May, 2007

The Undefined Definition of a Security: Why Investment Contract is the Last Security Standing and a Proposal for the Adoption of a Contextual Analysis to Determine its Reach

Bradley D Allen, Brigham Young University

Available at: https://works.bepress.com/bradley_allen/1/
The Undefined Definition of a Security: Why Investment Contract is the Last Security Standing and a Proposal for the Adoption of a Contextual Analysis to Determine its Reach

I. INTRODUCTION

A judicial “opportunity doesn’t always knock . . . sometimes it rings.”¹ In this case, however, the United States Supreme Court did not answer. Presented with an opportunity to clarify its dangerously broad definition of an investment contract under the securities laws,² the Court limited its decision to merely whether a transaction may be considered an investment contract if the scheme offers a fixed rather than variable return.³ Although the Court correctly concluded that an instrument offering a fixed return may properly be considered within the definition of investment contract, it failed to seize the opportunity to step beyond the formulaic conjunctive approach of SEC v. Howey to a more functional standard under which courts determine whether a scheme falls within the Securities Acts—specifically, whether the scheme is a quintessential security or otherwise is an instrument of the sort Congress sought to regulate by enacting the federal securities laws. Instead, the Court expanded the confusing, vague, and often inapplicable standard first announced in Howey⁴ and thereby effectively left investment contract as the last security standing in the Securities Acts’ exhausting definitions.

This Note begins with a brief account of the United States Supreme Court’s long struggle to determine whether an investment scheme qualifies as an investment contract and consequently falls within the reach of the Securities Acts. Part III reviews the trial, appellate, and ultimate disposition of Securities & Exchange Commission v. Charles E. Edwards. Part IV considers in more depth whether the Court’s definition of an investment contract from Howey should apply to

---

³ Edwards, 540 U.S. at 391.
schemes offering a fixed, rather than variable return, the consequences of broadening Howey to include fixed-return investments, and finally proposes that the Court adopt a contextual, balancing test to determine whether an investment scheme falls within the expansive reach of the Securities Acts. Lastly, Part V offers a brief conclusion.

The intent of this Note is to assert that while the Court correctly concluded that investments offering a fixed return and that the sale-and-leaseback scheme in Edwards may fall within the Securities Acts’ definitions of a security, it failed to seize an opportunity to abandon the objective, out-dated standard adopted in Howey over sixty years ago and to adopt instead a contextual examination that more closely matches Congress’ purposes of enacting the Securities Act of 1933 and the Securities Exchange Act of 1934. In nearly every case involving whether an investment scheme qualifies as a security, the Court has considered Congress’ purpose before evaluating whether a specific investment falls within the Securities Act even though it generally applies a conjunctive, elemental analysis to reach its decision. Instead, the Court should adopt a contextual standard that frankly considers whether an investment is one of the “countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” Interpreted against the familiar notion that Congress did not intend to create a broad

---

5 See Globerman, Casenote: The Elusive and Changing Definition of a Security: One Test Fits All, 51 Fla. L.Rev. 271, 288 (“[T]he reach of the Securities and Exchange Acts should cover all transactions that attempt to defraud public investors.”).

6 See generally Howey, 328 U.S. at 289—99 (discussing the origin of the term “investment contract” and Congress’ purpose in using the term without specifically defining it) (quotations in original); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847—48 (1975) (noting that “Congress did not attempt to articulate the relevant economic criteria for distinguishing ‘securities’ from ‘non-securities,’” but rather intended the broad and general terms to capture the various forms of instruments in our commercial world) (quotations in original); Reves v. Ernst & Young, 494 U.S. 56, 60—62 (1990) (considering Congress’ purpose to regulate the market sufficiently broad to “encompass virtually every instrument that might be sold as an investment”). See also Globerman, Casenote: The Elusive and Changing Definition of a Security: One Test Fits All, 51 Fla. L.Rev. 271, 292 (stating that Congress’ purpose in enacting the Securities Acts was to provide investors with enough information to make an informed investment decision and to hold issuers liable for any fraudulent activities).

7 Howey, 328 U.S. at 299. See also Page, Note: Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security, 1992 U.Ill. L.Rev. 249, 250 (“Instead of defining a security by its connotation—by listing the individually necessary and jointly sufficient attributes or
remedy for all fraud, a more supple, contextual rule to determine whether a scheme falls within the securities laws would provide just as much predictability and certainty as the definition of an investment contract given in Howey, but would allow courts greater flexibility to ensure that the expectations underlying the enactment of the Securities Acts are adequately met.

II. BACKGROUND

Three landmark United States Supreme Court decisions form the foundation for the doctrine of investment contracts under the securities laws—SEC v. W. J. Howey Co., United Housing Foundation, Inc. v. Forman, and Reves v. Ernst & Young. This section recounts those influential cases and their applicability to the Court’s ultimate disposition of Edwards.

A. SEC v. W. J. Howey Co.

The seminal case establishing the definition of an investment contract is SEC v. W. J. Howey Co., which was decided in 1946. There, the Securities & Exchange Commission (“SEC”) brought suit against two sister companies for the sale of unregistered and nonexempt securities. W. J. Howey Company and Howey-in-the-Hills Service, Inc. were Florida corporations under common control and management. W. J. Howey Company offered citrus elements of a security—Congress defined a security by many of its denotations by providing examples of commonly known securities.

8 Marine Bank v. Weaver, 455 U.S. 551, 556 (1982). Although most securities fraud cases are handled under Rule 10b-5, the rule nevertheless requires such deceit “in connection with the purchase or sale of any security.” Rule 10b-5, Securities Exchange Act of 1934. Thus, the definition of a security is a significant threshold for any action brought under Rule 10b-5. See also Kloos, Alter, & Stone, Securities Fraud, 43 Am.Crim.L.Rev. 921, 933 (“The definitions of "security" found in section 2(1) of the 1933 Act and section 3(a)(10) of the 1934 Act are used consistently in civil suits, SEC enforcement actions, administrative proceedings, and criminal proceedings.”).

9 See generally Darlene S. Wood, Casenote: Lease-back Arrangements are Investment Contracts and Therefore Securities Under the Securities Acts: SEC v. Edwards, 7 Duq. B.L.J. 135, 140—144 (outlining the history and need behind the creation of the Securities Acts from state blue sky laws to the adoption of Howey). But see McGinty, What is a Security, 1993 Wis. L.Rev. 1033, 1036 (arguing that the Court was correct to develop three different tests for investment contracts, stocks, and notes because of the importance to delineate between investments and non-investments when determining the reach of the Securities Acts).

10 Howey, 328 U.S. at 293.
11 United Housing, 421 U.S. at 837.
12 Reves, 494 U.S. at 56.
13 Howey, 328 U.S. at 293.
14 Id. at 294—95.
groves for sale primarily to patrons of a hotel in Florida and recommended that purchasers enter into service contracts with Howey-in-the-Hills Service, Inc. to cultivate and develop the properties.  

While purchasers of the citrus groves were not required to enter into the service contracts, 85% of the acreage sold during a three-year term was sold with the accompanying service contracts. The citrus groves were not fenced separately, and a purchaser had no right of entry, no right to market any of the crops, and no rights generally to any fruit in particular.

Although each grove was actually inspected by the prospective buyer before purchase, the Court determined such buyers were attracted to the citrus groves merely for the expectation of substantial profits, and the citrus-grove scheme thus fell within the definition of an investment contract under the Securities Acts.

The Court’s holding reversed the finding below that the form of the scheme prevented the application of the Securities Acts. W. J. Howey Company had argued that the transactions involved two separate contracts—one for the sale of each citrus grove and another agreement to manage the property—and the securities laws ought not combine the two. Instead, the Court looked to the economic reality of the entire transaction, not merely its form, and affirmed that the Securities Acts were enacted to govern “a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely from the efforts of the promoter or of some one other than themselves.” The Court determined that the totality of each transaction constituted a profit-seeking business venture because the

---

15 Id. at 295—96.
16 Id. at 296—97.
17 Id. at 296—302 (Frankfurter, J., dissenting).
18 Id. at 302 (Frankfurter, J., dissenting).
19 Id. at 298. In addition, the Court also suggested that because Congress used the same term, “investment contract,” that had been “crystallized” by prior judicial interpretation, it must have meant to attach the same meaning from state blue sky laws that were in existence prior to the enactment of the Securities Acts. Thus, the Court adopted a standard created from various state court decisions. Id. at 298 n.4. See also L. Loss, Securities Regulation, 455 (1961) (observing that the definition of security was modeled on the definitions from various state statutes).
promoters were offering an opportunity to share in the profits of a large citrus fruit enterprise without any desire of the purchasers to develop the fields themselves. The elements of a profit-seeking business venture—(1) an investment of money in a (2) common enterprise with (3) the expectation of profits (4) derived solely from the efforts of others—became the standard under which courts were to define an investment contract for purposes of the Securities Acts.

The Court’s substance-over-form analysis thus became critical in order to find the second element—a common enterprise. Moreover, the Court found that the investors had no experience or desire to cultivate the citrus groves and were merely interested in a sufficient return. Thus, the Court concluded they had an expectation of profits derived solely from the efforts of others. In fact, the parcels of land were so small that it would had been infeasible for most purchasers to have developed the groves themselves. Although the promoters had actually transferred legal rights in the separate grove parcels to each investor, the Court found such transfers were merely incidental to the economics of the transaction and rejected an alternative explanation that an investment contract must be speculative in nature or promotional in character. Rather, the standard was an investment of money in a common enterprise with the expectation of profits derived solely from the efforts of others.

The outcome, however, was not unanimous. Justice Frankfurter dissented and argued that the determination of an investment contract depended on the circumstances of a particular situation. Frankfurter argued that the Court had improperly merged two transactions into one and thereby upset the two lower courts’ findings of fact and relevant inferences. Since the lower

---

20 Id. at 299—300.
21 Id. at 298—299. See also Kloos, Alter & Stone, Securities Fraud, Am.Crim.L.Rev. 921, 944 (finding that although the word “solely” was used by the Howey court, subsequent court decisions have loosened this element and often tacitly omit the word from their restatements of the Howey test).
22 Id. at 298.
23 Id. at 299—300
24 Id. at 300—301.
25 Id. at 301—302 (Frankfurter, J., dissenting).
courts held that the formalities of the transaction ought to be preserved, Frankfurter wrote that the Court should have determined that neither transaction alone—the sale of citrus groves nor the service contracts—constituted a security and that nothing could be found to “indicate that Congress meant to bring every innocent transaction within the scope of the Act simply because a perversion of them is covered by the Act.” Against Frankfurter’s dissent however, Howey announced an elemental standard under which courts were to ignore formalities and evaluate the substance of a transaction to determine the reach of an investment contract under the Securities Acts.

B. United Housing Foundation, Inc. v. Forman

Notwithstanding the conjunctive standard announced in Howey, the Court was called upon again to determine the reach of an investment contract under the Securities Acts. In United Housing Foundation, Inc. v. Forman, tenants of low income cooperative housing brought suit alleging securities fraud from the sale of “stock” after monthly rental charges increased nearly 60%. United Housing Federation (“UHF”) organized a nonprofit cooperative housing corporation and issued stock in exchange for the right to occupy an apartment within the Co-op. UHF operated under the Mitchell-Lama Act, which was enacted to ameliorate a perceived crisis in the availability of decent low-income housing as a means of encouraging private developers to build low cost cooperative housing. Receipt of government benefits was

26 Id. at 302 (“If respect is to be paid to the wise rule of judicial administration under which this Court does not upset concurrent findings of two lower courts in the ascertainment of facts and the relevant inferences drawn from them, this case clearly calls for its application.”) (referencing Allen v. Trust Co. of Georgia, 326 U.S. 630 (YEAR)) (Frankfurter, J., dissenting).
27 421 U.S. 837, 844 (1975). Although the record did not specifically indicate why the term “stock” was used to transfer rights in the housing co-op instead of lease, interest, or other form, the Court noted that stock is generally used as a matter of tradition and convenience. Id. at 848 (referencing P. Rohan & M. Reskin, Cooperative Housing Law & Practice, § 2.01(4) (1973)).
28 United Housing, 421 at 841.
conditioned on a willingness to have the New York State review virtually every step of the development.  

UHF ultimately raised more than $375 million in construction loans and an additional $33 million from the sale of shares of stock. The stock could not be transferred to a non-tenant, pledged, or encumbered; it also possessed no voting rights. Shares did not convey to stockholders legal title to their respective apartments, but merely gave them the right to occupy the apartments. Tenants desiring to move out of the Co-op and thus sell their stock were required to offer the stock to Riverbay, the organization created to own and operate the Co-op, for sale at its initial selling price. If Riverbay declined to purchase the stock, the tenant could not sell it to a third party for more than the initial purchase price plus a fraction of the mortgage already paid off. A fund of nearly $1 million was created to ensure that those wanting to move out would receive full compensation in redemption of their shares.

The Court ultimately held that the shares of stock sold by UHF were not securities within the scope of the Securities Act. The stock transferred no voting rights, could not be transferred, entitled the owner to no claim on specific assets and thus shared none of the characteristics that fall within the ordinary concept of stock. The Court employed again a substance-over-form analysis to conclude that even though the term “stock” was used to describe UHF’s shares, the economic reality of the transaction, not merely its form, should be evaluated to determine if the scheme was of the type against which Congress sought to protect. Although the Court suggested the name used to describe the investment is not wholly irrelevant, it reasoned that the

30 Id.
31 Id. at 842—44.
32 Id. “Respondents do not hold legal title to their respective apartments, but they are purchasers and owners of the shares of Riverbay which entitles them to occupy the apartments.” Id. at 842 n.4.
33 Id. at 843—44.
34 Id. See also footnotes 5 and 6.
35 Id. at 847—60.
36 Id. at 850—52.
lack of common characteristics of stock precluded any purchaser from justifiably assuming that the Securities Acts governed the Co-op’s sale of shares.\footnote{Id. (“There may be occasions when the use of a traditional name such as ‘stocks’ or ‘bonds’ will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.”). Id. at 850—51.}

In addition to concluding that the shares were not “stock” under the Securities Acts, the Court also concluded that the shares were not investment contracts, as defined in \textit{Howey} to mean “an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.”\footnote{Id. at 851—52.} Although UHF probably constituted a common enterprise, the Court found no expectation of profits and distinguished cases involving an expectation of profits, which it interpreted as either capital appreciation or a participation in earnings, from instances “when a purchaser is motivated by a desire to use or consume the item purchased . . . .”\footnote{Id. at 852—53.} Here, investors were attracted solely by personal consumption—acquiring a place to live—and thus the Court held that the Securities Acts did not apply.\footnote{Id. at 853—54.} UHF’s advertising brochures did not seek to induce purchasers solely on the expectation of profits. In fact, tenants were unable to even make a profit on the sale, and therefore the majority concluded that investors did not purchase shares in the Co-op with the expectation of profits.\footnote{Id. at 854. Little risk existed as to whether tenants would be able to sell their respective shares in the Co-op because a special fund of over $1 million was created from contributions from all tenants to insure full compensation to anyone wishing to move out. Id. at 843 n.6.}

Justice Brennan, joined by Justices White and Douglas, disagreed and argued that investors had an expectation of profits in the form of government subsidies, tax savings, and cheap housing as a result of income from office and commercial space within the Co-op.\footnote{Id. at 860—66 (Brennan, J., dissenting).}
According to the dissent, profits should not be limited to merely capital appreciation or an expectation of profits, as the majority eluded to. Additionally, investors relied on the managerial efforts of UHF and Riverbay because profits of this sort were only available by operating a corporation of this sort and relying on its specialized skills. Thus, the minority concluded that the shares of stock should be considered both stocks and investment contracts under the Securities Act. Although the Court correctly observed that the Securities Acts ought not apply to goods bought solely for consumption, residential housing shares an element of investment.43 The investment element present in the shares sold by UHF lead the minority to conclude that the shares constituted stock and an investment contract.44 But contrary to the minority’s assertions, the majority of the Court distinguished the investment in the Co-op for personal consumption from those entered into merely for the expectation of profits.

C. Reves v. Ernst & Young

Not all investments in Co-ops, however, have been adjudicated under the Securities Acts’ definition of an investment contract. In Reves v. Ernst & Young, holders of demand promissory notes sold by a farmer’s cooperative brought suit against the Co-ops auditors, Ernst & Young, for intentionally failing to follow generally accepted accounting principles that would have made the Co-op’s insolvency apparent to the purchasers of the notes.45 The notes were uncollateralized, uninsured, and paid a variable rate of interest that was adjusted to ensure a higher rate than notes offered by financial institutions. Marketers informed holders that more than $11 million in assets stood behind the notes, but in 1984, the Co-op filed for bankruptcy protection from over 1,600 people who held notes worth a total of $10 million.46

43 Id. at 865. (Brennan, J., dissenting).
44 Id. at 866 (Brennan, J., dissenting).
46 Id. at 59.
The holders argued that the notes were securities under the Securities Acts and should therefore be provided the Acts’ antifraud protection. The Court agreed and held that the Co-op scheme fell within the Acts’ definition of a note, but rejected several competing standards under which the term note was defined.\textsuperscript{47} Not “any note”, however, should fall within the Securities Acts because not every setting involving a note involves an investment.\textsuperscript{48} Circuits were divided as to the proper standard for determining when a note qualified as “any note.” In fact, two circuits even adopted the \textit{Howey} test.\textsuperscript{49} The Court rejected such an approach because that test was formulated to define an investment contract, and “to hold that a note is not a security unless it meets a test designed for an entirely different variety of instrument would make the Acts’ enumeration of many types of instruments superfluous.”\textsuperscript{50} Congress intended to regulate all investments, and thus the interpretation of security “must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts.”\textsuperscript{51}

Although the Court did not adopt the \textit{Howey} test to determine whether a note fell under the Securities Acts, it did draw an interesting distinction between profits in the context of notes and investment contracts. For notes, the Court determined profit meant a “valuable return on an investment, which undoubtedly includes interest.” \textsuperscript{52} For investment contracts, however, the Court confirmed that it had defined profits much more restrictively under the \textit{Howey} test to mean either capital appreciation or a participation in earnings.\textsuperscript{53} Thus to apply \textit{Howey}’s definition of

\textsuperscript{47} Id. at 63—68. Specifically, the Court rejected the Eighth and District of Columbia Circuits approach which applied the test adopted in \textit{Howey} to define “any notes” and further found that the “investment versus commercial” approach adopted by a majority of circuits was the same way of formulating the approach the Court ultimately adopted—the family resemblance test. Id. at 63—65.

\textsuperscript{48} Id. at 63.

\textsuperscript{49} Id. at 64 (citing Baurer v. Planning Group, Inc., 669 F.2d 770, 777—79 (D.C. Cir. 1981) and Underhill v. Royal, 769 F.2d 1426, 1431 (8th Cir. 1985).

\textsuperscript{50} Id. at 64.

\textsuperscript{51} Id. at 63. Supra, note 6.

\textsuperscript{52} Id. at 68 n.4.

\textsuperscript{53} Id.
profits to notes “would be to suggest that notes paying a rate of interest not keyed to the earning of the enterprise are not ‘notes’ within the meaning of the Securities Acts.”

However, the Court declined to adopt Howey as the appropriate standard and found the distinction irrelevant.

Instead, the Court adopted a family resemblance test to determine whether the notes were of the sort Congress sought to regulate. The test implied a general presumption that all notes are within the definition of a security, but this presumption may be rebutted if the characteristics of a note are similar to the sort Congress clearly did not intend to regulate. This sort would be examined under four characteristics—first, the motivations prompting a reasonable buyer and seller to enter into the transaction; second, the plan of distribution of the instrument; third, the reasonable expectations of the investing public; and fourth, the existence of another regulatory scheme significantly reducing the risk of the instrument. After concluding that the Co-op’s notes were sold to raise capital, purchased strictly for investment, offered to a broad segment of the public, advertised as investments, and were not subject to another regulatory scheme, the Court concluded the Co-op’s notes qualified as securities and that the holders thereof were entitled to the protection of the Securities Acts.

D. Jurisprudence Leading into Edwards

When Edwards came before the Supreme Court, the Court was not writing “on a clean slate.” It had already adopted the objective test created in Howey—an investment of money in a common enterprise with the expectation profits derived solely from the efforts of others—as

\[54\] Id.
\[55\] Id. at 65—66.
\[56\] Id. at 66. The Court also suggested that the economic reality may not accurately determine whether a note is a “security” at the time it is issued. A flexible approach, however, would allow courts enough flexibility to “ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinative definition.” The Court urged Congress to create its mistake if it overvalued avoiding manipulation by the clever and dishonest. Id. at 63 n.2.
\[57\] Id. at 67—70.
\[58\] United Housing, 421 U.S. at 848.
the appropriate standard to define an investment contract and had also eluded that in the context of investment contracts, profits meant either capital appreciation or a participation in earnings. In addition, the Court had already adopted a family resemblance test to determine whether a note fell within the reach of the Securities Acts by subjectively comparing the economic reality of the transaction with what Congress sought to protect in enacting the federal securities laws. Some tension thus existed between the Court’s conjunctive standard to determine the reach of an investment contract and its contextual, economic reality analysis to define a note. An opportunity rang in Edwards to trade Howey’s elemental approach in favor of a balancing analysis that candidly considered Congress’ purpose in enacting the Securities Acts, but the Court failed to answer.

III. SECURITIES & EXCHANGE COMMISSION V. CHARLES E. EDWARDS

A. Statement of the Facts

Charles E. Edwards was the founder, sole shareholder, and chief executive officer of ETS Payphones, Inc. (ETS), a corporation formed to provide the owners of payphones with management services, such as placement, advertising, maintenance, coin collecting, and accounting services. Edwards also formed Payphone Systems Acquisitions, Inc. (PSA) to purchase telephone equipment and locations. Interested investors could purchase payphones indirectly from PSA and lease the phone back to ETS to manage in exchange for a fixed monthly fee. Under such a sale-and-leaseback agreement, purchasers should have received $82 per month per payphone, a 14% annual return on the $6,750 required to purchase the payphone and location. Purchasers were also promised a full refund of the purchase price at the end of the

---

59 Howey, 328 U.S. at 301.
60 See United Housing, 421 U.S. at 852 and Reves, 494 U.S. at 68 n.4.
61 Reves, 494 U.S. at 64—65.
62 Edwards, 540 U.S. at 391.
63 Id. at 391—92.
lease or within 180 days upon demand and could cancel the lease and repossess the payphones without penalty.\(^{64}\)

Additionally, investors were not involved in the day-to-day management or selection of locations of the payphones. ETS selected the location of the sites, connected the phones to local and long distance carriers, installed the equipment, collected coin revenues, and maintained and repaired the phones.\(^{65}\) Although the services contracts with ETS were offered to each purchaser, PSA did not condition any sales upon entering an agreement with ETS. Specifically, the service and purchasing aspects of Edwards' businesses were distinctly separated to avoid the appearance of a security.\(^{66}\) Entitled only to a contractually fixed return, investors were encouraged to “watch the profits add up.”\(^{67}\)

Profits, however, never added up. In fact, in September 2000 ETS filed for bankruptcy protection.\(^{68}\) Although ETS lost more than $33 million in the first six months of 2000, it nevertheless paid Edwards compensation of $2.24 million.\(^{69}\) From 1998 to 1999, Edwards personally claimed an additional $3 million in management fees and more than $11.6 million in interest free loans to companies he personally controlled.\(^{70}\) The SEC brought suit alleging that Edwards’ venture amounted to nothing more than a massive ponzi scheme raising more than

\^64 Id.  
\^65 Id.  
\^66 SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1282 n.1. As early as 1995, Edwards and his lawyers met with and told the SEC that the marketing and leasing aspects of ETS’ business would be “separated to avoid any claim that the payphone business involved a security.” The court of appeals did not mention what response the SEC gave Edwards. Distinct from the trial and appellate courts in Howey, however, each court considering Edwards combined the marketing and leasing aspects of ETS’ businesses into one transaction under a substance-over-form analysis. See also Darlene S. Wood, Casenote: Lease-back Arrangements are Investment Contracts and Therefore Securities Under the Securities Acts: SEC v. Edwards, 7 Duq. B.L.J. 135, 136 (suggesting that Edwards was assured by SEC attorneys if he separated the marketing and leasing aspects of his businesses, it would avoid the appearance of a security).  
\^67 Edwards, 540 U.S. at 394.  
\^68 Id. at 392.  
\^69 SEC v. ETS Payphones, 123 F.Supp.2d 1349, 1351 (U.S.D.C. Atlanta 2000).  
\^70 Id.
$300 million and that the over 10,000 should be entitled to the protections of the Securities Acts because the sale-and-leaseback scheme qualified as an investment contract and thus a security. 71

B. Northern District of Georgia’s Holding

The District Court concluded that the sale-and-leaseback of payphones was an investment contract and thus within the Securities Acts. 72 The court applied the Howey test and concluded that the scheme satisfied its “three elements—(1) an investment of money; (2) a common enterprise; and (3) an expectation of profits to be derived solely from the efforts of others.” 73 The court found a common enterprise in that the fortunes of investors were inextricably tied to Edwards because recovery depended on the financial viability of Edwards and ETS to generate a profit. 74 Next, the court determined that the third element—an expectation of profits to be derived solely from the efforts of others—required an examination of control. Although an agreement is not a security if the investor controls the profitability, any control maintained by investors here was merely illusory or insubstantial. Payphone locations were provided by PSA, ETS provided accounting and management services, and investors had no realistic alternative to allowing ETS to manage their investments. 75 “After contributing money, [investors] had little, if any, involvement in the enterprise.” 76 The court thus held that

71 ETS Payphones, 300 F.3d at 1283.
72 ETS Payphones, 123 F.Supp.2d at 1352—54.
73 Id. at 1352.
74 Id. at 1352—54. The district court did not specifically apply broad vertical commonality. In fact, it cited several decisions defining horizontal commonality and found that neither standard adequately addressed “the purpose of the federal securities laws—to protect potential and actual investors from fraud.” The district court’s “inextricably tied” language suggests it meant to apply horizontal commonality, but instead it analyzed the relationship between investors and Edwards, not between and individual investor and any other investors. Thus, the district court did not appropriately apply horizontal commonality. Id. at 1352 n.1 (relying on Marc G. Alcser, The Howey Test: A Common Ground for the Common Enterprise Theory, 29 U.C. Davis L.Rev. 1217 (1996); Revak v. SEC Realty Corp., 18 F.3d 81, 87—88 (2nd Cir. 1994); Stringer v. R.H.Love Galleries, Inc., 741 F.2d 144 (7th Cir. 1984); Newmeyer v. Philatelic Leasing, Ltd., 888 F.2d 385, 394 (6th Cir. 1989).)
75 Id.
76 Id. In addition, the district court relied heavily on Albanese v. Florida Nat’l Bank of Orlando, 823 F.2d 408, 410 (11th Cir. 1987), a similar sale-and-leaseback scheme involving ice machines.
the sale-and-leaseback agreements were investment contracts and that Edwards’ scheme was governed by the Securities Acts.

C. Eleventh Circuit Court of Appeal’s Reversal

The Court of Appeals, however, reversed and concluded that the sale-and-leaseback arrangements were not investment contracts because “investors did not expect profits to be derived solely from the efforts of others.”77 Under United Housing, profits meant either capital appreciation or a participation in earnings, and here the courts of appeals reasoned that because investors received a fixed, contractually guaranteed return, they had no claim to participate in ETS’ earnings.78 A participation in earnings required an intention of sharing risk, losses, and of course a company’s earnings, and according to the court of appeals, “ETS alone shouldered the risk of its placement of the telephones and ETS alone depended upon the earnings of its business.”79 Because investors bargained for a fixed return, their investment did not constitute an investment contract under the Securities Acts.

Notwithstanding, the court of appeals went one step further and broke Howey’s third element apart such that the expectation of profits requirement was separate from the to be derived solely from the efforts of others.80 The court found that even if an investment contract’s profits could be a fixed return, those profits were “not derived from the efforts of Edwards or anyone else; rather, they were derived as the benefit of the investors’ bargain under the contract.”81 Thus although the level of control retained by investors was disputed, the court concluded that any profits were in fact derived from his own bargain. Because each investor bargained to control the profitability of his investment, the court of appeals found no security.

---

77 ETS Payphones, 300 F.3d at 1284—85.
78 Id. See also United Housing, 421 U.S. at 852.
79 ETS Payphones, 300 F.3d at 1285.
80 Id.
81 Id.
Although Judge Lay concurred with the court’s holding that the sale-and-leaseback agreement did not amount to an investment contract, he wrote separately to disagree with any reaffirmation of vertical commonality as an appropriate standard under which to evaluate Howey’s second element—a common enterprise. “Broad vertical commonality . . . only requires a movant to show that the investors are dependent upon the expertise or efforts of the investment promoter for their returns.” According to Lay, vertical commonality amounted to nothing more than Howey’s third element—an expectation of profits to be derived solely from the efforts of others—and thus made Howey intrinsically redundant and its third element superfluous. Even the SEC had conceded in broad vertical commonality was an inappropriate test for the same reason—it collapses the second and third elements. Horizontal commonality, which requires a pooling of funds under which “individual investors shall all the risks and benefits of the business enterprise,” is thus the appropriate standard to examine the common enterprise element of Howey. The significance of the discussion was limited, however, because of the court’s holding that the sale-and-leaseback scheme guaranteeing a fixed return did not satisfy Howey’s third prong and thus did not constitute an investment contract under the Securities Acts.

D. United States Supreme Court’s Application of Howey

The United States Supreme Court granted certiorari to determine “whether a moneymaking scheme is excluded from the term ‘investment contract’ simply because the

---

82 Id. at 1285—88 (Lay, concurring).
84 Id. at 1285 (Lay, concurring).
85 Id. at 1286 (citing Brief for Appellant, SEC at 28 n. 11, SEC v. SG Ltd., 265 F.3d 42 (1st Cir. 2001).
86 Id. at 1283—84.
87 Id. at 1284.
scheme offered a contractual entitlement to a fixed, rather than variable return.”

The Court applied *Howey* and reiterated that its standard was a flexible, not static principle under which Congress sought to “regulate investments, in whatever form that are made and by whatever name they are called.” It found no reason to distinguish fixed from variable returns under *Howey* and saw no conflict with *United Housing* or any other precedent. Specifically, the Court interpreted *United Housing*’s reference that profits meant either capital appreciation or participation in earnings as merely examples or passing dictum and certainly not the only definition of profits.

Consequently, the Court reaffirmed its elemental test adopted in *Howey* as the appropriate standard under which to examine an investment contract and held that “an investment scheme promising a fixed rate of return can be an ‘investment contract’ and thus a ‘security’ subject to the federal securities laws.”

**IV. ANALYSIS**

This section considers the elemental test of *Howey* to determine whether the Supreme Court correctly interpreted its conjunctive standard to conclude that instruments guaranteeing fixed returns may qualify as investment contracts. Moreover, this section also addresses the consequences of the Court’s decision and suggests a proposal for the application of Section 2(a)(1) of the Securities Act of 1933 and Section 3(a)(10) of the Securities Exchange Act of 1934 to determine whether an investment scheme is caught within the Acts’ expansive reach.

---

88 Edwards, 540 U.S. at 391 (quotations in original).
89 Reves, 494 U.S. at 61 (emphasis in original).
90 Id. at 395—96 (noting that in United Housing, the Court “laid out two examples of investor interests that [it] had found to be ‘profits’ and that the Court will not be bound ‘unnecessarily to passing dictum that would frustrate Congress’ intent to regulate [investment schemes.]’”) (emphasis added) (quotations in original).
91 Id. at 397 (quotations in original).
A. Fixed vs. Variable Returns under Howey

Although the Court in Edwards probably reached the correct conclusion that the sale-and-leaseback of payphones scheme should fall within the reach of the Securities Acts, it failed to seize an opportunity to justify its strict test. Leading into Edwards, the Howey test was interpreted as requiring three elements—(1) an investment of money; (2) a common enterprise; and (3) an expectation of profits to be derived solely from the efforts of others. The test was thus an objective, conjunctive one with narrowly carved exceptions. Of those exceptions, one distinguished that if the investor's motivation in making the purchase was to use or consume the item, no security would be found. Another distinguished that if the investor controlled the profitability of the investment, the agreement was not a security. Though the Court quickly and easily reasoned that instruments promising fixed returns may qualify as investment contracts under Howey, it failed to seriously consider the impact of its decision on each element and therein failed to provide much guidance moving forward.

1. The Investment of Money Prong

Howey's first element—an investment of money—has been defined very broadly to include virtually every contribution of capital, services, or otherwise. Both the district court
and court of appeals found an investment of money therefore apparent in Edwards’ sale-and-leaseback scheme, and it is difficult to envision a circumstance where an investment of money would be affected by an instrument promising a fixed return because this requirement examines the investors contribution, while the fixed return is the receipt of the investor’s bargain. 99 Thus, Howey’s first element is uninfluenced by whether the instrument promises a fixed or variable return.

2. The Common Enterprise Prong

Howey’s second element—a common enterprise—is probably influenced by whether the instrument promises a fixed or variable return. Generally, the common-enterprise requirement is satisfied upon a showing of either vertical or horizontal commonality. 100 Horizontal commonality requires a pooling of funds that results in each individual investor sharing all the risks and benefits of the business enterprise such that “fortunes of individual investors are inextricably intertwined by contractual and financial arrangements to that of any other investors.” 101 Common stock provides a prime example because every investor generally has the same rights, preferences, and privileges as every other. 102 Thus, investors collectively share investments, but also goods, services, and promissory notes and that courts will construe this requirement broadly and look whether the investor subjected herself to financial loss by committing assets to the enterprise).

99 ETS Payphones, 123 F.Supp.2d 1349, 1352 (U.S.D.C. Atlanta 2000); ETS Payphones, 300 F.3d 1281, 1283 (11th Cir. 2002).

100 Marc G. Alcser, The Howey Test: A Common Ground for the Common Enterprise Theory, 29 U.C. Davis L.Rev. 1217 (1996). See also, Terry L. Sexton, Jr., Comment: The Circuit Courts' Split on the Common Enterprise Element of Securities Regulation - A Small Matter, or a Trap for the "Martha Stewarts" of the Business World?, 7 Duq. B.L.J. 111 (addressing the various approaches to determine the common enterprise element and arguing that although the U.S. Supreme Court is unlikely to adopt a specific standard, the various approaches create much uncertainty for attorneys and entrepreneurs when dealing with investment transactions); Loewenstein, The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law, 39 Ind. L.Rev. 17, 36 (arguing that whether vertical commonality is sufficient to satisfy the Howey test has divided the circuits for years and suggesting that the Court’s refusal to address the issue in Edwards can be interpreted as an adoption of vertical commonality or a removal of the commonality element all together).

101 Cooper v. King, 1997 WL 243424 at *2 (6th Cir. May 9, 1997).

102 Holder of preferred stock, however, would not have the same rights, preferences, and privileges because holder of such generally are “preferred” and thus may be entitled to dividends, distributions, and liquidations before holders of common stock.
profit and losses together. On the other hand, vertical commonality, a much broader standard, requires only “that the investors are dependant upon the expertise or efforts of the investment promoter for their returns.” A simple note would provide an illustrative example because the fortunes of its holder are dependant solely upon the success of the promoter for repayment and the fortunes of other investors are entirely irrelevant. The holder of a note stands alone, separate from any other investor. Thus, a telling difference between broad and horizontal commonality is whether the fortunes of the investor are “inextricably intertwined” with other investors or whether the investor stands alone.

The investors in Edwards’ sale-and-leaseback payphone scheme were not inextricably intertwined with any other investor because each had a contractual guarantee of a fixed return. Investors did not collectively share profit and losses together. In fact, one investor could have canceled the agreement and repossessed the payphone or simply required ETS to purchase the phone at the prearranged price without any consideration of any other investor. Because each agreement contracted for a fixed return, each investor stood alone, and by qualifying the scheme as an investment contract under the Securities Acts, the Court coincidentally affirmed broad vertical commonality as an appropriate standard under Howey to find a common enterprise.

---

103 ETS Payphones, 300 F.3d at 1284.
104 Holders of notes do, however, assume some level of risk of default such that the holder may not recover any of his investment in liquidation. A preferred creditor, such as lien creditor in bankruptcy, may have rights greater than even a holder of a note.
105 King, 1997 WL 243424 at *2. See also Kloss, Alter & Stone, Securities Fraud, 43 Am.Crim.L.Rev. 921, 941—943 (finding that the circuits are divided between which commonality approach to apply and outlining which circuits apply which standards). See also McGinty, What is a Security, 1993 Wis. L.Rev. 1033, 1036 (arguing that courts ought to simply remove the common enterprise element because of its inherent confusion); Gordon, Common Enterprise and Multiple Investors: A Contractual Theory For Defining Investment Contracts and Notes, 1988 Colum. Bus. L.Rev. 635 (recognizing that courts have been unable to decide upon the meaning of the common enterprise element of Howey and thus little predictability is available).
106 Edwards, 540 U.S. at 391—92.
107 Id.
108 But see SEC v. Infinity Group Co., 212 F.3d 180, 191 (3rd Cir. 2000) (suggesting that the distinction between a fixed and variable rate scheme was irrelevant to the determination of whether the transaction fell within the reach of the Securities Acts).
It is unclear, however, whether the *Howey* Court intended to adopt broad vertical or horizontal commonality as the appropriate standard.\(^{109}\) In fact, it is even more unclear which commonality standard Congress intended by including investment contract as a security under the Securities Acts.\(^{110}\) Thus, determining which commonality standard to apply certainly falls within the Supreme Court’s authority to review.\(^{111}\) The Court has never explicitly adopted horizontal commonality as the lone standard, and therefore may not have conflicted its precedent by qualifying the sale-and-leaseback scheme in *Edwards* as an investment contract.

Although the coincidental adoption of broad vertical commonality as an appropriate interpretation of a common enterprise may not have conflicted with the Court’s precedent, it must be considered alongside *Howey*’s final element—an expectation of profits derived solely from the efforts of others. According to Judge Kay’s concurrence at the circuit level, the adoption of broad vertical commonality make’s *Howey*’s final element superfluous because both elements would make the same examination into the level of control retained by the investor.\(^ {112}\) Thus, *Howey*’s elemental test is inherently redundant, and the Court has rendered one of its three requirements totally meaningless. In fact, the SEC, “the body charged with administering the Securities Acts,” has even taken the position that broad vertical commonality is not an appropriate standard because it collapses *Howey*’s second element into its third element.\(^ {113}\) Thus, schemes promising fixed returns to individual investors ought not fulfill *Howey*’s second

\(^{109}\) See generally Howey, 328 U.S. at 299—301 (suggesting that the term “investment contract” was taken from pre-securities laws jurisprudence from state courts under blue sky laws). See also Gordon, Common Enterprise and Multiple Investors: A Contractual Theory For Defining Investment Contracts and Notes, 1988 Colum. Bus. L.Rev. 635, 636 (arguing that both broad and vertical commonality standards are wrong and that a common enterprise should be defined as a profit-seeking venture in which there are multiple parallel investors).

\(^{110}\) See generally H.Rep.No.85, 73rd Cong., 1st Sess., p.11.

\(^{111}\) See generally Marbury v. Madison, 5 U.S. 137 (1803).

\(^{112}\) ETS Payphones, 300 F.3d at 1285 (Kay, J., concurring).

\(^{113}\) United Housing, 421 U.S. at 848. See also Brief for Appellant SEC at 28 n.11, SEC v. SG Ltd., 265 F.3d 42 (1st Cir. 2001).
element because of their lack of horizontal commonality. Moreover, broad vertical commonality should not be the standard to determine a common enterprise because it collapses the common enterprise prong into the expectation of profits requirement.

3. The Expectation of Profits Prong

*Howey’s* final element—an expectation of profits to be derived solely from the efforts of others—was the primary consideration of whether the sale-and-leaseback scheme in *Edwards*, and thus whether a scheme promising a fixed return, may be considered an investment contract under the Securities Acts.114 Some courts have taken one step further and separated this prong into two distinct requirements—(1) profits; and (2) derived solely from the efforts of others.115 Since the Court specifically addressed the profits element in isolation, this section will first address whether a fixed return may qualify as profits and then separately whether the fixed return would be derived solely from the efforts of others.

a. Definition of Profits. Fixed-returns on investments should probably constitute profits, but the Court in *Edwards* should have adequately confronted its prior, restricting language. Instead, it simply found “no reason to distinguish between promises of fixed returns and promises of variable returns” under *Howey* because in both instances, the investing public is attracted solely by investment income.116 Moreover, investors to whom such guaranteed-investments are pitched are in need of the protection provided by the Securities Acts and are thus a group Congress sought to protect.117 The Court cited several cases involving various forms of fixed returns and

---

114 Edwards, 540 U.S. at 394—397.
115 See ETS Payphones, 300 F.3d at 1285.
116 Edwards, 540 U.S. at 394.
117 Id. at 394—95.
reasoned that “[a]ny other conclusion would conflict with [its] holding that an investment contract was offered in Howey itself.”

The citrus grove investment scheme in Howey, however, did not promise a fixed return. In fact, Howey-in-the-Hills Service, Inc. was only accountable for “an allocation of the net profits,” which fluctuated from 20% annual return one season and the expected 10% annual return over a 10-year period. While several other cases cited by the Court certainly involve schemes promising fixed returns, not one specifically addresses the Court’s restrictive language from United Housing or Reves that profits meant either capital appreciation or a participation in earnings. In fact, the majority in United Housing specifically rejected the notion that tax benefits, increased savings, and rental income constituted profits to purchasers of Co-op shares. The dissent further suggests that the majority limited its definition of profits only to appreciation of capital or a participation in earnings. Although tucked away in a footnote, even Reves affirms the Court’s adoption of a restrictive definition of profits under Howey. Thus, the Court’s notion that profits under Howey may constitute forms other than capital appreciation or a participation in earnings in Edwards may conflict with its holding that an investment contract was not offered in United Housing.

Yet while fixed-income securities do not generally provide for a participation in earnings, some may actually provide an appreciation of capital. The value of a debt instrument depends

118 Id. at 397. See generally People v. White, 12 P.2d 1078, 1079 (1932) (agreement under which $5,000 was advanced under the promise that $7,500 would be repaid one year later); Stevens v. Liberty Packaging Corp., 161 A. 193, 193—94 (1932) (investment of $175 made under the promise of $56 payments for 10 years under a sale-and-leaseback of breeding rabbits); SEC v. Universal Service Association, 106 F.2d 232, 234 (1939) (transaction involving the assured profit of 30% qualified as an investment contract under Howey).
119 Howey, 328 U.S. at 296.
120 Supra, note 116.
121 United Housing, 421 U.S. at 852.
122 Id. at 863 (Brennan, J., dissenting).
123 Reves, 494 U.S. at 68 n.4. See also Steinberg, Notes as Securities: Reves and Its Implications, 51 Ohio St. L.J. 675, 679 (observing the different standards to determine profits and concluding that the definition of profits under the family resemblance test is more expansive than the same term under Howey).
largely on its term, face value, coupon rate, and prevailing market interest rates. If, for example, an investor purchased a note offering a 12% coupon rate, the value of that instrument may appreciate in value in prevailing market rates for similar notes fell below 12%. Although the fixed amount paid as interest remained unchanged, the investment may have appreciated in value. Thus, the fixed-return investments in Edwards may have been able to provide investors with capital appreciation and thus not conflicted with United Housing’s restrictive definition.

Rather than reasoning around its limitation of profits to either capital appreciation or a participation in earnings, the Court should have made a clear break from any restrictive definition of profits. Profits can be tricky to define specifically given the complexity of today’s markets and the sophistication of their participants. Nearly all valuations incorporate some form of profits, but that figure may constitute anything from gross margin to eventually to a diluted earnings per share. Similar to its definition of an investment of money, the Court should have explicitly abandoned any restriction on its definition of profits to include virtually anything the investor receives in return for his contribution and thus properly concluded that a fixed return certainly may constitute profits.124

b. Derived Solely from the Efforts of Others. As previously mentioned, the derived-soley-from-the-efforts-of-others element generally requires an examination into the level of control retained by the investor and is generally unaffected by whether a scheme promises a fixed or variable return. “If the investor controls the profitability of his investment, the agreement is not a security” because the spirit of a security for investment purposes is the separation of influence between promoter and investor.125 Typically, “[t]he investors provide the capital and share in the

124 Supra, note 97.
125 ETS Payphones, 123 F.Supp.2d at 1353.
earnings and profits; the promoters manage, control and operate the enterprise.”126 The court of appeals reasoned that by bargaining for a fixed return, investors may not have relied solely on the efforts of others because their contractually guaranteed returns “were derived as a benefit of [their] bargain under the contract.”127

The court of appeals reasoning, however, is flawed at best. Every conceivable investment scheme involves some sort of agreement, and to reason that such bargaining removes the scheme from the definition of a security would essentially take every investment out of the Securities Acts. Congress certainly did not intend that result when it drafted an overly inclusive definition of security.128 One investor’s bargain for a greater return than another should not deny him the protections of the Securities Acts otherwise available to the remaining segment of the investing public.

Instead, courts should examine an investor’s involvement in the day-to-day operations or management decisions of the business enterprise to determine whether the investment depends solely on the efforts of others.129 This examination is heavily fact dependant because of the varying forms of business and is generally unaffected by whether an investor bargained for a fixed or variable return. Investors offered a variable return in Howey, for example, relied solely on the efforts of others by giving Howey-in-the-Hills Service, Inc “full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops.”130 Investors retained no right to specific crops, no right of entry to market any crops and held such small

126 Howey, 328 U.S. at 300 (concluding that “arrangements whereby the investors’ interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed”).
127 ETS Payphones, 300 F.3d at 1285.
129 Alabanese v. Florida Nat’l Bank of Orlando, 823 F.2d 408, 410 (11th Cir. 1987) (holding that an investment scheme under which purchases of ice machines were considered investment contracts primarily because the company, not purchaser, maintained, serviced, managed, and operated the machines even where investors were allowed to select the locations).
130 Howey, 328 U.S. at 296.
parcels that any attempt to cultivate a grove without the service company would have proven unprofitable. Similarly, investors promised a fixed return in Edwards retained no right to select payphone sites, collect coin revenues, install equipment, or to maintain payphones. In fact, investors never even saw the telephones “and often did not even know where they were located.”131 Thus regardless of whether an investment scheme offers a fixed or variable return, an investor’s retention of control determines if his investment depends solely on the efforts of others and not the benefit of his bargain.

B. Consequences of Broadening Howey to Include Fixed-Return Schemes

Broadening Howey to include schemes promising a fixed return is not without consequences, however. The dissenters in United Housing recognized no distinction between stock and investment contracts and readily admitted that the attributes leading to a conclusion that the shares in the housing Co-op were stock also lead to a conclusion that the shares were investment contracts under the Securities Acts.132 Thus the distinction between stock and an investment contract has vanished and left the two terms superfluous under the Securities Acts. Broadening Howey further erases the distinction between a note and an investment contract.

The primary distinction between debt and equity investments are the rights, preferences, and privileges entitled to the holder. Generally, debt holders stand first in line with other creditors, and thus while they do not participate in the upside potential of an investment, they usually contractually limit their risk by guaranteeing a fixed return. Equity holders, on the other hand, generally stand behind creditors and are only entitled to remaining profits and assets. While equity holders therefore assume greater risk, their variable return may turn out to be much

131 Edwards, 123 F.Supp.2d at 1354.
132 United Housing, 421 U.S. at 866 (Brennan, J., dissenting) (“[T]he presence of the attributes that leads me to conclude that this stock constitutes an investment contract, lead me also to conclude that it is a ‘stock’ for purposes of the two statutes.”) (quotations in original).
greater. Thus, traditionally fixed returns could have been classified as debt securities and variable returns as equity securities. By extending Howey’s definition of an investment contract to include schemes promising a fixed return, the distinction between a note and an investment contract has vanished and left the two terms superfluous under the Securities Act. Thus, the overreaching definition of an investment contract has become the last security standing.

Moreover, broadening Howey to include schemes promising fixed returns also impliedly adopts broad vertical commonality as an appropriate standard under which to find a common enterprise. As previously mentioned, schemes promising fixed returns inherently require that the fortunes of each investor are not inextricably intertwined with those of other investors because there is generally no pooling of funds or risk. An individual investor’s retention of the right to a fixed return generally destroys horizontal commonality, and thus Howey’s second and third elements collapse into one leaving the test intrinsically redundant.

But the sale-and-leaseback scheme in Edwards ought to fall within the reach of the Securities Acts because it is probably one of the “countless and variable schemes devised by those who seek to use the money of others on the promise of profits” from which Congress

---

133 See Cody, Comment: The Dysfunctional "Family Resemblance" Test: After Reves v. Ernst & Young, When are Mortgage Notes "Securities"?, 42 Buff. L.Rev. 761, 789 (suggesting that the Howey test has become the federal courts’ test of choice for a variety of instruments, including those specifically enumerated in the Securities Act such as stocks and notes); Globerman, Casenote: The Elusive and Changing Definition of a Security: One Test Fits All, 51 Fla. L.Rev. 271, 292 (noting that Howey is the rudimentary definition of a security and thus it ought to define all forms of securities under the Securities Acts).

134 ETS Payphones, 300 F.3d at 1285—86 (Kay, J., concurring). See also Loewenstein, The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law, 39 Ind. L.Rev. 17, 36 (suggesting that the Court’s refusal to address the issue in Edwards can be interpreted as an adoption of vertical commonality or a removal of the commonality element all together).

135 SEC v. Infinity Group Co., 212 F.3d 180, 188 (3rd Cir. 2000) (defining horizontal commonality as the pooling of funds such that individual investors share all the risks and benefits of the enterprise). See also ETS Payphones, 300 F.3d at 1284 n.2. But see Globerman, Casenote: The Elusive and Changing Definition of a Security: One Test Fits All, 51 Fla. L.Rev. 271, 287-88 (“[T]he reach of the Securities and Exchange Acts should cover all transactions that attempt to defraud public investors. It should not matter whether the scheme involves one investor and one promoter, as in vertical commonality situations, or multiple investors pooling their assets to derive a profit allocable to all investors, as in a horizontal commonality scheme.”); Gordon, Common Enterprise and Multiple Investors: A Contractual Theory For Defining Investment Contracts and Notes, 1988 Colum. Bus. L.Rev. 635, 636 (arguing that a multiplicity test would be the proper balance in between vertical and broad commonality).

sought to protect the investing public. The problem is thus not whether Congress intended to include the Edwards’ scheme within its definition of security, rather the strict test the Court created under which to make its determination. By endorsing an elemental, conjunctive standard that seeks to define objective terms, a security like the scheme in Edwards may fall within Congress’ intent, but outside a reasonable expansion of Howey. The Court should have therefore abandoned Howey’s objective approach as the appropriate determination of an investment contract under the Securities Acts and adopted a contextual, malleable examination into the facts and circumstances of each investment scheme.

On the other hand, a contextual, malleable examination of facts and circumstances may provide little guidance for promoters to determine for themselves whether an investment falls under the Securities Acts. After broadening Howey’s objective elements and carving out several exceptions however, our current standard provides just as little guidance. Adjudicating

---

137 Howey, 328 U.S. at 299. The significance of properly defining a security is better understood with the significance of investment in the United States. See generally Darlene S. Wood, Casenote: Lease-back Arrangements are Investment Contracts and Therefore Securities Under the Securities Acts: SEC v. Edwards, 7 Duq. B.L.J. 135, 149 (suggesting that between 1929 and 1990, the number of investors over 30 fold and the percentage of the U.S. population owning stock increased from 1.2% to 21.1% and thus the need for investor protection has never been greater).

138 See Reves, 494 U.S. at 63 n.2 (“One could question whether, at the expense of the goal of clarity, Congress overvalued the goal of avoiding manipulation by the clever and dishonest. If Congress erred, however, it is for that body, and not this Court, to correct its mistake.”). See also Carney, Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis, 33 Emory L.J. 311 (arguing that the Supreme Court should address the open question of whether the investment contract analysis applies to all financial instruments or just those listed in the statutory definition).

139 See Kloos, Alter, & Stone, Securities Fraud, 43 Am.Crim.L.Rev. 921, 934 (“The case law is inconsistent and confusing with respect to the definition of a security. The Supreme Court has even admitted that its ‘cases have not been entirely clear on the proper method of analysis for determining when an instrument is a ‘security.’”’ (citing Landreth Timber Co. v. Landreth, 471 U.S. 681, 688 (1985)) (quotations in original). See also Loewenstein, The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law, 39 Ind. L.Rev. 17, 36 (arguing that the lack of clear responses from the U.S. Supreme Court regarding Howey’s common enterprise element has created much confusion in its interpretation); Van Huss v. Associated Milk Producers, Inc., 415 F. Supp. 356 (N.D. Tex. 1976) (“In the end one is left with the impression that he is dealing with an area of the law subject to wide variations, serious anomalies, and judicial disagreement, if not confusion. In short, the wealth of judicial writings on the subject has produced few discernible principles of decision.”); Carl W. Schneider, The Elusive Definition of a "Security": 1990 Update, 24 Rev. Sec. Commodities Reg. 13, 17 (1991) (“The constant heavy flow of litigation shows that much uncertainty remains in defining the term security . . . . There are many individual opinions that depart from [discernible] patterns, and, as in many areas of securities law, authority can be found for conflicting propositions. In
cases under a statute created “to regulate investments, in whatever form they are made and whatever name the are called” with a limiting standard amplifies confusion. In fact, by purposely not defining an investment contract in the Securities Acts or relevant legislative reports and not referencing any specific state blue sky laws, one may infer that Congress was not referring to any specific security at all. The appropriate judicial standard should thus not seek to define an investment contract with specific elements—rather, it should remain contextual, so as to provide “the investing public a full measure of protection.” Therefore, Howey’s elemental definition is not an appropriate standard under which to define an investment contract and thereby whether an investment falls within the Securities Acts.

C. Proposal to Adopt a More Contextual Standard

The Court has already rejected an elemental approach to define the term “note,” and thus the adoption of a contextual standard to define the term “security” is sensible. In Reves, the Court reasoned that the family resemblance test would provide lower courts the flexibility to
fulfill Congress’ purpose in enacting the Securities Acts without cramming square facts into the proverbial round standard of Howey.\textsuperscript{145} Howey was intended to provide predictability, certainty, and efficiency, and since much confusion has arisen instead, nothing would be lost by the shift to a more contextual analysis.\textsuperscript{146} In fact, Reves is evidence of the judicial success of adopting a contextual analysis to define a security because in the seventeen years since, not one case has come before the Supreme Court to determine whether a certain note qualifies as a security. Yet, several cases continue to appear as to whether certain investment schemes qualify as investment contracts and are thus securities within the reach of the Securities Acts.\textsuperscript{147}

The Court should thus adopt a contextual standard to determine whether an investment scheme falls within the reach of the Securities Acts. This standard would first examine whether an investment scheme qualifies as one of the specifically enumerated securities in the Securities Acts by contrasting the facts and circumstances to the common characteristics of those expressly listed.\textsuperscript{148} If the scheme does not fit qualify as one of the expressly listed securities, the standard

\textsuperscript{145} Reves, 494 U.S. at 66.

\textsuperscript{146} Supra, note 139.

\textsuperscript{147} See generally Howey, Edwards, Landreth Lumber, United Housing, Marine Bank, Teamsters. One may argue, however, that the Supreme Court is more likely to hear cases in which the definition of an investment contract is disputed simply because it is the catch-all term. Nevertheless, those cases inevitably involve the interpretation of a specific fact into one of Howey’s elements. But see Steinberg, Notes as Securities: Reves and Its Implications, 51 Ohio St. L.J. 675, 684 (reasoning that Reves’ contextual analysis is too indefinite for corporate planners to provide necessary guidance for commercial certainty); Page, Note: Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security, 1992 U.Ill. L.Rev. 249, 293—96 (arguing that Reves analysis leads securities law jurisprudence in the wrong direction when defining a security).

\textsuperscript{148} Section 2(a)(1) of the Securities Act of 1933 specifically defines security as “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”
would subsequently examine whether the scheme is of the sort Congress sought to regulate and whether the investor is of the group Congress meant to protect.  

149 This contextual standard would more appropriately provide courts with the flexibility Congress intended by defining the term security broadly to regulate “the virtually limitless scope of human ingenuity, especially in the creation of countless and variable schemes devised by those who seek to use the money of others on the promise of profits.”

150

1. Quintessential Securities

The first examination should be into whether the investment scheme in question shares the common characteristics of the specific securities enumerated in the Securities Acts. These securities may include a note, stock, bond, debenture, option, warrant, put, call, or certificate of deposit. Ample commentary exists to appropriately define each quintessential security. In

Section 3(a)(10) of the Securities Exchange Act of 1934 specifically defines security as any “any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”

149 See generally H.Rep.No.85, 73rd Cong., 1st Sess., p.11. See also Globerman, Casenote: The Elusive and Changing Definition of a Security: One Test Fits All, 51 Fla. L.Rev. 271, 281 (arguing that the Securities Acts' definition of a security is over inclusive because courts will disregard form and thus ignore the specific terms enumerated within the Acts anyway). But see McGinty, What is a Security, 1993 Wis. L.Rev. 1033, 1036 (arguing that the Court should instead develop a coherent set of tests for investment contracts, equity arrangements, and debt arrangements and thus separate investments from non-investments because the Securities Acts were designed to regulate only investments).

150 Reves, 494. U.S. at 60—61. See also Steinberg, Notes as Securities: Reves and Its Implications, 51 Ohio St. L.J. 675, 679 (arguing that Howey and Reves are quite similar because most the same considerations are made and thus guidance from Howey may still be applicable for determining whether a note is a security); Page, Note: Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security, 1992 U.Ill. L.Rev. 249 (arguing that the Securities Acts’ all inclusive and long-winded list of securities tends to define the vague with the ambiguous); Carney, Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis, 33 Emory L.J. 311 (arguing a market-oriented element should be included within the determination of if a scheme falls within the definition of a security).

151 Supra, note 146. But see See Globerman, Casenote: The Elusive and Changing Definition of a Security: One Test Fits All, 51 Fla. L.Rev. 271, 292 (suggesting that courts who hold transactions called one of the securities...
United Housing, for example, the Court suggested that some of the characteristics traditionally associated with stock are whether or not the instrument is negotiable, may be pledged, confers voting rights in proportion to the number of shares owned, and may possibly appreciate in value.\(^{152}\) Additionally, these characteristics may also include the right to receive dividends contingent upon an apportionment of profits and a claim in liquidation upon the remaining assets of a business enterprise.\(^{153}\) With reference to these and other characteristics, courts ought to be able to properly determine whether a scheme constitutes stock and thus a quintessential security.

Stock, however, is not the only quintessential security. Notes, for example, may also be quintessential securities.\(^{154}\) Consistent with Congress’ intent in enacting the Securities Acts and the Court’s interpretation thereof, not every note should qualify as a security.\(^{155}\) Section 3(a)(10) of the Securities Exchange Act of 1934, for example, limits the definition of note not to include any note whose maturity is less than nine months.\(^{156}\) Moreover, notes issued in consumer transactions are also generally found not to be included under the Securities Acts because of their purpose to regulate investments and not to place an onerous burden on commerce.\(^{157}\) The Court in Reves adopted the family resemblance test and outlined four determinations as to whether a note fell within the securities laws.\(^{158}\) Since the Reves test is consistent with the assertions made specifically enumerated in the Securities Acts are not securities create a false sense of security in the investing public because the Acts were designed to protect that body).

\(^{152}\) United Housing, 421 U.S. at 851.


\(^{154}\) Supra, note 146. See also Kloos, Alter & Stone, Securities Fraud, Am.Crim.L.Rev. 921, 935 (contrasting the different approaches to determine whether a stock and note are securities, although both may be considered quintessential securities).


\(^{156}\) Supra, note 146 (Noting that the definition of security “shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”)

\(^{157}\) Reves, 494 U.S. at 66 (“If the note is exchanged to facilitate the purchase and sale of a . . . consumer good . . ., the note is less sensibly described as a ‘security.’”).

\(^{158}\) Id. at 65. But see Page, Note: Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security, 1992 U.Ill. L.Rev. 249, 300 (arguing that the Court
in this Note, courts should continue to examine notes under the family resemblance test. Acting
under the presumption any note is covered within the Securities Acts, courts examine the
motivations behind each party for entering into the transaction, the plan of distribution, the
reasonable expectations of the investing public, and the existence of some other regulatory
scheme that renders the Securities Acts unnecessary.\textsuperscript{159} The family resemblance test provides
enough flexibility to courts to properly consider Congress’ purpose to include notes within the
Securities Acts but does not require courts to expand restrictive language to reach the proper
result.\textsuperscript{160}

In complex financial markets, however, the examination of whether an investment
scheme qualifies as a quintessential security is no easy task. The creations of various forms of
preferred stock and convertible debt have blurred the line between what might be considered
stock and what ought to be considered debt. However, the first step of the analysis proposed in
this Note only requires courts to determine whether the investment scheme shares the common
characteristics of a quintessential security. If the terms of a scheme are too complex to label as
“stock,” “note,” or any other quintessential security specifically listed, courts should then
proceed to determine whether the scheme is of the sort Congress sought to regulate by enacting
the Securities Acts.\textsuperscript{161}

2. More General Terms

\textsuperscript{159} Id. at 66 (recognizing also that the characteristics generally considered under the family resemblance test are not
\textsuperscript{160} Court have been given great flexibility to determine whether a certain note falls within the Securities Acts’ broad
definition without having to carve out specific exemptions. For example, short-term unsecured notes issued by a
bank to institutional investors, notes based on viatical contracts, notes packaged essentially as consumer loans with
enhancements, and notes issued to investors in exchange for bridge loans have all be determined to be outside the
scope of the securities laws under Reves’ family resemblance test. Kloos, Alter & Stone, Securities Fraud, 43
\textsuperscript{161} See generally H.Rep.No.85, 73rd Cong., 1st Sess., p.11.
To determine whether an investment scheme is of the sort Congress sought to regulate by enacting the Securities Acts, courts should examine a myriad of factors to determine whether application of the securities laws is appropriate. Such a contextual examination would abandon any attempt to explicitly define “investment contract” or “any instrument commonly known as a ‘security.’” Instead, this examination recognizes that Congress intended to paint with a large brush and had no intent of making reference to any specific form of security. These more general terms are nothing more than catch-all phrases to include any other investment scheme. Thus rather than continuing to restrictively define Howey’s objective elements, the second step of the analysis proposed in this Note suggests that the courts adopt instead a balancing test. Similar to the family resemblance test adopted in Reves to determine the reach of the term note, a contextual, balancing test could more appropriately examine whether an investment scheme is of the sort intended to be cast under the Securities Acts.

Courts should balance a myriad of factors to examine whether the securities laws are applicable and will most likely depend on the facts and circumstances of each context. Some

---

163 Reves, 494 U.S. at 60 (“In defining the scope of the market that it wished to regulate, Congress painted with a broad brush.”)
164 See generally Reves, 494 U.S. at 62—67; See also Cody, Comment: The Dysfunctional "Family Resemblance" Test: After Reves v. Ernst & Young, When are Mortgage Notes "Securities"?, 42 Buff. L.Rev. 761, 796—97 (praising Reves for resolving the inherent ambiguities in the circuit courts’ differing tests for determining whether notes are securities and thereby increasing outcome predictability); Steinberg, Notes as Securities: Reves and its Implications, 51 Ohio St. L.J. 675 (1990) (arguing that Court's decision in Reves, although far from being a model of clarity, helps to resolve ambiguities in this area); Simmons, When Are Notes Securities?: Adding Certainty to the Process of Defining A Security Under the Federal Securities Laws, 22 U.Tol. L.Rev. 1119 (1991) ("[Reves] is easy to apply . . . . This should add consistency and predictability to the subject . . . ."); Warren, The Treatment of Reves "Notes" and Other "Securities" Under State Blue Sky Laws, 47 Bus. Law. 321, 332 (1991) ("[Reves, and the adoption of its test by state courts,] will result in greater uniformity among the states and among the state and federal regulatory regimes."); But see Cody, Comment: The Dysfunctional "Family Resemblance" Test: After Reves v. Ernst & Young, When are Mortgage Notes "Securities"?, 42 Buff. L.Rev. 761, 798—99 (citing several criticism of Reves, including lack of direction for courts as to the weight between the four factors to balance and that Reves is simply a re-hash of Howey’s elements); Page, Note: Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security, 1992 U.Ill. L.Rev. 249 (“[T]he Supreme Court has stumbled into a line of analysis that not only muddies the concept of a security under the securities laws, but also does not provide the guidance necessary to accurately identify a security in a case involving anything more than an easily identifiable instrument at either extreme.”).
factors may include whether the investing public can reasonably assume that the securities laws apply\textsuperscript{165}, whether any other regulatory scheme would deem the securities laws unnecessary\textsuperscript{166}, whether the circumstances surrounding the transaction require the protection of the securities laws\textsuperscript{167}, whether an interest in tangible property was taken\textsuperscript{168}, whether the purchaser was made for personal use or consumption\textsuperscript{169}, whether the investor remained involved in the managerial operations of the enterprise\textsuperscript{170}, whether the transaction was in a commercial, consumer, or investment context\textsuperscript{171}, and whether the investment is easily negotiable or liquidated\textsuperscript{172}. These few considerations are certainly not exclusive and merely represent some of the concerns raised by the Court as to whether the Securities Acts ought to apply.\textsuperscript{173}

At the center of these concerns are the justifications for concluding that several investment schemes lay outside the reach of the Securities Acts. \textit{United Housing}, for example, suggests that where an investment is used for personal consumption, the securities laws ought

---

\textsuperscript{165} See \textit{United Housing}, 421 U.S. at 850—51 (suggesting that occasions may arise where the name of an instrument is dispositive because the purchaser may justifiably assume that the federal securities laws apply); Globerman, \textit{Casenote: The Elusive and Changing Definition of a Security: One Test Fits All}, 51 Fla. L.Rev. 271, 292 (suggesting that all schemes called one of the specifically enumerated securities in the Acts ought to fall with the statutes broad reach to protect the investing public from misunderstanding). But see Page, Note: \textit{Even After Reves, Securities Do Not Have Families: Returning to Economic and Legal Realities Through a Connotative Definition of a Security}, 1992 U.Ill. L.Rev. 249, 283 (arguing that public expectations of whether the Securities Acts apply is an inappropriate consideration).

\textsuperscript{166} See \textit{Marine Bank}, 455 U.S. at 557—59.

\textsuperscript{167} See \textit{United Housing}, 421 U.S. at 867 (Brennan, J., dissenting) (arguing that the federal securities laws ought to apply because the group of investors required the laws protection); See also Park McGinty, The Limited Liability Company: Opportunity for Selective Securities Law Deregulation, 64 U.Cin. L.Rev. 369, 440 (1996) (arguing that privately negotiation instruments are weaker candidates for securities regulation).

\textsuperscript{168} See \textit{Reves}, 494 U.S. at 67 (suggesting the presence of another regulatory scheme may prevent the application of the federal securities laws); See also Teamsters v. Daniel, 439 U.S. 551, 569—70 (1979) (reasoning that a pension plan may not qualify as a security because of federal regulation under ERISA).

\textsuperscript{169} See \textit{United Housing}, 421 U.S. at 852—53 (reasoning that where an investment is made for personal use or consumption, the investment may not be a security).

\textsuperscript{170} See Albanese, 823 F. 2d at 410 (suggesting that the ability to control the profitability of an investment may determine whether that investment qualifies as a security).

\textsuperscript{171} See \textit{Reves}, 494 U.S. at 67 (analyzing the context in which an investment is made).

\textsuperscript{172} See \textit{Landreth Lumber}, 471 U.S. at 694 (noting that liquidity and negotiability are common characteristics of securities and should thus be dispositive of whether a scheme qualifies as such).

\textsuperscript{173} Supra, notes 164 to 171
not apply.\textsuperscript{174} Moreover, \textit{Landreth Timber} suggests that a public expectation that stocks are regulated under the Securities Acts may sweep such an investment under the Securities Acts even where an economic analysis suggests otherwise.\textsuperscript{175} Lastly, \textit{Teamsters v. Daniel} suggests that a pension plan may not fall under the Securities Acts because such are regulated by the Employment Retirement Income Security Act of 1974 and would thereby undermine the requirements of the securities laws.\textsuperscript{176} Therefore, although subjective and highly fact sensitive, the second step of this contextual analysis does not render the Court’s previous decisions meaningless because these decisions are generally spotted with rational justifications for applying the Securities Acts. Rather, this analysis provides courts enough flexibility to justify an appropriate application of the Securities Acts but would not require broadening or contracting the objective definitions of terms even Congress did not seek to define.\textsuperscript{177}

V. CONCLUSION

This Note has asserted that while the Court in \textit{Edwards} correctly concluded that schemes promising a fixed return may fall under the Securities Acts, the Court failed to seize an opportunity to abandon \textit{Howey}’s elemental, conjunctive standard and instead to adopt a contextual, malleable analysis that considers the totality of each investment scheme. Though instruments offering a fixed return may certainly be considered securities or even investment contracts, \textit{Howey}’s restrictive elements may not catch such a scheme. Instead, the Court should simply consider whether the facts and circumstances suggest the scheme is one of the quintessential securities listed in the Securities Acts or whether it is of the sort Congress intended

\textsuperscript{174} United Housing, 421 U.S. at 837.  
\textsuperscript{175} Landreth Lumber, 471 U.S. at 693.  
\textsuperscript{176} Teamsters, 439 U.S at 569—70.  
\textsuperscript{177} See Brown & Barton, Securities Regulation, 56 Mercer L.Rev. 1341 (arguing that courts will continue to interpret the definition of a security broadly to capture as many investment schemes as possible and will thus preserve the breadth and flexibility within \textit{Howey}’s elements).
to regulate by enacting the federal securities laws. Because of the financial, legal and economic sophistication of promoters today, the Court ought not limit its standard to restrictive elements—rather, it should evaluate each scheme under the inclusive definition Congress provided. Thus while the Supreme Court correctly determined in *Edwards* that an investment scheme promising a fixed return may be considered an investment contract, it failed to answer a ringing opportunity to clarify the reach of a security under the Securities Acts.