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Discretionary Commodity Accounts as Securities: An Application of the Howey Test

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DISCRETIONARY COMMODITY ACCOUNTS AS SECURITIES: AN APPLICATION OF THE *HOWEY* TEST

INTRODUCTION

Since the early 1970's, trading in commodity futures contracts[1] has increased dramatically.[2] Many of the new participants, attracted by the possibility of large gains with a relatively small investment,[3] are not familiar with the complexities of the markets.[4] Thus a speculator[5] will

1. A commodity futures contract is a standardized sales contract for a fixed quantity of a commodity at a price agreed upon at the time of contracting. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 220 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); 1 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 4.6, at 82.181 (1984); 1 P. Johnson, Commodities Regulation § 1.03, at 8 (1982). Trading of futures contracts may take place only on "contract markets" designated as such by the Commodity Futures Trading Commission (CFTC). Commodity Exchange Act § 4, 7 U.S.C. § 6 (1982); CFTC v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 581 (9th Cir. 1982).

A futures contract "is little more than a wager that the market price of a given commodity will change in a given direction by a specified future date." Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 316 (S.D. Ohio 1979). The speculator contracts either to take delivery or to deliver a set amount of a commodity at a later date, usually with no intention of handling the actual commodity. *See* 1 P. Johnson, *supra*, § 1.04, at 9. Before the delivery date, the speculator almost always "offsets" his market position by taking an equal and opposite position on the market—in other words, contracting to deliver the commodity on which he promised to take delivery or contracting to take delivery on the commodity he promised to deliver. *Id.*; H.R. Rep. No. 975, 93d Cong., 2d Sess. 129 (1974). The speculator shows a profit if he buys the commodity for less than he sells it. 1 P. Johnson, *supra*, § 1.04, at 9.

2. Annual trading in agricultural commodities has risen from approximately twelve million contracts in 1970 to approximately fifty-seven million in 1983. Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, & Securities and Exchange Commission, A Study of the Effects on the Economy of Trading in Futures Options, figure III-1, at III-16 (1984) [hereinafter cited as Study]. Trading in contracts in metals, petroleum products, currencies and other commodities has also increased. *Id.*

One cause of the increased trading is the entrance of many new speculators into the commodity markets. *See* H.R. Rep. No. 975, 93d Cong., 2d Sess. 39 (1974) (boom in public interest in commodities trading attributed to price leverage, low margin requirements and volatile price action); 1 A. Bromberg & L. Lowenfels, *supra* note 1, § 4.6, at 82.101 (many investors attracted from the securities markets due to falling stock prices, rising commodity prices, inflation and dollar devaluation); 1 P. Johnson, *supra* note 1, at xxvi ("increased participation . . . by wealthy private investors"). In addition, the kinds of commodities traded have increased beyond the traditional agricultural commodities to such items as foreign currency and pass-through certificates of the Government National Mortgage Association (GNMAs). 1 P. Johnson, *supra* note 1, § 1.01, at 3; *see* Study, *supra*, at III-23.

3. A contract market requires the speculator to deposit with his broker only a percentage of the contract price. 1 P. Johnson, *supra* note 1, § 1.10, at 31. The amount of the deposit is determined by each exchange. *See* Commodity Exchange Act § 8a(7)(C), 7 U.S.C. § 12a(7)(C) (1982). If the value of the contract appreciates before the investor offsets his position, he receives the full amount of the appreciation. *See* 1 P. Johnson, *supra* note 1, § 1.10, at 31-32. If the value of the contract depreciates, however, he may lose much more than his original deposit. *See id.*

4. *See, e.g.*, Brodt v. Bache & Co., 595 F.2d 459, 459 (9th Cir. 1978) (plaintiff "knew little about the commodities market"); Hirk v. Agri-Research Council, Inc., 561 F.2d 96,

often give a futures commission merchant (FCM)[6] authority to buy and sell commodities in the speculator's name without prior consultation with the speculator.[7] Such an agreement is known as a "discretionary commodity account."[8]

In litigation between the speculator and his FCM,[9] a common strategy is to characterize the account as an investment contract[10] and thus a security under the Securities Act of 1933 ('33 Act)[11]and the Securities

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98 (7th Cir. 1977) (plaintiff "inexperienced in commodity trading"); *see also Extend Commodity Exchange Act: Hearings on H.R. 10285 Before the Subcomm. on Conservation and Credit of the House Comm. on Agriculture*, 95th Cong., 2d Sess. 187 (1978) (statement of Harold M. Williams, Chairman, Securities and Exchange Commission) (commodity brokers attempting to attract unsophisticated investors) [hereinafter cited as *Hearings on H.R. 10285*]; H.R. Rep. No. 975, 93d Cong., 2d Sess. 48-49 (1974) (unsophisticated investors attracted to commodity markets).

5. A "speculator" is a person who trades in futures contracts but who does not deal in the actual commodity. *See* S. Rep. No. 1131, 93d Cong., 2d Sess. 103 app. IX, *reprinted in* 1974 U.S. Code Cong. & Ad. News 5843, 5894 app IX.

6. A futures commission merchant (FCM):

> shall mean and include individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

Commodity Exchange Act § 2(a)(1)(A), 7 U.S.C. § 2 (1982).

7. *See, e.g.*, Brodt v. Bache & Co., 595 F.2d 459, 459-60 (9th Cir. 1978) (defendant not required to notify investor before transaction); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 98 (7th Cir. 1977) (plaintiff executed power of attorney giving defendant power to trade in plaintiff's name).

Even experienced commodity speculators may open discretionary accounts because they are unable to supervise their accounts on a full-time basis, which is a necessity as rapid price fluctuations require quick decisions. *See* Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); 1 A. Bromberg & L. Lowenfels, *supra* note 1, § 4.6, at 82.201.

8. *See, e.g.*, Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Brodt v. Bache & Co., 595 F.2d 459, 459 (9th Cir. 1978); Popham, Haik, Schnobrich, Kaufman & Doty, Ltd. v. Price, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,682, at 97,744 (D.D.C. Feb. 16, 1984), *rev'd on other grounds sub nom.* Popham, Haik, Schnobrich, Kaufman & Doty, Ltd. v. Newcomb Sec. Co., 751 F.2d 1262 (D.C. Cir. 1985).

9. *See, e.g.*, Mordaunt v. Incomco, 686 F.2d 815, 816 (9th Cir. 1982), *cert. denied*, 105 S. Ct. 801 (1985); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 219 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 98 (7th Cir. 1977); Gonzalez v. Paine, Webber, Jackson & Curtis, Inc., [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,867, at 94,512-13 (S.D.N.Y. Nov. 10, 1982).

10. *See, e.g.*, Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 105 S. Ct. 801 (1985); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 99 (7th Cir. 1977); *In re* Federal Bank & Trust Co. Sec. Litig., [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,565, at 98,876 (D. Or. June 4, 1984); Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 15 (D. Mass 1981).

11. Section 2 of the Securities Act of 1933 ('33 Act) provides that: "[U]nless the context otherwise requires—(1) The term 'security' means any note, stock, treasury stock,

Exchange Act of 1934 ('34 Act)[12] (collectively, Securities Acts).[13] If the FCM has failed to register the account with the Securities and Exchange Commission (SEC),[14] the speculator may rescind the account contract and obtain restitution of his entire investment.[15] To recover, the speculator need prove only that the account fits within the statutory definition of "security" and that the FCM failed to register it with the SEC.[16]

The first part of this Note argues that a discretionary commodity account falls within the definition of "investment contract" and as such is deemed a security under the Securities Acts. Part II asserts, however, that most discretionary commodity accounts are comprehensively regulated under the Commodity Exchange Act (CEA), and that it is therefore unnecessary to subject them to the strictures of the federal securities laws.

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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, [or] certificate of deposit for a security . . . ." 15 U.S.C. § 77b(1) (1982) (emphasis added).

12. Section 3 of the Securities Exchange Act of 1934 ('34 Act) provides that: "[U]nless the context otherwise requires . . . (10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, [or] certificate of deposit for a security . . . ." 15 U.S.C. § 78c(10) (1982) (emphasis added).

13. The Supreme Court has "consistently held that the definition of 'security' in the 1934 Act is essentially the same as the definition of 'security' in the . . . Securities Act of 1933." Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982). Therefore, this Note will refer to the two definitions as if they were one.

14. *See* Securities Act of 1933, § 5, 15 U.S.C. § 77e (1982) (issuers of securities must register the securities with the Securities and Exchange Commission).

15.
> Any person who . . . offers or sells a security in violation [of the registration requirements of the '33 Act] shall be liable to the person purchasing such security from him . . . [for] the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Securities Act of 1933, § 12, 15 U.S.C. § 77*l* (1982).

Plaintiffs often join their request for rescission and restitution with a securities fraud claim under § 10(b) of the '34 Act, 15 U.S.C. 78j(b) (1982). *See, e.g.*, Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 219 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 99 (7th Cir. 1977); *In re* Federal Bank & Trust Co. Sec. Litig., [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,565, at 98,875 (D. Or. June 4, 1984).

16. Securities Act of 1933, § 12, 15 U.S.C. § 77*l* (1982). The investor need not show any fault on the part of the promoter. *See* Lewis v. Walston & Co., 487 F.2d 617, 621 (5th Cir. 1973) (plaintiff may recover without any showing of "fault, negligent or intentional"); Wolf v. Banco Nacional de Mexico, 549 F. Supp. 841, 853 (N.D. Cal. 1982) (liability absolute), *rev'd on other grounds*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 784 (1985); Mason v. Marshall, 412 F. Supp. 294, 300 (N.D. Tex. 1974) (no need to prove reliance or materiality), *aff'd per curiam*, 531 F.2d 1274 (5th Cir. 1976); *cf.* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 275 (7th Cir.) ("Plaintiffs . . . sought to rescind the discretionary trading account and to recover their deposit, plus interest . . . ."), *cert. denied*, 409 U.S. 887 (1972).

I. A Discretionary Commodity Account as an Investment Contract

When a discretionary commodity account has been alleged to be a security under the Securities Acts, the courts have universally decided the issue by considering whether the account is an investment contract.[17] The term "investment contract," however, is not defined in either of the Securities Acts or in any legislative report.[18] This section discusses the judicially created definition of investment contract, the federal courts' diverse applications of the definition to discretionary commodity accounts and the proper application of the definition to such accounts.

A. *The* Howey *Case*

"Investment contract" was defined by the Supreme Court in *Securities & Exchange Commission v. W.J. Howey Co.*[19] The SEC brought an action to enjoin the sale of what it claimed were unregistered securities.[20] The specific issue before the Court was whether the offerings by W.J. Howey Company were investment contracts under section two of the '33 Act.[21]

Howey was a Florida citrus grower that for several years had planted about 500 acres of orange trees annually.[22] Each year the company would offer approximately half of the acres of new groves for sale to the public.[23] The public purchasers bought relatively small areas of the new groves.[24] With each purchase the company offered to service the acreage, stressing that "it is not feasible to invest in a grove unless service arrangements are made."[25] The service contract gave Howey exclusive possession of the land, and the landowner had no right to any specific fruit.[26] Profits from each purchaser's tract were allocated by crop volume estimates made at each tract at the time of picking.[27] Oranges from the en-

17. *See, e.g.*, Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 105 S. Ct. 801 (1985); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Moody v. Bache & Co., 570 F.2d 523, 526 (5th Cir. 1978); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 99 (7th Cir. 1977); Commercial Iron & Metal Co. v. Bache & Co., 478 F.2d 39, 41-42 (10th Cir. 1973); Westlake v. Abrams, 565 F. Supp. 1330, 1338 (N.D. Ga. 1983); Gamble v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,046, at 94,987 (S.D.N.Y. Dec. 30, 1982).

18. SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946); SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 581 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982); SEC v. Paro, 468 F. Supp. 635, 643 (N.D.N.Y. 1979).

19. 328 U.S. 293 (1946).

20. *Id.* at 294.

21. *Id.* at 297.

22. *Id.* at 294-95.

23. *Id.* at 295.

24. *Id.*

25. *Id.*

26. *Id.* at 296.

27. *Id.*

tire grove were then pooled and sold.[28] The income from the sale was then distributed to the landowners in accordance with the pre-picking estimate.[29]

In determining whether Howey had offered to enter into investment contracts, the Court found that the term "investment contract" was common in state "blue sky laws"[30] and "had been crystallized by . . . judicial interpretation."[31] The Court adopted the definition of investment contract that had been "uniformly applied by state courts":[32] "An investment contract . . . 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 . . . ."[33] Courts that have interpreted *Howey* often break this definition into three components: an investment of money, in a common enterprise, with the expectation of profits solely from the efforts of others.[34]

The *Howey* Court noted that this definition "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[35] Thus, *Howey*'s flexible definition comports with Congress' use of the concept "investment contract" as a catch-all to bring various investment schemes within the ambit of federal securities regulation.[36] Accordingly, the Court held that Howey's

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28. *Id.*

29. *Id.*

30. *See id.* at 298. The name "blue sky laws" was given to state laws that sought to protect investors from "speculative schemes which have no more basis than so many feet of 'blue sky.'" Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917).

31. SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

32. *Id.*

33. *Id.* at 298-99. The Court has reaffirmed this definition several times. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551, 559 (1982); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 (1979); United Housing Found. v. Forman, 421 U.S. 837, 852 (1975).

34. *See, e.g.*, Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Moody v. Bache & Co., 570 F.2d 523, 525 (5th Cir. 1978); Clayton Brokerage Co. v. Stansfield, 582 F. Supp. 837, 840 (D. Colo. 1984); Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983); American Grain Ass'n v. Canfield, Burch & Mancuso, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,695, at 93,473 (W.D. La. Feb. 1, 1982).

35. 328 U.S. at 299.

36. *See* Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982) (Congress intended "investment contract" to be a catch-all.); *cf.* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (broad definition permits fulfillment of statutory purpose of bringing various investments within the Securities Acts); H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933) (term "security" sufficiently broad to bring many investments within ordinary concept of a security); 1 L. Loss, Securites Regulation 483 (2d ed. 1961) (section entitled "Investment Contracts and the Other Catchall Varieties").

A clear purpose of Congress in defining "security" broadly was to afford investors protection under comprehensive federal law. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); *cf.* H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933) (broad definition allows inclusion of many types of investments).

offering constituted an offer to enter into an investment contract.[37] The land transaction underlying Howey's offer was not an investment contract,[38] but purchasers had invested money in a common enterprise with an expectation of profits solely from Howey's efforts.[39]

B. *Treatment of Discretionary Commodity Accounts in the Federal Courts*

The courts have not considered futures contracts to be investment contracts.[40] A futures contract involves no reliance on the efforts of others because the speculator's "expectation of profit arises solely from the speculative hope that the market price of the underlying commodity will vary in his favor, permitting purchase or sale at a profit."[41] As shown in *Howey*, however, an underlying transaction need not involve a security in order for the packaging of such a transaction to be a security.[42] Thus, a discretionary commodity account may be a security even though a futures contract is not.[43]

The federal courts agree that discretionary commodity accounts meet the first prong of the *Howey* test: The accounts are an investment of money.[44] As for the third *Howey* requirement—that the investor expect profits "solely" from the efforts of others[45]—the federal courts of appeals require only that "the efforts made by those other than the investor [be] the undeniably significant ones."[46] Thus, the third prong of *Howey*

37. *See Howey*, 328 U.S. at 301. The Court held that the '33 Act prohibits the offer as well as the sale of unregistered securities. *See id.* Thus, even though the investors were not required to enter into a service contract with Howey, the offer was sufficient to invoke the '33 Act. *See id.* at 300-01.

38. *See id.* at 299 ("offering something more than fee simple interests in land").

39. *Id.* ("The transactions in this case clearly involve investment contracts as so defined.").

40. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Moody v. Bache & Co., 570 F.2d 523, 525 (5th Cir. 1978); Christensen Hatch Farms, Inc. v. Peavey Co., 505 F. Supp. 903, 905 (D. Minn. 1981); *see* Gamble v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. ¶ 99,046, at 99,987 (S.D.N.Y. Dec. 30, 1982); *Hearings on H.R. 10285*, *supra* note 4, at 192 (statement of Harold M. Williams, Chairman, SEC).

41. McCurnin v. Kohlmeyer & Co., 340 F. Supp. 1338, 1341 (E.D. La. 1972), *aff'd per curiam*, 477 F.2d 113 (5th Cir. 1973); *accord* P & C Investment Club v. Becker, 520 F. Supp. 120, 122 (E.D. Pa. 1981); Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 315-16 (S.D. Ohio 1979).

42. See *supra* notes 38-39 and accompanying text.

43. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); *see* Commercial Iron & Metal Co. v. Bache & Co., 478 F.2d 39, 42 (10th Cir. 1973); Christensen Hatch Farms, Inc. v. Peavey Co., 505 F. Supp. 903, 905 (D. Minn 1981).

44. *See, e.g.*, Brodt v. Bache & Co., 595 F.2d 459, 460 (9th Cir. 1978); Clayton Brokerage Co. v. Stansfield, 582 F. Supp. 837, 840 (D. Colo. 1984); Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983); Troyer v. Karcagi, 476 F. Supp. 1142, 1147 (S.D.N.Y. 1979).

45. *Howey*, 328 U.S. at 298-99.

46. SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*,

should be satisfied if the promoter dominates the control of the account.[47] The center of the controversy concerns the second requirement—whether a discretionary commodity account is a common enterprise.[48] The remainder of this section discusses the circuit courts' differing analyses of the common enterprise requirement.

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414 U.S. 821 (1973); *see* SEC v. Professional Assocs., 731 F.2d 349, 357 (6th Cir. 1984); Goodwin v. Elkins & Co., 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 105 S. Ct. 118 (1984); SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 582 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982); Kim v. Cochenour, 687 F.2d 210, 213 n.7 (7th Cir. 1982); Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); SEC v. Murphy, 626 F.2d 633, 641 (9th Cir. 1980); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); Fargo Partners v. Dain Corp., 540 F.2d 912, 914-15 (8th Cir. 1976); *cf.* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 Okla. L. Rev. 135, 155 (1971) (none of the state definitions of investment contract cited by *Howey* used the word "solely").

The First and Fourth Circuits have not decided the issue. The Eleventh Circuit has expressly refrained from doing so. *See* Villeneuve v. Advanced Business Concepts Corp., 730 F.2d 1403, 1404 n.2 (11th Cir. 1984).

47. One who enters into a *discretionary* commodity account almost by definition relies solely on the efforts of others. However, if an investor did participate minimally in the account, there is no reason to believe that the courts would require a stricter "solely" standard for discretionary commodity accounts than they do for investment contracts in general.

48. Mordaunt v. Incomco, 105 S. Ct. 801, 802 (1985) (White, J., dissenting from denial of certiorari); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 15 (D. Mass. 1981); *see* Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 105 S. Ct. 801 (1985); SEC v. Continental Commodities Corp., 497 F.2d 516, 520 (5th Cir. 1974); *In re* Federal Bank & Trust Co. Sec. Litig., [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,565, at 98,876 (D. Or. June 4, 1984).

After attempting to bar Continental Commodities from offering unregistered discretionary commodity accounts to the public, *see* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974), the SEC has not taken a position on whether discretionary commodity accounts are securities, *see* A. G. Edwards & Sons, Inc., Investment Advisers Act of 1940 Release No. 1-6866, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,153 (Mar. 28, 1975) (SEC refused, due to "unsettled" case law, to issue no-action letter on issue whether discretionary commodity accounts are securities). In any event, the views of a federal agency have persuasive, but no binding effect on judicial interpretation of federal statutes. *See* Dirks v. SEC, 103 S. Ct 3255, 3262 (1983) (Court rejects SEC's interpretation of the '34 Act's antifraud provision.); NLRB v. Yeshiva University, 444 U.S. 672, 691 (1980) (Court rejects NLRB's analysis of the concept "managerial status"); 5 K. Davis, Administrative Law Treatise § 29.15, at 394 (2d ed. 1984) ("Courts commonly substitute their own policy ideas for those of specialized agencies."); *cf.* Letter from Harvey L. Pitt, General Counsel, SEC, to Judge Frank A. Kaufman (May 27, 1976), *reprinted in* Pargas, Inc. v. Empire Gas Corp., 423 F. Supp. 199, 251-52 app. G (D. Md.) (citation of "no action" letter as precedent for interpreting the federal securities laws is inappropriate), *aff'd*, 546 F.2d 25 (1976).

Discretionary commodity accounts should be distinguished from commodity pools. In a commodity pool the promoter pools the money of several investors and speculates in the commodity markets by using the pooled funds as deposits on futures contracts. 1 P. Johnson, *supra* note 1, § 1.15, at 52. The investors share in the profits in accordance with the amount of their investment. *Id.* The 1983 amendments to the Commodity Exchange Act expressly recognize that commodity pools are subject to the '33 and '34 Acts (Securities Acts). *See* Futures Trading Act of 1982, § 103, Pub. L. No. 97-444, § 103, 96 Stat. 2296 (codified at 7 U.S.C. § 6m (1982)).

1. Horizontal Commonality

In *Hirk v. Agri-Research Council, Inc.*,[49] the plaintiff claimed that his discretionary commodity account was a security and that the defendant was liable under the Securities Acts for various material[50] misrepresentations[51] and for failure to register the account with the SEC.[52] The Seventh Circuit held that a pooling of investors' funds or a pro rata distribution of profits among investors is required to satisfy the common enterprise element of *Howey*.[53] That is, unless the investors' funds are either commingled or the fortunes of all investors rise and fall together, the investment does not constitute an investment contract. This pooling or pro rata sharing is called "horizontal commonality."[54] Because Hirk's account was an *individual* discretionary account,[55] the court held that the account lacked the requisite horizontal commonality.[56] The court further held that the entrance of Agri-Research into a number of such accounts with investors did not provide this commonality.[57] Thus, Hirk's account was not an investment contract and was not subject to the Securities Acts.[58]

Although *Howey* used the phrase "common enterprise" without defining it,[59] *Hirk* supported its requirement of horizontal commonality by

49. 561 F.2d 96 (7th Cir. 1977).

50. See *infra* note 142.

51. *See Hirk*, 561 F.2d at 98. (regarding defendant's market experience and the profitability of the account).

52. *Id.* at 99.

53. *See id.* at 100-01.

54. Brodt v. Bache & Co., 595 F.2d 459, 460 (9th Cir. 1978); *see, e.g.*, Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 15 (D. Mass 1981); Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1236 (S.D.N.Y. 1981).

The Seventh Circuit's requirement of horizontal commonality has been adopted by the Third and Sixth Circuits. *See* Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 222 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982). Although the First Circuit has not decided the issue, the district courts in Maine and Massachusetts have followed the Seventh Circuit view. *See* Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 597 F. Supp. 213, 216 (D. Me. 1984); Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 15 (D. Mass. 1981).

55. *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977).

56. *See id.*

57. *See id.* (court relied on Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972), which held that an individual account contract was not an investment contract but merely an "agency-for-hire," *id.* at 277) Similarly, the Fifth Circuit in *Howey* held that Howey's offer was not an offer to enter into an investment contract because the Howey Company was to be a mere agent; otherwise every purchase/management contract would be a security. See SEC v. W.J. Howey Co., 151 F.2d 714, 717 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946). Thus, the Seventh Circuit's conclusion that an agency contract cannot be an investment contract is inconsistent with the Supreme Court's reversal of the court of appeals in *Howey*.

58. Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101-02 (7th Cir. 1977).

59. *See Howey*, 328 U.S. at 298-99, 301.

pointing to the fact that the oranges in *Howey* were pooled.[60] Thus, the Seventh Circuit concluded that horizontal commonality is a necessary element of any investment contract.[61] The funds of the Howey investors, however, were not pooled. An investor's payments were either for the initial purchase or for the servicing of the individual tract.[62] As noted in *Hirk*, the fact that the promoter enters into a number of similar contracts does not provide the pooling sufficient for horizontal commonality.[63] In addition, there was no pro rata distribution of profits. As discussed above, the profits in *Howey* were based on an estimate of the yield *of each tract*.[64] The pooling was done after the profit estimate.[65] The court of appeals in *Howey* noted this independence of the investor's fortunes: "It is quite clear . . . that each purchaser's income was in no sense dependent upon the purchase or development of other tracts than his own except in the sense that as grove owners generally prospered, each owner of a grove would."[66] The court of appeals concluded that this independence precluded the existence of an investment contract.[67] Therefore, the Supreme Court's reversal of the court of appeals logically means that neither the pooling of funds nor the pro rata distribution of profits—horizontal commonality—is a necessary element of an investment contract.

2. Vertical Commonality

The Ninth Circuit has defined a common enterprise as "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."[68] Thus, in the Ninth Circuit the common enterprise requirement is satisfied not only when there is a pooling or a pro rata sharing, but also when the fortunes of the investor and the promoter rise or fall together.[69] Such

60. *See Hirk*, 561 F.2d at 101.
61. *See id.*
62. SEC v. W.J. Howey Co., 328 U.S. 293, 295-96 (1946).
63. See *supra* note 57 and accompanying text.
64. See *supra* text accompanying note 27.
65. See *supra* text accompanying note 28.
66. SEC v. W.J. Howey Co., 151 F.2d 714, 717 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946). The plaintiff in Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972), pointed out the independence of the investors' fortunes in *Howey*. *Id.* at 279. The court, however, held that the individual aspect of the investment in *Howey* "did not obscure the economic reality of participation in a common enterprise." *Id.*
67. *See* SEC v. W.J. Howey Co., 151 F.2d 714, 717-18 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946).
68. SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).
69. To establish common enterprise in this way, the Ninth Circuit requires only that the fortunes of the investor and promoter rise *or* fall together. *See* Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 105 S. Ct. 801 (1985); Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978).

It does, however, require a *direct* correlation between the fortunes of the investor and those of the promoter. *See* Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc., a relationship between the promoter and the investor is known as "vertical commonality."[70]

The Ninth Circuit bases its broader view not on the text of *Howey*, but on the remedial purposes of the Securities Acts and the Supreme Court's directive of flexibility.[71] Even the looser standard of vertical commonality, however, is more than the *Howey* decision requires. The Howey Company's own monetary interest in each tract was limited to its service contract.[72] That is, there was no vertical commonality in *Howey* because the profits from each tract did not directly benefit the Howey Company.

3. Dominance Commonality

In *Securities & Exchange Commission v. Koscot Interplanetary, Inc.*,[73] the Fifth Circuit was asked to decide whether a pyramid scheme[74] was a security within the meaning of the Securities Acts.[75] As in *Howey*,[76] the SEC sued to enjoin the promotional enterprise for failure to register its offering as a security.[77] In the Koscot scheme, an individual investor realized a profit only if he attracted new investors to the scheme.[78] The fortunes of the investors were therefore independent,[79] but the court held that this fact was not decisive: "Rather, the requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied

686 F.2d 818, 819 (9th Cir. 1982) (promoter received percentage of assets managed, but because investor could withdraw funds from account, promoter would not necessarily have shared profits), *cert. denied*, 460 U.S. 1023 (1983); Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978) (no direct correlation because Bache could earn large commissions while investor could be "wiped out").

70. *See, e.g.*, Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 105 S. Ct. 801 (1985); Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1237 (S.D.N.Y. 1981).

Several district courts have adopted this broader view. *See, e.g.*, Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983); Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1239 (S.D.N.Y. 1981); Christensen Hatch Farms, Inc. v. Peavey Co., 505 F. Supp. 903, 906-07 (D. Minn. 1981).

The Eighth and Tenth Circuits had decided that discretionary commodity accounts may be securities before the Ninth Circuit in Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978), first discussed the vertical commonality analysis. *See* Commercial Iron & Metal Co. v. Bache & Co., 478 F.2d 39, 42 (10th Cir. 1973); Booth v. Peavey Co. Commodity Services, 430 F.2d 132, 133 (8th Cir. 1970).

71. *See* Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976). See *supra* notes 35-65 and accompanying text.

72. SEC v. W.J. Howey Co., 328 U.S. 293, 296 (1946).

73. 497 F.2d 473 (5th Cir. 1974).

74. A pyramid scheme is a multilevel distribution system in which a participant makes a profit by recruiting others to lower levels of the pyramid. Securities Act Release No. 9387, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,446, at 80,974 (Nov. 30, 1971).

75. *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 474-75 (5th Cir. 1974).

76. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 294 (1946).

77. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 474 (5th Cir. 1974).

78. *See id.* at 475.

79. *Id.* at 479.

to the efficacy of . . . Koscot . . . ."[80] In effect, *Koscot* eliminates the common enterprise requirement by holding that dominance by the promoter—the third *Howey* requirement—supplies the necessary common enterprise.[81]

Koscot was followed two days later by *Securities & Exchange Commission v. Continental Commodities*,[82] in which the SEC sought to enjoin the sale of unregistered discretionary commodity accounts.[83] The Fifth Circuit found that Continental's commissions were based on the number of transactions it completed for its client.[84] Because Continental was not affected by the performance of an investor's account, there was no vertical commonality between Continental and the investor.[85]

Continental relied on *Koscot*, holding that *Koscot* "decried a litmus application of the *Howey* test and expressed its preference for a resilient standard which would comport with the uniformly acclaimed remedial purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934."[86] Although the fortunes of the investor and the promoter were not intertwined,[87] the court held that the "critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise."[88] The court then expressly rejected a requirement of horizontal commonality[89] and concluded that Continental was offering to enter into a common enterprise.[90]

Because the fortunes of Continental and the investor were not intertwined, the court's holding can only mean that promoter dominance alone satisfied the commonality requirement.[91] The Fifth Circuit's common enterprise test has been referred to as vertical commonality,[92] although it is clearly distinguishable from the Ninth Circuit's version of vertical commonality.[93] This Note refers to the Fifth Circuit's interpreta-

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80. *Id.*

81. See *infra* note 91 and accompanying text.

82. 497 F.2d 516 (5th Cir. 1974).

83. *Id.* at 517.

84. *See id.* at 519 (speculator paid Continental for option to enter into a futures contract).

85. See *supra* note 69. The court in *Continental* did not use the phrase "vertical commonality" because it had not yet been coined.

86. *Continental Commodities Corp.*, 497 F.2d at 521.

87. See *supra* notes 84-85 and accompanying text.

88. *Continental Commodities Corp.*, 497 F.2d at 522.

89. *See id.*

90. *See id.* at 522-23.

91. *See* Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983); Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 15 (D. Mass. 1981); Berman v Bache, Halsey, Stuart, Shields Inc., 467 F. Supp. 311, 319 (S.D. Ohio 1979).

92. *See* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978); Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983); Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 15 (D. Mass. 1981).

93. *See* Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982) (merely furnishing investment counsel to another for a commission does not amount to a "common enterprise," though it would provide the requisite commonality in the Fifth Circuit), *cert. denied*, 105 S. Ct. 801 (1985); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1237 &

tion of the common enterprise element as "dominance commonality."

C. *The Correct Reading of* Howey

Although *Continental's* dominance commonality seems to alter substantially the *Howey* definition of "investment contract," the Fifth Circuit's view has both factual support in *Howey*[94] and textual support in the Securities Acts.[95] In addition, the *Howey* Court found that as states developed a working definition of "investment contract," it came to mean a contract for "the placing of capital or laying out of money in a way intended to secure income or profit from its employment."[96] The Court then paraphrased this state definition in what is now known as the "Howey test."[97] The state definition, however, contains no language of "common enterprise," and the Court did not state that its formulation of the definition was to differ from that of the states.[98] Further, none of the state cases cited by the Court[99] requires the element of common enterprise.[100]

A requirement of horizontal or vertical commonality thus has no basis in either the state origins or the fact pattern of *Howey*.[101] Although the Supreme Court did use the phrase "common enterprise" in its para-

n.11 (S.D.N.Y. 1981) (Fifth Circuit view broader than the Ninth Circuit view). Some courts, however, do not note the distinction between the two circuits. *See, e.g.*, Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983) (no distinction made between Fifth and Ninth Circuits' definitions of "vertical commonality"); Christensen Hatch Farms, Inc. v. Peavey Co., 505 F. Supp. 903, 906 (D. Minn. 1981) (court stated that the Fifth Circuit had adopted the Ninth Circuit's test for vertical commonality).

94. As noted above, the Howey Company's offer contained neither horizontal nor vertical commonality. See *supra* notes 59-67, 72 and accompanying text.

95. See *infra* note 105 and accompanying text.

96. SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (quoting State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)).

97. *See id.* at 298.

98. *See id.*

99. *See id.* at 298 n.4.

100. *See* People v. White, 124 Cal. App. 548, 555, 12 P.2d 1078, 1081 (1932) (investment of "money in expectation of a profit from the investment") (citing with approval State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)); Prohaska v. Hemmer-Miller Dev. Co., 256 Ill. App. 331, 343 (1930) (investment of money "into far-off speculative enterprises over which the investor has little or no control") (quoting with approval Kerst v. Nelson, 171 Minn. 191, 195, 213 N.W. 904, 905 (1927)); State v. Evans, 154 Minn. 95, 99, 191 N.W. 425, 426 (1922) ("placing of capital or laying out of money in a way intended to secure income or profit from its employment") (quoting with approval State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)); State v. Heath, 199 N.C. 135, 140, 153 S.E. 855, 858 (1930) (investment of money "upon the promise and just expectation that the investment would return a profit without any active effort on the part of the investors").

Three of the state cases cited in *Howey* neither involved nor defined investment contracts. *See* Moore v. Stella, 52 Cal. App. 2d 766, 127 P.2d 300 (1942) (issue whether deed to mineral rights is a security); Stevens v. Liberty Packing Corp., 111 N.J. Eq. 61, 161 A. 193 (1932) (issue whether contract to lease and sell rabbits is a security); Klatt v. Guaranteed Bond Co., 213 Wis. 12, 250 N.W. 825 (1933) (issue whether a corporate bond is a security).

101. See *supra* notes 59-67, 72, 98-100 and accompanying text.

phrase of the state definitions,[102] it should be clear that what seemed like an alteration of the *Howey* definition by the Fifth Circuit is in reality the most faithful explication of the *Howey* test.[103] In addition, the Fifth Circuit's reading of *Howey* follows the Supreme Court's direction that "investment contract" should be interpreted broadly to effect the remedial purposes of the Securities Acts.[104] It also comports with Congress' intent that the category "investment contract" be a catch-all for various investment devices so that they can be brought within some regulatory scheme.[105]

Thus, the application of *Howey*'s broad definition to discretionary commodity accounts clearly brings those accounts within the definition of investment contract. The opening of a discretionary commodity account is an investment of money with an expectation of profits from the substantial efforts of the promoter.

II. Limitations on the Scope of the Securities Acts

This Note has argued that the *Howey* definition of "investment contract" is to be construed broadly to effect the congressional purpose behind the Securities Acts. This broad reading, however, is qualified by statute. Each statutory definition of "security" lists a number of investment devices, including investment contracts, that are securities, but preceding each list is the caveat "unless the context otherwise requires."[106] This section interprets the meaning of this caveat and examines its implications for discretionary commodity accounts.

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102. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

103. *But see* Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 224 (6th Cir. 1980) ("Although the precise meaning of the phrase 'common enterprise' is far from clear, nowhere in *Howey* or later Supreme Court decisions is it intimated that that phrase is somehow redundant of other elements of the definition of a security.") (quoting with approval Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 319 (S.D. Ohio 1979)), *aff'd on other grounds*, 456 U.S. 353 (1982).

104. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (broad reading permits fulfillment of purpose of Securities Acts); *see also* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) ('34 Act "should be construed broadly to effectuate its purposes.").

105. See *supra* note 36 and accompanying text. The Fifth Circuit's broad reading also avoids the tenuous distinction between commodity pools, which are clearly regulated under the Securities Acts, see *supra* note 48, and discretionary commodity accounts. *See* Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981) ("[I]t makes no sense to penalize the single investor simply because he happens to be alone in his misfortune.").

It should be noted here that the horizontal and vertical commonality tests are not restricted to analysis of discretionary commodity accounts, but are used generally in connection with the *Howey* definition of "investment contract." *See, e.g.*, United States v. Jones, 712 F.2d 1316, 1322 (9th Cir.) (vertical commonality rendered sale/leaseback transaction a security), *cert. denied*, 104 S. Ct. 434 (1983); Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1185 (6th Cir.) (loan participation agreement did not constitute security), *cert. denied*, 454 U.S. 1124 (1981).

106. Securities Exchange Act of 1934, § 3, 15 U.S.C. § 78c(a) (1982); Securities Act of 1933, § 2, 15 U.S.C. § 77b (1982). For the text of the statutes, see *supra* notes 11 and 12.

A. *Pre-emption of the Securities Acts*

The Supreme Court has interpreted the definitional caveat to mean that the Securities Acts do not apply to an investment that is already comprehensively regulated at the federal level.[107] In *International Brotherhood of Teamsters v. Daniel*,[108] the Court was asked to decide whether noncontributory, compulsory pension plans were securities under the Securities Acts.[109] The Court noted the "existence of . . . comprehensive legislation governing"[110] the plans and held that the existence of such legislation "severely undercuts all arguments for extending the Securities Acts" to include them.[111] In *Marine Bank v. Weaver*,[112] the Court expanded its ruling in *Daniel* by holding that even though the investment in question was within the Securities Acts' definition of "security,"[113] it was unnecessary to subject that investment to the securities laws because the investors were "abundantly protected under the federal banking laws."[114]

Thus, whether an investment is an investment contract subject to the Securities Acts involves two questions. First, does the investment fall within *Howey*'s broad definition of investment contract? Second, is the investor already "comprehensively" protected at the federal level?

As argued above, discretionary commodity accounts do come within the *Howey* definition of investment contract.[115] Most commodity accounts, however, are regulated under the CEA by the Commodity Futures Trading Commission (CFTC).[116] Thus, if discretionary commodity accounts are comprehensively regulated, they should not be subject to the securities laws.

B. *The Commodity Exchange Act and Comprehensive Regulation*

In *Marine Bank* the Supreme Court used the term "comprehensive" without defining it.[117] This subsection examines some possible meanings of this term in the context of the regulatory measures of commodities regulation.

107. *See* Marine Bank v. Weaver, 455 U.S. 551, 558-59 (1982); *see also* Wolf v. Banco Nacional de Mexico, 739 F.2d 1458, 1462 (9th Cir. 1984) (alternative regulation need not be federal as long as regulation is comprehensive), *cert. denied*, 105 S. Ct. 784 (1985).

108. 439 U.S. 551 (1979).

109. *See id.* at 557.

110. *Id.* at 569.

111. *Id.*

112. 455 U.S. 551 (1982).

113. *See id.* at 556-57 (investment in question was a "certificate of interest" and thus within the statutory definitions of "security").

114. *Id.* at 559.

115. See *supra* Pt. I.

116. Commodity Exchange Act § 2(a)(1)(A), 7 U.S.C. § 2 (1982) (The Commodity Futures Trading Commission "shall have exclusive jurisdiction . . . with respect to accounts . . . involving contracts of sale of a commodity for future delivery . . . .").

117. *See* Marine Bank v. Weaver, 455 U.S. 551, 558 (1982).

1. Comprehensiveness by Specificity

Daniel noted the fact that the Employment Retirement Income Security Act of 1974 (ERISA) "deals expressly and in detail with pension plans . . . . requir[ing] pension plans to disclose specified information to employees in a specified manner . . . in contrast to the indefinite and uncertain disclosure obligations imposed by the antifraud provisions of the Securities Acts."[118] The Court went on to find that "this comprehensive legislation" cuts against application of the securities laws.[119] *Daniel* thus seemed to equate specificity of regulation with comprehensiveness of regulation; in other words, if federal law deals expressly and in detail with a type of investment, the law is comprehensive. Thus, the CEA is comprehensive in the sense that it specifically regulates the commodities markets.[120]

2. Comprehensiveness by Purpose

In *Marine Bank* the Court held that the existence of federal banking laws designed in part to protect investors[121] made it unnecessary to subject the investment to the securities laws.[122] The Court may have used the term comprehensive to mean that at least one purpose of the alternative federal regulation must be to protect investors.

The CEA, however, was not enacted to protect the speculator. It was enacted in 1922[123] in response to the complaints of farmers and merchants that speculators were manipulating the regional commodity markets.[124] Not suprisingly, the original Act was concerned mainly with protecting not the speculator but the people who dealt in the actual commodity.[125] By assigning enforcement of the Act to the Department of

118. International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 569 (1979).

119. *Id.* at 569-70.

120. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 355-56 (1982) (In another context the Court found that "[t]he Commodity Exchange Act . . . has been aptly characterized as 'a comprehensive regulatory structure to oversee the volatile and esoteric futures trading complex.' ") (quoting H.R. Rep. No. 975, 93d Cong., 2d Sess. 1 (1974)).

121. *See* H.R. Rep. No. 1948, 73d Cong., 2d Sess. 5 (1934) (amendments to Banking Act of 1933 necessary to "preserve the rights of the general depositors against preferences"); H.R. Rep. No. 150, 73d Cong., 1st Sess. 6 (1933) (Federal Deposit Insurance Corporation "makes absolutely safe and adequate provision for the protection of depositors.").

122. *See* Marine Bank v. Weaver, 455 U.S. 551, 559 (1982).

123. The Act was originally called The Grain Futures Act, ch. 369, 42 Stat. 998 (1922), but its name was changed in 1936 to the Commodity Exchange Act, *see* Commodity Exchange Act, ch. 545, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. § 1 (1982)).

124. *See* H.R. Rep. No. 1181, 95th Cong., 2d Sess. 82 (1978) (sentiment of Congress in passing the Act with agricultural producers who felt "victimized" by speculators). The Chicago Board of Trade "was looked upon as a gambling hell," *id.*, and speculators were blamed for "suicides and crimes," *id.* at 82-83.

125. *See id.* at 84 (1936 amendments expanded "the community protected under federal commodities law . . . to include speculators"); 1 A. Bromberg & L. Lowenfels, *supra*

Agriculture,[126] Congress reinforced this bias.[127] In 1974, Congress amended the CEA[128] to address, in part, the problems—mainly fraud—encountered by speculators.[129] The need for this change in focus of the CEA was aggravated by the entrance of many unsophisticated speculators into the market.[130] The CFTC was created by the 1974 amendments to take over enforcement of the CEA[131] after Congress had found that regulation by the Department of Agriculture was inadequate.[132] Although the CFTC is also concerned with farmers and merchants,[133] Congress clearly intended the 1974 amendments to protect speculators.[134] The CEA therefore meets the comprehensiveness criterion that investor protection be a goal of the regulation.

3. Comprehensiveness by Similarity to the Securities Acts

Daniel noted that like the Securities Acts, ERISA requires disclosure of information concerning investments.[135] In interpreting *Daniel*, the *Marine Bank* Court held the fact that ERISA requires disclosure made it "unnecessary to subject pension plans to the requirements of the federal securities laws as well."[136] Thus "comprehensive" may describe alternative federal regulation that protects the investor in ways similar to the Securities Acts.

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note 1, § 4.6, at 82.363 ("Historically, commodities law has been designed primarily to protect farmers.").

126. The Grain Futures Act, ch. 369, 42 Stat. 998 (1922), *amended by* Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 103, 88 Stat. 1392 (codified in scattered sections of 7 U.S.C. (1982)).

127. *See* 1 A. Bromberg & L. Lowenfels, *supra* note 1, § 4.6, at 82.363-64 (After passage of the CEA, "[i]t is no accident that . . . [it] was administered within the Department of Agriculture."); 2 P. Johnson, *supra* note 1, § 4.01, at 3 ("[P]rimary focus of the Department was the general welfare and prosperity of American agriculture . . . .").

128. *See* Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified in scattered sections of 7 U.S.C. (1982)).

129. *See* S. Rep. No. 850, 95th Cong., 2d Sess. 12-13, *reprinted in* 1978 U.S. Code Cong. and Ad. News 2087, 2100-01 (Commodity Futures Trading Commission, created in 1974, see *infra* note 131, affords speculators protection from unlawful behavior of commodity professionals); H.R. Rep. No. 1181, 95th Cong., 2d Sess. 87-88 (1978) (exchange heads considered fraud of investors to be impetus for amendments); H.R. Rep. No. 975, 93d Cong., 2d Sess. 48-49 (1974) (A consideration leading to the 1974 amendments was the "[e]xistence of schemes of systematic solicitations and bilking of unsophisticated potential customers.").

130. See *supra* note 4 and accompanying text.

131. *See* Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified in scattered sections of 7 U.S.C. (1982)).

132. *See* H.R. Rep. No. 1181, 95th Cong., 2d Sess. 88 (1978) ("[T]he Department of Agriculture's Commodity Exchange Authority could not enforce existing law" because of the small size of its staff); *see also* 1 P. Johnson, *supra* note 1, § 1.79, at 176 (Department of Agriculture had no expertise in nonagricultural commodities).

133. *See* Commodity Exchange Act § 3, 7 U.S.C. § 5 (1982) (commodities futures must be regulated to protect the producer or the consumer and persons handling commodities); 2 P. Johnson, *supra* note 1, § 4.01, at 4 (CFTC not insensitive to agriculture).

134. See *supra* note 129 and accompanying text.

135. International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 569 (1979).

136. Marine Bank v. Weaver, 455 U.S. 551, 558 n.7 (1982)

Like the protective disclosure requirement of the Securities Acts,[137] the CEA is designed to protect investors through disclosure.[138] The disclosure requirements under the CEA require individuals and firms involved in the trading of futures contracts to register with the CFTC.[139] The registration is extensive[140] and specifically designed to guard against commodity fraud.[141]

In connection with the disclosure requirement, the '34 Act seeks to protect investors against material misrepresentations[142] by allowing them

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137. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) ("The Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offering of securities . . . to protect investors against fraud . . . ."); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (One of the central purposes of the Securities Exchange Act of 1934 is "to protect investors through the requirement of full disclosure."); S. Rep. No. 792, 73d Cong., 2d Sess. 10-11 (1934) (Registration "provisions are regarded as the minimum which is requisite for the adequate protection of investors.").

138. The registration requirement allows the CFTC to determine whether a person is fit to engage in the desired business. *See* 1 P. Johnson, *supra* note 1, § 3.02, at 427; *cf.* Commodity Exchange Act § 8a(3)(M), 7 U.S.C. § 12a(3)(M) (1982) (Commission is authorized to refuse to register any person if it is found that there is good cause for doing so). To make its determination of fitness, the Commission is allowed a free hand in deciding what the applicant must disclose. *Id.* § 8a(1), 7 U.S.C. § 12a(1).

Almost all registration information concerning an FCM is available to the public. *See* CFTC Form 7-R, *reprinted in* 1 Comm. Fut. L. Rep. (CCH) ¶ 3515, at 3606 (Mar. 1984) [hereinafter cited as Form 7-R]. For a list of FCM information not available to the public, see *infra* note 140.

139. *See* Commodity Exchange Act § 4f, 7 U.S.C. § 6f (1982) (registration of futures commission merchants, introducing brokers and floor brokers); *id.* § 4k, 7 U.S.C. § 6k (registration of associates of futures commission merchants, commodity pool operators, and commodity trading advisors); *id.* § 4n, 7 U.S.C. § 6n (registration of commodity trading advisors and commodity pool operators).

140. For example, each application for registration as an FCM must be on CFTC Form 7-R. 17 C.F.R. § 3.10 (1984). Form 7-R requires that an FCM applicant must disclose, inter alia, its criminal, regulatory and civil record, Form 7-R, *supra* note 138, at 3611 to 3611-2, as well as its present business structure, *id.* at 3609-10. All information that is required on Form 7-R is available to the public, *id.* at 3606, except the date and place of birth of each principal and branch manager of an FCM, *id.*

In addition, any person who is associated with a futures commission merchant as a partner, officer or employee and who is involved in the solicitation or acceptance of customers' orders or who supervises such a person must register with the CFTC. Commodity Exchange Act § 4k, 7 U.S.C. § 6k (1982). Each associated person (AP) must disclose his criminal, regulatory and civil record to the CFTC. *See* CFTC Form 8-R, *reprinted in* 1 Comm. Fut. L. Rep. (CCH) ¶ 3521, at 3621 to 3621-3 (Mar. 1984). This information concerning the AP's disciplinary history, however, is not available to the public. *Id.* at 3613. For a thorough discussion of the CFTC's registration process, see 1 P. Johnson, *supra* note 1, §§ 3.01-3.32, at 426-60.

141. *Commodity Futures Trading Commission Oversight: Hearing Before a Subcomm. of the Comm. on Government Operations, House of Representatives*, 97th Cong., 2d Sess. 811 app. 4 (1982) (GAO Report, Improvements to CFTC's Registration Program Could Provide Better Customer Protection); 1 P. Johnson, *supra* note 1, § 3, at 424-25; *cf.* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 390 (1982) (CEA intended to protect futures traders from fraudulent conduct); Christensen Hatch Farms, Inc. v. Peavey Co., 505 F. Supp. 903, 910 (D. Minn. 1981) (primary purpose of CEA is protection from fraud).

142. Under SEC Rule 10b-5 misrepresentations are actionable only if material. 17

a private cause of action for securities fraud.[143] The CEA antifraud statute[144] uses "identical language"[145] and allows a fraud action against an FCM for any material misrepresentations concerning an investor's discretionary commodity account.[146] Thus it is apparent that the CEA protects the investor in ways similar to the Securities Acts.

4. Comprehensiveness by Scope: Where the Securities Laws Apply

Marine Bank based its holding on the fact that the investors in question were protected under the federal banking laws,[147] but cautioned that each transaction must be evaluated on its own.[148] Thus if the scope of the alternative act does not include *all* the investments that may be regulated under the Securities Acts, these unregulated investments should be subject to those Acts.[149]

C.F.R. § 240.10b-5 (1984). Facts are considered material if "there is a substantial likelihood that an ordinary investor would have considered them important in deciding whether or not to puchase the securities." Little v. Valley Nat'l Bank, 650 F.2d 218, 222 (9th Cir. 1981).

143. Section 10 of the Securities Exchange Act of 1934 provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1982). Although not explicit in the statute, "the existence of a private cause of action for violations of [10(b)] . . . is now well established." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976).

144. Section 4b of the Commodity Exchange Act provides in relevant part:

> It shall be unlawful (1) for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with any order to make, or the making of, any contract of sale of any commodity in interstate commerce, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person . . . (A) to cheat or defraud or attempt to cheat or defraud such other person . . . .

Commodity Exchange Act § 4b, 7 U.S.C. § 6b (1982).

145. Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 104 (7th Cir. 1977); *see also* 2 P. Johnson, *supra* note 1, § 5.39, at 311 (Section 4b of the CEA and § 10b of the '34 Act "serve similar puposes . . . although they are not similarly worded."). Compare *supra* notes 143 with *supra* note 144.

146. Commodity Exchange Act § 22(a)(1)(B), 7 U.S.C. § 25(a)(1)(B) (1982). Although the CEA antifraud statute does not require materiality, it is likely that the courts will imply a materiality requirement similar to that of SEC Rule 10b-5. 1 A. Bromberg & L. Lowenfels, *supra* note 1, § 4.6, at 82.370; *see* CFTC v. United States Metals Depository Co., 468 F. Supp. 1149, 1159, 1160 (S.D.N.Y. 1979).

147. *See* Marine Bank v. Weaver, 455 U.S. 551, 559 (1982)

148. *See id.* at 560 n.11.

149. In Board of Trade v. SEC, 677 F.2d 1137 (7th Cir.), *vacated as moot*, 459 U.S. 1026 (1982), the Seventh Circuit held that because the clear, statutory authority of the CFTC over commodity options on securities is *"plenary* . . . there is no need for compounding the regulation by adding the SEC." *Id.* at 1159 (emphasis added) (relying on

The CEA regulates all commodity[150] futures contracts traded on a contract market designated as such by the CFTC.[151] Because it is unlawful to trade futures contracts outside a market,[152] the CEA, in effect, regulates all futures contracts. The CEA expressly regulates all accounts involving futures contracts that are traded on a contract market.[153]

Marine Bank v. Weaver, 455 U.S. 551 (1982) and International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979)). The court in *Board of Trade*, in holding that the SEC was pre-empted from regulating commodity options on securities, clearly relied on the fact that the CFTC's authority over commodity options was explicit and full.

150. The CEA defines "commodity" by listing a number of commonly traded commodities, Commodity Exchange Act § 2(a)(1)(A), 7 U.S.C. § 2 (1982), but states that the term "commodity" also includes "all other goods and articles. . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in," *id.* This expansive definition of "commodity" was added in the 1974 amendments to allow regulation of the increasing number of items that had become the subject of futures contracts. *See* H.R. Rep. No. 975, 93d Cong., 2d Sess. 41-42 (1974); 1 P. Johnson, *supra* note 1, § 1.01, at 2-4.

Section 2(a)(1)(A) explicitly excepts any sale of a commodity for deferred shipment or delivery when such shipment is actually anticipated. Commodity Exchange Act § 2(a)(1)(A), 7 U.S.C. § 2 (1982); CFTC v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 576-77 (9th Cir. 1982).

151. Commodity Exchange Act § 2(a)(1)(A), 7 U.S.C. § 2 (1982).

152. *Id.* § 4, 7 U.S.C. § 6 (1982).

153. *Id.* § 2(a)(1)(A), 7 U.S.C. § 2 (1982). Section 2(a)(1)(A) of the Commodity Exchange Act provides:

> That the Commission shall have exclusive jurisdiction, except to the extent otherwise provided in section 2a of this title, with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 7 of this title or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 23 of this title.

7 U.S.C. § 2 (1982).

Section 2(a)(1)(A) further states:

> That, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws.

Id.

A problem that has divided the courts, and which is beyond the scope of this Note, is how to be consistent in interpreting the CEA's language of "exclusive jurisdiction" and the SEC "savings clause." The grant of exclusive jurisdiction is so broad, including any kind of transaction "involving" a futures contract, that it is not clear what type of commodity transactions still come under SEC jurisdiction.

The courts have split at least four ways on the issue of whether discretionary commodity accounts are "saved" by the SEC savings clause. *See* Mordaunt v. Incomco, 686 F.2d 815, 816 (9th Cir. 1982) (discretionary commodity accounts not within CFTC exclusive jurisdiction), *cert. denied*, 105 S. Ct. 801 (1985); Peavey Co. v. Mitchell, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,593, at 97,337 (W.D. Okla. Dec. 30, 1983) (SEC pre-empted but investors may maintain private action under Securities Acts); Gonzalez v. Paine, Webber, Jackson & Curtis, Inc., [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,867, at 94,514 (S.D.N.Y. Nov. 10, 1982) (Securities Acts pre-empted);

In *In re Federal Bank & Trust Co. Securities Litigation*,[154] plaintiffs entered into a discretionary commodity account with the defendants[155] in which all trading in futures contracts was to be done in the Bahamas.[156] Concerning a claim for commodity fraud, the court held that because the CEA regulates only those accounts that involve futures contracts traded on CFTC designated contracts markets,[157] the Bahamas trades were not covered and the plaintiffs were therefore not protected under the CEA.[158] Thus, although the commodities laws specifically regulate discretionary commodity accounts by protecting investors in a way similar to that of the securities laws, some discretionary accounts may not fall within the scope of the CEA.[159] In *Federal Bank*, the investors' only federal remedy may have been under the Securities Acts.

Following the Supreme Court's directive that each transaction should be examined separately,[160] discretionary commodity accounts that are unregulated by the commodities laws should be distinguished from those that are so regulated, and those accounts that do not come under the specific regulation of the commodities laws should be subject to the Securities Acts.

CONCLUSION

Because the definition of security in the Securities Acts included "investment contract" as a catch-all to bring various investment schemes within federal regulation, the Supreme Court has defined the phrase broadly. Discretionary commodity accounts that are not regulated by the commodity laws should be subject to regulation by the Securities Acts. Comprehensive CEA regulation, however, exempts most discretionary commodity accounts from regulation under the Securities Acts. Thus, those accounts that are regulated by the commodities laws should be under the exclusive jurisdiction of the CEA.

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Mullis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 492 F. Supp. 1345, 1350-51 (D. Nev. 1980) (SEC regulation pre-empted, but investors may maintain private action under Securities Acts if account was mainly a discretionary securities account).

154. [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,565 (D. Or. June 4, 1984).

155. *Id.* at 98,876.

156. *Id.* at 98,873.

157. *See id.* at 98,880.

158. *Id.* at 98,881.

159. Under section 2(a)(1)(A) of the Commodity Exchange Act, an account is within the jurisdiction of the CEA if it involves *a* futures contract. *See* 7 U.S.C. § 2 (1982). Thus, as long as the account involves one futures contract traded on a contract market, the CEA should have jurisdiction over that account.

160. *See* Marine Bank v. Weaver, 455 U.S. 551, 560 n.11 (1982).