of 1929 saw the collapse of the entire securities market and precipitated the country's decline into an unprecedented economic crisis.

The Stock Exchange Hearings\textsuperscript{34} of 1932 grew out of a Congressional conviction that the stock market crash was a cause rather than an effect of the Depression.\textsuperscript{35} The purpose of the hearings was to examine the forces behind the plummet in stock values and to prevent another crash.\textsuperscript{36} The Banking Committee exposed many of the abuses within the securities industry, leading to a recognition of the need for a national system of regulatory reform.\textsuperscript{37} The enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 was the end result of this pendulum swing in favor of reform.

The Senate outlined the purposes of the Securities Act of 1933 as follows:

\begin{quote}


32. \textit{Id.} at 145 (discussing the "inevitability of the bubble's collapse").

33. Seligman, \textit{supra} note 24, at 1-2.


\end{quote}
The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.

The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.38

Thus, the legislators were influenced by both ethical and prudential considerations. The Acts' drafters believed that imposition of a disclosure obligation would lead to an improved investment climate and ultimately to economic recovery.

The 1933 Act requires that all new issues that do not qualify for a listed exemption39 be registered prior to being offered or sold to investors.40 In addition, all sales must be accompanied by a prospectus.41 The federal regulation of securities thus operates as a disclosure system rather than a system of merit regulation. The investor is guaranteed the information in the registration statement and the prospectus. Armed with this information, she is then free to make her own assessment of the investment quality of the offered transaction. Finally, the 1933 Act ensures that the material information received by the prospective investor is fair and accurate by prohibiting misrepresentations in connection with the offer and sale of any security.42

The 1934 Act carries the disclosure standards beyond registration and initial sale to secondary trading.43 The Act imposes periodic reporting requirements that guarantee prospective purchasers updated information about the securities on offer. The 1934 Act outlaws the use of any "manipulative or deceptive device or contrivance"44 in connection with the sale of a security. The prohibition on fraud applies

40. Id. § 77e (1988).
41. Id. § 77e, 77j (1988).
42. Id. § 77q (1988).
whether the security was subject to registration or qualified for an exemption. The 1934 Act established the Securities and Exchange Commission as the body responsible for enforcing both Acts. The Acts constitute interrelated components of a federal regulatory system of full and fair disclosure.

The Supreme Court has addressed the construction and purposes of the Securities Acts with respect to some of the instruments that appear on the Acts' laundry lists. In *Landreth Timber Co. v. Landreth*, the Court addressed the question of whether an instrument labelled "stock" was a security. Rejecting the application of the economic reality test, the Court held that there was no need to look beyond the characteristics of the instrument to determine whether the Acts applied. The Court ruled that the shares in question, which were labelled "stock" and which demonstrated the attributes typically associated with stock, were securities. The Court indicated that its decision was compelled by the remedial purposes underlying the Securities Acts:

Reading the securities laws to apply to the sale of stock at issue here comports with Congress' remedial purpose in enacting the legislation to protect investors by "compelling full and fair disclosure relative to the issuance of the many types of instruments that in our commercial world fall within the ordinary concept of a security."

While recognizing that Congress had not intended to create a comprehensive federal remedy for all fraud, the Court nonetheless held that it would improperly narrow Congress' broad definition of "security" to hold that the traditional stock at issue fell outside the Acts' coverage.

In *Reves v. Ernst & Young*, the Supreme Court took a slightly different approach. *Reves* involved the question of whether a demand note properly fell within the definition of a security under the 1933 and 1934 Acts. The Court stated that "the phrase 'any note' should not be interpreted to mean literally 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts." The Court identified

45. Id.
46. Id. § 78d (1988).
48. See supra note 6 and accompanying text.
50. For a brief discussion of the economic reality test, see supra note 11 and accompanying text.
51. Landreth, 471 U.S. at 690.
52. Id. at 687 (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (citation omitted)).
53. Id. at 687-88.
55. Id. at 63.
"[t]he fundamental purpose undergirding the Securities Acts" as the elimination of abuses in the previously unregulated securities market. Further, the Court found that in enacting a definition of security sufficiently broad to encompass virtually any instrument that might be sold as an investment, Congress deliberately "painted with a broad brush." Despite this sweeping view of the legislative intent and the scope of the statutory language, the Court declined to find that every note is automatically a security. Instead, the Court established a presumption that every note is a security, but recognized that "this presumption cannot be irrebuttable." The Court adopted a "family resemblance" test under which a note is a security unless it bears a family resemblance to a judicially crafted list of instruments that are not securities. This list of "notes" that are not securities can be expanded as the need arises.

The *Reves* case may represent a retreat from the all-embracing view of the scope of the term "security." The *Reves* Court, however, was careful to emphasize that its holding applied only to notes, which it expressly distinguished both from stock and from investment contracts. The *Landreth* Court was similarly anxious to distinguish the catch-all categories, including the investment contract, from terms with a settled meaning, such as stock.

In both cases, the Court balanced the need to give full effect to the remedial purposes of the securities laws against the need to supply a limiting principle to prevent the Acts from becoming a general proscription against fraud in any context. Where the listed instrument has a familiar, readily identifiable meaning, the Court appears to have found that the "goal of clarity" predominated over "the goal of avoiding manipulation by the clever and the dishonest." In the case of a more flexible instrument, such as an investment contract, these priorities may be reversed. Indeed, if *Reves* signals a trend towards a more restrictive definition of security with respect to certain instruments, the courts may have to construe the investment contract even more broadly to ensure that the policies of investor protection underlying the Securities Acts are met.

Both *Landreth* and *Reves* included broad statements about the remedial purposes underlying the federal securities laws. The Acts were designed to remedy the evils that, in Congress' view, resulted from

56. *Id.* at 60.
57. *Id.*
58. *Id.*
59. *Id.* at 65.
60. *Id.*
61. *Id.* at 66.
62. *Id.* at 62.
63. *Id.* at 64.
underenforcement of the patchwork quilt of state regulatory schemes. Congress intended the Securities Acts to accomplish a number of objectives: to draw out timid capital,"66 to impose an ethic of full and fair disclosure, and to armor the country against another crash by granting investors the means to make informed investment decisions."57 Any rule of law or interpretation under the Acts, including the Howey test and its elements, must be measured against these remedial purposes.

II. The Howey Test and the Foundations of Investment Contract Analysis

Prior to the decision in SEC v. W.J. Howey Co.,68 no authoritative definition of the term "investment contract" existed under the Securities Acts. The term, however, was common in state blue sky laws that existed prior to the adoption of the federal statutes. Although the term also lacked an express definition under state law, it had been broadly construed by state courts to afford the investing public a full measure of protection.69 In interpreting the term "investment contract," courts generally disregarded form for substance and placed emphasis upon economic reality.70 The investment contract acted as a catch-all instrument, capable of capturing capital-seeking transactions that fell outside the more orthodox categories of securities, such as stocks or bonds. An investment contract under state law thus came to mean a contract or scheme for the "placing of capital or laying out of money in a way intended to secure income or profit from its employment."71

The federal legislators were no doubt familiar with the term and were aware of its evolution in blue sky jurisprudence as a broad, catch-all instrument. Thus, the Acts' drafters approved and adopted the expansive construction of the investment contract.72

Moreover, the Securities Acts contain more than one catch-all provision, designed to close any loopholes inherent in a specific definition

66. See S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933) (listing as one of the motivations behind the enactment a desire "to bring into productive channels of industry and development capital which has grown timid to the point of hoarding").

67. See, e.g., Reves, 494 U.S. at 60 ("The fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market.'" (quoting United Hous. Found. v. Forman, 421 U.S. 837, 849 (1975))).

68. 328 U.S. 293 (1946).

69. See, e.g., State v. Evans, 191 N.W. 425, 427 (Minn. 1922); State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920); Stevens v. Liberty Packaging Corp., 161 A. 193, 195 (N.J. 1932).

70. See SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (citing State v. Gopher Tire, 177 N.W. 937 (Minn. 1920)).

71. Gopher Tire, 177 N.W. at 938.

72. See, e.g., Reves, 494 U.S. at 77 (Rehnquist, C.J., dissenting) ("In construing any terms whose meanings are less than plain, we depend on the common understanding of those terms at the time of the statute's creation.").
of a security. The Acts refer to such flexible instruments as a "certificate of interest or participation in any profit-sharing agreement"\textsuperscript{73} and "any interest or instrument commonly known as a 'security',"\textsuperscript{74} as well as including the term "investment contract." To avoid redundancy, investment contracts should constitute those transactions that are not evidenced by a certificate or share and that do not fit the paradigm of that which would be "commonly known as a security." The inclusion of the term extends the reach of the Acts beyond those schemes that are directly analogous to familiar documents traded for speculation or investment. Responsibility for the further development of the term from this basis was left to the courts.

In 1943, in \textit{SEC v. C.M. Joiner Leasing Corp.},\textsuperscript{75} the Supreme Court confirmed that the investment contract would serve as an instrument enabling the courts to reach unusual or novel transactions that would not otherwise fall within the ambit of the Securities Acts.\textsuperscript{76} The Court stated:

\begin{quote}
[T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts."\textsuperscript{77}
\end{quote}

In 1946, the Supreme Court took up the task of setting workable limits on the investment contract while remaining true to the remedial purposes of the Securities Acts. In \textit{SEC v. W.J. Howey Co.},\textsuperscript{78} the SEC brought an enforcement action against a Florida corporation that owned a large citrus grove. The corporation had offered purchasers land sales contracts for small parcels of the grove along with a service contract for harvesting and marketing the fruit.\textsuperscript{79} The purchasers' tracts were jointly cultivated, and the company sold the produce, distributing the profits to the purchasers based on the acreage owned by each.\textsuperscript{80} Owing to economies of scale involved, the individual purchaser could not cultivate his or her small parcel profitably.\textsuperscript{81} The purchasers had no legal right of entry on the land to market the crop and had no right to specific fruit.\textsuperscript{82}

Based on these facts, the Court held that the transactions in effect involved the offer of an opportunity to contribute money and share in

\begin{itemize}
\item \textsuperscript{73} 15 U.S.C. § 78c(a)(10) (1988).
\item \textsuperscript{74} \textit{Id.}
\item \textsuperscript{75} 320 U.S. 344 (1943).
\item \textsuperscript{76} \textit{Id.} at 351.
\item \textsuperscript{77} \textit{Id.}
\item \textsuperscript{78} 328 U.S. 293 (1946).
\item \textsuperscript{79} \textit{Id.} at 295.
\item \textsuperscript{80} \textit{Id.} at 296.
\item \textsuperscript{81} \textit{Id.} at 295.
\item \textsuperscript{82} \textit{Id.} at 296.
\end{itemize}
the profits of a large citrus fruit enterprise, managed by the defendant corporation.\textsuperscript{83} The land sales contracts served as a convenient measure of the investors' respective shares of the profits, but the resulting transfers of rights in land were viewed by the Court as purely incidental to the profit-seeking venture:

The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed.\textsuperscript{84}

The \textit{Howey} Court elaborated on the term "investment contract," stating: "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 . . . ."\textsuperscript{85} From this language, the four elements that comprise the \textit{Howey} test emerged: (1) the investment of money; (2) in a common enterprise; (3) with the expectation of profits; (4) to come solely from the efforts of others.

The \textit{Howey} Court emphasized that its aim was to create a dynamic, flexible test that would give effect to the Congressional intent to protect the public from all deceptive schemes.\textsuperscript{86} The enduring validity of the test is evidenced by the fact that, forty-nine years later, courts still apply the \textit{Howey} test as the key to investment contract analysis.\textsuperscript{87}

An examination of the post-\textit{Howey} cases that have developed or refined the particular elements of the investment contract test\textsuperscript{88} illuminates a clear trend towards a less restrictive, more inclusive construction.\textsuperscript{89} This is consistent with the \textit{Howey} Court's objective of

\textsuperscript{83} Id. at 301. This holding represented an even further departure from the familiar paradigm of a security than had the \textit{Joiner} case, which involved the assignment of leaseholds on which oil wells were to be drilled. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 345 (1943).

\textsuperscript{84} \textit{Howey}, 328 U.S. at 300.

\textsuperscript{85} Id. at 298-99.

\textsuperscript{86} Id. The Court stated that the test "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." Id. at 299.

\textsuperscript{87} For example, Revak v. SEC Realty Corp., 18 F.3d 81, 87-88 (2d Cir. 1994), recently continued the application of the \textit{Howey} test as the authoritative standard in the investment contract analysis.

\textsuperscript{88} See Gene H. Williams, Note, \textit{The Continued Demise of the Howey Test: The Supreme Court Adopts the "Family Resemblance Test" For Identifying Notes as Securities}, 20 Stetson L. Rev. 613, 619-22 (analyzing the individual elements of the \textit{Howey} test). This discussion sets aside, for the moment, the common enterprise element, which will be expanded in part III.

\textsuperscript{89} Of course, to look at any one element of the test in isolation is somewhat artificial. Courts applying the test are looking at all the factors as interrelated components that collectively define a particular transaction as an investment contract.
creating a dynamic, flexible test and with the Congressional intent embodied in the Securities Acts.

A. The Investment of Money

The requirement of an investment of money is designed to capture only those investors who have undertaken some degree of economic risk.\(^{90}\) Consistent with the remedial purposes of the Securities Acts, courts have held that consideration other than cash satisfies this element.\(^{91}\) Interests in partnerships and stock in corporations, for example, are generally freely transferable for services or property.\(^{92}\) Thus, any plaintiff who had made the necessary investment of capital and undertaken the consequent risk of loss would not be eliminated on this first prong of the \textit{Howey} test.

While this element of the \textit{Howey} test seems simple, even self-evident, it has occasionally been the subject of dispute. For example, in \textit{International Brotherhood of Teamsters v. Daniel},\(^{93}\) the Supreme Court found that employee interests in a noncontributory, compulsory pension plan did not qualify as investment contracts subject to the Securities Acts. The Court based this conclusion on the fact that the employees had not been required to make a sufficient investment of money. The employees merely contributed labor and services, while the employer made the actual monetary contributions.\(^{94}\) Thus, the plaintiffs in \textit{Daniel} had not risked any economic loss and did not require the protections of the Securities Acts.

B. The Common Enterprise

The "common enterprise" element is the issue at the heart of this Note and is only briefly addressed here to give a sense of its relation


\(^{91}\) See, e.g., Joseph C. Long, \textit{An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation}, 24 Okla. L. Rev. 135, 161 (1971) (noting that "the consideration does not have to take the form of cash received").

\(^{92}\) For example, under § 6.21(b) of the Revised Model Business Corporation Act (1985), consideration may consist of "any tangible or intangible property . . . including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation." Revised Model Business Corp. Act § 6.21(b) (1985).

\(^{93}\) 439 U.S. 551 (1979).

\(^{94}\) Id. at 560-61; accord \textit{Black v. Payne}, 591 F.2d 83, 87 (9th Cir.) (holding that participation in Public Employees Retirement System did not constitute an investment contract), \textit{cert. denied}, 444 U.S. 867 (1979); see also \textit{Coward v. Colgate-Palmolive Co.}, 686 F.2d 1230, 1236-37 (7th Cir. 1982) (holding that there was no real economic risk to retirement plan's employee participants and thus the plan did not constitute a security), \textit{cert. denied}, 460 U.S. 1070 (1983); \textit{Childers v. Northwest Airlines, Inc.}, 688 F. Supp. 1357, 1362-62 (D. Minn. 1988) (finding that employee stock option plans were not securities under state or federal law).
to the Howey test as a whole. While the Howey Court did not make explicit its reasons for including this element, canons of construction compel the conclusion that it was neither inadvertent nor superfluous. Therefore, this element must meaningfully limit qualifying instruments to those that are properly subject to the Acts. Requiring that an enterprise be "common" seems designed to exclude one-on-one contracts, bargained for at arm's length. The common enterprise requirement posits some ongoing relationship or nexus among individuals with respect to a transaction. Where this nexus occurs, the ordinary rule of "caveat emptor" must give way to a policy of full disclosure. Courts have disagreed strenuously about the type of common interest and degree of commonality that any investment must exhibit.

C. The Expectation of Profits

The expectation of profits element of the investment contract test concerns the purpose for which capital is put forth by the investor. If the investor's purpose is to generate a return, regardless of the form in which such return is clothed, the policies of the Securities Acts come into play.

The courts have interpreted "profits" expansively and have refused to confine the term to any one form of return. Instead, the courts have preferred to define this requirement in broad terms, as capital appreciation or "a participation in earnings resulting from the use of investors' funds." The courts are generally in agreement that profits can include non-monetary returns. Conversely, even a monetary return may fail to satisfy this element on occasion. Interest proceeds,

95. For a more complete analysis of the common enterprise element, see infra part III.
96. See, e.g., United States ex rel. Harlan v. Bacon, 21 F.3d 209, 212 (8th Cir. 1994) ("[I]t is a cardinal and long-revered canon of statutory construction that Congress is not to be presumed to have done a vain thing, namely, using superfluous language.").
99. This disagreement will be explored at length in infra parts III and IV.
100. See Reves v. Ernst & Young, 494 U.S. 56, 66 (1990) ("[W]e examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it.").
101. Id. ("If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit [the instrument] is expected to generate, the instrument is likely to be a 'security.'").
103. See, e.g., Silver Hills Country Club v. Sobieski, 361 P.2d 906, 908-09 (Cal. 1961) (holding that membership interests in a country club were sufficient manifestations of profit to bring action within the state's securities laws); see also Thaddeus A.
for example, are monetary but are generally not considered to satisfy this element.\(^{104}\)

The Supreme Court addressed this requirement in \textit{United Housing Foundation, Inc. v. Forman}.\(^{105}\) In that case, the Court looked at shares of stock in a low-income housing cooperative to see if the shares qualified as investment contracts under the Securities Acts.\(^{106}\) The Court held that the shares in question did not meet the expectation of profits requirement because the purchasers' incentive in entering the transaction was to obtain affordable housing and not to earn a return.\(^{107}\) The Court thus examined the motivation of the investors rather than the form in which the return was received.

**D. Profits To Come Solely from the Efforts of Others**

The fourth element of the \textit{Howey} test addresses the degree of control exercised over the investment by the investor. If the investor is intimately involved in the running of the business, then he or she can affect the return received and is likely to have access to information regarding the investment's condition. This type of involved investor has no need for the enhanced disclosure required by the Acts. If, on the other hand, the investor is an outsider whose profits depend on exertions by third parties, the disclosure policies of the Acts are directly implicated.

The \textit{Howey} test therefore contemplates that the exertions relevant to the investment will come not from the investor\(^{108}\) but from the promoter or a third party.\(^{109}\) In accordance with the courts' generally expansive approach, later cases have softened this requirement by interpreting "solely" to mean "largely" or "principally."\(^{110}\) The courts'
refusal to be restricted to the literal term has enabled them to reach such transactions as founder-member arrangements, licensing agreements, and pyramid sale schemes.

SEC v. Glenn W. Turner Enterprises presents an example of an otherwise meritorious claim that would be defeated by an overly strict interpretation of Howey's final requirement. In Turner, a corporation with the unlikely name of Dare to Be Great, Inc. marketed self-improvement courses. The purchasers of the courses received two benefits: the privilege to attend seminars and, more significantly, the right to sell the courses to others and receive a commission. The district court preliminarily enjoined the sale of these courses as unregistered, non-exempt securities under the 1933 Act. On appeal, the Ninth Circuit acknowledged that the investor was required to exert some effort on his own behalf to realize a return. The court, however, reasoned that a literal interpretation of the final element of the Howey test would permit a dealer to evade the application of the Securities Acts simply by requiring the buyer "to contribute a modicum of effort." To avoid such an unrealistic consequence in light of the remedial purpose of the securities laws, the Turner court held that the test is whether the significant efforts of the enterprise are contributed by people other than the investor. The Turner court eschewed a literal interpretation of the fourth prong of the Howey test, but left to a later court the determination of just which efforts must be contributed by a third party for the enterprise to qualify as a security.

by parties other than the investor); SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973) (noting that a strictly literal interpretation would contravene the remedial purposes of the Securities Acts).


114. 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

115. Id. at 478-79.


117. Turner, 474 F.2d at 482.

118. Turner, 474 F.2d at 482.

119. Accord SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 464 (9th Cir. 1985); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974); see also Bailey v. J.W.K. Properties, 904 F.2d 918, 923-24 (4th Cir. 1990) (examining the ability of each individual investor to exercise ultimate control over the common enterprise).
In *Hocking v. Dubois*, the Ninth Circuit decided that the applicable standard is whether "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." Several other circuits have adopted the "undeniably significant" test that the Supreme Court noted, but did not apply, in the *Forman* case.

The courts have taken a consistently expansive approach in clarifying the particular elements of the *Howey* test. This expansive view corresponds with both the *Howey* decision's avowed intent to create a dynamic and flexible test and the policies underlying the Securities Acts. Moreover, the development of this expansive jurisprudence further supports an unrestricted approach. Any case construing the investment contract test must now take account not only of the statutes and the *Howey* decision, but of the inclusive trend that runs throughout the post-*Howey* investment contract analysis as well.

The courts' construction of the various elements of the *Howey* test adds up to a portrait of the investor whom the courts were anxious to protect under the rubric of the investment contract. The investor has undertaken some degree of economic risk. She is involved with at least one other individual in a transaction in which their interests may overlap or even conflict. The investor's motivation in making her investment is based upon the promise of a return. Finally, the investor of whom the courts are solicitous does not meaningfully participate in the running of the company in which she has invested and therefore has minimal or no control over the investment's perform-

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120. 885 F.2d 1449 (9th Cir. 1989).
121. *Id.* at 1455 (quoting *Turner*, 474 F.2d at 482).
122. *See, e.g.*, *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.) (advocating a non-literal reading of the term "solely"), *cert. denied*, 469 U.S. 831 (1984); *Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir.) ("[W]e adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." (quotation omitted)), *cert. denied*, 454 U.S. 897 (1981); *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) (stating that courts have noted that "solely" is not to be read strictly). The *Williamson* court cited three factors to be applied in determining if the test has been met with respect to a partnership, including: (1) an agreement of the parties that leaves so little power in the hands of the partner or venturer that the agreement in fact distributes power as would a limited partnership; (2) the partner or venturer is so inexperienced and unknowledgable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent upon some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. *Williamson*, 645 F.2d at 418-423.
124. *See supra* notes 90-94 and accompanying text.
125. *See supra* notes 95-99 and accompanying text.
126. *See supra* notes 100-04 and accompanying text.
The courts have concluded that such an investor has a special need for the full and fair disclosure mandated by the Securities Acts to make an informed investment decision.

III. DEFINING A COMMON ENTERPRISE: THREE COMPETING VIEWS

The common enterprise element of the investment contract test implicates the same policy concerns addressed by courts that have interpreted the other elements of the Howey test. Because the Securities Acts are not simply general proscriptions against fraud, the test must define those transactions whose characteristics are such that the application of the Securities Acts' protections is apposite. The test also must ensure that the investor for whose protection the Securities Acts were designed receives that protection.

The Howey Court required that to qualify as a security a particular transaction must constitute a "common enterprise." Clearly, this prong of the test contemplates that some relationship between individuals will exist with respect to a particular transaction. The case is silent, however, as to exactly what that relationship should be, how many individuals must be involved, or what role each individual should play if application of the Securities Acts is to be justified. Consequently, the courts have developed three different approaches to commonality: horizontal, strict vertical, and broad vertical, each based on courts' differing conclusions regarding the preconditions necessary to trigger application of the Securities Acts.

A. Horizontal Commonality

Horizontal commonality is the most restrictive of the three approaches to common enterprise and is based on some courts' interpretation of the facts of Howey itself. The horizontal approach examines the relationship among investors in a given transaction. Specifically, horizontal commonality requires a pooling of investors'

127. See supra notes 108-19 and accompanying text.
130. Id. at 294-97. In Howey, fruit from orange trees was collectively marketed and sold. Id. at 299. The proceeds were distributed to the investors in proportion to the number of citrus trees owned by each investor rather than by the yield of each individual tree. Id. at 296. This has been interpreted as leading to a requirement of pooling or a pro-rata distribution of profits. See, e.g., Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 222 (6th Cir. 1980) (holding that the transaction at issue did not involve pooling and therefore failed to meet the common enterprise test), aff'd on other grounds, 456 U.S. 353 (1982).
contributions and distribution of profits and losses on a pro-rata basis among investors. Courts adopting this view believe that only a transaction satisfying these conditions presents a common enterprise. Thus, the fortunes of each investor must be tied both to the success of the overall venture and to the fortunes of her fellow investors. By its terms, this test excludes transactions involving only one investor. Although technically the horizontal test requires the involvement of only three individuals (two investors and a promoter), the reality is that a system of pro-rata allocation is not very cost-effective unless several investors are involved. The horizontal test is therefore likely to embrace within its definition only those schemes in which numerous investors contribute to a fund and share proportionally in the returns.

Multiplicity of investors alone, however, is not enough. The commonality of interest among investors depends partly upon what the court determines to be the relevant investment unit. In Milnarik v. M-S Commodities, Inc. for example, a group of family members opened a discretionary commodity trading account. The Court of Appeals for the Seventh Circuit scoffed at the idea that "every conceivable arrangement that would fit a dictionary definition of an investment contract was intended to be included within the statutory definition of a security." The court concluded that the defendant

132. See Black's Law Dictionary 848 (abr. 6th ed. 1991) (defining "pro rata" as "[p]roportionately; according to a certain rate, percentage or proportion . . . . For example, if a corporation has ten shareholders each of whom owns 10% of the stock, a pro-rata dividend distribution of $1,000 would mean that each shareholder would receive $100.").
133. See Curran, 622 F.2d at 222-23.
134. Id. at 224; see also Deckebach v. La Vida Charters, Inc., 867 F.2d 278, 283 (6th Cir. 1989) (holding that plaintiffs failed to prove a common enterprise because they failed to demonstrate a pooling of venture capital); Arnold v. Bache & Co., 377 F. Supp. 61, 64 (M.D. Pa. 1973) (finding that a discretionary commodity account was not a security due to lack of common enterprise); Stuckey v. duPont Glore Forgan Inc., 59 F.R.D. 129, 131 (N.D. Cal. 1973) (holding that discretionary commodities futures trading account failed to demonstrate horizontal commonality).
135. Curran, 622 F.2d at 222-23.
137. Id. at 274; see also Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149, 1149 (N.D. Ill. 1970). For factually similar cases, see Brodt v. Bache & Co., 395 F.2d 459 (9th Cir. 1978), and SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974). See also Peloso & LaBella, supra note 131, at 308. A discretionary commodity trading account is one in which the investor gives the broker power of attorney to make all trading decisions. The broker is empowered to manage the account for the benefit of the investor and does not have to consult or obtain permission to trade the accounts. Id. at 308 n.1. This Note refers to this type of investment on a recurring basis to illustrate the distinct results obtained by applying the different commonality tests to the same or similar factual constructs.
138. Milnarik, 457 F.2d at 275-76.
broker was merely a common agent for all of his customers, including the plaintiffs. Common enterprise was lacking because these disparate customers made no unified investment decisions. The Milnarik court refused to credit the conversion of the agency relationship into a statutory security. The court's analysis was premised on its unarticulated assumption that the Howey test required a finding of a common enterprise among all the broker's customers. Milnarik did not address the commonality of interest within the family unit which held the account. While the larger investment unit failed the horizontal commonality test, this smaller group may well have participated in a common enterprise, even under the court's restrictive view.

The Seventh Circuit Court of Appeals maintained its allegiance to the horizontal test in Hirk v. Agri-Research Council, Inc. In Hirk, the investor opened a discretionary futures trading account and executed a power of attorney permitting the broker to trade his account. After suffering substantial losses, the investor sued claiming that he had been fraudulently induced to enter the trading agreement in violation of the 1933 Act. Hirk identified a “tripartite framework” of principles governing the construction of the term “investment contract”: the remedial nature of the securities laws, a legislative mandate for a liberal and flexible interpretation, and an emphasis on economic reality. None of these broad principles, however, was significant enough to divert the Seventh Circuit from its adherence to a strict pooling requirement. Because the investor in Hirk was unable to demonstrate that his funds were pooled with those of other investors, the court found that a common enterprise was lacking and the Securities Act did not apply. The court quoted with approval the Milnarik court's rejection of the all-inclusive, “dictionary definition” approach. Beyond its reluctance to overrule Milnarik, however, the court provided no affirmative support for the pooling limitation.

The strengths of the horizontal commonality test include its ease of application and the meaningful limits it sets on the types of enterprises that qualify as securities. The test establishes an easily determinable dividing line and does not require a great deal of difficult umpiring by the fact-finder. For example, it is clearly easier to assess whether

139. Id. at 278 (noting that plaintiffs were merely the principals of an agent).
140. Id. at 279.
141. Id.
142. 561 F.2d 96 (7th Cir. 1977).
143. Id. at 98.
144. Id.
145. Id. at 100.
146. Id.
147. Id. at 102.
148. Id. (quoting Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 275-76 (7th Cir. 1972)).
there has been pooling or a pro-rata sharing of assets than whether the success of the investment has been inextricably intertwined with the promoter's efficiency—a judgment called for under the broad vertical commonality test.\textsuperscript{149} Under the horizontal test, an investor or promoter need not wait for judicial resolution to know whether the prerequisites for the application of the Securities Acts have been met. If there are multiple investors and pooling or pro-rata allocation has occurred, then the issue meets the common enterprise requirement. Thus, the registration, disclosure, and other obligations under the Acts are triggered.

Furthermore, the horizontal test is likely to restrict qualifying investment contracts to transactions that closely resemble the conventional definition of a security. Qualifying investments will involve multiple contributors sharing profits and losses on a proportional basis, much as shareholders in a corporation do. The Securities Acts, however, include within their intention "any interest or instrument commonly known as a security" as a separate category of securities.\textsuperscript{150} To the extent that application of the horizontal test causes the definition of an investment contract to overlap with this additional category, this approach renders one of the listed instruments superfluous.

Courts relying on this test have pointed to the fact that the \textit{Howey} case itself involved multiple investors participating in a single investment enterprise.\textsuperscript{151} Neither the broad vertical nor the narrow vertical approaches have received even implicit Supreme Court endorsement.

Finally, the provisions of the Securities Acts were not intended to reach fraud in general, and the horizontal test is capable of identifying transactions to which the Acts should apply. As Professor Ronald Coffey noted:

The special prohibitions against misstatements and material omissions, together with specific procedures and remedies, constitute a general liberalization of common law fraud relief and are obviously meant to apply only when there are special policy justifications for invoking their protection.

Combining the preceding conclusions, the following proposition may be legitimately derived from an examination of statutory construction: A "security" is a transaction whose characteristics distin-

\textsuperscript{149} See infra notes 184-87 and accompanying text.


\textsuperscript{151} See, e.g., Hirk, 561 F.2d at 101 ("It is apparent then that this Court's decision in [an earlier case] was based on the assumption that a sharing or pooling of funds is required by \textit{Howey}."); see also SEC v. W.J. Howey Co., 328 U.S. 293, 296 (1946) ("All the produce is pooled by the respondent companies. . . .") This interpretation, however, merits closer analysis. The facts of \textit{Howey} indicate that the payments of the individual investors were for the purchase or servicing of individual tracts. The profits were based on the estimated yield of each individual tract. \textit{Id.} at 295-96. There is an argument to be made that this is not really a pooling of assets with a pro-rata distribution of profits but rather a convenient system of accounting which avoided the need to count each orange in calculating the investor's return.
guish it from the generality of transactions so as to create a need for the special fraud procedures, protections and remedies provided by the securities laws. This proposition may be rephrased in the form of a "master question" regarding the nature of a security: What characteristics or features of a transaction necessitate its being subject to the rather specialized anti-fraud protection afforded by the securities laws?  

The horizontal test answers this "master question" by requiring certain characteristics of qualifying transactions. A transaction in which there are multiple investors whose funds are pooled, and who receive a pro-rata distribution of profits or allocation of losses, is one to which the securities laws should apply under the horizontal test. The test seems to assume that where there is a single investor or where the investor's contribution is separate and distinguishable, the investor can negotiate for the relevant information and does not require the protection of the Securities Acts.

The horizontal test is unduly restrictive, however, when it limits commonality to transactions that involve more than one investor. Regardless of the fraud perpetrated or the investor's lack of expertise and dependence on the promoter, the common enterprise element will not be present unless multiple investors participate in a unified investment enterprise. This seems to postulate a buyer's market in securities, in which the single investor will have the market power to demand all necessary material information. It ignores the extent to which an inexpert single investor may not ask the right questions, or may not recognize a fraudulent, but reassuring response. In reality, a single investor may have an even greater need for disclosure. In the event of fraud, the single investor bears the entire loss alone. The horizontal test does not take into account the possibility of multiple, parallel frauds, each involving an investment contract between the promoter and one investor.

Horizontal commonality is also overly exclusive in its unduly mechanical reliance on pooling, a formal requirement that is largely irrelevant to the question of whether there is a special need for en-


153. See, e.g., Hirk, 561 F.2d at 100-01 (rejecting the investor's argument that a pooling requirement erodes the remedial potential of the Securities Acts and finding that the investor's claim failed the pooling requirement).

154. See id.; see also Gordon, supra note 97, at 667 (proposing a multiplicity test, under which a common enterprise is a profit seeking venture among a promoter and multiple parallel investors and does not extend to unique, individually negotiated contracts between two parties).

155. See, e.g., Hirk, 561 F.2d at 101 (interpreting Howey as requiring pooling of funds); see also Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 278 (7th Cir.) (finding a pooling of funds to be a prerequisite for application of the Securities Acts), cert. denied, 409 U.S. 887 (1972).
hanced disclosure.\textsuperscript{156} As discussed, this type of bright line indicator makes the test easily applicable. This may, however, also make the test easy to evade by a disingenuous promoter who simply maintains separate bank accounts or who dissipates the investors' contributions immediately.

Finally, one of the strengths of the horizontal test can be turned into an argument against it. The horizontal test restricts the application of the Securities Acts to transactions that closely resemble the scheme at issue in \textit{Howey}. The \textit{Howey} Court, however, provided no authority for the limitation and emphasized that its goal was to create a liberal and flexible test that would effectuate the policy of investor protection inherent in the Securities Acts.\textsuperscript{157} The Court recognized the futility of any attempt to predict the exact form of an investment contract in the future. The remedial principles of the Securities Acts and the dynamic intent of the \textit{Howey} Court are therefore frustrated by the horizontal test's insistence on confining the holding to its facts.

\textbf{B. Strict Vertical Commonality}

The hallmark of strict, or narrow, vertical commonality\textsuperscript{158} is the economic relationship between the investor and the promoter. Under the strict vertical test, a common enterprise exists if the fortunes of the investor and the promoter are interwoven and mutually dependent.\textsuperscript{159} This direct connection between the success of the promoter and the success of the investor\textsuperscript{160} leads to a corollary requirement that the risks of the venture be shared.\textsuperscript{161}

Strict vertical commonality rejects the requirement of multiple investors that is inherent in the horizontal test.\textsuperscript{162} Moreover, the strict vertical test is indifferent as to whether the investors' contributions are pooled in a single account or distributed on a pro-rata basis.\textsuperscript{163} The narrow vertical standard differs from the broad vertical approach in that the test depends not on the investor's dependence on the promoter,\textsuperscript{164} but on the economic parallel between the two parties' risks

\textsuperscript{156} See Gordon, \textit{supra} note 97, at 660.
\textsuperscript{158} "Strict" and "narrow" vertical commonality are synonymous terms.
\textsuperscript{159} Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), \textit{cert. denied}, 469 U.S. 1115 (1985).
\textsuperscript{160} SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 463 (9th Cir. 1985) (requiring a direct correlation between an investor and a promoter).
\textsuperscript{161} See \textit{Brodt}, 595 F.2d at 461.
\textsuperscript{162} Id.
\textsuperscript{163} Id. at 460-61. This distinction, however, may not be so great because the promoter and investor in a strict vertical jurisdiction must pool funds or share profits to demonstrate the necessary correlation in fortunes. \textit{Id}.
\textsuperscript{164} See, \textit{e.g.}, SEC v. \textit{Koscot Interplanetary, Inc.}, 497 F.2d 473, 478 (5th Cir. 1974) (holding that the impact of the promoter's efforts is the critical determinant of common enterprise).
and rewards. If the fortunes of the promoter and the investor rise or fall together, the strict vertical test is satisfied.

The strict vertical approach to commonality developed because some courts found that the horizontal test, with its stringent reliance on pooling, would exclude transactions in which vulnerable investors suffered losses at the hands of unscrupulous promoters, merely because the investors' funds were not pooled. For example, pyramid sales schemes typically involve a pass-through of contributions from investors at the bottom of the pyramid to the promoter at its apex. The investor contributions are never collected in one place, and thus, despite the existence of fraud and a common investment structure, the pooling requirement of the horizontal test is unmet. Some courts saw this as contrary to the remedial nature of the Securities Acts and developed a new form of vertical commonality in response to such situations.

The Ninth Circuit pioneered the strict vertical test in SEC v. Glenn W. Turner Enterprises, a case that focused on the expectation of profits requirement. The common enterprise analysis was confined to a single footnote, which stated, "A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." Despite its conclusory nature, this statement became the cornerstone of investment contract analysis not only for courts within the Ninth Circuit, but also for many other courts faced with interpreting the second element of the Howey test.

SEC v. R.G. Reynolds Enterprises, Inc. presents a recent application of the strict vertical test of commonality. In Reynolds, the defendant raised approximately $2,000,000.00 from 148 small investors who bought into a "managed account" advertised via the defendant's radio program and financial newsletter. The SEC brought an enforcement action alleging fraudulent misrepresentations and a violation of the registration requirement. The court casually mentioned that Reynolds deposited the investors' contributions into a single ac-

165. Brodt, 595 F.2d at 461.
166. See, e.g., SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir.) (finding a common enterprise despite the absence of pooling), cert. denied, 414 U.S. 821 (1973).
167. Id.
168. Id.
169. Id. at 482 n.7.
170. Id.
172. 952 F.2d 1125 (9th Cir. 1991).
173. Id. at 1128.
174. Id. at 1129.
count, but placed no reliance on the presence of pooling. Similarly, the court alluded to the defendant's expertise, a critical factor under the broad vertical test, but did not consider this factor dispositive. Instead, the court focussed on Reynolds's agreement to accept a percentage of the managed account's assets as a management fee.

The court found that this arrangement comprised a sufficient link between the fortunes of the investors and those of the promoter to qualify the transaction as a common enterprise. The scheme in question was therefore an investment contract to which application of the Securities Acts was appropriate.

An agent-principal relationship (such as a broker-customer relationship) will not always qualify as an investment contract under the strict vertical approach because often the economic fates of the promoter and investor are independent. In the usual context, the promoter will earn a commission regardless of the profits or losses of the investor. The transaction may not qualify as an investment contract, even if the promoter is paid a commission based on the percentage of the profits made by the investor. In Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc., for example, the court held that an investment contract was not present where the promoter received a percentage of the managed assets, because the investor could withdraw the profits as they accrued, and, in that event, the promoter would not have shared the profits.

The strict vertical standard answers Professor Coffey's master question with the following paradigm of a security: a transaction in which the investor and promoter's interrelationship is such that their fortunes rise or fall together. In other words, if the investor benefits, so does the promoter. This test exposes for the court's consideration the relationship between the promoter and the investor. This relationship is of paramount importance in determining whether the Acts' policies of enhanced disclosure are necessary to protect the investor.

Strict vertical commonality, while it addresses this critical relationship, is not without shortcomings. This approach is typically considered more liberal than the horizontal standard for common enterprise, but there is one area in which it may in fact be more restrictive. Under the strict vertical approach, the coverage of the Securities Acts

175. Id.
176. Id. at 1128.
177. Id. at 1130-31.
178. Id.
179. See Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982) ("The element of this definition that will generally be absent from a commodities futures trading account is the requirement of a common enterprise."), cert. denied, 469 U.S. 1115 (1985).
180. 686 F.2d 818 (9th Cir. 1982).
181. Id. at 619.
182. See supra note 152 and accompanying text.
may not be extended to fraudulent schemes in which the promoter does not share in the risks of the venture. This limitation is in contravention of the remedial purposes of the Securities Acts in that common enterprises among a class of investors will be excluded as long as the promoter's compensation is not tied to the performance of the group investment. The strict vertical test alone, therefore, is inadequate to ensure that a promoter who risks nothing fully discloses material information. 183

C. The Broad Vertical Approach

Broad vertical commonality is the most liberal of the common enterprise tests. 184 The broad vertical test rejects horizontal commonality's stringent reliance on pooling. Like the strict vertical test, broad vertical commonality depends on the relationship between the investor and promoter. 185 Unlike the narrow vertical approach, however, the broad vertical test is not concerned with the economic interdependence of the promoter and investor but instead examines the investor's dependence on the promoter's expertise. 186 Courts adhering to this view consider whether the investor's realization of profits is inextricably tied to the promoter's effectiveness and skill. Where this nexus occurs, the broad vertical test of commonality is satisfied. 187

The Fifth Circuit Court of Appeals developed the broad commonality standard in SEC v. Koscot Interplanetary, Inc. 188 The Koscot scheme involved another subsidiary of Glenn W. Turner Enterprises. 189 The scheme consisted of a multi-level network of independent distributors, purportedly engaged in the sale of cosmetics, all of whom were lured by the promise of "galactic profits." 190 Elaborately scripted "Opportunity Meetings" and "Go-Tours" were the means used to recruit new participants. Each new participant paid a sum of money to access the lowest level of the Koscot ladder. 191 Once a member of the organization, the investor ascended the ladder and earned commissions by convincing others to join the organization. 192

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183. In fact, a promoter whose compensation is tied to the performance of the venture has an incentive to promote the investor's interests and might be therefore less likely to perpetrate a fraud.
185. See, e.g., Continental, 497 F.2d at 522 ("[T]he critical factor is not the similarity or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts.") (quoting Koscot, 497 F.2d at 478).
186. Id. ("[T]he critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise.")
187. Id.
188. 497 F.2d 473 (5th Cir. 1974).
189. Id. at 475.
190. Id.
191. Id. at 475-76.
192. Id.
The SEC sought to enjoin the scheme for violations of the anti-fraud and registration provisions of the Securities Acts. Reversing the district court, the Fifth Circuit held that the promotional pyramid scheme in *Koscot* constituted a common enterprise and thus a security subject to the Acts. The court held that "the requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy of the Koscot meetings." Because the investor could not successfully recruit new participants outside the framework of the Go-Tours and Opportunity Meetings, the court found the necessary dependence on the Koscot organization.

The Fifth Circuit confirmed the applicability of the broad vertical standard two days later in *SEC v. Continental Commodities Corp.*, a case concerning the application of the Securities Acts to discretionary commodity trading accounts. Citing *Koscot*, the Fifth Circuit argued that "the critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent on promoter expertise." Because the investors relied on the business acumen of the promoter, the trading accounts qualified as investment contracts under the resilient approach of the broad vertical test. In the Fifth Circuit's view, the focus on investor dependence and promoter skill gives full effect to the remedial purposes of the Securities Acts and the underlying rationale of the *Howey* decision.

Broad vertical commonality seems to be directly related to the policy of disclosure underlying the Securities Acts. This approach asks whether the investor is dependent on the future exercise of the promoter's managerial and entrepreneurial effort and skill. This inquiry is directly relevant to the need for enhanced disclosure.

The broad vertical approach to commonality also is protective of the investor, because it looks at the relationship of the investor to the promoter at the time that the investor was induced to enter into the investment contract. If, at that time, a critical enticement was the promoter's expertise, the "expert" promoter should be held liable if the scheme turns out to be less than he advertised it to be.

The logical applicability of the broad vertical test, however, is undermined by two analytical flaws. First, the broad vertical test is largely duplicated by the other prongs of the *Howey* test. Broad vertical commonality is probably always present whenever the first, third, and especially the fourth prongs of the *Howey* analysis are met.

193. *Id.* at 474.
194. *Id.* at 478-79.
195. *Id.* at 479.
196. *Id.*
197. 497 F.2d 516 (5th Cir. 1974).
198. *Id.* at 522.
199. *Id.*
200. *Id.* at 522-523.
Whenever there is an investment of money with the expectation of profits to come solely from the efforts of others, the investor probably also relies on the expertise of the promoter. For example, if an investor with no previous experience in the industry were to invest money in a cattle-feeding scheme, and were doing so with the intention of receiving profits from the efforts of the feedlot managers, that investor would be automatically dependent on the feedlot managers' expertise. The test therefore appears to have no independent significance.

The second problem with the broad vertical test is that it is simply too broad. Because it requires only a commonality of interest between two parties to a contract, many profit or income-sharing contracts would qualify as securities. The Securities Acts are not meant to be general fraud provisions. Insofar as the broad vertical approach does not screen any further than the other elements of the Howey test and does not exclude transactions that do not have the indicia of securities, it does not answer Professor Coffey's master question.

While broad vertical commonality standard is the most liberal of the three tests, it can unduly restrict commonality in one circumstance. The focus on the promoter's expertise, taken to its logical extreme, would exclude knowledgeable investors who are not entirely dependent on the promoter's skills from the protections of the Acts. For example, a metallurgist who invested in a gold refining scheme would not qualify for the protection of the Securities Acts. This exclusion rests on the fallacious assumption that knowledge or expertise in an area shields the investor from any type of fraud. The Securities Acts were not intended to penalize knowledgeable investors but to protect all members of the investing public from fraudulent schemes.

202. These facts are similar to those presented by Long v. Schultz Cattle Co., 896 F.2d 85 (5th Cir. 1990).
203. See Gordon, supra note 97, at 665.
204. See supra note 152 and accompanying text.
205. For example, the broad vertical test is the only approach to have found a common enterprise in a broker-customer relationship. See SEC v. Continental Commodities Corp., 497 F.2d 522-23 (5th Cir. 1974); cf. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 222-23 (6th Cir. 1980) (holding that horizontal commonality does not exist unless there also exists some relationship which ties the fortunes of each investor to the success of the overall venture), aff'd on other grounds, 456 U.S. 353 (1982). Although the broker is technically the agent of the client, courts applying the broad vertical test have found a common enterprise based upon the broker's expertise.
206. See Continental, 497 F.2d at 522.
207. See Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). In Tcherepnin, the Court emphasized that a broad and expansive scope of the definition of security was necessary to carry out the remedial statutory purposes of the securities laws. Id.; see also Landreth Timber Co. v. Landreth, 471 U.S. 681, 687 (1985) (citing the Howey case as defining a security broadly so as to ensure full and fair disclosure with respect to a wide range of instruments). “[T]he reach of the Act does not stop with the obvious
broad vertical test undermines this goal when it excludes transactions in which a knowledgeable investor participates.208

D. The Problem

None of the existing tests is perfectly consistent with the remedial purposes of the Securities Acts, the rationale underlying the Howey case, and the expansive jurisprudence developed by the courts regarding the other elements of the investment contract analysis. Different factual contexts expose the weaknesses of the individual tests. The single investor is left vulnerable by the horizontal test. The narrow vertical approach denies protection to an investor in an enterprise in which the promoter does not share in the risks of the venture. The broad vertical approach is analytically flawed and will not protect a knowledgeable investor.

Moreover, the very existence of multiple tests undermines the purposes of the Securities Acts. The appropriate test should be universally applicable, because in drafting the 1933 and 1934 Acts Congress recognized that the existing structure of state regulation was inadequate in light of the interstate nature of many securities transactions.209 The Acts were intended to provide a uniform level of protection on a nationwide basis, and the splintering of the circuits on the common enterprise issue defeats this end. While distinctions among jurisdictions are an inevitable result of federalism, Congress in 1933 lifted the regulation of securities out of the realm of purely intra-state authority precisely because a system of inconsistent standards had proven ineffective.

Finally, to be effective, a universal test must capitalize on the strengths of the approaches that have evolved so far. While none of the existing tests is perfect, each has value as an analytical tool in determining those transactions to which application of the Securities Acts is appropriate.

IV. The Extent of The Split And The View From Mid-Decade

None of the three approaches to commonality has gained dominance over the other tests. Some courts' exclusive adherence to one test has crystallized over the years into unquestioning allegiance. Such entrenchment means that the differences among some courts have widened over time. For instance, the Third Circuit, which ad-

208. See SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 481 (9th Cir.), cert. denied, 414 U.S. 821 (1973). "The Acts were designed to protect the American public from speculative or fraudulent schemes of promoters." Id. (citing S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933)).

209. See supra notes 20-37 and accompanying text.
hers exclusively to the horizontal test, has developed a very different perspective from the Ninth Circuit, which follows the strict vertical approach, and the Fifth Circuit, which pioneered the broad vertical test. A uniform test that brings all these viewpoints into harmony to create an acceptable national standard would be difficult to achieve. While this entrenchment is a serious concern, at least those jurisdictions that have elected an exclusive approach have provided a degree of predictability for the litigants and business planners within their authority. A still greater concern is engendered by those district and circuit courts that have not elected a single approach. The multiplicity of available approaches means that the result in a given case can depend not only on the jurisdiction in which the case is brought but also on the judge selected to hear the case. Parties in very similar cases, even within a single circuit or district, can experience very different results depending on such variables. This violates the policies underlying the existence of a federal regulatory scheme and results in adjudications that are unprincipled because the applicable standards are manipulable.

An audit of cases decided within the 1990s clearly indicates that the Howey test is alive and well—and frequently litigated. A number of the recent cases were concerned with the construction of the first, third, and fourth elements of the Howey test. The common en-
Common Enterprise element also received its share of attention from the federal courts during this period. The circuits showed no greater consensus as to the common enterprise test than in prior periods, as recent cases have supported each of the horizontal,\textsuperscript{216} strict vertical,\textsuperscript{217} and broad vertical\textsuperscript{218} approaches to commonality. One trend that emerges from an examination of the recently decided cases is the courts' willingness and ability to manipulate the standard to reach a desired result.\textsuperscript{219} This manipulation is clearly possible when the court lacks an authoritative standard because the court can choose a more or less liberal test depending on its view of the facts of the case. The same phenomenon occurs, however, among courts that do adhere to a single standard; the courts will use the test to reach those transactions to which application of the Acts will result in what the court perceives as a just outcome. This type of manipulation may well be consistent with the remedial purposes of the Acts, as well as the Howey Court's goal of creating a flexible test. Nonetheless, a type of cognitive dissonance results as the courts stretch the settled meanings of various concepts to reach the outcome they perceive as just.

A prime example of this type of stretching is found in McCoy v. Hilliard.\textsuperscript{220} In McCoy, the Sixth Circuit examined the sale of managed barge investment programs.\textsuperscript{221} The barges were sold either individually or through limited partnerships and operated as part of a "pool" of barges in which revenues and expenses were allocated on a pro-rata basis among the various investors.\textsuperscript{222} By calling a fleet of barges a "pool" of barges, the court managed to pull the transaction within the ambit of the Securities Acts.\textsuperscript{223} Implicitly applying the horizontal test,
the court found such pooling adequate to qualify the scheme as a com-
mon enterprise.\textsuperscript{224}

The Sixth Circuit, in \textit{McCoy}, approached the common enterprise
problem very differently than did the Seventh Circuit in \textit{Wals v. Fox Hills Development Corp.}\textsuperscript{225} In \textit{Wals}, the court held that the sale of
condominium interests did not qualify as a security transaction, even
though rental pool arrangements were present in the case.\textsuperscript{226} The
court found that the rental pool arrangements were individual con-
tracts between each purchaser and the developer.\textsuperscript{227} Because there
was no overarching rental pool arrangement according to which prof-
its would be distributed pro-rata among all purchasers, the court
found that horizontal commonality was not present.\textsuperscript{228} This type of
rental pooling arrangement, however, is much closer to the formal
pooling requirement imposed in earlier horizontal commonality cases
than were the fleet of barges involved in \textit{McCoy}. The difference in
results may turn on the fact that in \textit{McCoy} the court smelled a scam,
while in \textit{Wals}, the court attributed the investors' loss to the overall
decline in the real estate market.

Another area in which the courts have exercised discretion is in de-
fining the investment unit within which the commonality is to be eval-
uated. In \textit{Stone v. Kirk},\textsuperscript{229} the transaction at issue was a tax shelter
involving joint ventures.\textsuperscript{230} The business of each joint venture en-
tailed the leasing of master recordings that could be used in the pro-
duction of phonograph records, tapes, and cassettes.\textsuperscript{231} In the court's
wry estimation, the investments "proved costly."\textsuperscript{232} The plaintiffs lost
the entire amount that they had invested, the anticipated tax benefits
were disallowed, and the IRS demanded penalties and interests on the
overdue taxes.\textsuperscript{233} Among other defenses, the promoter claimed that
the scheme lacked the necessary commonality to qualify as a secur-
ity.\textsuperscript{234} The court noted that the horizontal commonality requirement
had never been adopted by the Supreme Court, but went on to hold
that "the horizontal commonality requirement . . . means only that

\begin{footnotesize}
\textsuperscript{224} Id. at *8-9. The primary issue in the case was the reliance by the investors on
the efforts of third parties. The court found that the fourth prong of the \textit{Howey} test
was satisfied and that the interests in question were securities. \textit{Id.}

\textsuperscript{225} 24 F.3d 1016 (7th Cir. 1994).

\textsuperscript{226} \textit{Id.} at 1019.

\textsuperscript{227} \textit{See id.}

\textsuperscript{228} \textit{Id.}

\textsuperscript{229} 8 F.3d 1079 (6th Cir. 1993).

\textsuperscript{230} \textit{Id.} at 1081.

\textsuperscript{231} \textit{Id.} at 1082.

\textsuperscript{232} \textit{Id.} at 1083.

\textsuperscript{233} \textit{Id.}

\textsuperscript{234} \textit{Id.} at 1085; Defendant Kirk argued that the court's decisions in \textit{Deckebach v. La Vida Charters, Inc.}, 867 F.2d 278 (6th Cir. 1989), and \textit{Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}, 622 F.2d 216 (6th Cir. 1980), \textit{aff'd on other grounds}, 456 U.S. 353 (1982), mandated the imposition of the horizontal commonality requirement.
\end{footnotesize}
funds of two or more investors must go into 'a common pool from which all may benefit.' Because each of the joint ventures had multiple investors, and funds from a common pool were to be used to exploit a master recording for the benefit of all the venturers, the court found that the case presented the requisite commonality. The court drew no distinction between the common interests shared between the members of the limited partnerships and the commonality shared by the investors in the larger scheme. It therefore analyzed the common enterprise element with reference to the larger investment unit, as had the court in *Milnarik v. M-S Commodities, Inc.* Unlike the *Milnarik* court, however, the *Stone* court did not find this larger unit to be a stumbling block to a conclusion that the case presented an investment contract.

In *DCD Programs, Ltd. v. Hill, Farrer & Burrill*, the same type of investment-within-investment structure was analyzed under the narrow vertical test. There, the Ninth Circuit reviewed a scheme whereby money was raised by means of limited partnerships for investment in a larger venture, the Leighton corporations. Reversing the district court, the Ninth Circuit held that there existed a direct correlation between the Leighton scheme corporations and the monies received from the limited partnerships. Because their fortunes were clearly linked, the court held that the requisite strict vertical commonality was established. The *Stone* and *DCD* courts, then, applied different tests to very similar factual situations and yet reached the same outcome.

When a court felt that justice so required, the strict vertical standard has also proved malleable. In *SEC v. Eurobond Exchange, Ltd.*, the SEC brought an action against the president of an investment company, who sold to American investors certain interest-bearing foreign treasury bonds issued by various governments. These bonds were purchased in large part with foreign currency loans carrying much lower interest rates than those received on the bonds. The court affirmed the applicability of the strict vertical approach to the common enterprise test, holding that "'[i]t is not necessary that the funds of investors are pooled; what must be shown is that the fortunes..."
of the investors are linked with those of the promoters, thereby estab-
lishing the requisite element of vertical commonality."

The defendant, however, contended that his company's compensation was not paid from investor profits, but rather up front, and that therefore the requisite commonality was lacking.

The court nonetheless found that there was a common enterprise, based on two factors. First, a certain defined surplus from the scheme, if realized, was to belong to Eurobond under the terms of the agree-
ment. Second, and more importantly, the investor and Eurobond shared the risk of loss. If the foreign governments were to default on the bonds, Eurobond and the investors would lose whatever profits they gained from the bonds purchased with foreign currency loans.

As for loans from Eurobond itself, the investors were advised that "if Eurobond defaults, you could lose a pro rata portion your invest-
ment." The court therefore held that the investor's success corre-
sponded to the financial stability of Eurobond, and the requisite commonality was present.

Oddly enough, it was a court applying the most liberal of the three tests that was the exception to this trend of malleability. In Guidry v. Bank of LaPlace, the Fifth Circuit addressed a scheme whereby the "investors" would provide the promoter (or scam artist, as the case may be) with funds to purchase large blocks of airline tickets for groups taking gambling trips to Las Vegas. The promoter indicated that certain Las Vegas hotels would reimburse him for the tickets and pay him a commission. Each victim gave the promoter a check, and in return the promoter provided two checks, both post-dated one month later. One check was for the amount of the victim's check, and the other represented the victim's return on that amount. The federal securities claims were dismissed based on failure to satisfy the expectation of profits prong (the third element of the Howey test), but the case appears to support the Fifth Circuit's continuing adherence to the broad vertical commonality test. Interestingly, the case

245. Id. at 1339 (quoting Brodt v. Bache & Co., 595 F.2d 459, 460 (9th Cir. 1978)).
246. Id.
247. Id. at 1340.
248. Id.
249. Id.
250. Id. (citing United States v. Carman, 577 F.2d 556, 563 (9th Cir. 1978) (holding that where an investor's avoidance of loss depends on the promoter's sound management and continued solvency, a common enterprise exists)).
252. 954 F.2d 278 (5th Cir. 1992).
253. Id. at 281.
254. Id.
255. Id.
256. Id. The returns ranged between four and seven percent per month for various contributions, but each individual return was for a specific and non-variable amount, as represented by the second post-dated check. Id. at 281 n.2.
257. Id. at 284.
belies the assertion of some of the broad vertical test's critics that anything qualifies as a security under that test. In this case, the promoter committed an undoubted fraud, but the Securities Acts were held not to apply.

A second phenomenon that can be distilled from the current crop of cases is a tendency for courts to hold investment promoters to their word. Promoters who advertise a scheme as an investment and then attempt to defend a suit by pleading lack of commonality have not met with success. The courts again appear willing to stretch the applicable test to reach a just result.

In *Teague v. Bakker*, for example, the Fourth Circuit dealt with the collapse of the empire of television evangelist James Bakker. In particular, the court evaluated the status of the sale of “lifetime partnerships” (“LTPs”) entitling the purchasers to a short annual stay at a vacation retreat constructed by PTL (“Praise the Lord” or “People that Love”). The primary issue in the case was whether the purchasers made their investment with an expectation of profits to come solely from the efforts of others. The court held that the distribution of profits to the partners in the LTP scheme on a pro-rata basis was sufficient to meet the horizontal test and that the court therefore did not have to reach the issue of whether some form of vertical commonality would satisfy the second prong of the *Howey* test. This distribution of profits (in the form of appreciation in the value of the investors' stay at the resort) strays from the orthodox concept of a pro-rata allocation of returns. The court's decision to hold Bakker and his cohorts liable for the offer and sale of unregistered, non-exempt securities appears in part to have been motivated by the fact that Bakker touted the Lifetime Partnerships as a great investment in his solicitation pamphlets.

Another hyperbolic promoter got his comeuppance in *SEC v. R.G. Reynolds Enterprises*, a case in which the SEC brought an action against the promoters of an investment and gold buying program. The defendant, an investment adviser with a radio and television talk show, through his wholly owned corporation, offered and sold an in-

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258. The key player was sentenced to 15 years in prison after pleading guilty to charges stemming from the scheme. Id. at 280.
259. 35 F.3d 978 (4th Cir. 1994).
260. Id. at 981.
261. Id. at 986.
262. Id. at 986 n.8.
263. Id.
264. Among other unusual features, the investors' returns were not distributed to them at all. If the profits were measured by the appreciation in value of the investor's annual stay, that appreciation was inextricably linked to the PTL property.
265. *Bakker*, 35 F.3d at 983.
266. 952 F.2d 1125 (9th Cir. 1991). *Reynolds* is discussed above as a case exemplifying the strict vertical test of commonality. See supra text accompanying notes 172-78.
vestment program that he variously called a “Managed Account,” a “discretionary account,” the “30% Net Investment Program,” and the “Loan Program.” The investment was made in cash, and the investor was promised a high rate of return. Reynolds also marketed interests in a gold ore refining venture. Investors received for a single price a sales contract, a refining contract, and a security agreement. The court found that the transaction presented a common enterprise. The common enterprise analysis followed a lengthy exposition of Reynolds’s inflated promises, suggesting that the court was holding Reynolds accountable for hyping the ventures as “investments.”

Finally, the absence of an authoritative standard within particular circuits or districts continues to undermine certainty in both litigation and business planning. In Revak v. SEC Realty Corp., condominium purchasers brought suit against the sellers of the property, alleging that non-disclosure of a gas well on the property and other discrepancies in the closing documents constituted federal securities fraud. The Second Circuit defined horizontal commonality as “‘[tying] the fortunes of each investor in a pool of investors to the success of the overall venture’” and found the test unmet in the case before it. The court further noted, however, that it had “not previously considered whether vertical commonality (strict or otherwise) satisfy[ed] the common enterprise requirement of the Howey test.” The court found that there was nothing in the record of the case to indicate that the fortunes of the condominium purchasers were interwoven with the promoter’s fortunes so as to support a finding of strict vertical commonality. On that basis, it declined to decide whether the strict vertical test could be applied in the Second Circuit. The court did explicitly reject the broad vertical test, apparently applied by the district court, on the grounds that this test collapsed the second and fourth prongs of the Howey test into one standard.

268. Id. at 1128.
269. Id. Reynolds raised approximately $2 million from 148 investors in several states through the Managed Account. Reynolds deposited the funds in a single account and used a large portion of the funds to pay for air time for his shows, to gamble in Las Vegas, and to pay his fiancee’s rent, car and other personal expenses. Id.
270. Id. at 1129.
271. See supra text accompanying notes 172-78.
272. Reynolds, 952 F.2d at 1127-29.
273. 18 F.3d 81 (2d Cir. 1994).
274. Id. at 83.
275. Id. at 87 (quoting Hart v. Pulte Homes of Michigan Corp., 735 F.2d 1001, 1004 (6th Cir. 1984)).
276. Id. at 88.
277. Id.
278. Id.
279. Id.
Forty-nine years after the Howey decision, the situation is not just confusion but chaos. Neither offerors nor purchasers can be certain of the rule that applies to their transaction and therefore neither are able to plan their activities. Litigation is a roll of the dice in those districts which do not consistently apply a single commonality standard. Moreover, parties who sue in a district court with a consistent standard still run the risk that an undecided circuit may choose their case to announce an authoritative test which overrules the district court approach. Courts are attempting to fulfill the remedial purposes of the Acts to do justice in particular cases, but are forced to twist both words and concepts to do so.

V. A Proposal that the Supreme Court Mandate the Application of a Universal, Hybrid Test

Although Justice White urged his fellow Justices to settle the common enterprise controversy "[i]n light of the clear and significant split in the Circuits," to date the Supreme Court has declined to do so. The Securities Acts themselves were created out of a perception that a national standard was critical to the protection of the public from fraudulent and worthless securities. The Supreme Court's refusal to create an authoritative definition of a common enterprise frustrates this end.

Further, if the applicable test were able to give effect to the purposes underlying the Securities Acts as well as the linguistic and analytical framework of the Howey decision, the test would enable the courts to reach those transactions to which application of the Acts is appropriate. Achievement of this objective would free courts from the necessity of stating that black is white, an exercise in which the courts currently engage when the facts of a case require it.

Finally, the lack of a universal standard makes it impossible for investors and promoters to assess the likely consequences of their business activities. A host of implications flow from the determination that a transaction is governed by the Securities Acts. It is fundamentally unfair to hold individuals liable when their actions would not have been covered by the Acts at all, and certainly not violative of the Acts, if only they had drawn a different judge in the courthouse lottery or if the plaintiff had elected to sue in a different forum. Conversely, although the circumstances of their cases are identical, one plaintiff's injuries may be addressed while another is left without a

280. Mordaunt v. Incomco, 469 U.S. 1115, 1117 (1985) (White, J., dissenting). Three justices dissented from the denial of this certiorari petition. According to Supreme Court procedure, if any four justices vote in favor of certiorari, the case is accepted.
281. See supra notes 20-37 and accompanying text.
282. See supra part IV.
283. See supra text accompanying notes 1-3.
remedy. A single test is required, if the business community is not to be faced with "[the] daunting . . . prospect that parties to a transaction may never know whether they are covered by the [Securities] Acts until they engage in extended discovery and litigation."284

The justification for the inclusion of a catch-all category of "investment contracts" within the Securities Acts is that occasions will arise in which the policy considerations of the Acts must be given effect if the investing public is to be protected. Where an unusual transaction is involved, however, the scheme may not fit into one of the more traditional categories of securities. The Howey test, and the common enterprise element, must therefore be expansive enough to reach novel or ingenious instruments and limited enough to ensure that the Securities Acts do not act as a general proscription of fraud in any context. The test, and its subsections, must serve to identify those capital-seeking transactions to which application of the Securities Acts is particularly fitting.

Commonality must mean something. It must in some sense limit qualifying transactions, but it must not serve to hinder the remedial purposes of the Acts. Black's Law Dictionary defines "common" as, inter alia, that which is "shared among several."285 Logically, a common enterprise is an enterprise that is shared among more than one individual. Realistically, it may be common in two ways: it may be shared among a group of investors or it may be common to an investor and a promoter who share the risks associated with the venture. In either case, the requisite commonality should be found.286 To express a preference for one type of sharing over the other would be to impose an alien policy choice, to undermine the broad remedial purposes of the Securities Acts,287 and to misconstrue the intentionally expansive holding in Howey.288

The courts in every circuit therefore should apply a two-step test in determining whether the transaction at issue in a particular case satisfies the common enterprise element of the Howey test. First, the court should examine whether the pooling required by the horizontal test is present. If the required pooling or pro-rata sharing is not

284. Landreth Timber Co. v. Landreth, 471 U.S. 681, 696-97 (1985); cf. Marine Bank v. Weaver, 455 U.S. 551, 559 n.9 (1982) (rejecting the argument that the certificate of deposit at issue was transformed, chameleon-like, into a security once it was pledged).


286. See Hocking v. Dubois, 839 F.2d 560, 567 (9th Cir. 1988) ("When we embraced vertical commonality . . . we did not state that we intended to replace horizontal with vertical commonality; rather, we broadened the meaning of common enterprise beyond the 'strict pooling requirement' used by other circuits. In other words, we simply added an additional means of establishing a common enterprise, which comes into play only when there is no pooling of funds by several investors in a venture.") (citation omitted).

287. See supra notes 20-37 and accompanying text.

288. See supra notes 78-86 and accompanying text.
demonstrated or if the case involves only a single investor, the court should proceed to consider whether the strict vertical test is satisfied, that is, whether the fortunes of the investor correlate with the fortunes of the promoter. If either of the two tests are met, the court should conclude that the case presents a common enterprise, and if the remaining elements of the Howey test are met, the court should apply the Securities Acts.

The proposed hybrid test has the value of uniformity. The characterization of a transaction as a security raises questions of law and fact, but the ultimate issue of whether or not a particular set of facts is an investment contract is a question of law. The courts therefore require a meaningful standard, applicable to each one of the many transactions that come before them, that will give effect both to the intentionally broad holding of the Howey Court and the remedial purposes which underlie the federal Securities Acts. Leaving each circuit or district court to develop its own standard frustrates the intent of the Securities Acts to create a nationwide system of regulation precisely because inconsistent local laws had proven inadequate to protect the public from deception.

The hybrid test also avoids limitations inherent in either test applied singly. By requiring courts to look first at the pooling or pro-rata sharing of profits or losses and then at the correspondence of promoter and investor fortunes, the analysis does not stop at the formal, mechanical factor. The application of the narrow vertical test will al-

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289. In this, it differs from those courts which have on an ad hoc basis applied one or another of the commonality tests to an individual case. The hybrid test would require that every court in every case examine the transactions before it for both horizontal and strict vertical commonality.

290. United States v. Carman, 577 F.2d 556, 562 (9th Cir. 1978).


292. See id. (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)). The Congressional purpose in enacting this legislation was to protect investors by "compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" Id. (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)). As Professor Seligman notes: "The new law [referring to the Securities Act of 1933] will also safeguard against the abuses of high-pressure salesmanship in security flotations. It will require full disclosure of all the private interests on the part of those who seek to sell securities to the public. The Act is thus intended to correct some of the evils which have been so glaringly revealed in the private exploitation of the public's money."

Seligman, supra note 24, at 38 (quoting 2 The Public Papers and Addresses of Franklin D. Roosevelt 213-14 (1938)).

293. See supra notes 20-37 and accompanying text.

294. Interestingly, the Ninth and the Second Circuits, jurisdictions representing the largest securities markets in the United States, have found reliance on a single existing test inadequate. The Second Circuit has responded by declining to adopt an authoritative standard. See supra notes 273-79 and accompanying text. The Ninth Circuit has taken a slightly different approach, choosing to examine each transaction under both tests. See Hocking v. Dubois, 839 F.2d 560, 567 (9th Cir. 1988).
low courts to examine the entanglement of the promoter with the investors, which is surely relevant to a determination of whether such investors merit or require the protection of the securities laws. On the other hand, consideration of the tests in conjunction ensures that the mere fact that a promoter does not share in the risks of an enterprise will not disqualify a venture in which the investors' fortunes are closely tied, one to another.

The proposed hybrid standard completely excludes broad vertical commonality. While factors inherent in the broad vertical approach, such as promoter expertise and investor dependence, are among the policies driving the Securities Acts, these factors are tested by the other elements of the Howey test. The common enterprise test therefore need not duplicate that screening.

CONCLUSION

The controversy as to the appropriate test of the common enterprise element might seem to be of merely technical or semantic concern. Nothing could be further from the truth, as a pair of hypothetical instances will illustrate.

First, consider the case of Mr. Pennystock, a widower living on a fixed income. Mr. Pennystock falls into the hands of an unscrupulous promoter, who convinces him to attend a lecture on how senior citizens can stretch their social security checks. The meeting functions like a revivalist camp, with person after person standing up and declaring that selling the promoter's water filtration system for just a few hours a week doubled or tripled their income. The participants boast of new cars, new houses, and luxurious vacations. Mr. Pennystock is hooked and pays over the required sum of money to become a member of the scheme. The promoter who lured him in pockets a commission. In return for his investment, Mr. Pennystock receives free instruction in the organization's "foolproof" sales methods, a set of water filtration equipment, and, more importantly, the right to earn commissions himself by enticing prospective members to come to a meeting. Mr. Pennystock, however, has the misfortune to be at the bottom of this pyramid scheme at a time when the credulous population of the area has been fully exploited. He is unable to sell any of the water filtration systems and he cannot lure in any new recruits. He would like to sue the organization under the Securities Acts based on its fraudulent promises, but his opportunity for recovery is frustrated by the fact that the applicable jurisdiction has adopted the horizontal test as the exclusive measure of a common enterprise. Because Mr. Pennystock's contribution has never been pooled with those of his fellow dupes, the water filtration scheme is not a common enterprise under the horizontal test. Mr. Pennystock is therefore denied a remedy under the Securities Acts.
Mr. Pennystock's lawsuit would have been viable in the jurisdiction in which Ms. Easymark is eligible to sue. Ms. Easymark's jurisdiction accepts the strict vertical test of commonality. Ms. Easymark, however, has not invested in the water filtration enterprise. Instead, she joins with several coworkers in opening a discretionary trading account. Ms. Easymark and her fellow investors execute powers of attorney giving the broker full authority to trade on their behalf as he sees fit. Each investor's return is dependent on the overall performance of the account. The broker, however, does not share in the risks of the transaction, because his commission is not dependent on the profits of the investors. When the investors discover that the broker has bled the account dry, they seek to recover under the Securities Acts. The absence of a link between their fortunes and those of their disingenuous broker, however, is fatal in a strict vertical jurisdiction. Ms. Easymark, like Mr. Pennystock, is out of court because the transaction in which she invested does not constitute a common enterprise.

Both Mr. Pennystock and Ms. Easymark fit the model of the investor that Congress intended the Securities Acts to protect by means of the investment contract instrument. Each had undertaken an economic risk in making the investment. Each expected that investment in the enterprise, which had been represented to be extravagantly successful, would yield a profit. Finally, each lacked the capacity individually to achieve a return on his or her investment.

This, then, is a question of real justice for real people. The Supreme Court must address this issue to resolve the current imbalances. To give effect to the remedial purposes of the Securities Acts and to be consistent with the holding in Howey, the Court should require that in every case before the federal courts a uniform, hybrid test be applied. Under this test, transactions presenting the indicia of either strict vertical commonality or horizontal commonality will be subject to the provisions and protections of the Securities Acts.

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295. See supra notes 90-94 and accompanying text.
296. See supra notes 100-07 and accompanying text.
297. See supra notes 108-19 and accompanying text.