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Investment Management Arrangements and the Federal Securities Laws

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Professional investment managers are responsible for the investment of an ever-increasing part of the nation’s wealth. Mutual funds manage trillions of dollars of other people’s money, while banks, insurance companies, pension plans, investment advisers, broker-dealers, other institutions, and individuals manage much more.¹ The federal securities laws are an important element of the legal regime governing investment management.² Investment managers trigger federal securities laws when they offer or sell securities, and thus the whole effect of these laws turns on what the word “security” means. An investment manager who invests a client’s funds in stocks or bonds is subject to the federal securities laws. However, an investment management arrangement may itself be a security. If it is, the federal securities laws attach as soon as the investment manager offers to serve a prospective client even if the managed funds will not be invested in statutory securities.

This Article explores the regulation of investment management arrangements as securities. Part I briefly surveys the federal securities laws that govern the offer and sale of securities by investment managers. Part I then discusses the unusual circumstances of the early 1970s that led courts and the Security and Exchange Commission (“SEC”) to insist on a broad definition of the word “security,” which, it turns out, encompasses a wide variety of investment management arrangements. Although the circumstances that led to this expansion of the scope of the federal securities laws no longer apply, the

¹ See Martin J. Gruber, Another Puzzle: The Growth in Actively Managed Mutual Funds, 51 J. Fin. 783, 784–85 (1996); see also Robert Charles Clark, The Four Stages of Capitalism: Reflections on Investment Management Treatises, 94 Harv. L. Rev. 561, 564 (1981) (“The increasing separation of the decision about how to invest from the decision to supply capital for investment is one of the most striking institutional developments in our century.”); Jane E. Willis, Banks and Mutual Funds: A Functional Approach to Reform, 1995 Colum. Bus. L. Rev. 221, 221–23.

² See infra Part I.A.
law established in response to them still determines whether investment management arrangements are securities. This law, created largely to fill gaps in a dated regulatory regime, now poses substantial risks for investment managers and threatens to distort the regulation of investment management.

Part II examines the law governing whether investment management arrangements are securities, focusing on the requirement of common enterprise, the relevance of the way control is allocated between manager and investor, and the special status of trust arrangements. Part III deals with the related question of whether collections of managed accounts are investment companies. Part IV examines the principles and policies at play when investment management arrangements are subjected to regulation under the federal securities laws. Although courts called upon to judge investment management arrangements do not always clearly articulate the principles that guide their decisions, identification of these principles is essential for policymakers charged with administering and perfecting the federal securities laws and for managers and investors trying to structure their affairs to comply with them. This Article concludes that the question of whether an investment management arrangement is a security should turn on the degree to which the manager is responsive to the individual situation and objectives of the owner of the managed assets.

I. APPLICATION OF THE SECURITIES LAWS TO INVESTMENT MANAGEMENT ARRANGEMENTS

A. Securities Laws Governing Investment Management Arrangements

The federal securities laws regulate the activities of investment managers through three mechanisms: (1) the registration requirements of the Securities Act of 1933 ("Securities Act"),\(^3\) the Securities Exchange Act of 1934 ("Exchange Act"),\(^4\) and the Investment Company Act of 1940 ("Investment Company Act"),\(^5\) which require the filing of extensive documentation with the SEC and effectively force managers to disclose information to investors; (2) the regulatory regimes of the Exchange Act, the Investment Company Act and the Investment Advisers Act of 1940,\(^6\) which regulate the business practices of investment managers; and (3) the broad proscriptions of fraudulent activity contained in the several federal statutes.\(^7\)

The Securities Act requires that, absent an exemption, an issuer of securities must file a registration statement with the SEC before its securities may be offered for sale and forbids securities to be sold until the registration statement becomes effective. Once a registration statement has been filed, the form and content of prospectuses are closely regulated, and, broadly speaking, written offers of securities are prospectuses. The Investment Company Act, again speaking broadly, forbids an investment company to offer or sell its securities unless the company is registered under that Act. The operative term “offer” is so broadly defined in both acts that it includes most promotional activities of investment managers. Thus, if an investment management arrangement is a security, the registration requirements of the Securities Act and the Investment Company Act may both require the investment manager to make extensive filings with the SEC before commencing operations and may regulate the form and substance of the process by which the investment manager subsequently offers its services.

The disclosure regime of registration is supplemented by substantive management activities after funds are invested may also be subject to regulation. See 15 U.S.C. § 80b-6 (1994) (prohibiting transactions by investment advisers). 8 See Securities Act § 5(a), (c), 15 U.S.C. § 77e(a), (c) (1994).

13 Various exemptions from Securities Act and Investment Company Act registration may be available in some cases, but many investment management arrangements would not qualify for those exemptions. Each of those exemptions contains restrictions, including restrictions on advertising and sales to small or unsophisticated investors. See generally Thomas Lee Hazen, The Law of Securities Regulation §§ 4.1–29, 17.1, 17.3 (3d ed. 1995); 2 Louis Loss & Joel Seligman, Securities Regulation 1211–60, 1274–1454 (3d ed. 1989). More important, exemptions cannot be combined, so all transactions in an offering or issue of securities must satisfy a single exemption; if one does not, none does. See Cheryl L. Wade, The Integration of Securities Offerings: A Proposed Formula that Fosters the Policies of Securities Regulation, 25 Loy. U. Chi. L.J. 199, 199 (1994); cf. Securities Act Rules §§ 504(b)(2), 505(b)(2)(l), 17 C.F.R. §§ 230.504(b)(2), .505(b)(2)(l) (1995) (providing dollar amounts for Regulation D offerings). It is difficult to predict whether transactions will be integrated and treated as a single offering, and the prospect of apparently separate accounts being integrated makes it difficult to rely upon these exemptions to sell investment management services.
regulation of those in the securities business. The SEC and the National Association of Securities Dealers regulate securities brokers and dealers, and their regulations govern the details of broker-dealer operations. 14 Those who advise others as to the advisability of investing in securities for compensation are also subject to the Investment Advisers Act. 15 This act requires registration and periodic reporting, and also regulates investment adviser compensation. 16

Finally, the antifraud provisions of the federal securities laws independently control the form and substance of information that investment managers make available to prospective clients. 17 Moreover, while investment managers may not technically be in a fiduciary relationship with prospective clients before they assume office, the securities laws impose something very much akin to fiduciary responsibility even during the promotional phase of an investment management relationship. 18

B. The Context in Which the Securities Laws Have Been Applied to Investment Management Arrangements

Much of the law that determines whether investment management arrangements are securities was made in the early 1970s. That law developed largely in response to practices in two businesses that are themselves subject to extensive federal regulatory schemes: commodities trading and commercial banking. Since the early 1970s, commodities law and banking law have changed to address the problems posed by those practices directly, but the legal doctrines developed in the early 1970s still largely control the question of whether any investment management arrangement is a security for the purposes of the federal securities laws.

The first development that led to an expansion of the definition of the word security in the early 1970s was that nonagricultural commodities began to be widely traded on commodity exchanges, at a time when such commodities were

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16 See generally TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS (1978); HAZEN, supra note 13, ch. 18.

17 See HAZEN, supra note 13, § 1.2.

largely unregulated under the commodities laws. To obtain a remedy in federal court, commodity investors who felt they had been wronged argued that their commodity trading accounts were securities, and many federal courts agreed. Since then, the commodities laws have been repeatedly amended to police fraud in commodities dealing directly. Even if the remedies that commodity investors have been extended over the last twenty years are less generous than those available to security investors, it is unlikely that courts would have extended the scope of the federal securities laws as much as they did in the early 1970s if the remedies now available under commodities law had been available then. Nonetheless, the expansive scope that some courts gave to the securities laws still stands, and it provides the framework for determining whether any investment management arrangement is a security today.

The other important development that transformed the scope of the federal securities laws in the early 1970s was that commercial banks tried to offer investment management services to individuals in a manner that would have competed with—and to a substantial extent substituted for—mutual funds. The mutual funds responded by arguing that these services were securities that the banking laws forbade commercial banks to offer. The SEC responded by insisting that the arrangements were securities that had to be registered under the federal securities laws. The banking-law argument met with mixed
success, but the banks largely went along with the SEC and either altered their programs or registered them under the Securities Act and the Investment Company Act. This compliance effort has no doubt been expensive for the banks, but it has implications far beyond banking. The SEC's theory of why investment management arrangements may be securities was not limited to arrangements offered by banks, and the position to which the banks acquiesced, like the law that courts developed to deal with commodities fraud, continues to stand as a test of whether any investment management arrangement is a security.

Scholars have offered the law's response to the growth of investment management activities as a paradigm of legal evolution and the problem of statutory obsolescence. The issues raised by public trading of nonagricultural commodities and commercial-bank investment management activities were eventually addressed as commodities law and banking law questions. Unfortunately, the initial attempt to resolve those issues by expanding the definition of the term security created a new set of problems for the field of investment management. The expanded definition still governs the treatment of a wide variety of investment management arrangements under the securities laws, although these arrangements are often structured in apparent disregard of the possibility that they are securities. Moreover, disagreements about the meaning of the word security were never resolved, perhaps because the commodities and banking problems were eventually addressed elsewhere. Thus, the meaning of the word security, especially as it applies to investment management arrangements, remains unclear, and it is often difficult to determine whether a particular investment management arrangement is subject to the federal securities laws.

II. INVESTMENT MANAGEMENT ARRANGEMENTS AS SECURITIES

When an investment management arrangement is packaged as a conventional security, such as a share of common stock, the federal securities laws are clearly implicated in the marketing of the arrangement. Shares in an open-end investment company—popularly called a mutual fund—are an example. Such shares are subject to the registration requirements of the Securities Act; the investment company is subject to the Investment Company Act; the manager of the company is subject to the Investment Advisers Act;

26 See Langevoort, supra note 24; Willis, supra note 1; see also infra Part II.C.
27 See infra text accompanying notes 30–34.
28 See infra note 164.
29 See Clark, supra note 1; Langevoort, supra note 24.
30 See infra note 151.
brokers and dealers selling the shares are subject to the Exchange Act; and the antifraud provisions of the several federal securities statutes govern distribution of the shares. Those involved in the marketing and management of mutual funds presumably comply with the pervasive regulatory regime in which they operate, and they are at least on fair notice of its existence. Other investment management arrangements may also be securities; however, as the case law shows, investment managers often fail to take account of that possibility.

The Supreme Court frequently characterizes the federal securities statutes as remedial statutes that are to be broadly construed in determining whether an investment vehicle is a security. So commissioned, federal courts and the SEC have read the definition of security in the several federal securities statutes to include various arrangements between investment managers and their clients, and the Court itself has held some investment management arrangements to be statutory securities. Nevertheless, the reach of the federal securities laws has ebbed and flowed over time, and the meaning of the term security is still open in many of its particulars. However, while the route to classification of investment management arrangements as securities is not always clearly marked, it has been traveled enough to leave its broad contours familiar.

The Securities Act, the Exchange Act, and the Investment Company Act all define the word security by listing various instruments that are securities, and each list includes the term "investment contract." The Supreme Court

31 See supra notes 10–16.
elaborated the meaning of that term in *SEC v. W.J. Howey Co.*, in which it said that "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."  

The meaning of the term investment contract has been much litigated since *Howey*. It is by no means settled now, and the elements of the Court's test have acquired substantial gloss. Nonetheless, the Court defined the term broadly and, for present purposes, the coverage of the two Acts may be considered the same." (quoting *Forman*).


36 328 U.S. 293 (1946).

37 Id. at 298–99.

and further emphasized that its 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 money of others on the promise of profits." Moreover, federal courts faced with a perceived wrong may stretch to hold an investment to be a security in order to provide a federal remedy. In any event, many investment management arrangements have been held to be securities. Such arrangements take many forms, however, and it may be difficult to predict whether a court will characterize a particular arrangement as a security, especially given the disarray about what an investment contract is.

Judicial inquiry into whether a particular investment management relationship is a security usually focuses on one or more of the sometimes intertwined elements of Howey's definition of an investment contract, although, in practice, examination of the interaction of the various attributes of an investment vehicle may offer a better prediction of its ultimate characterization than a checklist approach. In any event, in disputes over whether investment management arrangements are investment contracts, and thus securities, three questions recur: (1) Is there a common enterprise?; (2) is the investor relying on the manager to produce profits?; and (3) does the use of a trust change the analysis?

A. Common Enterprise

The requirement that an investment contract be a common enterprise is probably the most unsettled element of the Howey test. Although some
apparently discordant cases can be reconciled on their facts, the case law on common enterprise leaves investors and managers with little clear guidance on the scope of the federal securities laws. Some courts have essentially eliminated the requirement of common enterprise as a meaningful limitation on the scope of investment contract, and some commentators would eliminate it explicitly. Much of the difficulty has arisen in cases presenting the question whether discretionary brokerage accounts constitute a common enterprise, but the various tests developed in the lower courts show little sensitivity to the way such accounts operate.

The Supreme Court said little about the common-enterprise element in Howey. In that case, a corporation that owned citrus groves in Florida offered to sell investors fee simple interests in the land of a grove, and an affiliated corporation offered to enter into service contracts for the management of the investors' trees and crops. The Court held that this constituted the offering of securities, even though investors were free to buy the land without entering into a service agreement with the promoters. The Court discussed the relevance of a common enterprise only in the course of explaining why the investments being offered were "something more than fee simple interests in land, something different from a farm or orchard coupled with management services." The difference, according to the Court, was in the fact that

individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.

The presence of a common enterprise may distinguish investment contracts that are securities from fruit orchards that are not, but courts called upon to classify investment management arrangements have found little guidance in Howey. Lower courts have developed three tests of commonality, which are—at least on their express terms—largely irreconcilable.

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42 See HAZEN, supra note 13, § 1.5, at 53–56; 2 LOSS & SELIGMAN, supra note 13, at 927–35; Gordon, supra note 38, at 635–42; Monaghan, supra note 38, at 2152–71.
43 See Howey, 328 U.S. at 295.
44 See id.
45 See id at 300.
46 Id. at 299.
47 Id. at 300.
48 In 1985, three justices dissented from the denial of certiorari in Mordaunt v. Incomco,
1. Horizontal Commonality

Setting a high threshold for the common-enterprise requirement would exclude most investment management arrangements from classification as investment contracts, at least absent pooling of managed assets and collective management.\footnote{49} For a while, the SEC and the courts seemed intent on doing just that.\footnote{50} For example, in Milnarik v. M-S Commodities, Inc.,\footnote{51} Judge (later Justice) Stevens of the Seventh Circuit rejected the argument that a discretionary account for trading in commodity futures was a common enterprise and hence a security.\footnote{52} Although the plaintiffs alleged that the broker had entered into similar arrangements with other customers, that was not enough to make the plaintiffs' account a security.\footnote{53} The investors in the several accounts "were not joint participants in the same investment enterprise,"\footnote{54} and because the plaintiffs' profits were not dependent upon those of other customers, the accounts were not securities.\footnote{55}

The Third and Seventh Circuits have joined the Sixth Circuit in adopting this most restrictive test of the common-enterprise requirement of Howey, the requirement of horizontal commonality among various investors.\footnote{56} Under this

\begin{itemize}
  \item A pooled investment vehicle is one in which all contributions of investors are treated as part of the same unit and the interests of investors are represented by participations in that unit. Common examples of pooled investment vehicles are commingled trust funds and investment companies.
  \item Despite the well-known existence of discretionary management services, the SEC has apparently never acted, either through enforcement or through its rulemaking authority, to have individual discretionary accounts registered as securities absent a common investment management scheme. For example, in 1970, the SEC attacked a managed account arrangement as a security on the ground, among others, that investment decisions were being implemented in all accounts on a uniform basis, but not simply on the ground that the accounts were being managed on a discretionary basis. See SEC v. First Nat'l City Bank, SEC Litigation Release No. 4534, [1969–1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,592 (Feb. 6, 1970); see also infra text accompanying note 211 (discussing Release No. 4534).
\end{itemize}

\begin{itemize}
  \item 457 F.2d 274 (7th Cir. 1972).
  \item See id. at 279.
  \item See id.
  \item Id. at 277.
  \item Id. at 276–77.
  \item See Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1017 (7th Cir. 1994); Deckebach
\end{itemize}
approach, which has been held to require that several investors' funds be pooled,\textsuperscript{57} conventional discretionary accounts, in which a manager makes investment decisions for a particular investor's account, are not securities, and even more exotic arrangements can be structured to avoid their being classified as securities.

2. Broad Vertical Commonality

Notwithstanding \textit{Milnarik} and similar cases, there were indications even before \textit{Howey} that a managed investment account, at least one over which the manager had discretionary authority, may be an investment contract.\textsuperscript{58} Another

\begin{itemize}
  \item See \textit{Milnarik} v. M-S Commodities, Inc., 457 F.2d 274, 277-78 (7th Cir. 1972); \textit{see also} \textit{Wals}, 24 F.3d at 1017; Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 99 (7th Cir. 1977); Meredith v. Conticommodity Servs., Inc., [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,701, at 98,672 (D.D.C. 1980); Darrell v. Goodson, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,349 (S.D.N.Y. 1980); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066, 1067 (D. Md. 1972), \textit{aff'd}, 491 F.2d 752 (3d Cir. 1973); \textit{cf. Curran}, 622 F.2d at 219 (holding commodities account was not a security even though broker falsely represented it would be pooled), \textit{aff'd on other grounds}, 456 U.S. 353 (1982). \textit{But cf.} SEC v. Lauer, 52 F.3d 667, 670 (7th Cir. 1995) (holding that an investment in a fraudulent scheme that was supposed to involve pooling but only succeeded in attracting one investor was a security: "[I]t is the character of the investment vehicle, not the presence of multiple investors, that determines whether there is an investment contract.").
  \item Thus, in 1935 one court wrote that

\begin{quote}
Whether one invests money in the proverbial gold mine, \ldots\, or invests in a speculative venture by reason of the claimed skill and experience of a grain and stock market manipulator to make profits, the transactions cannot be rationally distinguished in determining the dealings which Congress intended to regulate in using the term "investment contract." Both are investments \ldots\,. Both entail the issuance of a security. In one the investor expects profits by reason of the gold to be mined; in the other, by reason of the skill and experience of the defendant in the market. In both, the opportunities for fraud are notorious.
\end{quote}

approach to common enterprise—under which managed accounts are more likely to be classified as securities—requires not horizontal commonality among investors but instead vertical commonality between the investors and the manager or promoter. Most federal courts are satisfied that the common-enterprise requirement of the *Howey* test is satisfied by the presence of horizontal commonality in the form of pooled accounts, but some courts have held that one or another form of vertical commonality is sufficient even in the absence of horizontal commonality. Adding to the confusion, however, the courts that are satisfied with vertical commonality do not agree on what constitutes vertical commonality.

The SEC emphasized the commonality of discretionary management services offered to various customers in its early forays against managed accounts. Subsequently, however, the SEC and some courts began to take the position that the reliance an individual investor places in a manager's acumen can itself form the basis of a common enterprise sufficient to satisfy *Howey*. Under the broader test of vertical commonality, it is enough that the investor's success is dependent on the efforts of the manager.

The most influential statement of this approach is probably the Fifth Circuit's 1974 opinion in *SEC v. Continental Commodities Corp.*, a case in which the SEC sought to enjoin a firm dealing in commodities futures from violating the registration provisions of the Securities Act and the antifraud provisions of the Exchange Act. Following *Milnarik*, the district court

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59 See *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996); see also HAZEN, supra note 13, § 1.5, at 33.
60 See HAZEN, supra note 13, § 1.5, at 33.
61 See id.
63 497 F.2d 516 (5th Cir. 1974).
64 The court of appeals described the Continental Commodities' operations as follows:

The trading enterprise extended the opportunity to invest in commodities futures
dismissed the complaint, on the theory that since the accounts of individual investors were unrelated, no security was involved. The SEC appealed, but only on the theory that notes the firm had issued to its customers were securities. The court of appeals, however, examined the question of whether the investors were participating in a common enterprise, even though the issue was not contested by the parties. The court concluded that they were, and accordingly found that the investors' arrangements with Continental were securities.

The Fifth Circuit grounded its rejection of Milnarik on its decision in SEC v. Koscot Interplanetary, Inc., which it had rendered a few days before. Koscot held that a multi-level distributorship scheme was an investment contract, and hence a security, even though investors in the distributorship had to contribute their own efforts to accomplish their own success and realized a return that was largely independent of the return to other investors. According to Continental Commodities, the "critical inquiry" in deciding whether a common enterprise is involved

is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise. Continental Commodities renders investment counseling concerning which option on commodities futures to invest in, when to sell or exercise the option, and if the option is exercised, when to sell the specific futures contract. Lacking the business acumen possessed by promoters, investors inexorably rely on Continental Commodities undertook to recommend certain commodities futures contracts to its customers. An interested customer would first be issued an option, guaranteeing him the right to purchase the contract at a stated price, with the option to remain open for a specified period of time. Continental Commodities neither owned the underlying futures contract nor escrowed any portion of the customer payments for the purpose of acquiring such contracts. In addition, Continental Commodities undertook to advise a customer of the most opportune moment either to sell or to exercise the option. Finally, it also offered investment counseling as to the most propitious time to sell a specific futures contract.

Id. at 519.

65 See id. at 521.
66 See id. at 520.
67 See id. at 521–23.
68 See id. at 527.
69 497 F.2d 473 (5th Cir. 1974).
70 The primary issue in Koscot was whether the Howey requirement of an expectation of profits "solely from the efforts of others" was satisfied inasmuch as investors in the distributorship had to contribute their own efforts after investing money. The court held that the Howey test was satisfied. See id. at 479–85.
Commodities' guidance for the success of their investment. This guidance . . . is uniformly extended to all . . . investors. That it may bear more productive fruits in the case of some options than it does in cases of others should not vitiate the essential fact that the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of Continental Commodities.71

The court’s emphasis on the investors’ reliance on the defendants’ expertise suggests that a broker arranging a single managed account with a single customer may be selling a security, since a single investor can rely on a manager in the same way that many investors can.72 On the other hand, the defendants in Continental Commodities offered management services to many customers,73 and the action was initiated by the SEC, not by a customer seeking damages.74 Moreover, the court’s repeated references to “the trading enterprise” might be read to contemplate that a manager’s activities can constitute a common enterprise only when they involve several accounts or at least several investors.75 Nonetheless, several courts have held that a single customer’s managed brokerage account is a security.76

71 Continental Commodities, 497 F.2d at 522-23.
72 See 2 Loss & Seligman, supra note 13, at 933.
73 See Continental Commodities, 497 F.2d at 519.
74 See id. at 518.
75 See Gordon, supra note 38 (arguing that Howey’s common-enterprise requirement should be interpreted to require multiple parallel investors); cf. SEC v. Lauer, 52 F.3d 667 (7th Cir. 1995) (holding that an investment in a fraudulent scheme in which the promoter represented there would be pooling was a security even though the scheme attracted only one investor).
Continental Commodities and its progeny have been widely criticized by courts and commentators. The Ninth Circuit has developed a narrower test of vertical commonality, requiring “that the fortunes of the investors are linked with those of the promoters.” Under this test, it is not enough that the investors are dependent upon the efforts of the manager; the success of the manager and investor must be interdependent. Thus, a discretionary account is not a security if the brokerage firm is compensated only by commissions, since the firm profits even if the client does not. On the other hand, Howey's common-enterprise requirement is satisfied under this test if the manager receives a fee or bonus that is a function of the investor's profits, because the manager's own profit is then “contingent on the profit of his investors.”


78 See, e.g., 2 Loss & Seligman, supra note 13, at 933 (“Unless two or more persons in some sense share in the profitability of an undertaking, it is difficult to argue that there is a common enterprise.”); Gordon, supra note 38, at 664-66; Monaghan, supra note 38, at 2161-62.

79 SEC v. R.G. Reynolds Enters., Inc., 952 F.2d 1125, 1130 (9th Cir. 1991) (quoting SEC v. Goldfield Deep Mines, 758 F.2d 459, 463 (9th Cir. 1985)); see also Goldfield Deep Mines, 758 F.2d at 463 (“A common enterprise is a venture ‘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.”’”) (quoting Brodt v. Bache & Co., 595 F.2d 459, 460 (9th Cir. 1978), quoting in turn SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973).

80 See Brodt, 595 F.2d at 459; Schofield v. First Commodity Corp., 638 F. Supp. 4, 7 (D. Mass. 1985), aff'd, 793 F.2d 8 (1st Cir. 1986); Shotto v. Laub, 635 F. Supp. 835, 839 (D. Md. 1986); see also Hazen, supra note 13, § 1.5, at 33 n.45.

81 R.G. Reynolds Enters., 952 F.2d at 1131; see also Goldfield Deep Mines, 758 F.2d at 463 (“Here, the investors’ fortunes were clearly linked with those of appellants. The ore program required the sharing of profits, in that Goldfield [(the promoter)] was to receive a 25% royalty fee for processing the investors’ ore. Furthermore, the fortunes of both the investors and appellants were dependent upon the success of appellants’ unique ore processing technique. If the processing technique were to prove faulty, then both the investors and appellants would suffer financial losses. This direct correlation between Goldfield’s potential failure and the investors’ losses supports a finding of a common enterprise.”); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1229 (S.D.N.Y. 1981) (finding security where broker was to receive a percentage of investor’s profits).
4. Individual Treatment and Common Enterprise

While different courts have described the test of common enterprise in widely different terms and have applied very different tests in some cases, opinions that are expressed in irreconcilable terms often reach entirely consistent results. Moreover, the factors that courts have cited to explain themselves in the end draw distinctions that have little to do with the substance of managed accounts.

Although investment management relationships take many forms, courts have not always focused on the nuances of the arrangements before them. For example, the accounts at issue in Continental Commodities—the broadest common-enterprise case—were hardly typical brokerage accounts. Usually an investor with a brokerage account owns the assets purchased for the account, and the risk of loss is for all practical purposes solely a function of the wisdom of the investment decision. In Continental Commodities, on the other hand, the investors looked to their manager for more than advisory services. Continental placed its clients into naked options written by the firm, and the litigation grew out of its inability to make good the investors' claims against the firm. Accordingly, the investors faced not only the risk that the firm's advice was poor, but also the substantial risk that the firm would be unable to pay their claims even if their investments proved successful. Thus, the decision of the court—if not the language of its opinion—may have turned on the interdependence of the investors and their manager. In light of the investors' reliance on their manager's economic viability, Continental Commodities might not have been quite the startling decision that it appeared to be.

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83 In essence, the agreements between client and manager were the equivalent of evidences of indebtedness, another type of security under the federal securities laws. See SEC v. Western Pacific Gold & Silver Exch. Corp., [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,064 (D. Nev. 1975) (holding that sales agreements for client investments in gold coins and silver bars constituted "evidences of indebtedness" where clients did not acquire title to the gold or silver, but did acquire claims for money against the defendant, and where clients' moneys were subjected to the "risks of the enterprise"); see also 2 Loss & SELIGMAN, supra note 13, at 900–02.
The SEC has at times suggested that commonality derives from the mutual interest of investors in the financial health of their manager. For example, in a complaint against the Pacific Coast Coin Exchange (PCCE),\(^\text{84}\) the SEC alleged that PCCE sold its clients silver coins and other commodities on margin without purchasing or holding the coins or commodities until the margin accounts were paid in full.\(^\text{85}\) Instead, according to the SEC, PCCE commingled investor funds and subjected them to the risk of the PCCE venture.\(^\text{86}\) In effect, investors became creditors of the firm, an arrangement that might well have been classifiable as the issuance of a security in any event, on the theory that the underlying investment arrangements were evidences of indebtedness.\(^\text{87}\) Investor reliance on the manager's viability was thus arguably the key to the SEC's thinking on common enterprise.\(^\text{88}\) Nonetheless, courts that have followed *Continental Commodities* have ignored the investors' dependence on the continued success of their manager in that case.\(^\text{89}\)

In any event, the argument that *Continental Commodities* turned on the investors' reliance on the firm's viability would run into the Fifth Circuit's stated rationale. Although the court apparently understood that the investors' accounts represented investments in both commodities options and the financial health of the firm, it did not emphasize common investment in the firm as a

\(^{84}\) SEC v. MONEX Int'l Ltd., SEC Litigation Release No. 6645, 1974 SEC LEXIS 2114 (Dec. 18, 1974) (SEC alleged that a security existed where customers' funds were commingled in defendant's coin-investment enterprise, managed by defendant, subjected to the risks of that enterprise, and where investors relied on defendant's efforts for the safe return of their investments); *see also* SEC v. MONEX Int'l Ltd., SEC Litigation Release No. 7057, 1975 SEC LEXIS 959 (Aug. 25, 1975) (announcing that a permanent injunction had been granted against the defendants).

\(^{85}\) See MONEX, 1974 SEC LEXIS at *2.

\(^{86}\) See id.

\(^{87}\) See *Western Pacific Gold & Silver Exch. Corp.*, Fed. Sec. L. Rep. [1974–1975 Transfer Binder] (CCH) ¶ 95,064. The court in *Jenson v. Continental Finance Corp.*, 404 F. Supp. 792 (D. Minn. 1975), also concluded that contracts to purchase gold and silver coins were investment contracts. The opinion places substantially more weight than do *Continental Commodities* and *MONEX* on the degree to which the investors were coventurers with the firm.

\(^{88}\) See *also* Gary Plastic Packaging Corp. v. Merrill Lynch, 756 F.2d 230, 240 (2d Cir. 1985) ("The customers [of Merrill Lynch's program of marketing bank certificates of deposit] rely on the skill and financial stability of Merrill Lynch . . . .").

\(^{89}\) The Fifth Circuit followed and reaffirmed *Continental Commodities* in *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989). The court did not suggest that the promoter's viability was in doubt in *Long*, and the court again focused on the investors' reliance on the promoter's expertise. *Id.* at 140–41.
basis for concluding that the accounts were securities. Instead, the court explained its decision by emphasizing that investment success was "essentially dependent upon promoter expertise," that guidance was "uniformly extended to all . . . investors," and that the results of the enterprise as a whole and customer investments individually were "contingent upon the sagacious investment counseling of Continental Commodities." In sum, the court focused not on the investors' dependence on the continued viability of the firm, but on the expert advice the promoter promised to provide.

This expertise interpretation of Continental Commodities finds support in other cases. In SEC v. Brigadoon Scotch Distributors, Ltd., for example, the court acknowledged that commonality normally implies participation in a common fund, but held that "the requisite commonality of enterprise may also be achieved when 'the fortunes of all investors are inextricably tied to the efficacy [of the promoters' efforts].'" However, if Howey's common-enterprise requirement is satisfied whenever an investor's profits are affected by the competence of an investment manager, it does little to restrict the scope of the term investment contract. If common enterprise can be shown by the existence of an interest in managerial ability, security status turns largely on the provision of managerial assistance. Yet the degree of managerial assistance is...
precisely the issue raised by the second element of the Howey test: Do profits come from the efforts of others?96

In the end, however, given the way that accounts are actually managed, the common-enterprise issue is far less polar than these two explanations of the Continental Commodities line of cases would suggest. Although opinions involving managed accounts sometimes proceed on the assumption that investment accounts under a single manager have little in common except for the identity of the manager, in fact the investments in managed portfolios typically overlap. Investment managers seldom mimic individuals by seeking investment opportunities account by account. Instead, they evaluate investment opportunities first, and, where action is indicated, identify all accounts suitable for the action.97 Although not every investment is made for every account, the correspondence in activity among accounts with similar objectives is typically high. Correspondence tends to increase over time because investment managers necessarily follow only a limited selection of investment opportunities rather than the entire investment universe.98 Thus, even if common management is critical to common enterprise, sensitive scrutiny of managed accounts will often reveal it, and the practical realities of investment management that lead to overlapping portfolios will only reinforce commonality.

reliance and common-enterprise elements of Howey when it cited a variety of management services, including the initial purchase of rare-coin portfolios and administrative support thereafter, to establish the existence of commonality. See Brigadoon, 388 F. Supp. at 1291–92. This approach was compelled by the fact that the only thing all the clients shared was the defendants’ professional services.

*See infra* Part II.B (discussing efforts-of-others requirement). Critics have noted that the broad doctrine of vertical commonality duplicates the efforts-of-others element of the Howey test. See, e.g., Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994); Gordon, *supra* note 38, at 665. The Fifth Circuit has acknowledged this criticism, but indicated that it will continue to follow Continental Commodities nonetheless. See Long, 881 F.2d at 140–41.


98 After the most exhaustive study of managed individual accounts, the SEC’s Advisory Committee on Investment Management Services for Individual Investors pointed out that even when clients retain authority to reject or act upon any recommendation, many advisers make blanket recommendations to many of their accounts. While maintaining its position that such accounts should not be subject to formal registration, in the face of this observed disregard of individual client needs, the Committee suggested that the SEC require firms servicing nondiscretionary accounts to describe the basis for all recommendations made to the client in order to enable the client to exercise independent judgment. *Advisory Committee Report, supra* note 62, at 25–26; see also id. at 33–38 (suggesting disclosure guidelines). Advisers Act Rule 204-3, 17 C.F.R. § 275.204-3 (1995), responds to this concern. See Investment Advisors Act Release No. 664, 1979 SEC LEXIS 2235 (Jan. 30, 1979); see also Bines, *supra* note 97, ¶ 9.03[2][b].
A critical problem that the common-enterprise cases pose for investment management is that ordinary brokerage accounts ought not to be treated as securities, even if the registered representative handling the account recommends investments to the owner. Such accounts have long been common, and if they were supposed to be treated as securities, surely someone would have said so when the federal securities statutes were enacted. On the other hand, some individual brokerage accounts are securities, and the task is to draw distinctions. Unfortunately, however, the cases simply cannot be reconciled.

If there is a key to all of this, it may be that investment management arrangements are securities unless the manager treats each managed account separately. As the SEC has said in a related context, each account is “managed on the basis of the client’s financial situation, investment objectives, and instructions.” Using lack of individual treatment as the definition of security probably explains the cases as well as any other test, although it is not the test articulated by the courts. Moreover, this definition offers a distinction between conventional brokerage accounts—in which an investor expects to review and decide upon specific investments as they are made—and accounts employing a special trading system or investment approach—in which the most important decision the investor makes is whether to become involved in the first place. Although courts have not offered lack of individual treatment as the test of common enterprise, an individualization test of common enterprise is consistent with both the language of Howey as well as the policies underlying the securities laws.

When an investment manager handles all of its accounts the same way regardless of the situations of individual account holders, all the account holders receive common treatment, and thus a test of investment contract that turns on the absence of individual treatment for investors squares with the words the Supreme Court used to define the term in Howey: common enterprise. This

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99 See sources cited supra notes 58, 76.
100 Investment Company Act Release No. 21,260, supra note 62, at 86,969; see also infra Part III.
101 Cf. Eberhardt v. Waters, 901 F.2d 1578, 1580–81 (11th Cir. 1990) (“The thrust of the common enterprise test is that the investors have no desire to perform the chores necessary for a return, and are attracted to the investment solely by the prospects of a return.”).
102 See infra Part III. The individualization inquiry is like the horizontal approach to common enterprise in that it asks whether several investors are in the same situation, but individualization differs in that it does not ask whether those investors share risks or retain individual ownership of their assets. See supra Part II.A.1.
103 Professors Loss and Seligman endorse the Ninth Circuit's narrow approach to vertical commonality, in which a security can be found only when profits are shared, whether
test also squares with the little that the Supreme Court said about common enterprise in that case, which was to the effect that a common enterprise is an enterprise in which the interests of all investors are treated alike. As noted above, the Court found that the defendants in Howey were offering a common enterprise precisely because “individual development of the plots of land that [were] offered and sold would seldom be economically feasible.”

A test of common enterprise that treats investments as securities unless the investors receive individualized treatment also furthers the policies underlying the disclosure requirements of the securities laws. While disclosure is an appropriate tool for dealing with the issues created by nonindividualized investment management services, it is not well calculated to address the problems implicated by the factors to which the other tests of common enterprise are keyed. The primary consequence of holding that a particular investment management arrangement is a security is that the manager may have to describe the arrangement in a registration statement and statutory prospectus before proposing it to potential investors. The precise meaning of the term security in difficult cases might be thought to turn on precisely what ends the disclosure provisions of the securities laws are supposed to serve. However, a security has to be something about which meaningful disclosure can be made if the disclosure requirement is to make any sense, or if it is to accomplish anything at all.

If an investment manager proposes to manage accounts according to the individual needs of each investor as those needs change over time, then there is little for the manager to disclose to potential investors when the management relationship is created beyond how the manager will be compensated and how the managed assets will be safeguarded. On the other hand, if a manager proposes to treat all managed accounts alike and employ a common technique for choosing investments, then the registration statement can describe that technique. This technique is precisely that which prospective investors need to know before they hire a manager who will not provide them individualized services. In fact, nonindividualized investment management arrangements are treated as securities only if investors can be assured of getting adequate information about management arrangements when they need it.

between investors or between an investor and a promoter. See 2 LOSS & SELIGMAN, supra note 13, at 935. This approach does give some meaning to the term common enterprise, but there is no reason the protections of the federal securities laws ought to attach when (and whenever) a manager shares in an investor’s profits but not otherwise.

104 Howey, 328 U.S. at 300; see also supra text accompanying note 47.
106 See, e.g., Corgill, supra note 38; Gordon, supra note 38.
107 See infra Part IV.
Finally, lack of individual treatment is an appropriate test of common enterprise as a matter of administrative law. As discussed below, the SEC has looked to individualization to answer the analogous (and perhaps identical) question of whether managed accounts are securities for purposes of determining whether the creator of such accounts is operating an investment company that must register under the Investment Company Act. The SEC’s administrative construction is entitled to deference, and it also provides a more coherent body of law than what the courts have provided so far.

In the end, it is hard to fit investment management arrangements into Howey’s common-enterprise element. In Howey, the element served a function that may not be present in investment management cases. The Supreme Court’s task was to distinguish citrus groves that are not securities from complicated management arrangements that are, and common enterprise worked to do so. The factors that move courts to treat some investment management arrangements as securities are not always apparent, but whatever they are, they simply are not captured in any idea of commonality. Recognizing as much, some formulations of investment-contract doctrine simply abandon the common-enterprise requirement. Whether that is an accurate prediction of where the law is going as a general matter, it is at least a fair statement of much of the law governing the status of investment management arrangements.

B. Control Of Investment Decisions

Howey’s requirement that profits be expected “solely through the efforts of the promoter or of some one other than themselves” ties security status to the control investors retain over their investments. This requirement is illustrated in cases holding limited partnership interests to be securities and general partnership interests not to be. However, the reliance element of the Howey

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108 See infra Part III.
109 See supra note 46 and accompanying text.
111 See HAZEN, supra note 13, § 1.5, at 53.
112 Howey, 328 U.S. at 298.
113 Compare Holden v. Hagopian, 978 F.2d 1115 (9th Cir. 1992) (plaintiffs failed to plead allegations sufficient to establish that their general partnership interests were securities) and Klaers v. St. Peter, 942 F.2d 535 (8th Cir. 1991) (holding that particular general partnership interest was not a security) and Stewart v. Raglan, 934 F.2d 1033 (9th Cir. 1990) (same) and Banghart v. Hollywood General Partnership, 902 F.2d 805 (10th Cir. 1990) (same) and Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975) (holding that general partnership interest was not a security because partners all vested with complete managerial control), aff’d, 553 F.2d 750 (2d Cir. 1977) with Reeves v. Teuscher, 881 F.2d 1495 (9th Cir. 1989) (holding that limited partnership interests were securities, general partnership
test has been substantially refined, so that the "solely" requirement does not preclude all investor participation. It is now sufficient if 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."114 Franchising arrangements, for example, may be securities even if the franchisees are not totally passive. Instead of insisting on abject dependence, courts focus on the extent to which the promoter or a third party is involved in the subsequent management of the franchised business.115 Thus, a franchise is

interest was not) and SEC v. Interlink Data Network, 1993 U.S. Dist. LEXIS 20163 (C.D. Cal. 1993) (holding that limited partnership interest was a security) and Sampson v. Invest America, Inc., 754 F. Supp. 928 (D. Mass. 1990) (holding that limited partnership interests were securities) and Herman v. Doug Frank Dev. Corp., 385 F. Supp. 767 (S.D.N.Y. 1974) (holding that limited partnership interest was a security). But see Stone v. Kirk, 8 F.3d 1079 (6th Cir. 1993) (holding that interest in joint venture-general partnership that leased master recordings was a security); Koch v. Hankins, 928 F.2d 1471 (9th Cir. 1991) (holding that interest in general partnership may be a security); Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981) (holding that although there is a strong presumption against characterizing general partnerships as securities, it is appropriate to do so where the agreement leaves the investor with little power, where the investor is so inexperienced in business affairs as to be incapable of exercising power, or where the investor is so dependent on the unique skills of the promoter as to be incapable of exercising power); K.B.R. Inc. v. L.A. Smoothie Corp., 1995 U.S. Dist. LEXIS 15973 (E.D. La. Oct. 26, 1995) (holding that joint venture interest may be a security). See generally HAZEN, supra note 13, § 1.5, at 50–51 (collecting cases).

114 SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973); see also United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975) ("The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."); SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996) (discussing profits "predominantly" from the efforts of others); Monaghan, supra note 38, at 2147–48 (collecting cases). See generally HAZEN, supra note 13, § 1.5, at 31–32; 2 LOSS & SELIGMAN, supra note 13, at 941–48.

115 See, e.g., Meyer v. Dans un Jardin, S.A., 816 F.2d 533 (10th Cir. 1987) (holding that boutique franchise was not a security); Villeneuve v. Advanced Bus. Concepts Corp., 730 F.2d 1403 (11th Cir. 1984) (en banc) (distribution for sale of self-watering planters was not a security); Bitter v. Hoby's Int'l, Inc., 498 F.2d 183 (9th Cir. 1974) (holding that restaurant franchise was not a security since franchisees responsible for day-to-day management and operation of restaurant, despite strict franchise guidelines); Nash & Assocs., Inc. v. Lum's of Ohio, Inc., 484 F.2d 392 (6th Cir. 1973); Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666, 670 (10th Cir. 1972) (holding that restaurant franchise was not a security); Gotham Print, Inc. v. American Speedy Printing Centers, Inc., 863 F. Supp. 447 (E.D. Mich. 1994) (holding that master franchise for printing stores was not a security); SEC v. Bull Inv. Group, Inc., [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,010 (D. Mass. 1975) (holding that arrangement whereby local "dealers" (franchisees) would solicit new customers in return for a commission was a security because ultimate success or failure of the recruitment depended upon franchiser's sales-presentation efforts); L.H.M., Inc.
not a security if the franchisee will be largely responsible for running it, even if the franchiser will help start the franchised business. On the other hand, franchise programs may be securities when the franchiser is largely responsible for selling to the franchisee’s potential customers.

Courts have taken a similar approach to investment management services. For example, the classification of accounts invested in precious metals or rare coins depends on the extent to which buyers rely on someone else to accomplish their investment aims. Thus, those who simply sell precious metals to commercial buyers and investors are not selling securities; nor are coin dealers who sell their inventory to bona fide numismatists. Buyers of precious metals and coins have been held to have bought securities, however, when they have relied on the promoters to produce the product or given substantial weight to their opinions and recommendations about how to minimize risk while maximizing the chance of appreciation.

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For investment managers, the most important question arising from the requirement that profits be obtained "solely" through the efforts of others is whether complete discretionary authority is necessary for a managed account to acquire security status. Some courts have held that a nondiscretionary account cannot be a security because an investor who retains ultimate control of her own account is not "dependent on the managerial efforts of others." Nonetheless, just as courts have relaxed the "solely" requirement in franchising and pyramid schemes, some have relaxed it in respect of investment management accounts.

In *SEC v. Brigadoon Scotch Distributors, Ltd.*, which held that the sale
of rare-coin portfolios was a sale of securities, the court took the position that the advisory assistance the defendants provided investors, together with the administrative services they offered, was enough managerial control to satisfy Howey. A general extrapolation of this holding would mean that, even if clients retain authority to approve or disapprove the recommendations of investment managers, their accounts may nonetheless be securities. Indeed even in Continental Commodities, so far as appears from the opinion, investors retained the ultimate decision of whether to make specific investments.

Although the Supreme Court may some day say that it really meant "solely" in Howey, it is more likely that lower courts will continue to take a liberal position. Liberality is particularly appropriate in analyzing investment management arrangements, for both practical and theoretical reasons. Investment managers are not normally hired with the expectation that their advice will be rejected, so many nondiscretionary accounts share with discretionary accounts a real dependence on the managers' expertise and effective manager control. Moreover, the fundamental question raised by the entire line of investment management cases is whether the choice of an investment manager is itself an investment so that its promotion should be regulated by treating management arrangements as securities. If the question is whether investors should be protected at the start of an investment management relationship, then security status should not depend on precisely

123 See Brigadoon, 388 F. Supp. at 1293.

124 The court did give some weight to the fact that in many instances, the defendants' clients entrusted the actual selection of coins purchased for the client to be made by the defendants' agents in a manner which amounted to discretionary action by the agent. Yet the court held the investment arrangements to be securities, even when the option to allow the agent to select was not exercised, indicating that the crucial factor was that this option had been offered. Brigadoon, 388 F. Supp. at 1292.

125 In Messer v. E.F. Hutton & Co., 833 F.2d 909 (11th Cir. 1987), the successor court to the Fifth Circuit cited Continental Commodities as controlling precedent but stated that a "'non-discretionary' account cannot constitute an 'investment contract.'" Id. at 915.

126 Cf. Advisory Committee Report, supra note 62, at 19 (describing the position of SEC staff in no-action letters as follows: "Accounts will be treated as discretionary for purposes of determining the applicability of the registration requirements, even if discretionary authority is not given by the customer so long as the customer is given to understand that only through consistently following the adviser's advice will his objective be met or his business welcome or, without such efforts to discourage the exercise of his independent judgment, the customer in fact slavishly follows the adviser's recommendations.").

127 The Advisory Committee on Investment Management Services for Individual Investors argued this point in its report to the SEC. See Advisory Committee Report, supra note 62, at 23-24. The Committee also argued, however, that status as a security should depend on the existence of discretionary authority. See id. at 24-25.
w that arrangement is supposed to be conducted or how it turns out to be conducted, especially since neither party may be certain of what their future relationship will be when they enter into it. There is much to be said on both sides of the question of whether investment management services are securities, but the only argument for drawing the line at the existence of discretionary authority is that there should be an objective basis for determining when the managerial control element of Howey has been satisfied. The experience of the ranching cases, however, suggests that courts are not likely to accept the argument that the need for predictability justifies a bright-line rule.\textsuperscript{128}

Post-Howey legislative developments also suggest that even if discretionary authority is essential, the concept of discretion should be taken to encompass arrangements in which investors retain some control over the way their managers’ investment decisions are implemented. For example, section 3(a)(35) of the Exchange Act provides that:

A person exercises “investment discretion” with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.\textsuperscript{129}

Although section 3(a)(35) was added to the Exchange Act as part of a set of provisions regarding brokerage fees paid by fiduciaries and separation of brokerage and money management,\textsuperscript{130} the section reflects a legislative recognition that the possibility of abuse attaches to managed accounts generally, not just the subclass of fully discretionary accounts.

Discretionary accounts and other closely managed accounts are also treated as alike in the Employee Retirement Income Security Act of 1974, which provides that a person is a fiduciary with respect to an employee benefit plan if he either exercises discretionary authority or renders investment advice for

\textsuperscript{128} See supra notes 115–17 and accompanying text.
compensation. Although again the purpose of this statute was not to settle the question of whether investment management arrangements are securities, it does reflect a legislative determination that discretionary accounts have much in common with other managed accounts, and a decision that investment managers cannot avoid regulation by leaving nominal control over an investment account with their clients.  

C. The Form of the Arrangement: The Status of Trust Relationships

Although the several federal securities statutes refer to investment contracts, no particular form of arrangement between an investment manager and a client is necessary to create a statutory security. In Howey, the Supreme Court said that investment contract meant "a contract, transaction or scheme" with certain attributes, and since then the term investment contract has demonstrated an amazing capacity to absorb the schemes of promoters however they are constructed. Limited partnerships, participations in oil and

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132 The Department of Labor and the Internal Revenue Service have defined investment advice to give meaning to the statutory term fiduciary. See 29 C.F.R. § 2510.3-21 (1995) (Labor); 26 C.F.R. § 54.4975-9 (1995) (I.R.S.). Broadly speaking, a person who makes recommendations about securities gives investment advice if such person either has actual discretionary authority for the plan or provides individualized advisory assistance on a regular basis pursuant to an established understanding that provides that the adviser will render individualized advice for the plan and provides further that such advice will serve as a primary basis for investment decisions. See also Bines, supra note 97, ¶ 10.03[2]. Whatever the degree of managerial influence necessary to elevate a relationship to status as a security, it is clear that without some influence over an investment program, no security is created. Compare First Life Assurance Co., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,385 (1976) (holding that investment annuity programs are deemed to be securities because, although company refrained from making investment recommendations, annuitant could invest in securities issued by company, affiliate, or custodian) with Massachusetts Co., Inc., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,338 (1975) (holding that custodial accounts for transfer of money from fund shares to short-term debt instruments are not securities); see also Stuyvesant Life Ins. Co., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,294 (1975) (holding that investment annuities are deemed to be securities where issuer participates in decisions on investments).

134 See supra note 97 and accompanying text; see also Bosco v. Serhant, 836 F.2d 271 (7th Cir. 1987); Luce v. Edelstein, 802 F.2d 49 (2d Cir. 1986); Siebel v. Scott, 725 F.2d 995 (5th Cir. 1984); Mayer v. Oil Field Sys. Corp., 721 F.2d 59 (2d Cir. 1983); McGregor Land Co. v. Meguiar, 521 F.2d 822 (9th Cir. 1975); Miltland Raleigh-Durham v. Myers, 807 F. Supp. 1025 (S.D.N.Y. 1992); Sampson v. Invest America, 754 F. Supp. 928 (D. Mass. 1990); Hirsch v. duPont, 396 F. Supp. 1214 (S.D.N.Y. 1975), aff'd, 553 F.2d 750 (2d
gas investments, pyramid schemes, franchising arrangements, and a remarkable variety of other investment arrangements have all been held to be investment contracts, and a formal agreement has not been required either. In any event, because investment management arrangements in which the manager acts as an agent are typically created by contract, the most significant issue the contract requirement—such as it is—poses for those managing other people’s money is the degree to which trusts may be deemed statutory securities.

Neither the SEC nor the courts have been willing to permit the


characterization of an investment vehicle as a trust to deter them from applying
the securities laws. Thus, early in its administration, the SEC obtained an
injunction against an unregistered scheme to issue trust certificates, the proceeds
of which were to be commingled and used to acquire stock in a bank. As the
Supreme Court has sometimes emphasized, substance and economic realities
rather than form determine classification as a security, and the view that the
use of the trust form cannot control application of the federal securities laws
finds support in the well-established rule that formal compliance with state trust-
law requirements cannot control application of federal law.

The federal securities statutes themselves indicate that at least some trust
interests are securities. The definitions of the word security in the several
federal securities statutes do not list trusts or interests in trusts as securities, but
the Securities Act, the Exchange Act, and the Investment Company Act all
include collateral-trust and voting-trust certificates in their definitions. Similarly,
the special treatment accorded to trusts in the definition of the term
issuer in the three acts indicates that trusts issue securities, and thus that at least
some interests in trusts are securities. The references to trust certificates in

141 See, e.g., SEC v. Prof'l Assocs., 731 F.2d 349 (6th Cir. 1984) (holding that trusts
may be securities); Melton v. Unterreiner, 575 F.2d 204, 208-09 (8th Cir. 1978) (holding
that revocable inter vivos trusts used as method to sell undeveloped real estate are securities);
142 SEC v. Timetrust, Inc., 28 F. Supp. 34 (N.D. Cal. 1939), appeal dismissed per
stipulation, 118 F.2d 718 (9th Cir. 1941); see also Independent Bankers' Ass'n, SEC No-
1972) (two-level collective employee retirement trusts deemed to create a security even
though employees received only cash proceeds of the trusts and contributions came
exclusively from participating companies). But see Woodmoor Corp., SEC No-Action Letter,
transferability of shares in trust tied to separate ownership deed on real estate placed trustee
essentially in position of a custodian; hence, trust participations deemed not to be securities).
143 See, e.g., Reves v. Ernst & Young, 494 U.S. 56, 61 (1990); Marine Bank v.
Weaver, 455 U.S. 551, 556 (1982); United Hous. Found., Inc. v. Forman, 421 U.S. 837,
847-51 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co.,
328 U.S. 293, 298 (1946).
U.S.C. § 78c(a)(8) (1994); Investment Company Act §§ 2(a)(22) (defining issuer to include
person who issues security), 2(a)(28) (defining person to include company), 2(a)(8) (defining
company to include trust), 15 U.S.C. §§ 80a-2(a)(22), (28), (8) (1994); see also Securities
Act § 3(a)(6), 15 U.S.C. § 77c(a)(6) (involving issuer of equipment-trust certificates);
these definitions might suggest that only trust interests represented by (transferable) certificates are securities. However, section 3(a)(2) of the Securities Act now exempts interests and participations in a variety of single, common, and collective trust funds, and these exemptions would not be necessary if such interests and participations were not securities in the first place.

It is well settled that some trust interests are securities, such as shares in mutual funds organized as business trusts. On the other hand, ordinary

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147 See also Securities Act § 2(2), 15 U.S.C. § 77b(2) (1994) (“As used in this paragraph [i.e., the definition of the term person] the term ‘trust’ shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security.”); H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933) (“The term ‘trust’ is defined to exclude the ordinary noncommercial trust but to include that type of organization, commonly known as a ‘business trust’ or a ‘Massachusetts trust’, which, without resort to the device of incorporation, is used to achieve many of the purposes of the ordinary business corporation.”); 2 LOSS & SELIGMAN, supra note 13, at 1062.


149 See 2 LOSS & SELIGMAN, supra note 13, at 1062 n.452 (“reading the phrase ‘evidenced by a security’ [in section 2(2) of the Securities Act] to require that there be some tangible token of the beneficiary’s interest in the trust, or that the interest be transferable, would frustrate the legislative purpose, since a business trust could be operated with neither certificates nor free transferability”).

150 See cases cited supra note 141.

testamentary and irrevocable inter vivos trusts are not generally regarded as securities. Classification may be easy at the extremes. The difficult question is whether an investment management arrangement’s status as a trust is relevant to its status as a security.

Some provisions of federal securities law implicitly recognize a structural distinction between trust and agency accounts. A striking example is the contrasting classifications afforded participations in various collective investment vehicles under the Glass-Steagall Act. National banks are authorized by statute to manage collective trust funds of various types, and, as stated above, participations in many such trusts are exempt from registration under the Securities Act. In Investment Company Institute v. Camp, however, the Supreme Court interpreted the Glass-Steagall Act to prohibit banks from managing commingled agency accounts, regardless of compliance with the federal securities laws. Because, as a practical matter, investment management activities on behalf of commingled trust funds are similar to those performed for commingled agency accounts, both of which in turn are managed much like open-end investment companies, the Court’s construction of the Glass-Steagall Act suggests an important distinction between the status of participations in trusts on the one hand and agency vehicles on the other.

The precise holding of Camp was that participations in commingled agency accounts are securities, and that in marketing such securities, a commercial bank is engaged in underwriting securities, thereby violating the separation of commercial banking and investment banking activities imposed by the Glass-Steagall Act. Of greater moment for purposes of determining whether an investment manager can avoid application of the securities laws by structuring an investment management arrangement as a trust, however, is the Court’s citation of the fiduciary nature of trust services as the rationale for distinguishing forbidden participations in commingled agency accounts from permissible investment accounts traditionally managed by the trust departments of commercial banks. Expressing concern over promotional pressures capable

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152 See 2 Loss & Seligman, supra note 13, at 1060–64; see also 1 Frankel, supra note 16, § F22, at 281 (“A private trust is not a security.”).
155 See supra note 148 and accompanying text; see also Investment Company Act § 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1994) (stating that bank-maintained common trust funds are not investment companies).
156 401 U.S. 617 (1971).
157 See id. at 630.
158 See id. at 639.
of undermining traditional bank conservatism, the Court contrasted client expectations in the establishment of trust accounts with the attitude that might characterize participants in a commingled agency vehicle. Because the demands of the latter group would be for investment return alone, the Court concluded that "there is a plain difference between the sale of fiduciary services and the sale of investments."160

Camp might be understood to establish that when an investment management arrangement entails fiduciary service, it is not a security, at least for purposes of the Glass-Steagall Act. However, interests in some trusts plainly are securities, even though the trustee owes fiduciary duties to the trust beneficiaries.161 Nor did the Court in Camp suggest that every trust activity would survive scrutiny under the Glass-Steagall Act. On the contrary, the Court emphasized that for a long time after the Glass-Steagall Act's enactment, the Federal Reserve Board had permitted banks to use common trust funds only for "strictly fiduciary purposes."162 While Camp's investment-intent rationale may explain why participations in commingled agency accounts are securities, it does not offer a satisfactory test for determining when participations in trust vehicles are not.

For investment managers trying to minimize the burden of the federal securities laws, the critical task is to determine whether an investment management arrangement that would otherwise be a security will not be if it is structured as some form of a trust. In this respect, Camp's reference to the "true fiduciary purpose" of a trust relationship may have some bearing,

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159 See id. at 638.
160 See id.
161 See supra note 151 and accompanying text.
162 Camp, 401 U.S. at 621,

The Board of Governors of the Federal Reserve System which until 1962 had regulatory jurisdiction over all the trust activities of national banks, allowed the collective investment of trust assets only for "the investment of funds held for true fiduciary purposes." The applicable regulation ... specified that "the operation of such Common Trust Funds as investment trusts for other than strictly fiduciary purposes is hereby prohibited." The Board consistently ruled that it was improper for a bank to use "a Common Trust Fund as an investment trust attracting money seeking investment alone and to embark upon what would be in effect the sale of participations in a Common Trust Fund to the public as investments."

Id. (quoting 26 Fed. Res. Bull. 393 (1940)).
163 401 U.S. at 638 (emphasis added).

[The hazards of a collective investment fund] are all hazards that are not present when a
inasmuch as it suggests that the fiduciary service underlying a trust relationship that is not a security includes much more than a mere investment management service.\textsuperscript{164}

The distinction the Court drew between commingling trust funds and commingling agency funds suggests that typical testamentary and irrevocable inter vivos trusts may escape security status. While the Court's view of classical trusteeship may not describe the services desired by those establishing institutional and individual revocable trusts, settlors of conventional testamentary and irrevocable inter vivos trusts are motivated to establish trusts by a desire for special services and care for their beneficiaries, not merely investment guidance.\textsuperscript{165} Of course, settlors of testamentary and irrevocable bank undertakes to purchase stock for the account of its individual customers or to commingle assets which it has \textit{received for a true fiduciary purpose} rather than for investment. These activities, unlike the operation of an investment fund, do not give rise to a promotional or salesman's stake in a particular investment; they do not involve an enterprise in direct competition with aggressively promoted funds offered by other investment companies; they do not entail a threat to public confidence in the bank itself; and they do not impair the bank's ability to give disinterested service as a fiduciary or managing agent. \textit{In short, there is a plain difference between the sale of fiduciary services and the sale of investments.}


\textsuperscript{164} Since 	extit{Camp}, however, the presence of a trust seems to have become the de facto test of Glass-Steagall compliance. Thus, commercial banks may offer common trusts for individual retirement accounts. \textit{See} Investment Co. Inst. v. Conover, 790 F.2d 925, 930 (D.C. Cir. 1986) ("The existence of a trust relationship is sufficient, by itself, to take this case out of \textit{Camp}'s express teaching."); Investment Co. Inst. v. Clarke, 789 F.2d 175 (2d Cir. 1986); Investment Co. Inst. v. Clarke, 793 F.2d 220 (9th Cir. 1986); \textit{see also} 2 Loss & Seligman, \textit{supra} note 13, at 1028-29; Langevoort, \textit{supra} note 23, at 707-09; Stokely G. Caldwell, Jr., Note, \textit{Glass-Steagall and Collective Investment Trusts for Individual Retirement Accounts: Fiduciary Purpose or Investment?}, 42 WASH. & LEE L. REV. 961 (1985). As noted below, these common trusts have been treated as securities for purposes of the Securities Act and the Investment Company Act, in large part because they are not considered primarily fiduciary. \textit{See infra} note 169.

\textsuperscript{165} The point is not that the settlors of conventional trusts are indifferent to investment management, but that they seek more. \textit{Cf. Conover}, 790 F.2d at 937 (Glass-Steagall Act) ("[W]e do not believe that Citibank's characterization of the Trust as an 'investment opportunity' should bear on whether the Trust constitutes a bona fide fiduciary service. The two terms are not mutually exclusive. Any fiduciary service is also an investment opportunity if by that one means an opportunity to earn a return on one's money; very few customers would likely be satisfied with the services of a bank's trust department if the bank did no more than safekeep their funds. We agree with the Comptroller that the proper inquiry is whether
inter vivos trusts presumably want to realize a good return and protect the corpus. However, other objectives are also important to them, including shepherding resources, fairly apportioning benefits among beneficiaries and balancing the interests of immediate beneficiaries against those of remaindermen. If the test for classification of a trust account as a security is the primacy of investment intent, indicia of such intent might include irrevocability and an underlying transfer of the use of assets from the settlor to another beneficiary.

Camp involved the definition of security under the Glass-Steagall Act, and perhaps it does not govern definitional questions under the securities statutes. Although the Court did say that the definition of security under the Glass-Steagall Act was not to be construed narrowly, it stopped short of equating it to the definitions in the securities statutes. Camp thus left open the possibility that trust participations that are not securities under the Glass-Steagall Act might

the bank is offering a genuine fiduciary service in addition to an opportunity to earn a return.”). Ironically perhaps, portfolio managers for conventional trusts typically handle many more accounts than do pension fund and investment advisory account managers, while they are usually less experienced and competent as investment managers than the latter. See Edward S. Herman, Conflicts of Interest: Commercial Bank Trust Departments 59 (1975).


167 See Langevoort, supra note 24, at 708 n.122; see also 2 Loss & Seligman, supra note 13, at 1062-63 n.452 (“It has accordingly been suggested that a better line to achieve the legislative purpose is Professor Scott’s, to the effect that one useful classification of the principal purposes of trusts is ‘a general division into trusts created for the purpose of distributing the bounty of the settlor and trusts created for business purposes.’”) (quoting 2 Austin Wakeman Scott, The Law of Trusts 514 (2d ed. 1956), quoted in turn in Robert H. Mundheim & Gordon D. Henderson, Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans, 29 Law & Contemp. Probs. 795, 803 (1964)). But see supra note 164 (explaining that common trusts for individual retirement accounts are not securities for purposes of the Glass-Steagall Act).

168 See Camp, 401 U.S. at 635.
be securities under the Securities Act.\textsuperscript{169} On the other hand, the factor of investment intent that \textit{Camp} made the essential feature of a "Glass-Steagall Act security" supports the conclusion that participations in testamentary trusts and run-of-the-mill irrevocable inter vivos trusts are not securities under either statute. Courts and the SEC's Division of Investment Management have insisted that under the securities statutes, trusts are securities when the settlor's primary motivation is not to secure fiduciary services.\textsuperscript{170} On the other hand, when the settlor's primary purpose is to get fiduciary care, it hardly seems that settlors or beneficiaries require the separate protection of the securities statutes, especially since disclosure under those statutes would be inadequate for their protection in any event.

\textit{Howey} held that an investment contract under the securities statutes is an arrangement in which the investor is "led to expect profits,"\textsuperscript{171} and this might

\textsuperscript{169} In \textit{Securities Indus. Ass'n v. Board of Governors}, the Court looked to the definition of the term security in the Securities Act to illuminate the meaning of the term in the Glass-Steagall Act. 468 U.S. 157, 150–52 (1984). But see id. at 160, 174–75 (O'Connor, J., dissenting) (distinguishing the statutes). However, the D.C. Circuit has since held that the word means different things in the two statutes. See \textit{Conover}, 790 F.2d at 933–34; see also id. at 929 ("According to the Comptroller, moreover, 'the meaning of the term securities under the securities law [is] not necessarily synonymous with its meaning under the Glass-Steagall Act.'") (quoting Comptroller's ruling). In any event, the SEC has insisted that beneficial interests in common trust funds for individual retirement accounts are securities, and banks that have offered such interests have registered them under the Securities Act and registered the funds under the Investment Company Act while at the same time insisting that they are not offering securities for purposes of the Glass-Steagall Act. See, e.g., id. at 928 n.4; Commercial Bank, 1988 SEC No-Act. LEXIS 257 (Feb. 24, 1988); United Missouri Bank, 1981 SEC No-Act. LEXIS 4473 (Dec. 31, 1981); see also Elizabeth K. Norsworthy, \textit{Common Trust Funds—A Three-Dimensional Puzzle with Pieces that Never Fit}, 3 Inv. Law. at 23–24 (May 1996).

\textsuperscript{170} See cases cited supra note 151; Commercial Bank, 1988 SEC No-Act. LEXIS 257, at *1–2 (Feb. 24, 1988) ("[T]he [Investment Company Act] Section 3(c)(3) exclusion is available only if the common trust fund holds funds from individual trust accounts created by customers for bona fide fiduciary purposes. Bona fide fiduciary purposes involve, broadly speaking, those situations in which a bank is providing to individual trust accounts traditional estate planning and other fiduciary services, but not primarily money management."); First Jersey Nat'l Bank 1987 SEC No-Act. LEXIS 2797 (Nov. 13, 1987); United Missouri Bank, 1981 SEC No-Act. LEXIS 4473, at *2 (Dec. 31, 1981) ("The exception provided by section 3(c)(3) [of the Investment Company Act], the so-called 'common trust fund' exception, applies only to a common trust fund for moneys which a bank has received for bona fide fiduciary purposes."); Wells Fargo Bank, 1977 SEC No-Act. LEXIS 1823 (July 15, 1977); Norsworthy, supra note 169.

\textsuperscript{171} \textit{Howey}, 328 U.S. at 298–99. Another useful indicator of a settlor's interest is the nature of the marketing program which attracted her to the trustee in the first place. See infra
be read to exclude trusts of the classical variety, in which the primary motive of the settlor is something other than an expectation of profits. The Supreme Court developed the concept of "expectation of profits" in *United Housing Foundation, Inc. v. Forman*, in which it held that shares of stock of Co-op City (a subsidized residential cooperative) that entitled the owners to live in an apartment in the cooperative were not securities. The owners argued that the shares were investment contracts because their rent was to be reduced by virtue "of net income derived from the leasing by Co-op City of commercial facilities, professional offices and parking spaces, and its operation of community washing machines." The Court was not convinced, however, in part because the desired profits were "speculative," "insubstantial" and only "incidental" to the purpose of their investment, and, more to the point as the Court saw it, because the plaintiffs had been motivated to buy their shares "solely by the prospect of acquiring a place to live, and not by financial returns on their investments."

On an investment-consumption continuum, conventional inter vivos and testamentary trusts fall somewhere between investment transactions that are clearly securities, and consumption transactions that are not. Trust settlors typically want a good return, and the expectation of profits cannot be said to be insubstantial. On the other hand, when settlors set up conventional trusts, their primary goal is to gain trusteeship, and investment return is in an important sense only an "incidental" goal. *Forman* suggests that an investor's motive matters, and it supports the proposition that the test for classifying a trust under the securities statutes is the relative importance of the settlor's investment intent.

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Part II.C.

173 See id. at 847.
174 Id. at 855-56.
175 Id. at 856-57.
176 Id. at 853; see also International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 561-62 (1979).
177 See supra note 165.
178 Cf. SEC v. Heritage Trust Co., 402 F. Supp. 744, 749 (D. Ariz. 1975) ("The Court has reviewed the recent Supreme Court decision in *United Housing Foundation, Inc. v. Forman* . . . . Although defendants' sales brochures placed some emphasis on avoidance of probate as one of the advantages of a trust, it is also clear that the prime inducement was investment expertise, safety, and assured substantial return. It is difficult to believe any trustor would have invested without anticipation of a safe investment and a profitable return. *United Housing* does not dictate a result different from that reached here."); 2 LOSS & SELIGMAN, supra note 13, at 939 (*Forman*'s "notion involves a weighing of the purposes of an investment. When the profit-producing purpose is incidental, the purchase will not be
Recent developments further obscure the question of whether a trust designed and used to accomplish ends beyond investment management may be a security. In 1990, the SEC’s Division of Investment Management refused to assure International Asset Management, Inc. ("IAM"), an investment manager, that it would not recommend enforcement action if IAM marketed trust arrangements designed to protect the assets of wealthy investors against court judgments. IAM proposed that wealthy investors would place substantial assets in trusts organized in foreign jurisdictions that might not enforce judgments of United States courts. An affiliate of IAM would offer investment management services to the trusts, although a settlor could elect to direct the trust’s investments. Settlors would be entitled to replace the trustees of their trusts (including another IAM affiliate), except at times when they were subject to litigation in the United States. This right, IAM suggested, would lead it to provide each settlor individualized service and to follow his or her directions, for fear that otherwise the settlor would terminate IAM’s lucrative connection to the trust.

IAM argued that, because the settlor of each trust would effectively control its investments and would receive individualized attention, the trusts would not be securities, and hence that the trusts as a group would not be an investment company. However, the Division of Investment Management was concerned because a settlor would lose the power to replace the trustees in the event the settlor was subject to legal action in the United States. Moreover, the Division was not persuaded that IAM’s practical incentive to please the settlors would ensure that each settlor would “receive sufficiently individualized treatment (especially the ability to retain the indicia of ownership over the securities in its Account).” Absent assurances of individualized treatment, the Division was unwilling to agree that the proposed trust arrangements were not securities.

*International Asset Management* was not a litigated case, and it may simply reflect the reluctance of the Division of Investment Management to give its imprimatur to a complicated and not altogether attractive arrangement.

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181 See id. at *35.
182 See id. at *29.
183 See infra Part III (discussing investment companies).
185 Id. at *4.
186 See id. at *39.
Moreover, IAM's plan contemplated that assets would typically return to the settlor at the end of the trust term, and perhaps the Division viewed the plan as the sale of an exotic financial instrument, not as a method for transferring wealth with strings attached. However, it is noteworthy that the Division focused on the lack of individualized attention, and seemed unmoved by the fact that settlors creating such trusts would likely have been moved more by the desire to protect substantial personal assets from litigation than by a desire for investment guidance.

In 1995, Congress touched upon the possibility that trust interests may be securities in the Philanthropy Protection Act, which accords special treatment under the Securities Act, the Exchange Act, and the Investment Company Act to charities that operate charitable pooled income funds, which are often organized as trusts. Charitable donors transfer assets to these funds while retaining some property interest, typically a right to an income stream for life. The funds in turn commingle the donated assets, pay income to donors, and eventually pass along what is left to the charity.

Interests in such trusts would seem to be securities under Howey: the donor contributes money to a common enterprise (the fund) with the expectation of receiving profits (the retained income stream) arising from the efforts of others (the managers of the fund). The staff of the SEC has given such funds assurance that it will not recommend action under the Securities Act or the Investment Company Act if they meet certain conditions. No-action letters may not bind private parties, however, and after a party brought an action alleging that the fund should have registered under the Investment Company Act, Congress promptly acted to codify the SEC's no-action position. It amended the Investment Company Act to exclude charitable pooled income funds, collective trust funds, and similar funds from the definition of investment

187 See supra text accompanying note 167.
190 In an interpretative release, the SEC stated that a fund must satisfy three conditions: (1) The fund must qualify to receive tax deductible contributions under section 642(c)(5) of the Internal Revenue Code; (2) written disclosures must be given to each prospective donor; and (3) contributions to the fund must be solicited by a volunteer or employee whose compensation is not based on the amount of gifts. See Securities Act Release No. 33-6175, 5 Fed. Sec. L. Rep. (CCH) ¶ 47,374 (Jan. 10, 1980) codified at 17 C.F.R. § 71.11016 (1996); see also H.R. Rep. No. 104-333, supra note 166, at 7, reprinted in 1995 U.S.C.C.A.N. at 622.
company, and amended the Securities Act and the Exchange Act to make interests in such funds exempted securities under those statutes.

The Philanthropy Protection Act took an interesting approach to charitable collective trust funds. They are now excluded from the definition of investment companies, but they are only exempt from registration under the Securities Act and the Exchange Act; they may still be securities under those statutes, and indeed the legislative history suggests that they are, emphasizing as it does that the antifraud provisions of those statutes will still be available to the defrauded party. The House Commerce Committee's report on the Philanthropy Protection Act—the only committee report—explains that the Act codifies the SEC staff's position, which it explains as follows:

The rationale for the staff's position with respect to charitable income funds is that the primary purpose of persons who transfer property to these funds is to make a charitable donation, not to make an investment. The staff has concluded that this donative intent—combined with, among other things, the protections afforded by disclosure to donors and the applicability of the anti-fraud provisions of the securities laws to the operations of charitable income funds—makes registration under the Federal securities laws unnecessary.

This approach gives uncertain guidance for those creating traditional trusts, whose "primary purpose," like that of donors to charitable collective trusts, is to do something other than make an investment. In the Philanthropy Protection Act, Congress apparently decided that when a buyer's primary purpose for investing money is not to maximize income, registration under the Securities Act ought not to be required. Nonetheless, it left such investments as securities (if not as securities issued by investment companies), subject to the statutory antifraud provisions. Of course, Congress did not address the settlors of traditional trusts, and perhaps the most that can be said of them in light of this legislation is that the reason a settlor parts with money is apparently important, but not necessarily dispositive.

197 See supra note 166 (noting special treatment of funds holding revocable gifts).
III. INVESTMENT MANAGEMENT ARRANGEMENTS AS INVESTMENT COMPANIES

The Securities Act and the Exchange Act are not the only federal securities statutes implicated when investment management arrangements are securities. Individual arrangements that are securities may also collectively constitute an investment company subject to the Investment Company Act of 1940. An investment company is "any issuer which... is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing... in securities." An investment company is "any issuer which... is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing... in securities."¹ The critical word issuer is defined to include any "person who issues or proposes to issue any security,"² a person in turn includes "a company,"³ which includes "any organized group of persons whether incorporated or not."⁴ Within this structure, a set of managed accounts may be regarded as an organized group and therefore a statutory company.⁵ If the managed accounts are securities, then the group of managed

² Investment Company Act § 2(a)(22), 15 U.S.C. § 80a-2(a)(22) (1994) ("issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.").
⁴ Investment Company Act § 2(a)(8), 15 U.S.C. § 80a-2(a)(8) (1994) ("Company" means a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.").

The treatment of unincorporated entities as investment companies has been one of the more complicated developments of the federal securities laws, but it is now well settled that such entities may be investment companies. See Prudential Ins. Co. v. SEC, 326 F.2d 383, 388 (3d Cir. 1964) (holding that a segregated variable annuity account was an investment company); see also SEC v. American Bd. of Trade, Inc., 751 F.2d 529, 536 (2d Cir. 1984) ("The SEC points out that the authority of the Prudential case has not been questioned by any court in the twenty years since it was decided. We have no disposition to assume such a role, and we perceive no valid distinction between Prudential and the case before us."); Investment Company Act Release No. 21,260, supra note 62, at 86,967 n.14; cf. SEC v. United Benefit Life Ins., 387 U.S. 202 (1967) (reserving question of whether collective investment fund should be separated from insurance company and considered an investment company). See generally 2 LOSS & SELIGMAN, supra note 13, at 1009 ("If all this startles at first blush, it must be remembered that a corporation, too, is a persona ficta; one gets used to the idea.").
accounts is an issuer (i.e., a company issuing securities (the accounts)). Finally, inasmuch as the purpose of the managed accounts is to invest in securities, the group of accounts is an issuer engaged in investing in securities, and hence an investment company.\textsuperscript{203}

The legislative policy implicit in the Investment Company Act justifies treating related managed accounts as an investment company. Most of the dangers recited in section 1(b) of the Investment Company Act\textsuperscript{204} are present to a large degree when many individual accounts are under the control of a single investment manager. Like investment advisers to mutual funds, investment managers can exercise control over their clients' investment decisions, can serve their own purposes by placing overvalued securities in their clients' portfolios,\textsuperscript{205} can overtrade or engage in other questionable trading practices to generate commissions for their own purposes,\textsuperscript{206} and can subject their clients' accounts to unsafe leverage in hopes of improving investment performance.\textsuperscript{207}

Without the Investment Company Act, owners of managed accounts, unlike investors in investment companies, would be without the protection provided

\textsuperscript{203} See Investment Company Act § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (1994). A set of managed accounts may be an investment company even if the portfolio of the managed accounts does not consist exclusively of securities. Section 3(a)(1) declares an issuer to be an investment company if it is engaged "primarily" in the business of securities investment. Section 3(a)(3) provides a numerical test: it includes any issuer that "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets . . . ." 15 U.S.C. § 80a-3(a)(3). Because, in many cases, there would be no intent to form a statutory investment company, a set of managed accounts, if subject to the Investment Company Act, might be considered an "inadvertent" investment company. See generally Edmund H. Kerr, \textit{The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act}, 12 STAN. L. REV. 29 (1959); Cohen & Hacker, \textit{supra} note 151.

\textsuperscript{204} 15 U.S.C. § 80a-1(b) (1994). See generally 3 FRANKEL, \textit{supra} note 16, ch. 18 § A2 (discussing policies underlying Investment Company Act); \textit{Advisory Committee Report, supra} note 62, 39–58 (discussing investor protection and small-account management services).

\textsuperscript{205} See BINES, \textit{supra} note 97, ¶ 10.06[2]. Similarly, assets might be moved from one mutual fund to another in anticipation of stock market moves. In \textit{SEC v. Fundpack, Inc.}, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,951 (D.D.C. 1979), a special master was appointed to supervise the election of a new board of directors for a mutual fund that the court found to have been the victim of inadequate disclosure, self-dealing, and breach of fiduciary duty in connection with such practices. See \textit{id.} at 95,981–82. The SEC charged the practices had caused wide fluctuations in the fund's net assets, thereby causing the fund to incur extraordinary operating costs and investment losses that had not been disclosed to shareholders. See \textit{id.} at 95,979.

\textsuperscript{206} See BINES, \textit{supra} note 97, ¶ 10.06[1].

\textsuperscript{207} See \textit{id.} ¶ 5.03[2].
registered investment companies by outside directors, or the specific statutory restrictions on transactions with affiliates and interested persons.\textsuperscript{208}

The current law governing whether managed accounts are investment companies can be traced back to the late 1960s, when First National City Bank ("Citibank") and Merrill Lynch offered a discretionary management program that essentially placed an investor into one of two portfolios depending on whether her objective was income or growth.\textsuperscript{209} Although the program was promoted as one offering individualized advice, in a 1970 lawsuit, the SEC took the position that the similarity of portfolios rendered each separate account a security, and that Citibank was operating an unregistered investment company.\textsuperscript{210} The case eventually settled, with the SEC indicating that the bank could offer similar services to small customers, so long as the bank did not have discretionary authority over investments and customers were given a choice over which brokerage firm would handle their accounts. Since then, the SEC's staff has continued to take the position that the Investment Company Act is implicated if substantially similar advice is rendered to each of a group of accounts.\textsuperscript{211} The staff also asserted, in a related development, that participations


\textsuperscript{209}The program, the Special Investment Advisory Service, was structured so that the customers would give the bank a power of attorney along with a deposit of at least $25,000, together with instructions to invest in a particular portfolio of securities. The makeup of the portfolio depended on whether the customer's objective was income or growth, but all accounts opened at the same time with the same objective would be invested in the same portfolio.


Registration of such an arrangement under the Investment Company Act would be necessary where substantially the same, or substantially overlapping, advice is rendered to each account or to a discernible group or groups of accounts, and where such accounts engage in the same securities transactions. Also, the interests offered in such an arrangement (the accounts) may be securities required to be registered . . . .
in a security are themselves securities, and that those participations, taken collectively, constitute an investment company.\footnote{212}

Shortly after settling \textit{Citibank}, the SEC established an Advisory Committee on Investment Management Services for Individual Investors.\footnote{213} The Committee concluded that individual ownership of securities in an investment account is so unlike the status of shareholders of traditional investment companies as to justify treating them differently.\footnote{214} Accordingly, the Committee concluded that an investment advisory arrangement should not have to register under the Investment Company Act, so long as the investors owned all their investments directly and the managers did not pool the assets of several managed accounts.\footnote{215} The Committee did conclude, however, that advisory services may constitute securities subject to the registration requirements of the Securities Act:

\emph{The Committee believes that, under certain circumstances, the promotion and operation of an investment advisory service may involve a public offering of securities in the form of discretionary accounts. An investment service which is operated on a discretionary basis and does not afford investors individual attention would appear to be offering an investment contract or security, and if substantially the same investment advice is given to all clients or to discernible groups of clients, and clients are generally solicited, there could be a public offering of securities.} 


\footnote{213} \emph{See} Josephthal \& Co., SEC No-Action Letter, \textit{[1974–1975 Transfer Binder]} Fed. Sec. L. Rep. (CCH) \textsection{}80,116, at 85,125 (Nov. 25, 1974) (stating that participations in certificates of deposit and other commercial instruments are securities; the offeror may be an investment company); Arthur E. Fox, SEC No-Action Letter, \textit{[1974–1975 Transfer Binder]} Fed. Sec. L. Rep. (CCH) \textsection{}80,082, at 85,036 (Nov. 12, 1974) (stating that participations in a large-denomination certificate of deposit are securities; the offeror of the participations is an investment company); \emph{see also} Morgan Stanley \& Co., SEC No-Action Letter, \textit{[1986–1987 Transfer Binder]} Fed. Sec. L. Rep. (CCH) \textsection{}78,337, at 77,066 (Dec. 4, 1985) (referring to the “long-standing position” of the SEC’s Division of Investment Management, “that the offer and sale to the public of certificates representing undivided participations in a security involves the offer and sale of a security separate from the underlying security and that the issuer of the separate security is subject to the 1940 Act, absent an appropriate exception or exemption”).

\footnote{214} \emph{See Advisory Committee Report, supra note 62, at 22–24.}

\footnote{215} \emph{See id.}
offering of one or more investment contracts or securities which should be registered under the Securities Act.\textsuperscript{216}

In 1980, the SEC proposed a rule to address the question of whether a set of advisory accounts is an investment company.\textsuperscript{217} It explained that since the law in this area was not fully developed, it did not believe it would be appropriate to adopt a rule defining specifically which investment management services must register as investment companies.\textsuperscript{218} Instead, the SEC proposed Investment Company Act Rule 3a-4, which would have provided a safe harbor from registration under the Investment Company Act for investment managers who provided their clients with individualized treatment.\textsuperscript{219} The proposed rule would have required a manager to furnish continuous advice based on the individual needs of each client.\textsuperscript{220} The safe harbor in the proposed rule would also have been conditioned on the client's maintaining all indicia of ownership of the securities held in the account and the right to instruct a manager to refrain from making particular investments.\textsuperscript{221}

The proposed rule generated some controversy and was never adopted.\textsuperscript{222} Nonetheless, the SEC's Division of Investment Management has regularly granted no-action letters to managers who have represented that they would comply with the terms of the proposed rule.\textsuperscript{223} Over time, however, the

\textsuperscript{216} Id. at 23.
\textsuperscript{218} See id. at 83,572.
\textsuperscript{219} See id. at 83,573.
\textsuperscript{220} The proposed rule would have required a significant amount of contact between the investment manager and its client, including an initial interview, followed by subsequent interviews at least annually, quarterly reports to the client, availability for consultation, and maintenance of the indicia of ownership by the client. See id. at 83,575.
\textsuperscript{221} See id. The proposed release also indicated that if a management arrangement was operated within the proposed rule's safe harbor, the Division of Corporation Finance would not recommend enforcement action under the registration provisions of the Securities Act with respect to the arrangement. See id. at n.15.
\textsuperscript{222} The tenor of comments on the proposed rule is interesting. Most commentators opposed the rule as being overly burdensome on managers, but the Investment Company Institute, which represents registered investment companies, complained that the rule would have allowed de facto investment companies to escape regulation. See Investment Company Act Release No. 21,260, supra note 62, at 86,968.
practices of groups of managed accounts have evolved. In 1972, the SEC’s Advisory Committee described the typical arrangement as one marketed to investors who preferred not to invest in mutual funds. The SEC continued to be concerned with managers who provided portfolio services, but also with sponsors who delegated management to others, including sponsors who invested managed funds in mutual funds.

In 1995, the SEC proposed a new rule 3a-4. The new rule is modeled on the original proposal, but modified in light of the SEC’s experience with no-action letters. It would exclude certain investment management programs from the definition of investment company. Like the first proposed rule, the central theme of the new proposal is an insistence on individualized treatment. The proposed safe harbor would be available to an investment management program provided that:

(i) Each client’s account be managed on the basis of the client’s financial situation, investment objectives, and instructions; (ii) the sponsor of the program obtain information from each client that is necessary to manage the client’s account individually; (iii) the sponsor and portfolio manager be reasonably available to consult with clients; (iv) each client has the ability to impose reasonable restrictions on the management of the account; (v) each client be provided with a quarterly statement containing a description of all activity in the client’s account; (vi) each client retain the indicia of ownership of all securities and funds in the account; (vii) the sponsor establish and effect written procedures that are reasonably designed to ensure that each of the conditions of rule 3a-4 is met; (viii) if the sponsor designates another person to perform certain obligations under the rule, the sponsor obtain from that person a written agreement to perform those obligations; (ix) the sponsor maintain and


224 See Advisory Committee Report, supra note 62, at 6.
228 See id.
229 See id. ("The revised proposed rule would include a number of conditions intended to ensure that clients in programs that rely on the rule receive individualized treatment."); see also id. at 86,970 (discussing provisions designed to ensure individualized treatment).
preserve the policies, procedures, agreements and other documents relating to the program in the manner set forth in the rule; and (x) the sponsor furnish to the Commission upon demand copies of specified documents.\(^{230}\)

While the proposed rule would provide at least some investment managers a clearly charted safe harbor from the Investment Company Act, several of its particulars would limit its usefulness to investment managers. First, a condition of the safe harbor is that the sponsor complete and file a form with the SEC.\(^{231}\) Filing of this form is a condition of the safe harbor—if the form is not filed, there is no exemption.\(^{232}\) Thus, a sponsor who structures a program that happens to satisfy the requirements of the rule but fails to file a form—perhaps because it has not considered the possibility that it is an investment company—will not have the safe harbor.\(^{233}\)

In addition, the proposed rule provides a safe harbor only from the Investment Company Act, not from the Securities Act or the Exchange Act. However, the reason that investment managers have to worry about the Investment Company Act is the possibility that the investment management arrangements they offer may be securities, and the test of whether they are is the same under the several federal securities statutes.\(^{234}\) Accordingly, any manager who needs proposed rule 3a-4 also needs protection from the other statutes. The reason the proposed safe harbor is conditioned on a manager's giving individualized attention is to assure that the management arrangement is not a security. When the SEC proposed the rule, it recognized that if investment management arrangements are securities they implicate all the federal securities laws, not just the Investment Company Act, and it clearly intended that managers who satisfy the conditions of the rule would not have to register under the Securities Act.\(^{235}\) Nevertheless, the proposed rule only says that

\(^{230}\) Id. at 86,966; see also id. at 86,978–79 (containing text of proposed rule).

\(^{231}\) The form is quite short, and consists largely of identifying information about the sponsor and a notice that the sponsor intends to rely on the rule 3a-4 safe harbor. See id. at 86,979.

\(^{232}\) See id.

\(^{233}\) In contrast, the Regulation D exemption from the registration requirement of the Securities Act requires the issuer to file a Form D with the SEC, but failure to file does not destroy the exemption. See Rule 503, 17 C.F.R. § 230.503 (1995). The form required by proposed rule 3a-4 does not contain information that would be useful to investors, and even the SEC justifies it only as a tool for monitoring compliance with the proposed safe harbor. See Investment Company Act Release No. 21,260, supra note 62, at 86,976. However, by requiring filing of the form as a condition of the safe harbor, the SEC would succeed in retaining a jurisdictional hook on those availing themselves of the rule.

\(^{234}\) See supra note 35; see also infra note 248 and accompanying text.

\(^{235}\) The preliminary note to the proposed rule expressly states that interests complying
complying arrangements are not collectively an investment company; it does not say they are not securities. Accordingly, the proposed rule does not extend complying managers a safe harbor from the other federal securities statutes.

In any event, proposed rule 3a-4 offers only a safe harbor, not a complete definition of the term “investment company.” Even if the SEC eventually adopts the rule, the status of managed accounts under the Investment Company Act will remain unsettled and investment managers will remain at risk. Investment managers who inadvertently create investment companies do risk substantial legal sanctions. Although the law governing the status of managed accounts as investment companies has developed largely in the context of SEC no-action letters, the SEC does actively enforce the Investment Company Act.

The recently settled case of In re Clarke Lanzen Skalla Investment Firm,236 shows that managers sometimes still run afoul of the registration requirements of the Investment Company Act, and that rather technical factors may determine whether a program is an investment company or not. Clarke Lanzen established about 360 accounts in what it called its “managed asset allocation program.”237 Customers chose among six different investment strategies, such as aggressive, balanced, and conservative, each with its own predetermined investment formula. After a customer chose a strategy, the customer’s funds were invested in various mutual funds, with the funds of all customers choosing a particular strategy invested in the same funds. Customers gave Clarke Lanzen discretionary authority, meaning that although customers retained authority to change their investment strategies or liquidate, they had no contractual right to instruct Clarke Lanzen to refrain from investing in a particular fund.238 The investments of all the customers in a particular mutual fund were carried in a single omnibus account in the custodian’s name. Clarke Lanzen charged a setup fee and an annual fee based on assets under management.239

The SEC instituted public administrative proceedings against Clarke Lanzen under the Securities Act and the Investment Company Act.240 The SEC found that the managed asset allocation program was an investment company, and that Clarke Lanzen violated section 7(a) of the Investment Company Act by with the rule need not be registered under the Securities Act. See Investment Company Act Release No. 21,260, supra note 62, at 86,978, 86,969 n.26. Even if this note is binding as part of the rule, managers would still be subject to the other provisions of the Securities Act and the Exchange Act, including the antifraud provisions. See id. at 86,968 n.18 (stating no-action position of Division of Corporate Finance).


237 Id. at *2.

238 See id. at *8–9.

239 See id. at *7.

240 See id. at *1.
operating the program and offering interests therein without registering the
program under the Investment Company Act. The SEC followed the
reasoning of Citibank and its no-action progeny, reasoning that "[i]f clients of a
managed discretionary account program . . . do not receive individualized
advisory services and do not retain sufficient indicia of rights traditionally
associated with individual ownership of the securities purchased for their
accounts, the pool of nominally separate client accounts in the program may be
an investment company." The SEC applied the Howey test to determine
whether interests in the program were securities for the purposes of the
Investment Company Act, and concluded that they were, because the common
enterprise element was satisfied by virtue of the pooling of the investors' funds
and the fact that the advisory fees were based on the value of assets under
management. This finding also dictated a finding that Clarke Lanzen had
violated section 5 of the Securities Act by offering and selling interests in the
program without registering them under that Act.

If managed accounts are securities, few would argue that those accounts
should not be treated collectively as an investment company. The strongest
argument that the Investment Company Act does not apply to a group of
investment accounts classifiable as securities is that the Act was intended to
apply only to pooled management, and that most investment management
arrangements do not involve pooling. The SEC's Advisory Committee on
Investment Management Services for Individual Investors suggested this
distinction, taking the position, as noted above, that an individual who owns
securities in an investment account is so unlike the shareholder of a traditional
investment company as to justify treating them differently.

That argument, although it has some appeal, is unlikely to prevail. The
distinction between pooled and nonpooled accounts finds no support in the
Investment Company Act unless the meaning of "organized group" in the
definition of "company" in section 2(a)(8) of the Act turns on whether the
securities belonging to investment accounts are separated from each other. Such
an interpretation, however, is sharply inconsistent with the SEC's insistence that
a collection of managed accounts is an investment company if the investors do
not receive individualized attention. If a group of managed accounts are

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241 The SEC also found that the program violated section 12(d) of the Investment
Company Act by investing more than 10% of its assets in the securities of registered
investment companies. See id. at *13–15.
242 Id. at *10.
243 Id. at *12.
244 Id. at *9.
245 See Advisory Committee Report, supra note 62, at 22–24.
246 See supra Part II.A.4; infra note 260 and accompanying text. The SEC's position is
sufficiently related to be statutory securities, they are almost certain to be found to be sufficiently related to be members of an organized group.

Furthermore, the pooling-nonpooling distinction makes little policy sense, since the opportunities for investment managers to perpetrate the abuses which led to the passage of the Investment Company Act are not less likely simply because accounts are not pooled.\(^{247}\) An investment manager willing to dump an overvalued underwriting into a client's account will have more difficulty doing so when portfolios are maintained separately than when they are maintained in common. Similarly, an investment manager anxious to stimulate referrals by broker-dealers might trade clients' portfolios more rapidly than they would otherwise, regardless of whether the securities in each account are maintained separately or in common.

In the end, the question of whether a set of managed accounts is an investment company depends largely on the question of whether individual accounts are securities.\(^{248}\) Particularly under a \textit{Howey} analysis, the same commonality that establishes an investment management operation as a statutory security also establishes it as a statutory investment company. To be sure, the SEC possesses discretionary authority to waive compliance with all or part of the Investment Company Act,\(^{249}\) and it could exempt managed accounts that comply with some form of safe-harbor rule. However, the SEC uses its discretionary exemption power sparingly and restrictively,\(^{250}\) as the experience of variable life insurance indicates,\(^{251}\) and, as discussed above, the SEC has

\(^{247}\) See supra text accompanying note 11 (discussing declaration of policy in the Investment Company Act).

\(^{248}\) Conversely, if the individual interests are not statutory securities, no collection of such interests is an investment company. See Foundation Community Health Plan, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,150 (Jan. 23, 1975).

\(^{249}\) 15 U.S.C. § 80a-6(c) (1994).


\(^{251}\) The SEC had for some time maintained that variable life insurance ("VLI"), under which benefits are determined according to the asset value of a portfolio of securities, was itself a security and, therefore, that a set of VLI contracts constituted an investment company. After much controversy, the SEC adopted Investment Company Act Rule 3c-4, and Investment Advisers Act Rule 202-1, which exempted VLI from both of these statutes. Yet the ensuing opposition by interest groups opposed to these blanket exemptions (particularly the investment company industry) led to the qualification that state protective regulation comparable to that under the two federal statutes must exist before a federal exemption would
been slow to provide safe-harbor relief, and even the safe harbor it has proposed is incomplete. The complications and problems that the Investment Company Act poses for investment management arrangements arise because those arrangements are treated as securities. To avoid those complications and problems, the extension of security status to investment management arrangements needs to be limited in the first place.

IV. DEFINING SECURITY STATUS ON THE BASIS OF INDIVIDUALIZED TREATMENT

If all courts extended the Howey definition of investment contract to encompass managed accounts as easily as some have, the consequences for investment managers would be enormous. Investment managers provide a wide variety of services to large numbers of investors, often without ever considering the possibility that these activities are themselves securities. Aside from the mischief attendant to the SEC's selective exercise of its enforcement power, managers who fail to register under the Securities Act may face a particular risk, since under that Act buyers of unregistered securities can recover their investments from their sellers. If investment management arrangements are securities, investors have a put against their investment managers for the amount of their initial investments, regardless of how skillfully their investments have been managed.

As outlined above, the law governing the characterization of investment


252 See supra notes 229–35 and accompanying text (discussing the proposed rule 3a-4 safe harbor).

253 Because the definitions of security are the same in the Securities Act and the Investment Company Act, see supra note 35, it would be difficult to limit the reach of the Investment Company Act by treating managed accounts as securities under the Securities Act but not under the Investment Company Act. See also supra note 235 and accompanying text (discussing failure to include express safe harbor from Securities Act in proposed rule 3a-4).

management arrangements as securities is cloudy at best. When the law began
to cloud, however, several important constituencies began to suggest that the
treatment of investment management arrangements under the securities laws
ought to turn on the extent to which managers provide individualized services.
This insight was not widely embraced at the time, but many of the cases and
administrative decisions addressing the status of particular investment
management arrangements under the securities laws tacitly respect a distinction
based on individualized treatment of investors. In any event, there are good
reasons for basing the characterization of investment management arrangements
as securities in the absence of individualized treatment of managed assets.

In 1970, the SEC’s Advisory Committee on Investment Management
Services for Individual Investors suggested distinguishing investment
management relationships on the basis of individualized treatment.255 The
Advisory Committee concluded that investment management services tailored
to the individual needs of an investor should not be regarded as a security, or at
least should be regarded as exempted private offerings.256 While a private-offering theory still leaves managers liable to securities fraud,257 the concept of
individualization as a basis for avoiding security status has appeal.

Although the SEC never adopted the Advisory Committee’s
recommendation in a formal rule,258 it has used individualized treatment as its

255 See Advisory Committee Report, supra note 62.
256 See id. at 24–25. The Advisory Committee took the position that in a case of true
individualization, the need for disclosure is less immediate than where securities of industrial
and investment companies are acquired, because close communication between client and
adviser provides a perpetual feedback mechanism for indication of the client’s approval or
disapproval of investment decisions. The Committee also pointed out that the protective
devices found in the Investment Advisers Act and, to some extent, in the Exchange Act of
1934, would still check unsavory practices. Further, the Committee suggested a new Advisers
Act rule for these accounts, requiring the persons offering these services to give clients an
information statement as would be specified in such a rule. In the view of the Committee, an
information statement would be less costly, would afford greater flexibility as to content, and
would be subject to a less formal review process than would a Securities Act registration
statement, thus encouraging the growth of mini-accounts. See id. at 24–38.
257 The proposal to treat investment management arrangements as private placements
would be difficult to accomplish, at least under existing law, given the restrictions implicit in
the private offering exemption. See supra note 13 and accompanying text. Nor would a
private-placement theory be of much use to commercial banks, because, although it suggests a
means for avoiding registration under the Securities Act, it concedes that managed accounts
are securities, so that the problem created by the underwriting prohibitions of the Glass-
Steagall Act may still exist. See supra note 149 (comparing the definition of security in the
Glass-Steagall Act with those in the securities statutes).
L. Rep. (CCH) ¶ 79,767 (Apr. 30, 1974) (requesting public comment on the role of the SEC
basic test of determining whether a group of managed investment accounts is an investment company. Individualization is also the common thread uniting the requirements of the safe harbor from investment company status in proposed rule 3a-4. The test of individualized treatment is not simply a preference of the SEC and its Advisory Committee; it comports with the substantial body of law already addressed to the characterization of investment management arrangements, and furthers the policies underlying the federal securities laws.

By requiring investment managers either to treat their managed accounts as securities or to provide investors individual attention, a test of individualization ensures that before committing to a manager, investors will receive either extensive information immediately or the assurance of a close personal relationship and a stream of pertinent information that will permit them to evaluate their managers on a continuing basis. Moreover, while


260 See Investment Company Act Release No. 21,260, supra note 62; see also supra notes 229-35 and accompanying text (discussing proposed rule).

261 See supra Part II.A.4. The SEC's Advisory Committee also considered the applicability of the Investment Company Act to individualized accounts. Arguing that the policies underlying the Securities Act and the Investment Company Act are not identical, the Committee recommended that accounts not receiving individualized services be registered as investment companies, while those receiving individualized services not be registered. See Advisory Committee Report, supra note 62, at 22-23. Investment Advisers Act § 202(a)(13), 15 U.S.C. § 80b-2(a)(13) (1994), lends some support to the Committee's approach to avoiding registration under the Securities Act and the Investment Company Act. It defines "investment supervisory services" as "continuous advice" based on the "individual needs of each client." Under section 208(c), 15 U.S.C. § 80b-8(c), only those persons a substantial portion of whose activities consist of providing "investment supervisory services" may use the title "investment counsel." By granting this trade advantage, Congress itself made at least one important distinction in the area of investment management based on individualized services.

262 See supra Part II.A.4. If prospective investors are to have sufficient information to reach a considered judgment before they commit their money, it is important that investors be
individualization may not be subject to precise definition, and thus might be
difficult to define in particular cases, it is no less determinate than the other tests
of security that courts have crafted, and at least the SEC has developed a
substantial body of law distinguishing management programs on the basis of
individualized treatment of investors. The SEC (or the courts) might also
develop more clearly stated guidelines if individualization were acknowledged
to be the critical question, and indeed proposed Investment Company Act
Rule 3a-4 provides a relatively clear definition of individualized treatment and
guidelines for meeting it.

In assessing the test of individual treatment, it is fair to recognize that the
manner in which an investment opportunity is promoted is often an important
background consideration in deciding whether that opportunity is a security.

assured of individualized treatment before investment management arrangements are created.
To a substantial extent, this assurance can be provided by treating the way investment
management arrangements are promoted as a factor in the test of individual treatment that
determines whether they are securities. See infra text accompanying notes 261–71. In
addition, a test of individualized treatment would require that, to avoid being treated as
securities, investment management arrangements must be structured to guarantee that
investors will receive individualized treatment after they have entered into those
arrangements. See supra text accompanying note 127. Regulation of promotion and creation
alone would be insufficient to assure individualized treatment, however, because a real test of
individualized treatment requires that the manager’s behavior be assessed as the relationship
develops. This examination could be accomplished on an ad hoc basis or by the application of
clear standards of management similar to those articulated in proposed rule 3a-4. See supra
notes 229–35 (discussing proposed rule 3a-4).

263 See sources cited supra note 259.

264 The Advisory Committee recommended that the SEC publish guidelines on
individualized treatment and offered a list of criteria for the SEC to consider in doing so. See
Advisory Committee Report, supra note 62, at 27–32.

265 See Investment Company Release No. 21,260, supra note 62 (proposing rule); see
also supra notes 229–35 and accompanying text (discussing proposed rule).

of the Securities Act does not apply to privately negotiated secondary transactions) and
Marine Bank v. Weaver, 455 U.S. 551 (1982) (holding that a unique, privately negotiated
profit-sharing agreement was not a security) with Landreth Timber Co. v. Landreth, 471 U.S.
681 (1985) (holding that sale of all the stock of a corporation was a sale of securities).

In holding that commingled agency accounts are securities for purposes of the Glass-
Steagall Act, the Supreme Court in Investment Co. Institute v. Camp emphasized that they are
likely to produce promotional and performance pressures. 401 U.S. 617, 636–38 (1971). Camp
thus suggests that, at least in some contexts, the way an investment is marketed is
relevant to whether it is a security. Whatever might be said about the validity of the Supreme
Court's distinction between commingled agency accounts and other bank-sponsored
investment management arrangements, the Court did attempt to tie security status to concern
Indeed, one might accurately say that a concern with marketing and promotional practices pervades the cases dealing with the definition of over the methods of promotion that banks might adopt.

Of course, banks do promote their investment management services—even those services that are not securities—to both institutional investors, like pension and profit-sharing accounts, and to individuals. Courts and commentators alike have spotlighted the tenuousness of the Supreme Court's attempted distinction between commingled agency accounts and other bank-sponsored and bank-managed investment services. See Langevoort, supra note 24, at 703–04.

The new structure of the banking industry makes a complete anachronism of Camp's fiduciary rhetoric. One doubts that many sophisticated people today see the banker as anything but a businessperson under pressure to sell products and generate profits—not a likely source of "disinterested investment advice" unless that service is paid for.

Id.; see also Investment Co. Inst. v. Conover, 790 F.2d 925, 937 (D.C. Cir. 1986) (noting that banks likely face competitive pressures when they market collective trusts for IRAs, but holding they are still not securities); John W. Church, Jr. & Richard B. Seidel, The Entrance of Banks into the Field of Mutual Funds, 13 B.C. INDUS. & COM. L. REV. 1175 (1972); James G. Woltermann, Comment, National Banks and Mutual Funds: Where Can They Go After Investment Company Institute v. Camp?, 60 KY. L.J. 757 (1972). Perhaps Camp reflected less a response to the imperatives of the Glass-Steagall Act than to a decision that bank entry into the provision of investment management services had come so far as to require a general review by Congress. See Langevoort, supra note 24. Because, under a literal reading of the statute, the sale of participations in commingled agency accounts could easily be regarded as contrary to the statutory prohibitions against underwriting, and since the Court knew that Congress was examining the commingled agency account issue in connection with its hearings on amending the Investment Company Act, the Court's decision to hold the line against further bank encroachments is entirely understandable, if perhaps somewhat disingenuous. See, e.g., Hearings on Mutual Fund Legislation of 1967 Before the Senate Comm. on Banking and Currency, 90th Cong., Pt. 3, 1249 (1967); Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 139, 179, 456–58 (1969). The report of the Senate Committee on Banking and Currency, 91st Cong., 10–12, 23 (1969), indicated that Senate Bill 5224 proposed expressly to authorize banks or savings and loan associations to operate a collective fund for managing agency accounts. The House Committee on Interstate and Foreign Commerce, in its Report, 91st Cong., 2d Sess. 9 (1970), refused to take a position whether commingled agency accounts were considered permissible under the Glass-Steagall Act. Recognizing that the Camp case was pending before the Supreme Court, however, the Committee did take the position that if such accounts were permitted, they ought to be regulated as investment companies. Both the House approach and the Senate approach were eliminated in conference. See Conference Report, Investment Company Act Amendments of 1970, No. 163, 91st Cong., 28–29 (1970).
Perhaps the security status of investment management arrangements depends not only on a lack of individual treatment, but also on how management services are marketed—how clients are sought, what promises are made, what information is disclosed and withheld, and so forth. However, the question of marketing may be more of a refinement of an individual-treatment test than a substitute for it.

Consider, for example, the Supreme Court's approach in Howey. The Court emphasized both the investors' passivity and the promoters' creation and marketing of substantially similar, if not identical, interests in the orange-grove scheme. These factors indicate an absence of both individual treatment and public marketing. For investment management arrangements generally, on an individual-treatment analysis, red flags for security status might include heavy portfolio overlap or joint management of a large number of accounts. Yet, these elements will almost always be present when a manager markets investment management arrangements to many potential customers. Once again, making marketing practices dispositive of whether an investment management arrangement is a security will, in the end, identify arrangements in which investors are unlikely to receive individual attention. However the test is phrased, individual treatment seems to be the key.

V. CONCLUSION

The general question of which investment management arrangements are securities for purposes of the federal securities laws is important to the extent

267 See HAZEN, supra note 13, § 1.5, at 31 ("[A] reading of all of the relevant [investment contract] cases leads to the conclusion that what is being offered may not be as important as how it is being presented."); see also SEC v. Brigadoon Scotch Distrub., Ltd., 388 F. Supp. 1288, 1292 (S.D.N.Y. 1975) (referring to defendants' "investment-oriented advertising"); Advisory Committee Report, supra note 62, at 17; Carney, supra note 38; FitzGibbon, supra note 38; cf. 17 C.F.R. § 230.151(a)(3) (1996) (establishing a safe harbor for annuities that are not marketed primarily as investments).

268 Cf. Carney, supra note 38, at 364 (suggesting that courts use a two-step analysis in defining securities).


270 See generally Advisory Committee Report, supra note 62.

271 See Advisory Committee Report, supra note 62, at 19 ("Mass merchandising of discretionary accounts of relatively small size, through advertising in the mass media or similar promotional efforts, was viewed with skepticism by the [SEC's] staff which believed that such activities would probably be inconsistent with individualized investment advice and services").
that those laws affect the public interest, and the question of whether a specific arrangement is a security is certainly important to the investment manager and investors involved. Nonetheless, stating the law governing the general question with any precision is difficult, and whether a particular investment management arrangement will be treated as a security is often impossible to predict.

Although much of what appears to be discord in the case law is more rhetorical than real, courts do disagree about what constitutes a security. Moreover, authoritative determinations of security status have never been made with respect to vast numbers of investment management relationships. Nevertheless, certain factors do recur in authoritative determinations that particular investment management arrangements are securities.

An investment management arrangement is more likely to be found to be a security if the manager has made false statements of material facts relevant to the underlying investments or has failed to disclose a substantial risk that the investor will suffer if the manager's firm fails. Similarly, excessive optimism about the prospect for gain from using a particular investment approach, especially with insufficient reference to the risk of loss, can be an important factor in establishing security status. Finally, a generalized advertising campaign, especially one going beyond mere solicitation of interest from investors seeking personal investment counseling, may support an inference that what is being offered is a security.

Undoubtedly, several forces push courts and regulators to hold investment management arrangements to be securities. Dissatisfied investors who can convince courts that managed accounts are securities can obtain relief under the antifraud provisions of the securities laws if the underlying investments are not securities—for example, when managers invest client funds in commodities or precious metals. Even when the underlying investments are in securities, if an investor can show that the managed account is itself a security, the Securities Act provides a neat remedy for recovering the account's lost value without showing that the manager was incompetent or engaged in fraud. If the arrangement was not registered and the manager cannot prove an exemption, then the investor can rescind under section 12(1). In contrast, the regulation of investment management services under other federal securities laws, particularly the Investment Advisers Act of 1940, is underdeveloped and offers investors relatively little protection. Recoveries are thus less certain than under the Securities Act, and litigation is likely to be more complex.


From the point of view of the SEC, the Securities Act offers a useful vehicle to police investment managers who offer services of doubtful merit and managers who make technically accurate statements that are likely to take advantage of investor naiveté. By enjoining the marketing of an investment program for nonregistration,274 the SEC can pre-empt the use of programs it believes may be fraudulent without proving fraud. In doing so, the SEC does not so much perfect the disclosure philosophy of the securities laws to ensure that investors have information before engaging investment managers, as it completely prevents the marketing of services of which it disapproves.

The SEC’s interests have predominated in the law governing whether investment management arrangements are investment companies, because much of the authoritative discussion of that question is contained in SEC responses to requests for no-action assurance. In that context, the SEC has an incentive to broadly construe the term security in order to maximize its jurisdiction, because only if investment management arrangements are securities can collections of such arrangements be subject to regulation as investment companies.275 In assessing what moves the SEC’s general approach to the question of whether investment management arrangements are securities, one should note that the SEC has done little to assist investment managers who want to provide information to prospective investors without running afoul of the registration provisions. The SEC first proposed rule 3a-4 fifteen years ago and has never issued a Securities Act registration form specifically tailored for the offering and selling of investment management services and for responding to the needs of persons interested in such services.

A final explanation for the intrusion of the securities laws into arrangements between investment managers and their clients lies in the fragmentation of federal regulation of investment management.276 For some time, the investment management activities of underwriters, broker-dealers, commodity trading advisers, insurance companies, investment counselors, and banks have been regulated by different regulatory authorities acting under separate administrative regimes. Compartmentalized regulation of comparable activities has created discontinuities that generate regulatory strain, and perhaps the natural response has been for courts and the SEC to find a common basis for regulation under the securities laws.

While these considerations may explain why various actors want investment management arrangements to be treated as securities, they do not justify using

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275 Cf. supra note 231 and accompanying text (discussing reporting requirement under proposed rule 3a-4).
276 See supra Part I.B.
an expansive definition of security to accomplish regulation of investment management. Other remedies are available to deal with fraud in the marketing of investment management services and fraud and mismanagement in their operation, without adding a guarantee against investment failure under the securities laws. Moreover, to the degree the SEC or private plaintiffs succeed in applying the the securities laws selectively to offers of investment management services, they also burden investment management arrangements which are conducted honestly and properly.\textsuperscript{277}

Nonetheless, the securities laws have a proper place in the regulation of investment management arrangements when managers provide common management service to various investors instead of tailoring management to the needs of each investor. An appropriate balance between permitting investment management practices to evolve and protecting the interests of investors can be achieved by treating investment management arrangements as securities unless managers act on the basis of each client’s individual financial situation, investment objectives, and instructions. Individualized attention is expensive of course, and providing individualized attention to small investors on a profitable basis may be impossible. Certainly, many managers faced with the cost of complying with the securities laws would decline to offer nonindividualized management services to small investors. Mutual funds, on the other hand, do provide nonindividualized management services to small investors, and they do so under a regulatory regime designed to protect those investors. Perhaps those who desire nonindividualized investment management services ought to be directed to mutual funds, and those who wish to provide such services ought to comply with the regime that regulates mutual funds. In any event, that seems to be the decision enacted in the securities laws, and that decision is effectuated by treating nonindividualized investment management arrangements as securities.

\textsuperscript{277} In this regard, the quick enactment of the Philanthropy Protection Act is instructive. See supra notes 188–97 and accompanying text.