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What is a Security? -- A Redefinition Based on Eligibility to Participate in the Financial Markets

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What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets

Scott FitzGibbon*

I. INTRODUCTION

People generally believed in the 1930s, as they do today, that the Great Depression was caused by a malfunctioning of the securities markets.1 It was under the impetus of this belief that President Roosevelt proposed and Congress passed the early New Deal securities laws—the Securities Act of 1933 (the Securities Act),2 and the Securities Exchange Act of 1934 (the Exchange Act).3 "Whatever may be the full catalogue of the forces that brought to pass the present depression," stated the House Report on the Securities Act, "not [the] least among these has been [the] wanton misdirection of the capital resources of the Nation" through the flotation of vast quantities of worthless securities.4 As one result, the Senate Report

* Assistant Professor of Law, Boston College Law School. It was because I was in the midst of producing this Article that I was unable to contribute to the Minnesota Law Review's memorial issue for Professor J. Morris Clark, which was published in March. I therefore dedicate this Article to his memory.

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1. See text accompanying notes 80-94 infra.


noted, capital, or some of it, grew "timid to the point of hoarding."\textsuperscript{5}

The Securities Act, the Exchange Act, and (to a lesser extent) subsequent securities laws\textsuperscript{6} are largely revisions of the law of contracts.\textsuperscript{7} They attempt to handle with special strictness and specificity, in the area of securities transactions, traditional contract law problems such as defective disclosure, unequal access to information, and abuse of relationships of trust and dependence.\textsuperscript{8}

The development of contract law into branches identified according to either the nature of the items or services transferred or the nature of the relationships established was famil-

\textsuperscript{5} S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933), reprinted in 2 LEGISLATIVE HISTORY, supra note 2, Item 17, at 1. For a statement that the securities laws were enacted because of the belief that the Crash had caused the Great Depression, see R. POSNER, ECONOMIC ANALYSIS OF LAW 331 (2d ed. 1977).


\textsuperscript{7} President Roosevelt, in his 1933 message to Congress proposing securities legislation, stated: "This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.'" H.R. Doc. No. 12, 73d Cong., 1st Sess. 1 (1933), reprinted in 2 LEGISLATIVE HISTORY, supra note 2, Item 15, at 1.

\textsuperscript{8} For example, the contract law prohibition of false statements by one party to the other is reproduced and extended to certain parties not in privity, and the contract law regarding nondisclosure is made stricter, by the many provisions that prohibit various parties from making "an untrue statement of a material fact or [omitting] to state a material fact necessary to make the statements . . . made not misleading." This prohibition or one much like it appears, among other places, in sections 11(a) and 12(2) of the Securities Act, 15 U.S.C. §§ 77k(a), 77l(2) (1976), and in rule 10b-5 (promulgated under the Exchange Act), 17 C.F.R. § 240.10b-5(b) (1979), reprinted in 3 FED. SEC. L. REP. (CCH) ¶ 26,744 (1978). Detailed rules setting forth what affirmative disclosures certain parties must make, and how and when they must make them, are the focus of the Securities Act, especially of its registration and prospectus provisions. Similar concerns figure prominently in the Exchange Act and the Investment Company Act.

The common law principles that fall under the heading of "fiduciary duties" are supplemented in securities law by several different types of provisions: provisions that prohibit market institutions and corporate insiders from engaging in certain transactions that might tempt them to harm customers or the public, see, e.g., 17 C.F.R. § 240.10b-6 (1979) (rule 10b-6 promulgated under the Exchange Act), reprinted in 3 FED. SEC. L. REP. (CCH) ¶ 26,745 (1978); provisions that require the insider or institution to give a preference to members of the public, see, e.g., 17 C.F.R. § 240.11a-1(T) (1979) (rule 11a1-1(T) promulgated under the Exchange Act), reprinted in 3 FED. SEC. L. REP. (CCH) ¶ 26,756 (1978); and provisions that impose special disclosure obligations when adversity of interest may exist, see, e.g., 17 C.F.R. § 240.10b-10 (1979) (rule 10b-10 promulgated under the Exchange Act), reprinted in 3 FED. SEC. L. REP. (CCH) ¶ 26,749 (1978).
DEFINITION OF SECURITY


10. For example, it has been said that the most widely adopted test for determining when notes are securities—"notes" being one of the most common and important categories likely to give rise to serious disagreement under the language of the statute—"does not provide a predictive standard" and that it "can only result in an arbitrary application of the securities acts in many cases." Pollock, Notes Issued in Syndicated Loans—A New Test to Define Securities, 32 BUS. LAW. 537, 541-42 (1977).

11. During the first six months of 1979, for example, decisions of federal courts reflected continuing controversy over whether the following arrangements involved securities: a mortgage loan from a savings and loan association to a real estate developer, e.g., First Fed. Sav. & Loan Ass'n v. Mortgage Corp., 467 F. Supp. 943 (N.D. Ala. 1979); interests in various sorts of employee retirement plans, e.g., International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); Black v. Payne, 591 F.2d 83 (9th Cir.), cert. denied, 100 S. Ct. 139 (1979); Tanaggi v. Grolier Inc., 471 F. Supp. 1209 (S.D.N.Y. 1979); a lease of premises for a retail shop in a shopping center, e.g., Cordas v. Specialty Restaurants, Inc., 470 F. Supp. 780 (D. Or. 1979); loans to a business evidenced by its promissory notes, e.g., Ross v. Popper, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,888 (S.D.N.Y. 1979); certificates of deposit, passbooks, and similar instruments issued by banks, e.g., Hamblett v. Board of Sav. & Loan Assoc., 472 F. Supp. 158 (N.D. Miss. 1979); Hendrickson v. Buchbinder, 465 F. Supp. 1250 (S.D. Fla. 1979); a discretionary trading account in commodity futures, e.g., Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311 (S.D. Ohio 1979); an arrangement for participation in a mail advertising venture, e.g., SEC v. Paro, 468 F. Supp. 635 (N.D.N.Y. 1979); a bank participation in a trust company loan to a business, e.g., Provident Nat'l Bank v. Frankford Trust Co., 468 F. Supp. 448 (E.D. Pa. 1979); notes deposited in connection with a franchise arrangement, e.g., Principe v. McDonald's Corp., 463 F. Supp. 1149 (E.D. Va. 1979); a sale of stock in connection with an agreement under which the purchaser was to become ex-
an area of law where obscurity and vagueness can disrupt fundamental business relationships, this is an expensive anomaly.

This Article is devoted to the development of a clear definition of the term "security" as it is used in the Securities Act and the Exchange Act.12

II. THE DEVELOPMENT AND CURRENT STATE OF THE DEFINITION OF "SECURITY"

A. THE CASE LAW

The definitions of "security" in the principal securities laws13 and in the proposed Federal Securities Code14 are simi-

ecutive vice president of the issuer, e.g., Coffin v. Polishing Machs., Inc., 596 F.2d 1202 (4th Cir.), cert. denied, 100 S. Ct. 142 (1979); and limited partnership interests in an intended tax shelter, e.g., Bartels v. Algonquin Properties, Ltd., 471 F. Supp. 1132 (D. Vt. 1979). In a clear majority of these cases, it would have been difficult for anyone to predict the result, and in none was a decision articulated that is likely to afford much predictability. In all of the cases, considerable ranges of neighboring questions remain unresolved.


13. "Security" is defined in the Securities Act as follows:

When used in this title, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or in general, any interest or instrument commonly known as a
lar to one another, and consist of categories of securities such as

“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.

Act as follows:

When used in this chapter, unless the context otherwise requires—

(10) The term “security” means any note, stock, treasury stock,
bond, debenture, certificate of interest or participation in any profit-
sharing agreement or in any oil, gas, or other mineral royalty or lease,
any collateral-trust certificate, preorganization certificate or subscrip-
tion, transferable share, investment contract, voting-trust certificate,
certificate of deposit, for a security, or in general, any instrument com-
monly known as a “security”; or any certificate of interest or participate-
in, temporary or interim certificate for, receipt for, or warrant or
right to subscribe to or purchase, any of the foregoing; but shall not in-
clude currency or any note, draft, bill of exchange, or banker’s accept-
ance which has a maturity at the time of issuance of not exceeding
nine months, exclusive of days of grace, or any renewal thereof the ma-
turity of which is likewise limited.


The Investment Company Act and the Advisers Act contain definitions
identical to that in the Securities Act. See Investment Company Act of 1940,
§ 2(a)(36), 15 U.S.C. § 80a-2(a)(36) (1976); Investment Advisers Act of 1940,
by reference the Securities Act definition. Trust Indenture Act of 1939, § 303(1),
contains a definition similar to those in the Securities Act and the Exchange

14. “Security” is defined in the proposed code as follows:

(a) [General] “Security” means a bond, debenture, note, evidence
of indebtedness, share in a company (whether or not transferable or
denominated ‘stock’), preorganization certificate or subscription, in-
vestment contract, certificate of interest or participation in a profit-
sharing agreement, collateral trust certificate, equipment trust certifi-
cate (including a conditional sale contract or similar interest or instru-
ment serving the same purpose), voting trust certificate, certificate of
deposit for a security, or fractional undivided interest in oil, gas, or
other mineral rights, or, in general, an interest or instrument com-
monly considered to be a “security,” or a certificate of interest or par-
ticipation in, temporary or interim certificate for, receipt for, guarantee
of, or warrant or right to subscribe to or buy or sell, any of the forego-

(b) [Exclusions] Notwithstanding section 299.53(a), “security”
does not include (1) currency, (2) a check (whether or not certified),
draft, bill of exchange, or bank letter of credit, (3) a note or evidence of
indebtedness issued in a primarily mercantile or consumer, rather than
investment, transaction not involving a distribution . . . , (4) an inter-
est in a deposit account with a bank (but not a participation in such
interests), (5) . . . a bank certificate of deposit that ranks on a parity
with an interest in a deposit account with the bank, (6) an insurance
policy (including an endowment policy) issued by an insurance com-
pany, (7) an annuity contract (including an optional annuity contract
under which the insurance company promises to pay one or more sums
of money that are fixed or vary in accordance with a cost-of-living in-
dex or on any other basis specified by rule, (8) a commodity contract
(whether for present or future delivery) or warrant or right to buy or
as "debentures," "notes," and "shares in a company," joined with elastic clauses such as "unless the context otherwise requires" and "any instrument or interest commonly known as a 'security.'" The extreme flexibility of these provisions, and the absence of any apparent efforts on the part of the draftsmen to express common concepts or principles in the definitions,\(^5\) provide an invitation to courts to develop a set of coherent guidelines.

The leading Supreme Court effort to develop such guidelines is *SEC v. W.J. Howey Co.*,\(^6\) in which the Court determined that sales contracts for plots of orchard land and contracts to service the fruit trees constituted securities for purposes of the Securities Act. The defendants were two sister corporations, one of which owned large tracts of citrus groves in Florida, and the other of which cultivated the groves and serviced them in various ways. To obtain financing, the company that owned the land offered plots of trees to the public, especially to guests at a nearby resort hotel owned by one of the defendants. These guests were primarily business and professional people from out of state. They and others were offered small plots arranged in long, narrow strips so that an acre, for example, consisted of a row of forty-eight trees. Offerees were encouraged to enter into a ten-year contract with the service company under which the service company took a leasehold interest in the land and assumed full discretion and authority for cultivating, harvesting, and marketing the crops. The purchasing "owner," after entering into the contract, had no right to any specific fruit; his right was limited to a portion of the profits determined on the basis of the amount of fruit harvested from his plot.\(^17\)

The Court held that the arrangements involved securities

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\(^5\) For a discussion of the similar "commercial-investment" distinction, see text accompanying notes 147-169 infra.  
\(^6\) *SEC v. W.J. Howey Co.*, 151 F.2d 714, 717 (5th Cir. 1945), rev'd, 328 U.S. 293 (1946).
for purposes of the registration and disclosure provisions of the Securities Act. Writing against the background of the expansive interpretation given the term "investment contract" under state securities laws, Justice Murphy observed that the term "security" was defined by the statute to include an "investment contract," which meant "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." This formulation, still generally considered to be the classic definition, was held to encompass the

18. The principal state case on which Justice Murphy relied was State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920), in which the court broadly stated that "investment" for purposes of the definition of "investment contract" in the state securities laws included "the placing of capital or laying out of money in a way intended to secure income or profit from its employment." Id. at 56, 177 N.W. at 938. See SEC v. W.J. Howey Co., 328 U.S. at 298. State securities laws had been enacted under the impetus of the progressive movement and in aid of business interests in the enacting states. See generally M. Parrish, Securities Regulation and the New Deal (1970). Their purposes were understood by courts to be very broad, and not particularly connected with the protection of a market in securities. The court in Gopher, for example, said that "the purpose of the statute is to protect the public against imposition." 146 Minn. at 55, 177 N.W. at 938. The court in Vercellini v. U.S.I. Realty Co., 158 Minn. 72, 74, 196 N.W. 672, 672 (1924), stated that "Blue Sky Laws are intended to protect one class of individuals from the imposition of another class." The term "investment contract" made its way into state securities laws (and from them into the federal laws) as part of an effort to regulate purported sales of out-of-state land. Note, Pension Plans as "Investment Contracts," 96 U. Pa. L. Rev. 549, 553 (1948).


20. For the twenty years following Howey, the Supreme Court was almost silent as to the definition of the term "security." But see SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (holding, without discussion, that variable annuity contracts constituted securities). When the Court broke its silence in SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967), it applied the "character in commerce" language of SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1944), and, in an opinion by Mr. Justice Harlan, did not even mention Howey. The Howey test became unpopular among the commentators. See, e.g., Long, An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation, 24 Okla. L. Rev. 135, 177 (1971) (describing Howey as "tragic"); Tew & Freedman, In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship between an Issuer of Securities and the Security Purchaser, 27 U. Miami L. Rev. 407, 448 (1973) (remarking with regret that "criticism of Howey is a mark of progressive thought"). Nevertheless, the case was very widely followed in the lower courts, and the Supreme Court in United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975), stated that the Howey test "embodies the essential attributes that run through all of the Court's decisions defining a security."

It should be noted that the Howey Court was not defining "security" in general, but rather "investment contract," which is a portion of the statutory definition of "security." Thus, it would be consistent with a very restrictive reading of Howey for a court to hold that an instrument which had failed the Howey test was a security under some other portion of the definition, or to hold that an instrument which had passed the Howey test was nevertheless not
fruit grove arrangements because such arrangements really involved "an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents." The offerees "have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment." The Court concluded that in view of these facts,

all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts . . . .

As with many leading cases, the Court's opinion in Howey has undergone a type of common law codification, or has been regarded by some lower courts as codified. The definition of an "investment contract" has become known as the "three-prong test" of Howey: An "investment contract" is (1) an investment of money (2) in a common enterprise from which one is led to expect (or does expect) profits (3) solely from the efforts of others. A literal application of the test, however, would lead to unacceptable results. The test seems to produce the result that whenever one puts funds in the hands of others in the hope of gain, one is purchasing a security, at least so long as one does not assist in the efforts of the recipients to use the funds productively. (Indeed, it is widely accepted today that some such assistance will not disqualify the instrument.) The test pro-

a security because of the introductory phrase in the definition—"unless the context otherwise requires." See, e.g., Daniel v. International Bhd. of Teamsters, 561 F.2d 1223, 1265 (7th Cir. 1977) (describing the Howey test as the "first hurdle"), rev'd, 439 U.S. 531 (1979). In most instances, however, the Howey test has been determinative. For a close analysis of the extent to which the Howey test applies to other than "investment contracts," see Braniff Airways, Inc. v. LTV Corp., 479 F. Supp. 1279, 1283-86 (N.D. Tex. 1979) (concluding that the test is "at least relevant" there).

21. 328 U.S. at 299.
22. Id. at 300.
23. Id.
24. See, e.g., SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974) (holding that pyramid marketing scheme, in which "investor's" profits were partly a product of his own selling efforts, involved a security because "the critical inquiry is 'whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise'") (quoting SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973)); Securities Act Release No. 5347, 38 Fed. Reg. 1735 (1973), reprinted in [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,163 (stating that condominiums offered in conjunction with servicing arrangements can constitute securities because, inter alia, "an investment contract may be present in situations where an investor is not wholly inactive"). The Supreme Court in For-
vides no way to avoid the conclusion that virtually all loans involve securities, including commercial loans from banks, secured revolving credit loans from credit companies, and consumer loans to individuals. Similarly, the Howey rubric might require the conclusion that a dealer has purchased a security by making advance payments under a contract for the supply of goods. The goods represent a benefit to the dealer arising from the efforts of the supplier; the dealer expects a "profit" in that the benefit of the goods will be greater than their cost. Moreover, how are we to avoid the conclusion that the result in Howey would have been the same if the leaseback and servicing arrangements had not related to adjacent strips of fruit trees but instead covered entire farms, and, indeed, that it would have been the same if there had been no servicing arrangement but instead merely a sale and leaseback?

Considerations such as these have led to many efforts to modify and reinterpret the three-prong test, the most important of which are the Supreme Court decisions in United Housing Foundation, Inc. v. Forman and International Brotherhood of Teamsters v. Daniel. In Forman, prospective tenants of Co-op City, a publicly financed low-income housing project that was organized as a cooperative, were required, as a condition of occupancy, to purchase shares of "stock" in the nonprofit corporation that owned and operated the land and buildings. A prospective tenant had to purchase eighteen shares per room at $25 per share, for a total of $1,800 for a four-room apartment. The nature of this stock was described by the Court as follows:

The sole purpose of acquiring these shares is to enable the purchaser to occupy an apartment in Co-op City; in effect, their purchase is a recoverable deposit on an apartment. The shares are explicitly tied to the apartment: they cannot be transferred to a non-tenant, nor can they be pledged or encumbered, and they descend, along with the apartment, only to a surviving spouse. No voting rights attach to the shares as such: participation in the affairs of the cooperative appertains to the apartment, with the residents of each apartment being entitled to one vote irrespective of the number of shares owned.

Any tenant who wants to terminate his occupancy, or who is forced to move out, must offer his stock to Riverbay at its initial selling price of $25 per share. In the extremely unlikely event that Riverbay declines to repurchase the stock, the tenant cannot sell it for more than the initial purchase price plus a fraction of the portion of the mortgage

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25. For a discussion of debt instruments, see text accompanying notes 144-182 infra.
that he has paid off, and then only to a prospective tenant satisfying
the statutory income eligibility requirements.\textsuperscript{28}

Some of the tenants sued the nonprofit corporation and the
state, alleging violations of rule 10b-5 and other antifraud provi-
sions of the securities laws arising from misstatements of
financial arrangements relevant to the likelihood and amount of
rent increases. The Court held that, despite the fact that the
instruments in question were called "stock," they should be
tested by reference to "economic realities" and that under such
an approach, they were not securities.\textsuperscript{29} The Court discovered
two major aspects of the Co-op City arrangements that caused
them to fail the \textit{Howey} test. First, the return sought by the
supposed investors was in the form of a right to occupy apart-
ment space. "What distinguishes a security transaction—and
what is absent here—is an investment where one parts with his
money in the hope of receiving profits from the efforts of
others, and not where he purchases a commodity for personal
consumption or living quarters for personal use."\textsuperscript{30} The right to
occupy apartment space was not, the Court indicated, a "financial
return."\textsuperscript{31} In addition, the Court analyzed the manner in
which the issuing corporation hoped to earn returns that could
be passed along to the tenants as rent reductions. After re-
marking that "[b]y profits, the Court has meant either capital
appreciation resulting from the development of the initial in-
vestment . . . or a participation in earnings resulting from the
use of investors' funds,"\textsuperscript{32} the Court stated:

The Court of Appeals also found support for its concept of profits in
the fact that Co-op City offered space at a cost substantially below the
going rental charges for comparable housing. Again, this is an inappro-
priate theory of "profits" that we cannot accept. The low rent derives
from the substantial financial subsidies provided by the State of New
York. This benefit cannot be liquidated into cash; nor does it result
from the managerial efforts of others. In a real sense, it no more em-
 bodies the attributes of income or profits than do welfare benefits, food
stamps, or other government subsidies.

The final source of profit relied on by the Court of Appeals was the
possibility of net income derived from the leasing by Co-op City of
commercial facilities, professional offices and parking spaces . . . . The
income, if any, from these conveniences . . . is to be used to reduce
tenant rental costs. [But] this income . . . is far too speculative and in-
substantial to bring the entire transaction within the Securities Acts.\textsuperscript{33}

As a result, the expectation-of-profits prong of the \textit{Howey} test

\textsuperscript{28} 421 U.S. at 842-43 (1975) (footnotes omitted).
\textsuperscript{29} \textit{Id.} at 848-52, 858.
\textsuperscript{30} \textit{Id.} at 858.
\textsuperscript{31} \textit{Id.} at 853.
\textsuperscript{32} \textit{Id.} at 852.
\textsuperscript{33} \textit{Id.} at 855-56.
was not satisfied; this prong was interpreted by the Court to require that the profits hoped for by the supposed investor be “derived from the entrepreneurial or managerial efforts of others.”

Although the Court’s opinion in Forman never explicitly departed from Howey, it might be viewed as adding two new requirements: first, that the return be “financial” in form or at least not be something to be consumed; and second, that the activities engaged in by the issuer—the activities which put it in a position to furnish the return—be predominantly “entrepreneurial and managerial.”

Daniel, the second major Supreme Court case interpreting Howey, dealt with the issue of whether an interest in the Teamsters’ Union Pension Fund was a security. The fund was established out of contributions made by employers of Teamsters; collective bargaining agreements required these employers to make payments to the fund in proportion to the number of Teamsters that they employed. The plan did not permit employees to opt out, nor did it in general contemplate their making contributions on their own behalves. Upon retirement, an eligible employee received a pension in a fixed amount determined according to a formula that took into account anticipated employer contributions, anticipated performance of the investments made, and the anticipated amount of other pensions. The Supreme Court held that “the Securities Acts do not apply to a noncontributory, compulsory pension plan,” and that consequently the employee did not have a cause of action under the antifraud provision of the securities laws.

The Court first reasoned that the “investment of money” requirement of Howey was not satisfied. The plaintiff argued

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34. Id. at 852 (emphasis added).
35. The Supreme Court prominently described the plan as “noncontributory.” 439 U.S. at 553. For a further discussion of employee benefit plans, see text accompanying notes 183-191 infra.
36. The fund was administered by trustees who invested the assets. 439 U.S. at 561.
37. For a description of the Teamster plan and the various types of tax-qualified employee benefit plans, see Kelly, Securities Regulation of Retirement Plans After Daniel, 10 Loy. Chi. L.J. 631, 635-40 (1979). See also note 184 infra.
38. 439 U.S. at 570.
that although the employee normally made no direct payment of any kind into the fund, the requirement was satisfied because the employer contributed money, and the employee induced him to do so by working. The Court did not explicitly reject this argument; it did not state that indirect payments or payments in services rather than in cash could never satisfy the requirement. Rather, it appeared to rest its conclusion on the impossibility of distinguishing, in either the consideration furnished by the employee to the employer or the payment by the employer to the fund, a separable element constituting consideration for the supposed security. The Court’s reasoning in this regard suggests that it was applying a different test, such as one of motive:

In every decision of this Court recognizing the presence of a “security” under the Securities Acts, the person found to have been an investor chose to give up specific consideration in return for separable financial interest . . . .

In a pension plan such as this one, by contrast, the purported investment is a relatively insignificant part of an employee’s total and indivisible compensation package. . . . His decision to accept and retain covered employment may have only an attenuated relationship, if any, to perceived investment possibilities of a future pension.40

A second basis for the decision was the lack of expectation of profits from the efforts of others. The Court focused not on the presence or absence of profits but on their source:

It is true that the Fund . . . depends to some extent on earnings from its assets. In the case of a pension fund, however, a far larger portion of its income comes from employer contributions, a source in no way dependent on the efforts of the Fund’s managers. . . .

[In addition,] the principal barrier to an individual employee’s realization of pension benefits is not the financial health of the Fund. Rather, it is his own ability to meet the Fund’s eligibility requirements. Thus, even if it were proper to describe the benefits as a “profit” returned on some hypothetical investment by the employee, this profit would depend primarily on the employee’s efforts to meet the vesting requirements, rather than the fund’s investment success.41

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40. 436 U.S. at 559-60.

41. Id. at 561-62 (footnote omitted). It is clear that the Court, in stating that the hoped-for gain related largely to employer contributions, was not making the fallacious argument that the plan did not involve a security because employer contributions with respect to the employee in question accounted for a large part of his return. That would be similar to arguing that a corporate bond is not a security because a large portion of the anticipated payments are to be the repayment of principal at maturity. Rather, the Court probably had in mind the point made in Judge Cummings’ opinion in the court below: one’s hope of gain depended in part on employer contributions made with respect to other employees who later, for one reason or another, became disqualified and forfeited their pensions. When that happened the payments made on behalf of disqualified employees remained in the fund and were taken into consideration in determining the amount of benefits to those who did not forfeit. See Daniel
Two points can be made about the state of the law after Forman and Daniel. The first is that a great deal remains unresolved. The current status of the three-pronged Howey test, including the doubts, questions, and modifications suggested by Forman, Daniel, and other recent cases can be depicted as follows:

A "security" (by means of the term "investment contract" in the statutory definition), is a contract, transaction or scheme—

1. "Whereby a person invests his money." Despite its evident hostility to the view that a security was present, the Daniel Court did not insist that a direct money contribution be made by the supposed investor, and indeed it would be difficult to insist that a standard equity share, for example, was not a security even if it was obtained for real or personal property. After Daniel, however, serious doubts about the presence of a security must arise when, under the circumstances of the purchase, it is impossible to find a divisible portion of the consideration that is attributable to the acquisition of the instrument. But does it make sense to hold that a standard equity share acquired for a week's work is a security whereas the same share acquired together with $200, indivisibly in consideration for two weeks' work, is not? Can this problem be solved by reference to the motives of the worker, as the Court at one point seems to imply?

2. "In a common enterprise and is led to expect profits." Is a common enterprise present when there is only one investor in the business? As to profits, after Forman one might be inclined to say that they must be "financial" or that one must expect them in some form other than that of a "commodity for personal consumption." Why? Would it matter that one did not use up the consumable return but sold it for cash, perhaps in advance of receiving it?

42. See text accompanying note 19 supra.
43. See also Long, supra note 11, at 114.
44. It is also worth noting that the Daniel Court mentioned that the form of consideration—work—was not "tangible." International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979).
45. See text accompanying note 40 supra.
47. United Hous. Foundation, Inc. v. Forman, 421 U.S. at 858.
How would this apply to a commodity future? After Forman, it may also be true that the return, even if in cash or some other clearly acceptable form, will not qualify as a "profit" unless it is paid out of "earnings" or "capital appreciation" resulting from the use of investors' funds. Must courts actually conduct an inquiry into causation, and thus trace the invested funds or apply some test like the "but for" test?

3. "Solely from the efforts of [others]." After Forman, and after taking into account the judicial retreat from the "solely" requirement, this prong must be amended to read: largely from the entrepreneurial or managerial efforts of others. How much is "largely" and against what is it measured? What is meant to be ruled out by the imposing phrase "entrepreneurial and managerial efforts?" All undertakings involve the exercise of management functions, but nearly all involve additional work at nonmanagerial levels. Daniel suggests that forfeitures of pension rights by other employees do not count as the products of managerial or entrepreneurial efforts. The Court in Forman stated that government subsidies are also ineligible. This clearly raises difficult questions in an economy in which tax incentives and disincentives are prominent considerations in every important business decision.

The second point about the current state of the law is that even what has been resolved may not have been articulated in a way that fully reflects the courts' reasoning or that provides a reliable guide to their future holdings. Two recent district court opinions demonstrate this point. In Cordas v. Specialty Restaurants, Inc., the plaintiff claimed that her lease of business premises in a shopping center involved the sale of a security, thus affording a basis for a fraud claim when the shopping center did poorly. After considerable discussion, which was induced in part by the fact that the plaintiff had given a substan-

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48. See note 24 supra and accompanying text.
49. See 421 U.S. at 852.
50. For a theory under which this and other elements of the Howey test would be interpreted by reference to the amount of control the investor may exercise, see Newton, What Is a Security?: A Critical Analysis, 48 Miss. L.J. 167, 190 (1977) ("If the efforts . . . produce an actual right of control, the existence of a security is precluded.").
51. See 439 U.S. at 561-62.
52. 421 U.S. at 855.
tial security deposit, the court held that no security was involved.\textsuperscript{54} The result is sensible, and one naturally looks to \textit{Forman} for authority. But it will be noted that neither of the major disqualifying features mentioned in \textit{Forman} was present in \textit{Cordas}: the return—a commercial leasehold—was not for "personal consumption," and the profit-generating activities of the lessor could not be dismissed as relating to government benefits but rather were of a thoroughly managerial and entrepreneurial nature.\textsuperscript{55} In \textit{Tanaggi v. Grolier Inc.},\textsuperscript{56} an employee claimed that a security was involved in a voluntary employee pension plan to which the employee made contributions. The court rejected that contention even though one of the major disqualifying features in \textit{Daniel} was absent—there was clearly a "separable contribution" attributable to the employee—and even though the other major disqualifying feature was of diminished importance—the court did not indicate that forfeitures by other employees constituted a major source of the profits. If the \textit{Cordas} and \textit{Tanaggi} results seem intuitively correct, that must be because of factors not fully articulated in the leading cases.

The ambiguity of the \textit{Howey} test, even in its revised form, suggests that the door is still open to the development of basic principles in this area, and the welcome mat is out. Intriguing language, suggestive of a theory, appears in several cases. In the early case of \textit{SEC v. C.M. Joiner Leasing Corp.},\textsuperscript{57} for example, the Supreme Court stated that the test is "what character the instrument is given in commerce";\textsuperscript{58} instruments would be

\textsuperscript{54} \textit{Id.} at 790.

\textsuperscript{55} \textit{See id.} at 785. The court rested its holding on its conclusion that the "profits solely [or preponderantly] from the efforts of [others]" prong of \textit{Howey} was not satisfied, since plaintiff was to contribute efforts by managing her shop. The opinion fails to distinguish clearly between (i) the benefit measured by the market value of the leasehold, which would be greater or less according to the general success of the shopping center in attracting business, and to which plaintiff's efforts would have contributed only slightly; and (ii) the benefits involved in owning and operating her store (that is, the store's profitability), to which her efforts would have been far more important. Only the former benefit is relevant under \textit{Howey} because only the former benefit is the direct product of the investment at issue; the profitability of the store was a product of many transactions, no others of which were stated to involve the lessor. It therefore is difficult to justify the court's result under \textit{Howey} and \textit{Forman}. The test proposed in this Article justifies the result in the manner explained in note 117 infra.

\textsuperscript{56} 471 F. Supp. 1209 (S.D.N.Y. 1979). Other cases since \textit{Daniel} dealing with pension plans are cited in note 185 infra. For a better approach to the problem, see text accompanying notes 183-191 infra.

\textsuperscript{57} 320 U.S. 344 (1943).

\textsuperscript{58} \textit{Id.} at 352-53.
securities if "they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts.'"\(^{59}\) Lower court decisions in the area of debt instruments have inquired whether the instrument or the transaction in which it passes is of a "commercial" nature, in which case no security is involved, or an "investment" nature, in which case a security is present.\(^{60}\) In its recent opinions, the Supreme Court has frequently mentioned the importance of looking to the "economic realities" involved.\(^{61}\) We should accept these comments as indicating a direction. Scholars can learn from the insights to which courts aspire as well as those that they have actually achieved.

B. THE COMMENTATORS

Commentators offering general guidance as to the definition of "security" have more often than not followed the general lines of an approach suggested by Professor Ronald Coffey. Professor Coffey argued that a security is a "transaction whose characteristics distinguish it from the generality of transactions so as to create a need for the special fraud procedures, protections, and remedies provided by the securities laws."\(^{62}\) This need for special protection, he observed, is most likely to be present when the buyer's investment is at risk, when the investment is in a "risk enterprise" with which the buyer is unfamiliar and over which he has no control, and when there is a reasonable expectation of return in excess of value given. This approach would afford the benefits that might be expected from a broad application of the securities laws; it is supported by language frequently found in the cases stating that the securities laws are to be construed broadly, and that the definition of "security" in particular should be "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."\(^{63}\) It is also supported by cases, notably from the Court of Appeals for the Ninth Circuit, applying a "risk capital" test.\(^{64}\)

59. Id. at 351.
60. For an extensive discussion and critique of the commercial-investment distinction, see text accompanying notes 144-169 infra.
64. See, e.g., United Cal. Bank v. THC Financial Corp., 557 F.2d 1351, 1358 (9th Cir. 1977). See also Amfac Mortgage Corp. v. Arizona Mall, Inc., 583 F.2d
and by cases applying a "commercial-investment" distinction to debt instruments.\(^{65}\) On the other hand, it would be difficult to think of instruments that created a more desperate need for special protection than those in *Daniel*, which were subject to vesting requirements so obscure and difficult to meet that the defendants admitted that they were shocking.\(^{66}\)

In its most extreme form—a form commonly found in the literature—this "need for buyer and offeree protection" test would be applied by taking into account all of the characteristics of the transaction proposed to be subjected to the securities laws, rather than only the characteristics of the instrument involved. For example, if an instrument were issued and sold in a transaction in which the purchaser lacked information or expertise, and at a time when the issuing company was in a shaky condition, the instrument would be especially eligible for characterization as a security.\(^{67}\) Presumably, if the instrument were later resold to an expert business analyst at a time when the issuing company was in excellent condition, it would lose its standing as a security under the test. This approach would produce anomalous results, such as causing the same instrument to be a security at one time but not at another according to the type of transaction involved, and causing some instruments to be deemed securities and others of an identical issuer and class not to be, according to their different trading patterns. Neither common usage nor the syntax of the securities laws countenances such results, which would make a hash of some of the major provisions. Consider, for example, the difficulties in determining the number of offerees for purposes of the Securities Act nonpublic-offering exemption\(^{68}\) when some of the


\(^{67}\) The test proposed by Professor Coffey appears to be transaction-based, in that it is formulated using the word "transaction" as the predicate: "A 'security' is [a] transaction in which ...." Coffey, *supra* note 62, at 377. This contrasts with the statutory definitions in the principal securities laws, see note 13 *supra*, in which "instrument" or "interest" is occasionally used in that way.

offerees are knowledgeable and hold controlling interests while other offerees are ignorant outsiders. Consider the difficulties in applying the test to provisions, such as the Exchange Act registration requirement, that use the term "security" without identifying any particular transaction.

These objections might be circumvented by a more cautious form of the "need for protection" test under which one would ignore factors peculiar to the transaction at issue; the determination as to need for protection would be made wholly on the basis of the nature of the instrument and of the issuer. An instrument would be more likely a security, for example, if it were issued by a risky company or a company raising start-up capital, and if it involved close participation in the risks. This cautious form of the test avoids many of the defects of the extreme form, but at the price of leaving the less risky instruments and issuers outside the securities laws—an unacceptable price when one recalls that a seller may almost as readily use fraud to overprice a safe instrument as a risky one.

Furthermore, both the bold and cautious forms of the test are vulnerable to the objection that the securities laws protect sellers as well as purchasers: rule 10b-5 and section 14(e) of the Exchange Act are examples. Is the test to be inverted when a seller sues, so that, in order to afford him more protection, the instrument will be held to be a security when it is relatively risk-free and (applying the bold form of the test) when the issuer is doing well and the purchaser is well informed and canny? A test that reaches different results depending on...
who brings the suit is certainly undesirable. Again, protection is afforded not only to buyers and sellers but also to brokers by section 17(a) of the Securities Act. Is an instrument to be considered a security according to whether it can be traded through a broker? Similar problems arise under those sections of the securities laws that identify which exchanges and markets are subject to SEC marketplace regulation.

It can only be helpful, in view of the current state of the authorities, to accept the commentators' suggestion and inquire into the purposes behind the securities laws. Most of the context of a lawsuit under rule 10b-5 brought by the issuer, see Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974). In Bellah, the court implied that a different standard would have applied to the question if the suit had been brought by the purchaser; it distinguished decisions in lawsuits brought by purchasers by observing that in the case at hand "the maker... seeks to invoke the Act's prophylactic protection. While we do not disparage the conclusions reached in [two cases involving lawsuits by purchasers], we do suggest that a maker cannot bring the notes he executes within the Act merely by demonstrating his own lack of fiscal integrity." Id. at 1112 n.3 (emphasis added).

75. 15 U.S.C. § 77q(a) (1976). In United States v. Naftalin, 441 U.S. 768 (1979), the Court held that wrongs against brokers may be the subject of criminal prosecutions under section 17(a) of the Securities Act.

76. In response to these objections, the "need for protection" test might be framed differently according to the section of the securities laws at issue. The term "security" when used in sections primarily designed for purchaser protection, like the remedial provision of the Securities Act, would be interpreted under the "need for purchaser protection" test; when used in sections primarily designed for seller or offeree protection, such as section 14(e) of the Exchange Act, it would be interpreted under a test of need for seller protection. The proposition that the term "security" may be defined differently for purposes of different sections of the securities laws is supported, at least by implication, in 4 L. Loss, SECURITIES REGULATION 2485 (2d ed. Supp. 1969). See also SEC v. National Sec., Inc., 393 U.S. 453, 465-66 (1969) (In interpreting the term "purchase or sale," the Supreme Court acknowledged that "the same words may take on a different coloration in different sections of the securities laws."). (emphasis added). Revising the "need for protection" test in this way, however, would not solve the problem as to those sections of the acts that protect both purchasers and sellers. It would also fail to resolve another shortcoming of the test: it is unsatisfactory when applied to cases in which the plaintiff, whether a purchaser or seller, alleges fraud arising from statements relating not to the security, but to the consideration for which it was exchanged. See, e.g., MacAndrews & Forbes Co. v. American Barmag Corp., 339 F. Supp. 1491, 1490-91 (D.S.C. 1972) (holding bills of exchange to be securities for purposes of an action brought under section 17 of the Securities Act and under rule 10b-5 by an issuer alleging misrepresentations about the machinery for which the bills were exchanged). A similar situation is presented by cases such as Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), in which the 10b-5 plaintiff was the corporate seller of securities, the defendants were not the purchasers but rather persons and entities that assisted in the sale, and the alleged deception related neither to the security nor to the consideration given for it, but to the purported misappropriation of the assets. For an indication that rule 10b-5 continues to be available for use in attacks on fraud collateral to the security transaction, see Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977).
fusion stems from the view, which many commentators adopt without discussion, that those purposes were simply to protect against fraud and other defects in disclosure. The following discussion proposes a test based on a somewhat different view of the legislative purpose, and leads to an instrument-based rather than a transaction-based test.

III. A BETTER DEFINITION OF "SECURITY"

A. WHY HAVE DIFFERENT LAWS FOR SECURITIES?

It seems most unlikely that the lawmakers thought that fraud, inadequate disclosure, market manipulation, or many of the other things prohibited by the securities laws were wrongful or undesirable only when securities were involved. Evidently, they decided to legislate as to only some of the conduct they believed wrongful—not an unusual procedure for lawmakers with the common law as a backstop, especially when they are federal lawmakers acting during a major crisis in an area that is widely regulated at the state level. That explains why they did not undertake a general revision of the law of contracts or corporations. But why did they focus on securities?

Lawmakers often legislate in an area merely because national experience has painted them a vivid picture of it. In the early part of this century, national experience, or its interpreters, did paint such a picture: that of the American public purchasing unsound stocks and bonds at inflated prices under the influence of misleading statements and the high-pressure tactics of corporate insiders, broker-dealers, and investment bankers; that of the "humble, honest citizens" being "plundered and despoiled of their small earnings... by the alluring machinations of the deceptive, misleading, and fraudulent devices which the unscrupulous, cunning, and deceitful 'Get-Rich-Quick Wallingford's' of our day practice."77 Sometimes lawmakers see such a vivid picture and do nothing more abstract than prohibit the activity depicted. This was the case in those states that, hoping to prevent the revival of the saloon after the end of Prohibition, forbade establishments that served liquor by the drink from having swinging doors and certain other architectural features.78 The image of shysters selling worthless stocks and bonds to widows seems to have been a

77. The statement is that of the attorney general of Iowa, describing the purpose of Iowa securities regulation, quoted in M. Parrish, supra note 18, at 7.
78. See, e.g., Act of May 10, 1934, ch. 478, § 105(9), 1934 N.Y. Laws 1111.
major factor in the passage of the blue sky laws. No doubt the same is true of the federal securities laws.

By 1933, however, the picture had become more complex. The financial markets and, indeed, the economy, had collapsed. As a result, not only the purchasers of the unsound stock but also ordinary workers and farmers were impoverished. The lawmakers were presented with reasons to conclude that, while fraud and the other prohibited activities are generally undesirable, these activities are especially undesirable when securities are involved, because the result could be general economic collapse.

As with artists, when legislators search for causes, the results are likely to be symbolic and abstract. References to widows and con men in the legislative history of the securities acts are crowded out by references to markets, supply, demand, capital, and the depression. By singling out "securities" as the object of a set of laws, the New Deal was identifying a segment of the national economy, rather as it singled out banking in other legislation. Defining "security" involves determining what this segment is and why it was thought to merit special protection.

79. "Blue sky" laws are state securities laws. Consider, for example, the statement of an early advocate of state securities laws: "Funny how simple are the solutions of these intricate problems. Just stop it. That's all." Kohr, The Blue Sky Law, 17 TECH. WORLD MAGAZINE 36, 39 (1912). For an extensive description of the populist, progressive, and reformist currents that influenced antispeculation legislation, see C. COWING, POPULISTS, PLUNGERS, AND PROGRESSIVES (1965). For a sketch of the development of statutory blue sky definitions of "security," see Long, supra note 11, at 96-98.

80. The defrauded widow made her mournful appearance more than once in the debates on the Securities Act as well. See 77 CONG. REC. 2925 (1933) (remarks of Rep. Bulwinkle); id. at 2935 (remarks of Rep. Chapman); id. at 2983 (remarks of Sen. Fletcher).

81. "National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry . . . are precipitated, intensified, and prolonged by manipulation and . . . by excessive speculation" on securities exchanges and over-the-counter markets. Exchange Act § 2(4), 15 U.S.C. § 78b(4) (1976). For a description of what contemporaries thought were the causes of the depression, which included (in addition to misconduct in the securities markets) high tariffs, the economic troubles of the farmers, and the failure of United States' allies to pay their war debts, see C. COWING, supra note 79, at 196-98, 209-10.

82. See Senate Committee on Banking and Currency, Stock Exchange Practices, S. REP. No. 1455, 73d Cong., 2d Sess. 81 (1934) ("The purpose of the [Exchange Act] is . . . to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation or control."), reprinted in 5 LEGISLATIVE HISTORY, supra note 2, Item 21, at 81.
It is helpful in making this determination to understand how, in contemporary opinion, misconduct with respect to securities could harm the general economy. President Roosevelt expressed his belief in a chain of causation between such wrongdoing and the Great Depression. "[M]uch of our trouble today," he said in a fireside chat in 1934, "has been due to a lack of understanding of the elementary principles of justice and fairness by those in whom leadership in business and finance was placed ...." What analysis lies behind this attractive but cryptic synthesis of ethics and economics?

One portion of the picture may be of help. It prominently features the public financial markets and the major financial market participants: corporations seeking to obtain financing and to use it in production, financial intermediaries and financial service organizations such as banks and broker-dealers, and members of the public who have saved and who wish to obtain income by putting their savings at the disposal of others. The instruments listed in the statutory definitions of "security" are the primary vehicles of these markets—that is, they are, or represent, bundles of financial claims and liabilities. Financial markets serve as a channel through which savings are allocated to investment, and they perform the closely related function of pricing financial instruments, thereby assisting in the allocation of savings to those economic units that can use them most productively. The widespread view in the 1930s was that these functions had miscarried. President Roosevelt, members of Congress, and their contemporaries, in surveying the situation before the Crash, perceived the financial markets to have been plagued by "the overnight manufacture of security issues [and] the flotation of issues without adequate disclosure of facts," both of which damaged honest enterprises seeking capital and led to wild speculation. The

84. The term "savings" is commonly defined as income not spent on consumption. See, e.g., R. ROBINSON & D. WRIGHTSMAN, FINANCIAL MARKETS: THE ACCUMULATION AND ALLOCATION OF WEALTH 437-38 (1974).
86. F.D. Roosevelt, untitled note, in 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, supra note 83, at 215. For an indication that contemporary Congressional and popular opinion also emphasized abuses such as high-pressure salesmanship, see F. ALLEN, SINCE YESTERDAY 136 (1939).
87. See S. REP. No. 47, supra note 5, at 1 ("The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation [and] to protect honest enterprise, seeking
result, aggravated by manipulation of the securities markets and excessive use of credit in financing market transactions, was the swelling and eventual bursting of a speculative bubble. This led to a loss of confidence—to that "fear itself" which President Roosevelt said alone deserved to be feared—and a consequent "hoarding," such that savers, especially those who were outsiders, refrained from venturing into the financial markets. This in turn impaired the economy. Exaggerated somewhat in detail and precision, the general view was that the following causal chain existed: (i) fraud and similar misconduct led to speculation, which, aggravated by market manipulation, resulted in (ii) the Crash, which in turn caused (iii) loss of confidence in the financial markets and hoarding by those who otherwise would have invested, which caused in some way (perhaps by starving business of capital) (iv) the initiation and continuation of the economic collapse. The securities laws were intended to prevent the recurrence of this process or capital by honest presentation, against the competition afforded by dishonest securities . . . ").
even to reverse it—"to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power." 94

Were these views correct? Modern economists generally agree on the presence of fraud and speculation, and that this was one cause of the Crash, although another cause was a business downturn earlier in 1929. 95 There is good statistical evidence that the Crash was closely followed by a general decline in investment in financial assets, and especially a decline in investment in the riskier sorts of instruments, whether or not there was "hoarding" in the more limited sense of "accumulation of currency." 96 There is support for the view that this

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94. S. REP. No. 47, supra note 5, at 1, reprinted in 2 LEGISLATIVE HISTORY, supra note 2, Item 17, at 1. See also 77 CONG. REC. 2935 (1939) (remarks of Rep. Chapman) ("We believe the enactment of this bill into law will bring money from the hoarders' hiding places. It will be conducive to confidence on the part of investors. It will stimulate industry; it will accelerate the wheels of commerce."). The interpretation of congressional intent suggested in the text is supported by Justice Brennan's recent statement for the Court that "Congress' primary contemplation [in adopting the Securities Act] was that regulation of the securities markets might help set the economy on the road to recovery." United States v. Naftalin, 441 U.S. 768, 775 (1979).

95. For the view that fraud or speculation helped to cause the Crash, see L. CHANDLER, AMERICA'S GREATEST DEPRESSION, 1929-1941, at 17-19 (1970); J. GALBRAITH, THE GREAT CRASH: 1929, at 174 (3d ed. 1972); Kirkwood, The Great Depression: A Structuralist Analysis, 4 J. MONEY, CREDIT & BANKING 811, 822 n.12 (1972). But see Benston, The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23, 52-53 (H. Manne ed. 1969) ("A careful examination of the Senate hearings that preceeded [sic] passage of the Securities Act of 1933 and the voluminous Pecora Hearings that preceded the Securities Exchange Act of 1934 fails to turn up more than one citation of fraudulently prepared financial statements. . . . Thus, the need for the financial disclosure requirements [appears] to have had [its] genesis in the general folklore and 'abuses' of turn-of-the-century finance rather than in the events of the 1920s . . . insofar as fraud and misrepresentation are concerned.") (citations omitted).

96. There was a marked diminution in investment in financial assets during 1930, 1931, and 1932, as compared to the three previous years, on the part of nonagricultural individuals, nonfinancial corporations, and unincorporated businesses. Moreover, there is some indication that the flight from stocks was more marked than from government securities. See P. TEMIN, DID MONETARY FORCES CAUSE THE GREAT DEPRESSION? 131-35 (1976) (presenting flow-of-funds figures for those groups). Hoarding in a narrower sense is contraindicated by the fact that money holdings decreased. Id. The monetarist view, contested by Temin, is that this was caused by a drop in the money supply rather than by a
caused the increase in the return that had to be paid on all but short-term instruments. It is more controversial to say that the economic depression was the upshot, and it is at best incomplete to attribute such a result solely to shortages of funds for business. In their lucid book Financial Markets: The Accumulation and Allocation of Wealth, Robinson and Wrightsman offer the following more extended account:

There are at least three ways in which a turn in the stock market might cause economic activity to change. One way is through a wealth effect. A sharp fall of stock prices reduces the market value of investors' financial wealth. Feeling poorer, investors may feel compelled to reduce their consumption expenditures.

Another way is through a financing effect. Selling stock when prices are abnormally depressed can have an adverse dilution effect on existing stockholders. To the extent that corporations rely on external equity to finance capital expenditures, an unfavorable stock market can lead to a postponement of business investment and initiate a downturn in economic activity. The fact is, however, that most corporations raise considerably more new capital through retained earnings and by borrowing in credit markets than by selling new stock. Thus a stock market decline cannot be said to make funds much less available for business capital expenditures.

Still another way is through an expectations effect. A declining stock market may cause businessmen to develop pessimistic expectations of future business conditions. Business expects an economic downturn, so it does not invest and a downturn materializes. The Great Depression of the 1930s would have happened anyway, but it probably would not have been as severe as it was had there not been a shattering of business confidence following the Crash.

Explanations for the depression may be divided into two classes. One, the monetarist explanation, emphasizes the collapse of the banking system as a primary cause; the other, the spending explanation, emphasizes a fall in spending, especially spending on consumption. In each case, the stock market crash is perceived as one of the causes of the primary cause;

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97. P. Temin, supra note 96, at 169.
98. “Investment fell in 1930, as it falls in all recessions, but it did not fall more than usual. The Depression was not caused by a dramatic collapse of investment.” Id. at 172. Demand for funds by business also fell, according to Temin. Id. at 134-35. For a tentative expression of doubt that the Crash was a significant cause of the depression, see Green, The Economic Impact of the Stock Market Boom and Crash of 1929, in Federal Reserve Bank of Boston, Consumer Spending and Monetary Policy: The Linkages 189 (1971). For an expression of doubt that the Crash caused a reduction in investment spending by increasing yields, see id. at 199-201.
99. R. Robinson & D. Wrightsman, supra note 84, at 378-79. For a vigorous criticism of the application of the "expectations effect" analysis to the depression, see P. Temin, supra note 96, at 75-83.
monetarists see the Crash as a cause of the banking crisis,\textsuperscript{100} and spending theorists observe that it had an impact on spending.\textsuperscript{101} These alternative views thus do not involve a denial that fraud and speculation caused the Crash or that the Crash caused the depression; instead, they provide different links in the chain of events between the Crash and the depression. Such views might detract from one's respect for the conclusion that the depression could have been cured by prohibiting fraud on the financial markets; the introduction of such cataclysms as the collapse of banks into the causal chain makes the chain appear less susceptible to a simple reversal. Those views, however, do not undercut the legislators' hope that such prohibitions would help prevent future depressions.

B. What is a Security?

"Security" should be defined so as to respect the intention of the framers to focus the securities law on the financial markets. Perhaps the most obvious definition would be that any instrument is a security which is the subject of transactions in the financial markets, or, perhaps, which has in the past been the subject of such transactions. But it would be better to adopt a broader definition that would include not only those instruments that have entered the market, but also those that are "waiting in the wings." Although all the common stock of the Boston Gas Company has been owned for over fifty years by Eastern Gas and Fuel Associates,\textsuperscript{102} it seems obvious that the securities laws should cover it. The alternative approach—making actual participation a requirement—would occasionally cause some instruments of an issue and class to be called se-

\textsuperscript{100} See, e.g., M. Friedman \& A. Schwartz, The Great Contraction: 1929-1933, at 59 (1965) (stating that the bank failures were largely attributable to the decline in the value of the banks' portfolios of securities). See also M. Friedman \& A. Schwartz, supra note 96, at 306-07 (stating that the Crash "helped to deepen the contraction"). For a close critique of this view, see P. Temin, supra note 96. For a monetarist response, see Klein, Book Review, 50 J. Bus. 244 (1977). For another work in the area by Friedman and Schwartz, see Money and Business Cycles, 45 Rev. Econ. \& Statistics 32 (Supp. Feb. 1963).

\textsuperscript{101} Cf. P. Temin, supra note 96, at 170-72 (describing the Crash as having contributed to the depression, as one of several factors, by reducing wealth in the hands of consumers, which in turn contributed (in small part) to the reduction in consumption expenditures, and thus to the general economic decline). It should be noted that Temin's acceptance of the spending hypothesis is a qualified one.

DEFINITION OF SECURITY

securities while others of the same issue and class were not.  

The definition, therefore, should identify as securities not only those instruments that have been or are the subject of transactions in the financial markets, but also those instruments that could be. Accordingly, the following definition is suggested: A security is a financial instrument eligible to participate in a public market. In other words, a security is an instrument that can be sold in a public market by an economic unit to obtain funds for investment, and that can be purchased in a public market by an economic unit which has accumulated savings and which hopes, by making the purchase, to make a profit related to the issuer's business.

Some of the components of the definition are broad ones. The term "instrument," for example, is intended to be a nonrestrictive term applicable to any candidate for inclusion as a "security" and should be taken to include almost any bundle of rights and duties. The more restrictive parts of the definition—the requirements that the instrument be a "financial" one and that it be responsive to the markets in various ways—call for a closer analysis.

1. The Requirement That the Instrument Be a Financial One

The term "financial instrument" is intended to mean an instrument that, when issued and sold, can operate to transfer the savings of the purchaser to the investment uses of the issuer and can do so in accordance with judgments by the market regarding the most productive allocation of those savings.

What features must an instrument possess to enable it to operate as a channel for a desirable allocation of savings to investment? Very little seems necessary to allow an instrument to be used to take in "savings"; anything that can be purchased can be purchased out of savings. "Investment," as the term is used here, occurs when funds are employed in the production of goods and services rather than in obtaining goods and services for consumption. This suggests more stringent requirements.

103. See text accompanying notes 67-69 supra.

104. Perhaps a fuller sketch of an "instrument" would be as follows: it is a set of rights and duties conferred (or purported to be conferred) by one party upon another, under circumstances such that the rights and duties would normally be treated as a unit and would normally be transferred, if at all, as a unit. The term "instrument" also includes the documents reflecting such rights and duties.

105. The requirement that the instrument be an investment vehicle might find some grounding in the "investment of money" prong of Howey.

106. "Investment," as defined in J. Bowyer, Investment Analysis and
a. It Must Be Possible to Issue and Sell the Instrument for the Purpose of Obtaining Funds for Investment

Just as anything that can be purchased can be purchased out of savings, so it might seem that anything that can be issued and sold can be issued and sold to raise funds for investment. But there are two instances in which this would not be the case.

First, when the issuer was not engaged in the production of goods and services, the instrument would not be financial. Intermediaries, however, are not excluded by this qualification. Their business, like that of an investment company, is to reinvest; they are part of the process of producing goods and services, and the instruments they issue may be financial ones. Similarly, governments produce goods and services; thus, the instruments they issue may be financial. Nor, of course, is the qualification intended to rule out those issuers that contribute to the production of goods and services by functioning as service or assistance operations rather than as primary producers: delivery companies and management consultant firms are producers of goods and services, and so is the individual who, although owning no business of his own, is an employee of a productive business. Very little, then, is ruled out by this part of the test.

One exclusion would be that of instruments issued by an individual not working for any enterprise, such as someone

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MANAGEMENT 9 (4th ed. 1972), is “the commitment of funds with the hope of gain.” See also BLACK'S LAW DICTIONARY 960 (4th rev. ed. 1968) (defining “investment” as “[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment”).

107. The term “issuer” means the party that creates and is subject to obligations by the instrument. In the case of a note, for example, the issuer is the borrower. It would be undesirable to permit a company to avoid the securities laws by contracting out of or passing to an affiliate those functions, such as the production of goods or services, which if conducted directly would make its instruments securities under the test proposed in this Article. The term “issuer” for purposes of the test should therefore include such an affiliate or contracting party. An analogous approach is used under current law—the “profits from the efforts of others” requirement of Howey can be satisfied by the efforts of parties other than (but associated with) the issuer. See R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 227-28 (4th ed. 1977) and cases cited therein. The term “issuer” is defined in section 2(4) of the Securities Act, 15 U.S.C. § 77b(9) (1976), and in section 3(a)(8) of the Exchange Act, 15 U.S.C. § 78c(a)(8) (1976).

108. Robinson and Wrightsman, however, question whether governments can be said to invest. See R. ROBINSON & D. WRIGHTSMAN, supra note 84, at 24-25.
DEFINITION OF SECURITY

who is almost wholly a consumer. The requirements of the Daniel and Forman cases that the hope of gain must arise from the managerial or entrepreneurial efforts of others bear a close relationship to this exclusion. Managerial efforts, however, are a part of every enterprise; perhaps it was not the absence of managerial efforts but rather the absence of productive efforts that caused the Court to exclude enterprises that thrive largely on government benefits or on forfeitures by creditors. The issuers in Forman and Daniel, Co-op City and the Teamsters' Fund, made money in productive as well as nonproductive ways, so the results in those cases cannot be fully explained by reference to the proposed requirement that the issuer be engaged in the production of goods and services, unless a test of preponderance is to be applied.

Second, the instrument would not be financial when the issuer, although engaged in the production of goods or services, could not use the proceeds from the sale of the instrument for production. This is the case, for example, with the typical short-term consumer loan instrument; the consumer might produce goods on his job as a factory worker, but the proceeds of his borrowing would be unlikely to facilitate this work. Probably few important cases will be resolved by this portion of the test. Because money is fungible, no producer that uses money in its production activities should be heard to say that the proceeds of its sale of some particular instrument were earmarked for nonproductive activities. Even were such earmarking possible, economic enterprises that are legally required to act for the economic benefit of their owners should not be heard to say that they are raising funds for consumption.

b. The Attractiveness of the Instrument Must Relate to the Success of the Productive Activities of the Issuer

Not every instrument issued to obtain funds for production can be a financial instrument. For example, unauthorized trad-

109. See text accompanying notes 26-41 supra.
110. Should engaging in a legal battle to become a beneficiary of an estate be regarded as a productive activity for purposes of this test? See SEC v. Latta, 250 F. Supp. 170 (N.D. Cal.) (securities held to be involved in the sale of 1/21,000 interests in such proceeds as the seller might obtain in her legal battle to cause a redistribution of an estate), aff'd per curiam, 356 F.2d 103 (9th Cir. 1965), cert. denied, 384 U.S. 940 (1966).
111. For example, when a stipend is paid to the widow of the chief executive, courts should, as they do when the propriety of such an expenditure is at issue, remember that the health and productivity of the enterprise is furthered by decent treatment of those that work for it.
ing recently occurred on the floor of the New York Stock Exchange in coupons conferring upon the bearer the right to travel half-fare on certain domestic airline flights. Nothing in the tests developed so far would exclude these coupons from the category of "securities." The issuers, American Airlines and United Airlines, are certainly engaged in the production of services, and sale of such coupons could certainly have been arranged so as to raise funds to assist in such production. In fact, the coupons had been given away by the airlines to their passengers, but no part of the test makes that a disqualification. A share of equity is no less a financial instrument for having been given away by the issuer; the test asks whether the instrument is capable of being sold for the specified purpose. Nevertheless, the coupons should be excluded because, although they can be used in the marketplace to take advantage of one of the marketplace's great services—the channeling of funds from savings to investment—they cannot be used to take advantage of another service: the formation and execution of market judgment as to where investment funds can best be employed. It should thus be an additional part of the definition of "financial instrument" that the instrument be responsive to the market's judgments of such matters—that it be an instrument by which the issuer can obtain funds for investment by appealing to the market's view as to whether the issuer can use them well. The market forms and executes these "judgments," of course, wholly in response to the prospect of economic rewards to market participants. This part of the definition can therefore be revised as follows: an instrument is not a "financial" one unless it affords the holder prospects of gain that are preponderantly dependent on the success of the productive activities of the issuer.

What types of instruments would be ruled out by this requirement? First, no instrument could qualify as "financial" which did not afford any hope of return; the market would have no incentive to assess such an instrument. A non-interest-bearing note issued at par, such as a check, is for this reason not a financial instrument. When the financial vice president of General Motors issues a company check in order to obtain cash, he is issuing an instrument that can be used to transfer

112. See Wall Street J., June 28, 1979, at 1, col. 4.
113. For a case holding checks to be securities when they are interest bearing, see United States v. Attaway, 211 F. Supp. 682 (W.D. La. 1962).
the recipient's savings to the company's productive efforts, but he is not issuing a financial instrument.

Second, the requirement rules out instruments that offer prospects of return that are mainly dependent on factors other than the success of the productive activities of the issuer. The half-fare coupons are thus excluded because, although one might hope for a profit from buying one—hope, for example, that air fares would go up—the fulfillment of this hope would in no important way depend on the wisdom with which the airlines operated. Gambling contracts would be excluded for similar reasons. A ticket on a horse is not a financial instrument, even though the proceeds of its sale may be used by the racetrack to continue producing what is arguably an entertainment service, because the holder's prospects of gain depend on the race rather than on the profitability of the racetrack. Commodity futures, which have been described as "little more than . . . wager[s] that the market price of a given commodity will change," are excluded for this reason, as are instruments . . .

114. *Birch v. Hunter*, 158 F.2d 134 (10th Cir. 1946) (holding, without discussion, that a "statement of account" reflecting gambling winnings was a security within the meaning of the National Stolen Property Act, which defined "security" in language similar to that in the federal securities laws).


116. Commodity futures have been uniformly held not to be securities. *See*, e.g., *McCurnin v. Kohlmeyer & Co.*, 340 F. Supp. 1338, 1341-42 (E.D. La. 1972) (cotton futures held not to be securities under the Securities Act because, among other things, "[t]he expectation of profit arises solely from the speculative hope that the market price of the underlying commodity will vary in [the investor's] favor"); *Sinha, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966) (sugar future held not a security under either the Securities Act or the Exchange Act because, among other reasons, "[t]he mere presence of a speculative motive on the part of the purchaser or seller does not evidence the existence of an 'investment contract' . . . . [T]he expected return is not contingent upon the continuing efforts of another."). *See also* *Glen-Arden Commodities, Inc. v. Costantino*, 483 F.2d 1027, 1033 (2d Cir. 1974) (dictum). For a discussion of options to purchase or sell securities, see text accompanying notes 140-141 infra.

A different issue is whether an interest in a trading account in commodities futures constitutes a security. For a discussion of the divergent authorities on this question, see *Curran v. Merrill Lynch*, Pierce, Fenner & Smith, Inc., 554 SEC. REG. & L. REP. (BNA) G-1 (6th Cir. May 12, 1980). An approach similar to that suggested by this Article was taken in *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978), in which the court held that an interest in a discretionary commodities trading account did not constitute a security because the "common enterprise" requirement of *Howe v. Bache & Co.* was not satisfied. There was insufficient commonality between the defendant enterprise and the investor, the court reasoned, because "the success or failure of Bache as a brokerage house does not correlate with individual investor profit or loss. On the contrary, Bache could reap large commissions for itself and be characterized as successful, while the individual accounts could be wiped out." *Id.* at 461.
that reflect only advance payments for goods or security deposits for leaseholds. The general economic success of the "issuer" has some bearing on the value of these instruments, the issuer's survival is likely to be a condition to the honoring of the half-fare coupons or racetrack tickets or to the delivery of goods or services. But the market will chiefly assess such instruments by reference to matters extraneous to the prospects of the issuer, and consequently these instruments should not be considered securities. This part of the definition is sup-

117. A related problem is raised by an instrument whose value will be assessed in the market, not by reference to factors extraneous to the economic position of the issuer, but rather by reference to some part of the issuer's business. This might be the case, for example, with corporate instruments whose return was tied to the performance of only one of the issuer's divisions or tied only to sales figures for one of its products. Pyramid selling schemes usually have this feature, since certain of the common enterprise's sales rather than its overall profits usually form the basis of the return or commissions. See, e.g., SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) (holding that such an arrangement did involve securities). The same can be said of short-term debt instruments, since their value does not reflect changes in long-term prospects, or even of debt instruments in general, since their value does not reflect variations in a company's prospects above the level of performance that would enable it to pay principal and interest. Perhaps considerations such as these lie behind the greater reluctance of courts to consider debt instruments securities, especially when the loans involved are not risky ones. See, e.g., Amfac Mortgage Corp. v. Arizona Mall, Inc., 583 F.2d 426 (9th Cir. 1978) (applying the "risk capital" test discussed in note 64 supra and accompanying text and in note 169 infra). Pushing the analysis further, one can see that even equity, in a leveraged company, has this characteristic: its value will not distinguish between the prospects of a bankruptcy in which a significant amount would be distributed to the debtholders, and a bankruptcy in which very little would be distributed, so long as equity would be wiped out. Since the capital allocation process probably proceeds successfully by means of these customary instruments, no instrument should be disqualified as a security simply because its value rests on less than all of the factors relevant to the issuer's business, at least when its value relates to a major part of that business. See SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) (assignments of leasehold interests held to involve a security when their chief value arose from the prospects of discovering oil on the land, and when the seller was itself in a position to profit from such a discovery since the seller retained ownership of nearby land).

Some cases involve hybrid instruments offering prospects for profit that are only related to a portion of the issuer's business. This is typical, for example, of interests in real property located in projects operated by the seller or lessor, such as shopping centers, cooperative housing projects, and condominium developments. Although the value of the property depends primarily on factors extraneous to the business of the seller or lessor, to some extent the value rises and falls with the success of the project as a whole, as with, for example, the success of the shopping center in attracting customers. The hope of return wholly independent of the issuer's business is usually substantial, and the cases since Forman usually, and correctly, find no security to be involved. See, e.g., De Luz Ranchos Inv., Ltd. v. Coldwell Banker & Co., 608 F.2d 1297 (9th Cir. 1979) (holding that sales of plots of land did not constitute sales of a security despite representations in the selling literature to the effect that facilities would be built for a "planned community" in the area and that assistance in
ported by the portion of *Howey* (not part of the three-prong test) emphasizing that, in the fruit orchard enterprise, the investors "share in the earnings and profits." 118 This part of the definition also has a certain amount in common with the portion of the three-prong test which, as modified by *Daniel* and *Forman*, requires the instrument to offer a hope of gain from the managerial or entrepreneurial efforts of others. 119

118. 328 U.S. at 300.
119. It also has much in common with the indications in *Forman* that "profit" means "earnings" or "capital appreciation" resulting from the use of the investors' funds. *See* United Hous. Foundation, Inc. v. *Forman*, 421 U.S. 837, 854 (1975).
2. **The Instrument Must Be Eligible to Participate in a Public Market**

a. **The Nature of the Requirement**

Markets are sometimes distinguished according to whether they are "open" or "negotiated." Robinson and Wrightsman explain the distinction this way:

The rules of the New York Stock Exchange (NYSE) require that bids and offers must be made audibly. This means that the NYSE is a kind of open double auction market. While actual membership in the exchange is restricted, anyone of minimum financial respectability can engage a broker to act for him in that market. It is effectively an "open market." At the other extreme a loan arranged between a farmer and his banker is clearly a negotiated transaction. Many transactions fall between these two limits. The open-market system implies interest rates and prices that are freely available to anyone who meets the minimum tests of market participation—which means, in effect, anyone who can pay the cash or deliver the securities involved. Furthermore, the operating rules of open markets are usually standardized. The negotiated market often results in a price or interest rate that applies to that one transaction with side conditions tailored to fit the special circumstances of the case.\(^{120}\)

The term "public market" is intended to mean the "open market" described by Robinson and Wrightsman. A market can become less open in various ways and in different respects. The use of the word "public" is intended to emphasize that if a market is less open to the ordinary or unsophisticated investor, or to the investor not possessed of great wealth, that should be especially disqualifying.

The proposed definition stipulates that an instrument, even if it is "financial," is not a security if it is not "eligible" to be bought and sold in open or public markets.\(^{121}\) The requirement

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121. This part of the test finds some support in the language in Joiner. The Court stated that the definition of "security" in the Securities Act was intended to include "many documents in which there is common trading for speculation or investment." 320 U.S. at 351 (emphasis added). A comparable focus on eligibility to move in public markets is reflected in article 8 of the Uniform Commercial Code, which requires, as a condition of an instrument's being considered a "security," that it be "of a type commonly dealt with on securities exchanges or markets" and that it be "either one of a class or series or by its terms divisible into a class or series of shares, participations, interests, or obligations." U.C.C. § 8-102. The Official Comment states that at the core of the definition is the notion that a security is a share or participation in an enterprise or an obligation that is of a type commonly traded in organized markets for such interests or is commonly recognized as a medium for investment. The ambit of the definition will change as "securities" trading practices evolve to include or exclude new property interests. It is believed that the definition will cover anything which securities markets, including not only the organized exchanges but as well the
of eligibility can be elucidated by the observation that an instrument is eligible to participate in a market if it is excluded only by chance or agreement but not by anything closely related to the instrument’s component parts. Instruments represent a wide variety of rights and duties, and some of them are, for example, too personal to the first creator and holder to make them attractive to outside parties who participate in the markets. In connection with a lease of an apartment, for example, a landlord receives a security deposit, and undertakes to repay it, often with interest, under certain conditions. Whether or not he does so in the form of a separate writing or as a part of the lease contract, he might be considered to be a debtor for the amount of the deposit and to have given a note representing the debt. Nevertheless, even though instruments representing debt are one of the most common forms of securities, are widely traded on the stock exchanges, and are frequently registered under the securities laws, we would be most reluctant to call that particular instrument a security, even if the landlord wrote it out as a separate document. When we call to mind some of the peculiarities of that debt—that it is due when the tenant vacates the apartment, which is at no fixed time, and that it is subject to offset against other liabilities of the tenant, including liabilities arising from damage to the apartment—it becomes apparent that it could never be traded in a public market. The Forman case, which involved “stock” that functioned very nearly as a rent deposit, might have been decided on this ground.

Why exclude negotiated markets? The negotiated markets serve as an important channel of savings to investment and so serve the purposes that the securities laws were designed to further. Hoarding and misallocations can damage those markets and could thereby have contributed to the Great Depression by directly influencing the general economy and by

"over-the-counter" markets, are likely to regard as suitable for trading. . . .

Interests such as the stock of closely-held corporations, although they are not actually traded upon securities exchanges, are intended to be included within the definitions . . . by the inclusion of interests "of a type" commonly traded in those markets.

Id., comment 2. The Official Comment goes on to announce that "[t]his definition has no bearing upon whether an interest is a 'security' for purposes of federal securities laws. By the same token the definitions of 'securities' for purposes of those laws has [sic] no bearing upon whether an interest is a security within the definition of this Article." Id., comment 3.

122. See text accompanying note 28 supra.
spreading mistrust to the public financial markets.\textsuperscript{123} But there are several reasons why the lawmakers were correct in focusing on the public markets. The private financial markets are in significant part comprised of transactions in which the parties on both sides are large institutions, often financial intermediaries such as banks; this is so because of the heavy transaction costs, including the costs of negotiation and information gathering.\textsuperscript{124} These large institutions have the expertise and economic resources to protect themselves against frauds and many of the other evils that the securities laws were intended to prevent. Even when an unsophisticated or disadvantaged party is involved, the protections of the common law are more likely to be available if the transaction is in a private market; in a public market the victim may never learn the identity of the other party to the transaction and may therefore have no one to sue.\textsuperscript{125} In addition, wrongdoing in the private markets is less likely to impair confidence in the general financial marketplace. It is less likely to become generally known, and more likely to be perceived as unique to the transaction or the parties. Someone who buys a worthless bond through an exchange blames the market. Someone who lends a thousand dollars to a business associate and does not get it back blames himself and the associate.

\textsuperscript{123} The collapse of the Florida land boom in 1926-1928 was cited by one contemporary analyst in connection with his prediction of a similar collapse on the financial markets. See J. GALBRAITH, supra note 95, at 89-90 (citing Address by Roger Babson, 16th Annual National Business Conference (Sept. 5, 1929), reprinted in 129:1 THE COMMERCIAL & FINANCIAL CHRONICLE 1530 (1929)). It should be noted, however, that the Florida land market had attained, during its boom, many of the characteristics of a public market. See J. GALBRAITH, supra, at 23-24.

\textsuperscript{124} See J. LIGHT & W. WHITE, supra note 85, at 183-84.

\textsuperscript{125} See, e.g., Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933) (president of a corporation who purchased shares of the corporation's stock without full disclosure held not liable under state law, apparently, in part, because the transaction took place on a stock exchange). The federal securities laws are frequently interpreted so as not to apply to instances in which adequate state protections exist. See, e.g., Santa Fe Indus. v. Green, 430 U.S. 462, 478-79 (1977) (holding that minority shareholders had no remedy under rule 10b-5 for breach of fiduciary duty in connection with a freeze-out merger because of, inter alia, the availability of state corporate law remedies); Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1044 (7th Cir. 1979) (holding that a particular pledge of securities did not constitute a "sale" within the meaning of the Securities Act or the Exchange Act because of, inter alia, the availability of state law protections for secured transactions).
DEFINITION OF SECURITY

b. Features Qualifying an Instrument to Participate in a Public Market

The following are characteristics that an instrument must have in order to move in the public financial markets and thus be eligible for inclusion in the category of "security":

(i) The Instrument Must Not Be Unique

When an instrument confers on its holder rights that are not readily comparable to the rights conferred by any other instrument of the issuer, the determination of the price between a rational seller and buyer must occur within the context of each transaction in which the instrument is purchased and sold; by hypothesis there cannot be other contemporaneous transactions in similar instruments. The public markets cannot perform their pricing function in such a case, and, as a result, any transactions in such an instrument will have many of the most important features of negotiated transactions. For this reason, an instrument such as a note evidencing a loan with detailed terms different in important respects from those of other loans to the borrower,126 or an instrument giving a right to the profits on a unique farm, cannot conveniently travel in the public financial markets and is not a security under the proposed definition. The bundles of rights in the Howey case—rights to the proceeds of strips of fruit orchards—were correctly held to be securities and are not excluded as unique if, as seems to have been the case, they were roughly the same for each purchaser. But they would not have been securities if they had related, rather than to adjacent strips of trees, to entire farms located in various parts of the region, so that the potential profit could be expected to vary considerably from farm to farm.127

126. For a discussion of debt instruments generally, see text accompanying notes 144-182 infra. For authority supporting the view that uniqueness tends to disqualify a debt instrument from being a security, see note 170 infra.

127. This portion of the proposed test bears some relationship to the "common enterprise" requirement of Howey, as interpreted by some courts to require commonality among investors. See, e.g., Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 99-102 (7th Cir. 1977) (requiring "a sharing or pooling of funds" of multiple investors). On the one hand, the test proposed in this Article is more inclusive, in that it can be satisfied when there is only one investor, provided a number of identical instruments have been created. Cf. Troyer v. Karcagi, 476 F. Supp. 1142, 1147-49 & n.7 (S.D.N.Y. 1979) (requiring only a "one-to-one relationship between an investor and an investment manager"—that is, "vertical commonality"); Tisch Printing, Inc. v. Hastings, 456 F. Supp. 445, 447-49 (D. Colo. 1978) (holding that a purchase by a single enterprise of all of the stock of two corporations constituted the sale of securities within the Exchange
(ii) The Instrument Must Be Available for Cash or for Something of General Value

An instrument that cannot by its nature be acquired for cash, but only in return (as all or part of the purchase price) for something such as personal labor for a particular employer, cannot be traded in the public markets and therefore is not a security.\(^{128}\) Excluded for the same reason are instruments that, although initially available for cash, cannot by their nature yield a return without an additional contribution of labor.\(^ {129} \) These requirements are related to the prong of the Howey test that speaks of an "investment of money" and to the "solely [or largely] from the efforts of [others]" requirement.\(^ {130} \)

Two qualifications should be noted. First, an instrument should be deemed available for cash if cash can readily be employed to acquire it indirectly as well as directly. Shares of common stock obtainable only by conversion of preferred pass the test if the preferred is purchasable for cash. Second, an instrument should be regarded as available for cash if the only impediment to cash purchase is a private stipulation or agreement to the contrary. Equity shares that the issuer will convey only to its executives in return for their labor would pass the test.

The notable exclusions from the category of "securities" under this part of the test are employee benefit plans when, because of the nature of the plan and the relevant tax laws, the instruments (the interests in the benefit funds) must be ac-

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\(^{128}\) See Long, supra note 11, at 115.

\(^ {129} \) This justifies the results in many of the cases which hold that no security was involved in certain distributorship agreements, \( e.g., \) Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635 (9th Cir. 1969), or in certain franchise arrangements, \( e.g., \) Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666 (10th Cir. 1972). Some cases, however, have held pyramid selling schemes to be securities; a return from such arrangements cannot be obtained without some work as a salesperson. \( e.g., \) SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974). \( See also \) Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974). Perhaps such cases can be explained on the ground that the work involved was (or was represented to be) part-time, temporary, or, as the court in Koscot emphasized, ministerial. For an opinion that may indicate a retreat from Koscot, see Piambino v. Bailey, 610 F.2d 1306 (5th Cir. 1980).

\(^ {130} \) See text accompanying note 19 supra.
DEFINITION OF SECURITY

quired largely in exchange for labor for a particular employer or through a particular union.131

(iii) Return on the Instrument Must Be in Cash or in Something of General Value

When the instrument offers a return in cash or the like, it offers something that will appeal equally to all participants in the public markets. To the extent that the return is in a form that can be enjoyed profitably only by a few, or can be enjoyed by some much more than by others, the instrument loses its appeal to the public markets and is likely to move only in private transactions. For example, a nonprofit corporation's "stock" that offered a return in the form of fuel, tires, and repair facilities for truckers on the West Coast should not be regarded as a security; the stock is valuable only to West Coast truckers.132 Forman is explicable on this ground. The supposed securities involved in that case were part of a package in which the chief benefit to the "purchasers" was the right to an apartment in Co-op City. The market for such a benefit is probably too small to permit the functioning of the public market pricing mechanism.133

(iv) The Instrument Must Not Possess Other Disqualifying Features

Other features might tend to disqualify an instrument from moving in the public financial markets. One such feature, for example, would be a provision making the amount of the instrument's return contingent upon matters partly within the control of the original holder, as in one recent case involving a promise to make payments in an amount that would vary according to the promisee's tax position.134 Any transferee of such an instrument would be at a severe disadvantage compared to the original holder. A debt instrument with an ex-

131. For further discussion of employee benefit plans, see text accompanying notes 183-191 infra.
133. The Court in Forman observed that the benefit of low rents did not count as a "profit" within the meaning of Howey because, among other reasons, "[t]his benefit cannot be liquidated into cash." 421 U.S. at 855.
tremely short term might also be disqualified; prohibitive transaction costs tend to limit purchasers and sellers of such instruments to large institutions, so that the market for the instruments necessarily lacks many of the features of the fully public market.135 Another such disqualifying feature would be a legal impediment to trading in the public markets: a feature possessed, for example, by certain nontransferable government securities issued for specialized purposes such as to provide benefits from tax-qualified pension plans. A provision reserving apartments in Co-op City to persons with low incomes is another example of a relevant legal impediment.136

c. Marginal Cases

Many instruments will prove to have both disqualifying and qualifying features, or to have features that tend to be disqualifying but only in unimportant respects. For example, instruments that have unique features are disqualified; thus, leaseback and servicing arrangements on identical strips of fruit trees are securities but such arrangements on entire farms are not. But what about intermediate cases such as leaseback and servicing arrangements on various-sized plots of fruit trees in similar but not identical soil conditions? What about the instruments representing a privately negotiated debt when there are two institutional lenders rather than one, so that the instruments, although unique as to all the other debt instruments of the borrower, are identical to one another? What about a debt instrument that is unique in its complex prepayment provisions but has the same maturity date as the issuer's other debt—and the maturity date is a week away? Again, we have seen that payment of a return in something not cash and not readily convertible into cash disqualifies the instrument. But almost everything can be turned into some amount of cash; the

135. For a discussion of the treatment of short-term business debt proposed herein, and some discussion of the short-term debt market, see text accompanying notes 171-178 infra.

136. In order to rent an apartment in Co-op City, a prospective tenant was required to have a monthly income of no more than six times the monthly rent. In addition, preference was given to veterans, the handicapped, and the elderly. United Hous. Foundation, Inc. v. Forman, 421 U.S. 837, 841 n.1 (1975).

Impediments to transferability that, while not imposed by law, are required by the nature of the issuer should probably disqualify the instrument as a security. Country club memberships might be excluded in part on this ground; the nature of country clubs dictates restrictions on the transfer of memberships. But see Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).
significance of the West Coast truckers case\textsuperscript{137} is that the return is in a form that is of much more value to the recipient than it is to the market—it cannot readily be turned into \textit{enough} cash to make the sale worthwhile. Again, we have seen that an instrument does not qualify as a security if it cannot be acquired for cash, so that interests in a pension fund are not securities if they can be obtained only for labor for a particular employer. But what about a contributory pension fund, to which the employee, once employed by the company that established the fund, can add some of his own money and so increase his prospective pension?

There are two ways of proceeding that will assist in marginal cases. The first approach is theoretical: in adjudicating the marginal cases, courts should measure the significance of a supposed disqualifying feature by referring to the degree to which it tends to restrict transactions in the instrument to negotiated rather than public markets. This calls for a difficult calculation involving consideration not only of the nature of the instrument itself, but also of the quality of the public and negotiated markets. To the extent that the public markets improve their ability to assess instruments, gather and communicate information about them, and effect transactions in a cheap and efficient fashion, and to the extent that participation in the public markets is what economists call broad, deep, and resilient,\textsuperscript{138} instruments will move more readily in them. The introduction and development of the national market system,\textsuperscript{139} for example, may open the public markets to more instruments.

This suggests a practical approach to supplement the theoretical one. Economic theory cannot wholly determine which instruments the public markets will absorb and process; this depends in part on the habits and practices of the markets, on the expertise of their participants, and on the extent and efficiency of the market participants' intelligence apparatus. When an instrument (or one similar to it) is in fact traded in

\textsuperscript{137} See text accompanying note 132 \textit{supra}.


public markets (on stock exchanges or over the counter), that should indicate that it is a security. Similarly important are the requirements imposed by financial market institutions for processing or otherwise handling instruments in the financial markets: listing requirements of the stock exchanges are an example, as are the rating requirements of Moody's or Standard and Poor's.

C. Two Special Cases: Options and Purported Financial Instruments

Without modification, the test proposed above would exclude two types of instruments that deserve inclusion as "securities": securities options and instruments that purport to have all the characteristics of securities but in fact do not.

1. Options and Other "Secondary Securities"

Options to purchase or sell securities, like options on commodities, resemble wagers that the security in question will rise or fall in price; the option holder's prospects of gain have little to do with the economic performance of the creator of the option unless the creator happens also to be the issuer of the underlying security. Therefore, under the tests proposed above, many options are not "financial instruments" and hence not securities.

Nevertheless, it would be undesirable to exclude these instruments from the definition; they are closely linked with instruments that are the object of the protections of the securities laws. An option that participates in the public markets can directly affect the market in the underlying security and is psychologically linked to it as well. Fraud and other misconduct in the options markets is thus likely to undermine confidence in the securities markets generally. For this reason it is desirable to conclude, as the authorities generally do, that options on securities and similar devices are themselves securities, or at least that they constitute "financial instruments"

140. For a survey of recent studies establishing the impact of options trading on the market performance of the underlying securities, and on securities exchanges more generally, see SEC, REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS 12-18 (Feb. 15, 1979), excerpted in [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,945, at 81,297-303.

under the proposed definition and are securities when they are eligible to participate in the public markets.

2. Purported Financial Instruments

Forgeries of securities would not be considered securities under the test proposed above; their value does not depend on the success of the productive activities of the issuer (neither the purported issuer nor the actual makers—the forgers). Also excluded would be an instrument that authentically created an interest in a stated issuer, but an issuer that was falsely held out as engaging in a productive activity—an issuer that was, for example, just a shell for receiving money to be looted by the principals, or an issuer whose only income-producing activity was to continue defrauding others, as in a Ponzi scheme. When such instruments participate in the public markets, they undermine investor confidence at least as much as when conventional financial instruments are traded without adequate disclosure. Investors are less willing to purchase any financial instrument when there is a danger that it may not be authentic. Therefore, the few authorities that exist on the subject are correct in regarding these devices as securities. The test proposed in this Article should be amended to bring within the definition of “financial instrument” any instrument that has been given by its creator the appearance of having features

(3d Cir. 1976) (stating in dictum that “[o]ptions ... are securities”); Lubin v. Belco Petroleum Corp., [1978 Transfer Binder] FED. SEC. L REP. (CCH) ¶ 96,543, at 94,237 (S.D.N.Y. 1978) (holding that a put is a security for Exchange Act purposes, when the put in question was issued not by the issuer of the underlying security, but by its general partner); Lloyd v. Industrial Bio-Test Laboratories, Inc., 454 F. Supp. 807, 810-11 (S.D.N.Y. 1978) (holding that a call is a security for Exchange Act purposes, when the call in question was issued by an entity unrelated to the issuer of the underlying security).

See, e.g., Lawler v. Gilliam, 569 F.2d 1233 (4th Cir. 1978) (holding, without discussing whether the instruments involved were securities, that a remedy under the Securities Act was available in connection with the offer and sale of notes in an enterprise that was represented as engaged in the wine-importing business, but in fact merely served as part of a scheme to defraud investors); Seeman v. United States, 90 F.2d 88 (5th Cir. 1937) (holding forgeries of bonds to be securities). See also Goodman v. Hentz & Co., 265 F. Supp. 440 (N.D. Ill. 1967) (holding that the antifraud provisions of the securities laws applied to the actions of a broker in representing that he had purchased and sold securities for customers when in fact he had not). But cf. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 554 SEC. REG. L REP. (BNA) G-1, G-4 (6th Cir. May 12, 1980) (rejecting, on factual grounds, plaintiff's argument that an interest in a commodity future account should be regarded as a security because plaintiff had been falsely told that the elements of a common enterprise were present). For citations to cases of forged instruments and related matters under blue sky law, see 1 L. Loss, SECURITIES REGULATION 511-12 (2d ed. 1951); 4 id. at 2556-57 (Supp. 1969).
that would qualify it as a financial instrument—that is, the features of having been issued (1) by a company that produces goods and services, (2) under circumstances such that the issuer will receive the proceeds and be able to use them in its productive activities, and (3) under circumstances such that the value of the instrument turns on the success of the productive activities of the issuer. No elaborate contrivances are necessary to confer such an appearance; the necessary illusion would normally be created by the words “Common Stock of the Widget Manufacturing Company” at the top of the certificate.143

IV. APPLICATION OF THE DEFINITION TO PARTICULAR CASES

The following applies the definition proposed above to some of the major areas of controversy and confusion.

A. CERTAIN DEBT INSTRUMENTS

Under the Howey test,144 it is difficult to exclude from the category of “security” any instrument representing an obligation to pay principal and interest on borrowed funds. Long-term notes, short-term notes, commercial paper, instruments representing bank borrowings, and perhaps trade credit, all pass the three-prong test even after the modifications of Daniel

143. The proposed modification for “purported financial instruments” obtains some support from those portions of the statutory definitions that include as a security “any instrument . . . commonly known as a ‘security.’” Securities Act § 2(1), 15 U.S.C. § 77b(1) (1976); Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1976). Further support is provided by the statement of the Court in Joiner that “it is not inappropriate that the promoters’ offerings be judged as being what they were represented to be.” 320 U.S. at 353. The corollary point made above—that merely calling an instrument by some name such as “stock” provides some indication that it should be counted as a financial instrument—is supported by those cases that have applied a “literal” test. See text accompanying notes 165-169 infra. The Supreme Court in Forman indicated that the name given to an instrument, although perhaps significant, is not determinative:

In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. 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.

421 U.S. at 850. The test proposed in this Article would, similarly, determine the influence to be afforded the name of an instrument by asking what the name would lead a reasonable party to believe. The test proposed would be whether a reasonable party would believe that the instrument had the characteristics of a financial instrument rather than whether it was subject to the securities laws.

144. See text accompanying note 19 supra.
and Forman. The creditor has given value in the hope of gain in the form of interest arising from the efforts of the borrower. Courts, however, have been unwilling to go as far as this logic would push them, sensing, for example, that it is incorrect to characterize a business as issuing securities whenever it takes down funds under a line of credit from its bank. Accordingly, courts have developed supplementary doctrines.

The most important of these doctrines employs the "commercial-investment" distinction. Backtracking from the view expressed earlier in dictum that "almost all notes are held to be securities," various circuits, most notably the third, fifth, and seventh, have adopted the view that debt instruments are not securities in a "commercial context" but are securities in an "investment context." Whether the context is commercial is determined by reference to a number of factors: the number of parties to whom the instrument was offered or sold—more than one such party tends to establish an investment context; the motives of the purchaser—a motive to speculate or "invest" suggests an investment context; the use to which the issuer intends to put the proceeds—using them as "venture capital" or to acquire "investment assets" indicates an investment context, whereas using them to purchase "consumer goods or particular business goods or services" indicates a commercial context; the source of the "impetus" for the transac-

145. See text accompanying notes 45-50 supra.


147. Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 991-92 (5th Cir. 1969).


149. See, e.g., Lino v. City Investing Co., 487 F.2d 689, 694-95 (3d Cir. 1973) (commercial context established in part by the fact that there was no public offering of the notes).


151. See Zabriskie v. Lewis, 507 F.2d 546, 551-52 (10th Cir. 1974) (holding that certain notes were securities because, inter alia, they were given to obtain funds to "promote a corporation"); Lino v. City Investing Co., 487 F.2d 689, 694-95 (3d Cir. 1973) (arguing that certain notes were not securities because no solicitation of venture capital was involved).


tion—if the person with the money provides the impetus, that tends to establish the transaction as an investment, whereas if the issuer takes the leading role, that suggests a commercial transaction, and the degree to which the purchaser incurs risks or "relies" on the issuing entity—"placing funds at great risk, giving \[the\] note payee extensive collateral rights, \[and\] making repayment of \[the\] funds contingent upon some event" indicate that the instrument is a security. In addition, a note is more likely to have an investment character if it is part of an issue with many payees and many notes, if it involves a large dollar amount, and if it is long term, and if it affords a return other than in fixed amounts at fixed times or a "gain beyond repayment . . . with interest." The authorities tend to accompany lists of these factors with the observation that adjudication must proceed on the facts of the individual case, with differing weights to be assigned to the different factors, and with the possibility left open that there are more factors to be discovered. A version of the commercial-investment distinction is proposed in the American Law Institute's Federal Securities Code.

The commercial-investment distinction is not helpful in adjudication and is liable to criticism as incoherent unless its proponents can explain it more satisfactorily than in the form of a laundry list. It is a transaction-based form of the "need for


154. See 508 F.2d at 1359.
155. Id. at 1361 (citing Comment, supra note 148, at 510-24).
156. See 508 F.2d at 1361.
157. See id.
161. The definition of "security" in the proposed code excludes a "note or evidence of indebtedness issued in a primarily mercantile or consumer, rather than investment, transaction not involving a distribution." ALI FED. SECURITIES CODE § 299.53(b)(3) (Proposed Official Draft, Mar. 15, 1978). A significant part of the proposed definition is set forth in note 14 supra. The comment to this section states that it "codifies the mercantile-investment dichotomy that is emerging as the least imperfect solution to a troublesome problem." Id., comment 3 at 159.
162. The difficulty of applying the distinction was noted by the court in McClure v. First Nat'l Bank, 497 F.2d 490, 492 (5th Cir. 1974), cert. denied, 420 U.S.
DEFINITION OF SECURITY

regulation” test and suffers from the same drawbacks as does that test. The commercial-investment test was intelligently criticized by Judge Friendly in Exchange National Bank v. Touche Ross & Co. Judge Friendly proposed, as an alternative, that greater attention be paid to the literal language of the statutory definitions. This approach is called by some the “literal” test. Judge Friendly, however, was aware that the statutory phrase “unless the context otherwise requires” is an invitation to go beyond literalism, and he accordingly noted several instances in which the context does otherwise require:

the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a “character” loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business.

Although Judge Friendly concluded that the notes at issue were securities, he mentioned many factors in addition to the fact that the term “notes” appears in the statutory definition:

The “loan” was negotiated with the Bank's chief administrative officer, not with a lending officer. The form of the note was dictated not by the Bank but directly by the borrower and ultimately by NYSE. The notes themselves bore scant resemblance to the standard forms used in commercial lending. More important of all were the subordinated character of the notes and the knowledge of both parties that the proceeds would be considered by NYSE as the equivalent of equity capital for the purpose of enabling Weis further to expand its business by borrowing. The notes reflected the Bank's foregoing of the usual and important rights to take as security any property of the borrower that came into its possession or to exercise a right of set-off. Finally, the Exchange National loan was no isolated transaction but a part of a

930 (1975). See R. JENNINGS & H. MARSH, supra note 107, at 857 (“the recent cases have held that whether or not a promissory note is a security depends upon whether it is a ‘commercial’ or an ‘investment’ note, whatever that means”); Pollock, supra note 10, at 543 (“the reason that no effective list of general characteristics has been produced is that there may, in fact, be no generally recognized concepts of investment or commercial notes, or, if these concepts do have generally recognized traits, they may overlap to such a degree that no distinction can be drawn”).

163. This should be clear from the list of factors set forth above. See Lipton & Katz, “Notes” Are Not Always Securities, 30 Bus. Law. 763 (1975) (“[t]he focus is now on the nature of the transaction giving rise to the issuance of the note”). For a case applying the commercial-investment distinction to one transaction only—that in which a note was assigned—without reference to the transaction in which the note was issued, see Old Security Life Ins. Co. v. Waugneux, 484 F. Supp. 1302 (S.D. Fla. 1980).

164. See text accompanying notes 62-76.

165. 544 F.2d 1126 (2d Cir. 1976).

166. See, e.g., Amfac Mortgage Corp. v. Arizona Mall, Inc., 583 F.2d 426, 431 n.6 (9th Cir. 1978).

167. 544 F.2d at 1138.
large financing operation conducted by Weis . . . .\textsuperscript{168}

It thus is clear that the "literal" test, like the commercial-investment test, involves a range of factors—in fact, many of the same ones. Both tests lack the theoretical grounding necessary to determine what factors should be relevant and how their importance should be assessed.\textsuperscript{169}

The definition suggested in this Article would resolve some of the major issues about debt instruments in the following manner:

1. \textit{Long-Term Loans to Business Enterprises}

This is an area in which some instruments should be securities and others should not, depending on the structure of the relationship between the parties. It will be clear in virtually all cases that "financial instruments" are present: the note or bond will be a channel by which savings may be transferred to investment, and the interest on the loan will constitute a profit dependent upon the productive activities of the enterprise. Ability to move freely in the public financial markets will not be impaired by the form in which consideration is paid to the borrower or back to the lender; it is normally cash in both instances.

The principal issue in most long-term loan cases will therefore be whether the instrument is so closely "tailored" to the particular needs of the parties to the transaction as to make the instrument "unique" and thus ineligible to move in the public markets. Most instruments representing debts arising from the typical close and complex relationship between a business and its principal commercial banker will be tailored to such an extent that courts should exclude them from the category "security."\textsuperscript{170} For example, an instrument should not be considered a

\begin{itemize}
\item \textsuperscript{168} \textit{Id.} at 1138-39.
\item \textsuperscript{169} The same can be said for the "risk capital" test applied by the Ninth Circuit, under which a debt instrument is a security if the lender "contributed 'risk capital' subject to the 'entrepreneurial or managerial efforts'" of others. United Cal. Bank v. THC Fin. Corp., 557 F.2d 1351, 1358 (9th Cir. 1977) (quoting Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976)). \textit{See also} Amfac Mortgage Corp. v. Arizona Mall, Inc., 583 F.2d 426 (9th Cir. 1979); Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976). In Kotz, the court indicated that the risk capital test is largely identical to the commercial-investment test. \textit{Id.} at 1257.
\item \textsuperscript{170} \textit{See} Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1262 (9th Cir. 1976) (Wright, J., concurring). In arguing that a note given in exchange for a bank loan should be excluded from the category of "security," Judge Wright noted:

Rather than relying solely on semi-anonymous and secondhand market information, as do most investors, the commercial bank deals "face-to-face" with the promissor. The bank has a superior bargaining position
security if it reflects inventory financing on a revolving credit basis and contains provisions for an interest rate that varies with the lending bank's prime rate, provisions for inspection by the bank of books and records, provisions for forwarding of various documents and financial reports to the bank on a periodic basis, and provisions for the maintenance by the borrower of a compensating balance. On the other hand, an instrument should be deemed a security when it is free from personal particularities, when the interest rate is set by reference to the prime rate of banks generally or of some nonparty bank, when rights of inspection and enforcement of default provisions are exercisable by a trustee, when the principal amount is fixed rather than variable and is to be taken all at once rather than on a revolving basis, and when rights under the debt arrangement are not contingent upon rights and duties arising from activities in other areas of the relationships between the parties—that is, when the instrument can be used "off the peg" by strangers rather than being "tailored" to a particular lender. Some of the factors in the commercial-investment test—and perhaps also in Judge Friendly's test—survive as important considerations in this analysis; others do not. The motives of the lender are irrelevant. The use of the proceeds is irrelevant; all that survives of this requirement is that the borrower must be a business engaged in the production of goods or services. The source of "impetus" for the transaction is irrelevant—certainly a transaction initiated by the issuer should be within the scope of the securities laws and not excluded as "commercial." On the other hand, it is relevant that the instrument is capable of being offered and sold to a large number of parties, and that it is one of a large number of similar instruments.

Since there will be many intermediate cases, some presumptions may be appropriate. It might be appropriate, for example, to adopt a presumption that a security is involved in any borrowing in which the borrower is a business and there are

and can compel wide-ranging disclosures and verification of issues material to its decision on the loan application. The bank here obtained a covenant to permit it to inspect [the borrower's] property and records "at such times as [the bank] may reasonably request." Far from purchasing an instrument whose terms were fixed prior to the time of its offering, the bank negotiated the terms of the note in question. When it discovered a change in [the borrower's] financial status, it was able to negotiate new terms and restrictions on [the borrower's] dealings.

But see SEC v. Diversified Indus., Inc., 465 F. Supp. 104, 111 (D.D.C. 1979) (holding a purchase-money mortgage note to be a security when it was issued by a corporation to a trust in exchange for land acquired for investment).
numerous lenders on identical terms. Any long-term negotiable debt instrument issued by a business should be a security, and so should any business debt instrument in which the rights of the lenders are held by a trustee; trusteeship is a device for facilitating the holding of the instrument by absent, distant parties previously unconnected to the borrower.

2. Short-Term Loans to Business Enterprises

Excluding short-term debt instruments from the definition of "security" is sometimes dictated by the statutory language, since instruments with a maturity of less than nine months are expressly excluded from the definition in the Exchange Act. Although the Securities Act does not expressly except short-term debt instruments from its definition, those instruments which "arise out of a current transaction or the proceeds of which have been or are to be used for current transactions" are excluded from its registration requirements. Courts have gone further and have held that short-term instruments are not securities even when they are not excluded under the terms of these provisions. This approach is difficult to reconcile with the tests adopted by the leading cases. The three-prong test of Howey for example, does not appear to give any basis for considering the length of a loan's term. The exclusion of short-term loans is more easily reconciled with the commercial-investment distinction because the list of factors establishing that distinction has been stipulated to include term, but most of the other factors could be as easily satisfied in a short-term as in a long-term loan.

Since term is merely a matter of degree, it is not surprising that theories which recognize, as all must, that some debt instruments are securities tend also to include some short-term instruments. The definition proposed in this Article at least explains why it makes sense to be less inclusive when the instru-

174. See text accompanying note 19 supra.
DEFINITION OF SECURITY

ment is short-term. The shorter the term, the less an instrument is like a financial one—the less the hope of gain and risk of loss depend on the skills and abilities of the borrower. The market, when processing a proposed twenty-five year borrowing by a major enterprise, has a strong incentive to assess closely the enterprise's probable success; when processing a piece of ten-day commercial paper⁷⁵ proposed to be issued by the same enterprise, however, the market has little incentive for such an assessment and is likely to form its judgments based on factors that relate to the general money market.⁷⁶

The "eligible to move in the public markets" requirement is also less readily satisfied when the instrument is short-term because many short-term instruments—commercial paper, for example—are tailored to meet the cash flow needs of the lender and the borrower⁷⁷ and because the market in such instruments tends to be almost exclusively a negotiated one involving large institutions.⁷⁸

Under the circumstances, it would be consistent with the proposed definition to frame a presumption or a rule that short-

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⁷⁵. Commercial paper is comprised of short-term, unsecured promissory notes, normally issued by business enterprises to satisfy current cash requirements, and having an average term of 30 days. In the normal functioning of the commercial paper market, the financial officer of a corporation, foreseeing a need for cash in the near future, telephones an investment banking house, which in turn wires to its salespeople around the country the information that the issue is available, stating the company's credit rating and the desired maturity and rate. Institutions with money on their hands for a short period—such as insurance companies and pension funds—respond, specifying a desired maturity date. (Some large issuers place their commercial paper directly rather than through an investment banker.) The whole process can be completed so rapidly that the issuing corporation may receive its money by the end of the day. Once placed, the paper tends to stay placed, because of the short terms and the fact that the maturity date has been tailored to the needs of the lender; there is little after-market trading. See J. Light & W. White, supra note 85, at 280-88; Arenson, Commercial Paper Surge, N.Y. Times, Feb. 4, 1979, § 3, at 1, col. 3.

⁷⁶. It might also be argued that short-term instruments fail the requirement of susceptibility to be sold to obtain funds for investment since the proceeds of sales of such instruments are apt to be used by a business for day-to-day needs rather than for "investment" in the narrower sense of capital investment. This is frequently the case with commercial paper, for instance. See Arenson, supra note 175. In this Article, however, the term "investment" includes any use in the production of goods and services.

⁷⁷. J. Light & W. White, supra note 85, at 280.

⁷⁸. Bank loans constitute by far the largest form of short-term business debt (about $112 billion), followed by loans from finance companies (about $45 billion) and commercial paper (about $13 billion). Id. at 260 (amounts outstanding on Dec. 31, 1977). Commercial paper is purchased largely by institutions such as pension funds and insurance companies. Arenson, supra note 175.
term loans to business enterprises are excluded from the category "security." Alternatively, instruments with a well-recognized character in the money markets, such as commercial paper, might be excluded.

3. Consumer Loans and Other Borrowings by Individuals

Courts have generally concluded that no security is involved in borrowings by individuals, such as consumer and residential mortgage loans, despite the difficulty of excluding such loans under the three-prong *Howey* test. Judge Friendly in *Exchange National Bank* called an unsecured short-term personal loan to an individual "the very archetype of what the securities laws were not intended to cover," but noted that they might be securities if one applied the unmodified *Howey* test. Some consumer lending even edges towards the "investment" rather than the "commercial" side of the commercial-investment distinction: some is risky, heavily collateralized, long-term, and engaged in at the initiation of and on the impetus of the consumer lender. Consumer loans are also likely to involve an instrument labelled a "note" and thus to fall within the literal language of the statute.

The courts' desire to exclude such instruments from the category of "security" is surely correct, and the definition proposed in this Article would almost always exclude them. They would seldom qualify as "financial instruments" because the issuer—that is, the individual borrower—is not in a position to use them for the purpose of producing goods and services to any noteworthy extent. The individual may produce goods and services at his place of employment, but a loan to assist him in purchasing a residence or a boat or in paying his accumulated utility bills will not contribute much to that effort. Furthermore, in the vast majority of cases, the instrument given to evidence the borrowing will be one of a kind; there will normally be only one lender, one instrument, and a set of terms different

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179. *See also* National Bank of Commerce v. All Am. Assurance Co., 583 F.2d 1295 (5th Cir. 1978) (holding that a promissory note given by an individual in exchange for bank loan was not a security).


181. *Id.*

182. It might be argued that the proceeds of such loans are invested in the domestic production of goods and services. A graphic illustration is the case of a loan for kitchen improvements to be used in cooking for the family. Even if this argument is correct, the instrument is not a financial one because the lender's hope of return does not depend on the success of those activities.
from those applicable to any other borrowing in which the consumer is engaged. Consequently the instrument will be ineligible to move in public markets. Such borrowings are, of course, generally conducted in negotiated rather than public transactions. The proposed definition therefore excludes consumer borrowing in all but very unusual circumstances.

B. INTERESTS UNDER EMPLOYEE RETIREMENT PLANS

In *Daniel*,183 the Supreme Court held that the employee's interest under a union retirement plan pursuant to which the employers made contributions to a retirement fund was not a security when the employee's participation was involuntary (he could not, for example, elect to take cash instead of employer contributions), when the plan did not contemplate that the employee would in general make direct contributions, and when the plan was a "defined benefit plan"—that is, a plan in which the amount of retirement benefits is not designed to rise or fall according to the success of the investments made by the trustees.184 Since then, lower courts have held such interests not to be securities when the employee's participation was voluntary and when he made contributions himself,185 and legislation has been proposed excluding many such arrangements from the anti-fraud provisions of the securities laws.186 The SEC staff, in an extensive release, has adopted the view that

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183. See text accompanying notes 35-41 supra.

184. A "defined benefit plan" is one under which the retirement benefits to be received by the employee are fixed, and the employer's contribution to the plans can usually be adjusted as necessary to afford those benefits. (Of course, the level at which they are "fixed" may have been set to reflect anticipated performance of the securities in which contributions are invested as well as to reflect anticipated employer contributions.) A "defined contribution plan," by contrast, is one in which pension benefits are based on contributions together with gains, losses, income, and expenses resulting from the securities in which the contributions are invested; the amount of benefits may thus vary according to such performance. See Employee Retirement Income Security Act of 1974, § 3(34), (35), 29 U.S.C. § 1002(34), (35) (1976). The *Daniel* plan, however, like many multi-employer collectively bargained defined benefit plans, differed from the standard defined benefit plan in that the employers' obligations to contribute were limited to contractually fixed amounts. See Securities Act Release No. 33-6188, 45 Fed. Reg. 8960 (1980) (to be codified in 17 C.F.R. § 231.6188), reprinted in 1 FED. SEC. L. REP. (CCH) ¶ 1051, at 2073-7 n.29 (1980).


the Daniel analysis should be extended to exclude as securities employee interests under many, but not all, types of retirement plans.187

When the Howey test is adjusted according to the definition proposed in this Article, these extensions of Daniel are readily justified. Interests in such retirement plans are normally "financial instruments" since savings can be channeled to investment through them in such a way that hope of gain turns on the success with which the fund is operated. (This conclusion is undermined to the extent that the prospect of return depends on factors extraneous to the investment success of the fund, such as forfeitures by other employees or government insurance-of-benefits arrangements,188 and consequently some such instruments may fail to qualify as securities upon a close investigation of the particular fund's financial results.) However, the requirement that the instrument be eligible to participate in the public markets will tend to exclude many of these interests. First, nearly all instruments relating to employee retirement plans are nontransferable (except, upon death, to designated beneficiaries) because of the requirements of the laws that provide favorable tax treatment to qualified plans.189 This itself prevents the instruments from participating in a secondary market of any kind, public or negotiated. As to the primary market, the instruments fail the "readily obtainable for cash" requirement—one can normally obtain such an instrument only in exchange for work done for a particular employer or through a particular union, and one cannot circumvent this requirement by hiring someone else to work on one's behalf. (Some plans permit additional cash contributions by the employee, but in the typical case employment is still a condition to participation.) In addition, the instruments may be

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187. See Securities Act Release No. 33-6188, supra note 184, reprinted in 1 Fed. Sec. L. Rep. (CCH) ¶ 1051 (1980). This release states, among many other things, that employee interests will not be treated by the staff as securities for Securities Act purposes where they are under either involuntary, contributory plans or voluntary, noncontributory plans. Id., 45 Fed. Reg. at 8964-65, reprinted in 1 Fed. Sec. L. Rep. (CCH) ¶ 1051, at 2073-9 to -10. However, the release further states that "the interests of employees in voluntary, contributory, corporate pension and profit-sharing plans are securities within the meaning of section 2(1) of the 1933 Act." Id., 45 Fed. Reg. at 8966, reprinted in 1 Fed. Sec. L. Rep. (CCH) ¶ 1051, at 2073-12 (1980).

188. For example, the Pension Benefit Guaranty Corporation provides for such arrangements. See 29 U.S.C. § 1323(a)-(f) (1976).

189. See, e.g., Employee Retirement Income Security Act of 1974, § 206(d)(1), 29 U.S.C. § 1056(d)(1) (1976) (with certain exceptions, "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated").
disqualified from participating in a public market because benefits are allocated according to the circumstances of the individual beneficiary; each instrument is "unique" within the meaning of that term in the proposed definition because benefits commence not at some uniform date but, typically, when the employee reaches the age of 65, dies, or becomes disabled.\textsuperscript{190}

For these reasons, interests under employee retirement plans of the standard, tax-qualified varieties are ineligible to move in the public financial markets (and of course they do not move in them). They should therefore never be considered securities, whether or not employee participation in them is voluntary, whether or not additional employee cash contributions are permitted, and whether they are of the "defined contribution" or "defined benefit" variety.\textsuperscript{191}

V. CONCLUSION

In order to alleviate the general uncertainty about the definition of "security," courts should adopt a governing principle

\textsuperscript{190.} A less important form of uniqueness is involved in a case in which each instrument differs from the others only in its "maturity" date—the date the issuer's payments are to begin—because the market's pricing of one such instrument can be readily applied to another by the use of a discounting formula. The value of pension plan interests also varies according to the probability of the holder's early disability. \textit{But cf.} SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (annuity contracts held to involve securities despite the likely presence of some of these features).


The view presented in the text with respect to employee plans cannot be readily extended to retirement plans for the self-employed ("Keogh Plans"). The market for interests under a Keogh Plan is more nearly public because the only major restriction on participation is the requirement that one be self-employed. For a description of Keogh Plans and their position under the Internal Revenue Code and the federal securities laws, see Securities Act Release No. 33-6183, \textit{supra} note 184 (expressing the view that "voluntary contributions by participants to such plans would create securities"), \textit{reprinted in} 1 FED. SEC. L. REP. (CCH) \textsuperscript{1} 1051, at 2073-13 to -14 (1980). Nor does the view presented in the text extend to the issue whether instruments made by the trustees of funds under retirement plans involve securities.
derived from congressional intent and redefine “security” as a financial instrument eligible to move in the public financial markets, together with certain related instruments that closely affect those markets. This definition may not yet appear in the language of the cases, but in a certain sense it can already be said to be law; it is supported by the “character the instrument is given in commerce” language of the Court in *SEC v. C.M. Joiner Leasing Corp.*,¹⁹² and is consistent with the results in other Supreme Court cases.¹⁹³ Courts should not be deterred from adopting it by the three-prong dictum of *Howey*; though frequently quoted, that test is more often the object than the instrument of analysis. An impressive array of cases departs from its literal terms. It is submitted that the test proposed in this Article accords with the cases when the *Howey* test does not—cases in such areas as commodity options, advance payments for the purchase of goods, long-term bank loans to enterprises, consumer loans, and interests in employee retirement plans. When portions of the *Howey* test accord with the results of the cases, the results are also congruent with the test proposed here and are explained by its rationale. Under the circumstances, courts mindful of the superior authority afforded results over language should not hesitate to apply the proposed test. Similarly, those responsible for developing the proposed federal securities code should abandon their intention to perpetuate the laundry-list style of statutory definition¹⁹⁴ and instead draft a more coherent definition along the lines proposed here.

¹⁹². 320 U.S. 344, 352 (1943).
¹⁹³. *See* text accompanying notes 24-61 *supra*.
¹⁹⁴. The definition of “security” in the proposed Federal Securities Code is set forth at note 14 *supra*. By including the term “investment contract” in the definition, the draftsmen make it very likely that the present case law will continue in force, with all its confusion, to the detriment of the proposed code’s chances of real success in its stated purpose of simplification.