Investment Contracts: Expanding Effective Securities Regulations

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INVESTMENT CONTRACTS: EXPANDING EFFECTIVE SECURITIES REGULATION

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I. INTRODUCTION

"Novel or atypical methods should not provide immunity from the securities laws.""1 It is well established that the federal securities laws must be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes."2 With regard to regulating investment contracts under these laws, the courts have indicated a willingness to keep pace with the changing times and the investment schemes which accompany them.

There can be no doubt as to congressional intent in enacting the Securities Act of 19333 and the Securities Exchange Act of 1934.4 In considering the 1933 Act, the Senate Committee on Banking and Currency declared:

The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion . . . .5

Simultaneously, the House Committee on Interstate and Foreign Commerce, after studying the decade following World War I, reported that:

$25,000,000,000 worth of securities floated ... proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities . . . . Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the

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1 A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967).
5 S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933).
worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.\(^6\)

Clearly, a principal goal was to protect the investing public and to assure "that the persons . . . who sponsor the investment of other people's money should be held up to the high standards of trusteeship."\(^7\)

The purpose of the Securities Act of 1933 as stated in the preamble is "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . . ."\(^8\) The vehicle through which "full and fair disclosure" is to be made is a registration statement, without which, absent an exemption, the use of the mails and facilities of interstate commerce for the sale of a security is prohibited.\(^9\)

The purpose of the registration statement is to provide the investing public with pertinent business and financial facts concerning the issuer and its securities so that investors will be able to make informed decisions regarding the purchase of securities.\(^10\)

Similarly, responding to the President's demand for securities "legislation [that] has teeth in it"\(^11\) following "the speculative orgy of 1928 and 1929,"\(^12\) Congress enacted the Exchange Act. Although intending to extend "the legal conception of a fiduciary relationship—a guarantee of 'straight shooting,'"\(^13\) Congress realized it could not specifically enumerate all proscribed acts and practices "for some purposes may be turned to illegitimate and fraudulent means . . . ."\(^14\) Rather, "broad discretionary powers"\(^15\) were conferred on the Securities and Exchange Commission. Therefore, the Commission in section 10(b) was empowered to prohibit "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations" which may have been promulgated in the public interest.\(^16\)

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7 Id. at 3.
8 Securities Act of 1933, ch. 38, Preamble, 48 Stat. 74.
9 Securities Act § 5. The more common exemptions include the intrastate offering and the private placement. See id. §§ 3(a)(11), 4(2).
11 H.R. Rep. No. 1455, 73d Cong., 2d Sess. 81 (1934) President Roosevelt stated:
It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.
12 S. Rep. No. 1455, 73d Cong., 2d Sess. 81 (1934)
14 Id. at 7.
15 Id.
16 Section 10 of the Exchange Act requires that "the use of any means or instrumen-
II. INVESTMENT CONTRACTS: SUBSTANCE OVER FORM

Recently, a number of novel or atypical investment schemes have been challenged by the Commission. In each instance, the defendants contended that they were not selling securities, but rather products or services and were, therefore, outside the scope of the federal securities laws. However, in convincing the courts that these schemes involved securities, the Commission successfully argued that the offer consisted of an investment contract. As a result, compliance with the Acts’ registration and anti-fraud provisions, among others, was ordered through the issuance of orders enjoining future violations. Understanding the recent decisions involving whiskey warehouse receipts, pyramid sales schemes, and certain commodity offerings and their implications is facilitated by a brief examination and analysis of the historical concept of investment contracts.

The definition of the word “security” in the Securities Act was intended to be “in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the concept of a security.” Therefore, section 2(1) of the Securities Act states in part:

[T]he term “security” means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a security.

The United States Supreme Court has, on five occasions, interpreted the term “investment contract.” In SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).
ing Corp., a landmark decision, the Supreme Court held that "the nature of the assets back of a particular document or offering" was not determinative on the issue of whether a security was being offered: 20

The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be. 21

In Joiner the defendants had used the mails to solicit purchasers for leasehold subdivisions in land surrounding the drilling of an exploratory oil well, emphasizing "the character of the purchase as an investment and as participation in an enterprise." 22 If the drilling were successful and a new oil field realized, clearly, the value of the leases around the well would have greatly appreciated.

In reversing both the trial court and circuit court of appeals, the Supreme Court concluded "that defendants were not, as a practical matter, offering naked leasehold rights." 23 Rather, the investor was offered "a form of investment contract"; 24 for in addition to purchasing a lease he also received without additional expense the opportunity to profit from the exploratory oil drilling. Recognizing the legislative intent, as well as the fact that "[t]he trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end," 25 the Supreme Court stated that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." 26

From the outset the Court realized that in some instances proof of a security "must go outside the instrument itself as we do here." 27 With a view to the future, the Joiner Court warned that

the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of

20 320 U.S. 344, 352 (1943). See Securities Act §§ 20(b), 22(a) and Exchange Act §§ 21(c), 27, which empower the Commission to bring injunctive actions in the federal courts.
21 320 U.S. at 352-53.
22 Id. at 346.
23 Id. at 348.
24 Id. at 349.
25 Id.
26 Id. at 350-51.
27 Id. at 355.
dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"28

In SEC v. W. J. Howey Co.,29 the Supreme Court, in reversing the lower court's refusal to grant injunctive relief, noted its approval of the Joiner decision. Ostensibly, parcels of a citrus grove had been offered for sale to the public by the W. J. Howey Co. However, a service contract for cultivating, harvesting, and marketing of the crops was also offered, and 85 percent of the land sold was accompanied by such a service contract with Howey-in-the-Hills Service, Inc.30 Net profits were remitted to each owner.

Disregarding form in favor of substance and with emphasis on economic reality, the Court held that the land sales contract and the service agreement, "regardless of the legal terminology in which such contracts are clothed,"31 constituted an investment contract within the meaning of section 2(1):

In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise . . . . [Such a definition] embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.82

The Court concluded that the respondents were offering more than just a fee simple interest in land. Rather, they were offering "an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents."33 The Court noted that this offer was made to people who live in "distant locations," and who lack the means or experience necessary to realize profits from the citrus groves. The Court determined that these investors had no desire to own the grove per se but were "attracted solely by the prospect of a return on their investment."34 "The test," the

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28 Id. at 351.
29 328 U.S. 293, 299 (1947).
30 Both W. J. Howey Co. and Howey-in-the-Hills Service were under common control and management. Id. at 295.
31 Id. at 300.
32 Id. at 298-99.
33 Id. at 299.
34 Id. at 300.
Court concluded, "is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

Adhering to the principles set forth in the above cases, the Supreme Court, in its three most recent decisions in the area, found investment contracts to exist where profits were to be realized through outside managerial efforts. In *Tcherepnin v. Knight*, the Court held that an investment contract existed where the investors were "participants in a common enterprise—a money lending operation dependent for its success upon the skill and efforts of the management of City Savings in making sound loans." Similarly, in *SEC v. Variable Annuity Life Insurance Co. of America*, the Court found an investment contract where the sale of an annuity "place[d] all the investment risks on the annuitant, [and] none on the [insurance] company" which was responsible for managing the investments and making the investment policy. In *SEC v. United Benefit Life Insurance Co.*, the Court held that the "Flexible Fund" program, the subject of the controversy, was an investment contract, as it was "pitched to the same consumer interest in growth through professionally managed investment as mutual funds."

**Whiskey Warehouse Receipts**

In January 1974, after obtaining injunctions in several actions involving the sale of scotch whiskey interests, the Commission urged consumers to exercise caution before making such investments. Advising the public that the sale of whiskey warehouse receipts has been interpreted as the sale of securities by more than one district court, the

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35 *Id.* at 301. See also *Huberman v. Denny's Restaurants, Inc.*, 337 F. Supp. 1249 (N.D. Cal. 1972), where the sale of property which was leased for a restaurant franchise constituted the sale of a security, since the rent was determined according to the gross sales of the restaurant, and the lessor's role was totally passive.


39 *Id.* at 211. Federal courts have continually looked beyond the nature of the assets involved in an offering and, where substance dictated, held that a security was being offered. See, e.g., *Continental Marketing Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968) (beavers); *D.H. Roe v. United States*, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961) (oil leases); *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961) (mortgages and deeds of trust); *Penfield Co. v. SEC*, 143 F.2d 746 (9th Cir.), *cert. denied*, 323 U.S. 768 (1944) (whiskey bottling contracts); *SEC v. Crude Oil Corp. of America*, 93 F.2d 844 (7th Cir. 1937) (crude oil); *SEC v. Bourbon Sales Corp.*, 47 F. Supp. 70 (W.D. Ky. 1942) (whiskey); *SEC v. Bailey*, 41 F. Supp. 647 (S.D. Fla. 1941) (tung trees); *SEC v. Tung Corp. of America*, 32 F. Supp. 371 (N.D. Ill. 1940) (tung trees).

Commission warned that promotional literature and other sales representations in many instances were not accurate and in fact violated the anti-fraud provisions of the federal securities laws. Among the more common false and misleading statements or omissions of material facts, the Commission noted the following:

(1) Although a return of 20 to 25 percent a year is advertised, many investors have in fact sustained losses.

(2) Although investments can be made in either malt or grain whiskey, investors are not apprised of the differences between the types.

(3) Investors are not informed that the prices they pay for raw whiskey are generally in excess of the trade prices for the same. In some instances, the investor may pay as much as double the actual market price.

(4) Investors are not advised that they may encounter difficulty in disposing of their individual holdings, causing them to become dependent upon the company for resale.

(5) Investors are not informed that they may subject themselves to governmental regulations if they attempt to dispose of or import their holdings.\(^\text{41}\)

The announcement concluded that individuals should insist on receiving a prospectus before investing.

In the past year, as a result of the widespread injury resulting from the sale of whiskey warehouse receipts, the Commission instituted a number of injunctive actions. In each case the Commission sought to restrain further violations of the registration and anti-fraud provisions of the federal securities laws. In all three instances where a decision has been rendered the Commission’s prayer for relief has been granted.\(^\text{42}\)

\(^{41}\) Id. See also SEC Securities Act Release No. 5018 (Nov. 4, 1969).

\(^{42}\) SEC v. Glen-Arden Commodities, Inc., Civil No. 73-1264 (E.D.N.Y., Jan. 17, 1974), aff'd, No. 74-1039 (2d Cir. Mar. 14, 1974); SEC v. Hassenden-Rimar, Int'l, Inc., 362 F. Supp. 323 (1973), appeal docketed, No. 73-2297, 4th Cir., Oct. 29, 1973; SEC v. M.A. Lundy Associates, 362 F. Supp. 226 (D.R.I. 1973). Previously, in SEC v. Brigadoon Scotch Distrib. Co., 480 F.2d 1047 (2d Cir. 1973), the Commission's right to issue subpoenas during the course of its investigation of the sale of whiskey warehouse receipts was upheld. Respondents contended that they sold commodities or documents of title to specific casks of whiskey and therefore were not subject to Commission regulations. Noting that there were "serious questions about whether their activities are subject to regulation by the SEC," id. at 1052, the court held:

It is apparent from the SEC's Order [of investigation] in this case that its investigation has the legitimate purpose of determining whether the whiskey or warehouse receipts sold by appellants, in the context of the representations or understandings that may surround their sale, are securities covered by the securities acts, and, if so, of determining whether any securities violations have occurred. The Securities Act and the Exchange investigations ... and the information sought through the subpoenas is obviously relevant to the inquiry.

Id. at 1054.
The basic premise behind the investment in whiskey receipts, as touted by the promoters, is quite simple. The production of consumable whiskey involves distilling, aging, and blending. Aging is a fundamental and significant part of the process. Since the value of whiskey increases with age and no short cut for years of aging has been invented, the investor in many instances is led to expect profits automatically at the end of a given period. Companies, therefore, offer the sale of whiskey to be aged in Scotland, usually coupled with the concomitant sale of various managerial services.

In the initial decision in the area, the district court, in SEC v. M. A. Lundy Associates, concluded that whiskey warehouse receipts are in fact securities within the meaning of section 2(1). To solicit investors, defendants Lundy and Scotch Whiskey, Ltd., the latter representing a British company for the purpose of selling scotch warehouse receipts in the United States, placed the following advertisements in newspapers: "Invest In Scotch Whiskey For Profit"; "Exceptional Capital Growth Is Possible When You Buy Scotch Whiskey Reserves By The Barrel"; "Insured (Lloyd's of London) No Loss Policy"; "Insured Investment For Profit And Growth In Scotch Whiskey." Those responding to the advertisement were sent a brochure which stated that "the older the whiskey the more the price appreciates," and that there is a "guaranteed appreciation" with the purchase of malt whiskey, for it "increases in value automatically while it gets older."

Relying on the Joiner Leasing and Howey decisions, the district court determined that the sale of scotch whiskey warehouse receipts constituted the sale of an investment contract. The court rejected the defendants' contention that the sales involved were sales of commodities and, therefore, not subject to regulations by the Commission. Concluding that the investor's purpose was to realize a profit on resale, and that in order to do so he was dependent on the broker's advice, the court disregarded form and looked to the substance of the transaction. Moreover, the court emphasized the "economic reality:"

[T]he more critical factor is the nature of the investor's participation in the enterprise. If it is one of providing capital with the hopes of a favorable return then it begins to take on the appearance of an investment contract notwithstanding the fact that there may be more than one party or other than a principal party and his agent on the other end of the transaction or transactions.

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44 Id. at 236
45 Id.
46 Id. at 238, quoting Continental Marketing Corp. v. SEC, 337 F.2d 466, 470 (10th Cir. 1967), cert. denied, 391 U.S. 905 (1968).
Holding that an investment contract existed, the court enjoined the defendants from further sales in violation of the registration provisions of the Securities Act.

Next, the court turned to the Commission's contention that the defendants were violating the anti-fraud provisions of the Acts. The court noted that the investment brochure "fails to disclose that the appreciation in the value of scotch whiskey is based upon the economic law of supply and demand, and that there is no guarantee, as Lundy admitted, of appreciation in value based solely on the aging process of whiskey." Moreover, the court found that the advertisements referring to insurance were misleading in that they led investors to believe that their investments were protected from loss, for, in fact, the insurance afforded protection only against physical loss or damage to the whiskey or casks. The court concluded that "[t]he investment is not insured for profit as is recited in the advertisement . . . ." As a result, the court issued an injunction against further violations of the anti-fraud provisions.

One month later, the district court, in SEC v. Haffenden-Rimar, International, Inc., reached the same conclusion. The facts, which were similar to those in Lundy, were undisputed: "The defendants' newspaper advertisements, brochures and salesmen classified the scotch whiskey which was being offered for sale to the public as an investment which can be expected to yield twenty to twenty-five percent per annum." Again, investors were advised that as the scotch ages it becomes more valuable, and that the investment was insured by Lloyds of London. What the investors were not told was that their purchase price included a mark-up of up to 70 percent, and that the salesman received a commission. Significantly, the defendants selected the scotch, cask, and warehouse for each individual investor. However, the defendants contended that they were selling raw unblended whiskey and not securities.

Following the Joiner Leasing and Howey guidelines, the court was satisfied that the offer and sale of scotch whiskey under these cir-

47 Violations of Securities Act § 17(a) and Exchange Act § 10(b), as well as rule 10b-5, were alleged.
48 362 F. Supp. at 236.
49 Id. at 239.
50 In addition, the court issued an injunction against future violations of the bookkeeping provisions of Exchange Act § 17(a) by the defendants, who were found to be selling securities and had "failed to keep and maintain proper books and records relating to the sales." Id. at 239.
52 Id. at 324.
53 Id. at 325.
cumstances constituted the sale of a security. In determining that the defendants were offering and selling investment contracts, the court concluded:

Most, if not all, of the investors relied solely on the advice of the defendants in selecting, buying, storing, trading and selling the Scotch represented by their warehouse receipts and/or letters of acknowledgement — Their participation in the enterprise was limited to providing capital with the hope of a favorable return.\(^5\)

Having determined that securities were being offered and sold, the court found that the defendants violated the anti-fraud provisions of the Acts by making false and misleading statements of material facts, as well as omitting to state material facts to prospective purchasers. The misrepresentations included statements regarding annual profits, insurance, and the soundness of the investment. In addition, investors were not advised of the commissions retained on each resale and of possible tax consequences resulting from the resale of their holdings.\(^6\) Moreover, the defendants failed to advise investors fully of the market fluctuations in scotch whiskey and of the basis for projected profits on their investments.\(^7\) Based on the record, the court found sufficient basis for granting permanent injunctions against the defendants.

In \textit{SEC v. Glen-Arden Commodities, Inc.},\(^8\) the most recent decision, the district court concluded that the sale of whiskey warehouse receipts by the defendants was a “pervasive scheme to defraud the public.”\(^9\) With facts similar to those in \textit{Lundy} and \textit{Haffenden-Rimar}, the Commission alleged the sale of unregistered securities induced by false and misleading statements by an unregistered broker-dealer. Included among the false representations were statements regarding appreciation and profits, lack of financial risk involved, and availability of insurance for the investment.\(^10\) Mindful of the public interest involved, the court, in granting the injunctive relief requested, rejected as untenable the defendants’ contention that they were selling raw unblended whiskey with which the customer could do as he pleased and concluded that an investment package was being offered.

Adhering to the \textit{Joiner Leasing} and \textit{Howey} guidelines, the court determined that a security in the form of an investment contract was being offered and sold to the public. In reaching this conclusion, the

\(^5\) Id. at 327.
\(^6\) Id.
\(^7\) Id.
\(^8\) Id.
\(^9\) Id. at 327.
\(^10\) Id.
court considered "the manner in which the Scotch whiskey warehouse receipts were sold — the information given, profits predicted, services promised and the obligations to be assumed by the purchasers . . . ".\textsuperscript{60} The court found that the defendants, in their advertisements, sales literature, and representations by their salesmen, "emphasized that the purchasers were making an investment."\textsuperscript{61} Moreover, the right of actual ownership was insignificant to the purchaser. Investors' testimony led the court to determine that "they were not knowledgeable about the Scotch whiskey market and relied solely on the expertise of defendants in the management of their investments."\textsuperscript{62} The court declared: "Of critical importance is the testimony of all the investors that if they had not been furnished cooperage and insurance and had not been promised assistance in the liquidation of their investments they would not have purchased the warehouse receipts."\textsuperscript{63}

The district court's holding was affirmed in all respects by the Court of Appeals for the Second Circuit,\textsuperscript{64} which adopted the broad reading of \textit{Joiner}, and focused on the defendants' promotion of the whiskey interests as investments and the absence of a ready market for the whiskey represented by the warehouse receipts: "This brings the scheme within a long line of cases where purported sales of tangible property, service contracts or both were held to be investment contracts . . . when in fact what was being sold was an investment \textit{entrusting the promoters with both the work and the expertise to make the tangible investment pay off}."\textsuperscript{65} Thus, one court of appeals has now accepted the contention, clearly established at the district court level, that the sale of whiskey warehouse receipts, as outlined above, constitutes the sale of a security.\textsuperscript{66}

\textit{Pyramid Sales Operations}

In the area of pyramid sales arrangements, the courts in large part have demonstrated a continued willingness to afford investor protection through a flexible interpretation of the federal securities laws. In a pyramid scheme, individuals are induced to invest in the company as

\textsuperscript{60}Id. at 5.
\textsuperscript{61}Id. at 12.
\textsuperscript{62}Id. at 11.
\textsuperscript{63}Id. at 12.
\textsuperscript{64}No. 74-1039 (2d Cir., Mar. 14, 1974).
\textsuperscript{65}Id. at 16-17 (emphasis in original).
\textsuperscript{66}A number of state securities laws include whiskey warehouse receipts in their definition of securities. \textit{See} FLA. STAT. ANN. \S 517.02(1) (1972); N.C. GEN. STAT. \S 78-2(2)(g) (1965); O\textit{HIO REV. CODE ANN.} \S 1707.01(B) (Page 1972). \textit{See also} LA. REV. STAT. \S 51:701(1) (1974) and N.H. REV. STAT. ANN. \S 421:2 (1973), which define all warehouse receipts as securities for state law purposes.
distributors who ostensibly participate in the sale of some specific product. In fact, in order to make money the distributors must sell distributorships to other individuals. The typical arrangement, whereby the distributor receives compensation based on the recruitment of new individuals, is like that of a chain letter, and the market becomes similarly saturated as the scheme expands.

In SEC v. Glenn W. Turner Enterprises, Inc., the district court held that the sale of motivation courses to the public through a pyramid operation constituted the sale of a security. Having determined that the purchasers believed they were buying more than course materials, and that the ultimate success of this operation rested with the promoters, the court concluded that an investment contract was being offered and sold to the public.

In selling “Adventures” (self-improvement courses), Dare to be Great, Inc., a wholly owned subsidiary of Glenn W. Turner Enterprises, Inc., offered to purchasers the right to sell Adventures to other members of the public. In seeking new customers, salesmen were only to entice prospects to attend an Adventure Meeting organized by the defendants. It was at these “canned” revival-type meetings that the planned sales pitch was delivered and sales realized.

In granting the injunctive relief sought, the court cited the legislative intent behind the securities laws and previous case law under the Acts. Noting that investors were promised, and in fact expected, a return on their investment, the court declared: “The very purpose of the statutes would be violated if they were construed to apply only to familiar and conventional transactions, and were not capable of adaptation to novel and irregular schemes fairly covered by the intent and text of the statutes.” The inherent evils in the pyramid operation, the court stated, were intended to be curbed by the Securities Act.

Moreover, the court held that regardless of the layman’s perception of an offering, whether it was in fact a security was a legal matter. In determining “what is commonly known as a security” rather than an investment contract, the court applied the “risk capital test,” i.e., “the subjection of the investor’s money to the risk of an enterprise over which he exercises no managerial control is the basic economic reality of a security transaction.”

68 348 F. Supp. at 771.
69 Id. at 772.
70 Id. at 773. In addition, the court found the contracts to be certificates of interest in
Turning to the Howey test, the court had no difficulty in determining the existence of contracts which were mutually regarded as investments as well as the existence of a common enterprise where any return to the investors depended on the defendants' success in attracting more purchasers. The "sticking point" involved the requirement that profits be derived "solely" from the efforts of others. Noting that a narrow interpretation of "solely" would be anomalous to the precedents, the court rejected the defendants' contention that since the investor must work for a return on his investment, profits did not stem solely from the efforts of the promoter. Rather, the court looked to "whether or not the investor has substantial power to affect the success of the enterprise." The court concluded that the "solely" requirement was met: "The significant efforts in this promotion are the specialized, professional, high-powered tactics used at these meetings by defendants, and the ordinary investors by themselves would be unsuccessful at persuading anyone else of parting with $2,000 to $5,000."

Affirming the district court's decision, the Court of Appeals for the Ninth Circuit devoted its attention only to the question of whether an investment contract existed. The court acknowledged at the outset that the Dare to be Great investor had to exert some efforts to realize a return on his money. However, taking into account the intent of Congress as well as previous declarations by the Supreme Court regarding the flexibility of the definition of a security, the court rejected the contention that "solely" should be interpreted literally in defining an investment contract. Instead, the court reiterated that substance, not form, controls and concluded that a strict interpretation of the term "solely" could lead to "unrealistic results if applied dogmatically." For, "by adding a requirement that the buyer contribute a modicum of effort," a promoter would be able to place his scheme outside the

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a profit sharing agreement and therefore includable in the definition of a security under another provision of section 2(1). Id. at 776.

11 Id. at 774.
12 Id.
13 Id. at 775.
14 Id. However, in SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973), appeal docketed, No. 73-2339, 5th Cir., June 14, 1973, the court, on similar facts, wherein the defendant corporation marketed cosmetics through distributorships in a pyramid organization, held to the contrary. Concluding that the distributors' efforts were more than token in nature, the court held that the sale of a security was not involved.
15 474 F.2d 476 (9th Cir. 1973).
16 Id. at 482.
17 Id.
18 Id. at 483.
definition of an investment contract.\textsuperscript{79} The more "realistic test" adopted by the court was "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."\textsuperscript{80} Therefore, the court correctly refused to preclude the existence of an investment contract merely because the investor performed some incidental tasks.

Since the Supreme Court denied certiorari,\textsuperscript{81} the Ninth Circuit's decision is significant. Moreover, the \textit{Turner} decision is in accord with the Commission's position that

the assignment of nominal or limited responsibilities to the participant does not negative the existence of an investment contract; where the duties assigned are so narrowly circumscribed as to involve little real choice of action or where the duties assigned would in any event have little direct effect upon receipt by the participant of the benefits promised by the promoters, a security may be found to exist.\textsuperscript{82}

In addition, the Court of Appeals for the Third Circuit, relying on the above, recently declared:

The reasoning of the Supreme Court, the Ninth Circuit, the SEC and Supreme Court of Hawaii leads us to hold that an investment contract can exist where the investor is required to perform some duties, as long as they are nominal or limited and would have "little direct effect upon receipt by the participants of the benefits promised by the promoters."\textsuperscript{83}

In light of the remedial nature of the Securities Acts and the necessity to interpret the same flexibly, it is hoped that the views of these circuit courts will be followed.

Presently, the Commission is involved in litigation with two pyramid sales organizations, one based on the west coast, the other on the east. In \textit{SEC v. Holiday Magic, Inc.},\textsuperscript{84} the Commission, relying on the \textit{Turner} decision, is seeking to enjoin the defendants from further violations of the registration and anti-fraud provisions of the Securities Acts. In addition, ancillary relief in the nature of the appointment of

\textsuperscript{79} Id. at 482. Additionally, the court found a common enterprise to exist where the "fortunes of the investor are interwoven or dependent upon the efforts and success of those seeking the investment or of third parties." Id. at 482 n.7.

\textsuperscript{80} Id. at 482.

\textsuperscript{81} 94 S. Ct. 117 (1973).

\textsuperscript{82} SEC Securities Act Release No. 5211 (Nov. 30, 1971).

\textsuperscript{83} Lino v. City Investing Co., 487 F.2d 689, 692 (3d Cir. 1973), citing State v. Hawaii Mkt. Center, Inc., 485 P.2d 105 (Hawaii 1971). The circuit court, however, in reversing the lower court, found "significant efforts" were made on the part of the investor. Id. at 693.

\textsuperscript{84} Civil No. C-73-1095 (N.D. Cal., filed June 28, 1973).
a receiver, an accounting, and disgorgement of receipts is being sought. Holiday Magic, one of the corporate defendants, ostensibly sells cosmetics. However, the Commission alleges that the true nature of the business is the sale of interests in a pyramid sales operation. Other affiliated corporate defendants purportedly market, among other things, automotive additives, clothing, vitamins, food supplements, and home care products. Similarly, the Commission contends that the sale of distributorships, like those sold by Dare to be Great, constitutes the sale of a security. No decision has been rendered to date.

In SEC v. Galaxy Foods, the Commission is seeking to enjoin further violations of the registration and anti-fraud provisions in connection with the offer and sale of franchises in a pyramid sales operation, contending that such constitutes the sale of a security. Small compared to the nationwide scope of Glenn Turner Enterprises and Holiday Magic, Galaxy Foods nevertheless followed the same method of inducing prospective investors to group meetings for a high-pressure sales pitch. The Commission, in addition to injunctive relief, is again seeking a receiver, an accounting, and disgorgement of the receipts.

Enforcement actions against pyramid sales operations have generated a great deal of publicity. Until the question is finally resolved it can only be hoped that the public is being made aware of these fraudulent operations through the media. For, as the defendants in Turner stated, compliance with the federal securities laws would mean the end of their enterprise. Concurring, the court believed that the "disclosure and anti-deception provisions of the statutes would be totally inimical to the success of the promotion, for it is based upon blinding potential prospects to the realities of the scheme."

Commodities

Recently, with investors eschewing the stock market, brokerage houses have sought to attract public participation in the commodity markets. The Commodity Exchange Act, which prohibits the trading of puts and calls, applies only to commodities enumerated in the Act. Consequently there has arisen the trading of options in unregulated commodities, and these transactions have in some instances been held to constitute the sale of securities.

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85 Civil No. C-73-1742 (E.D.N.Y., filed Nov. 26, 1973). Defendants consented to an order of preliminary injunction and thereafter moved to dismiss the complaint on jurisdictional grounds. On February 1, 1974, the court denied the motion.
86 348 F. Supp. at 772.
88 Id. § 6C(3)(B).
89 Id. § 2.
In SEC v. Goldstein, Samuelson, Inc., the Commission alleged violations of the registration and anti-fraud provisions in the sale of $10,000 units of a Planned Commodity Option Account by defendant Goldstein, Samuelson, Inc. In an explicit attempt to avoid any governmental regulation, Goldstein, Samuelson offered to the public seven unregulated commodities of which the investor selected three. The firm then purchased double options, both a put and a call, in these commodities. Under the Plan the defendants agreed to repurchase the commodities at an amount not less than 10 per cent above the original purchase price, investors being advised that they were not only guaranteed a profit but could speculate without any risk of loss. In connection with these sales it was alleged that the defendants were making false and misleading statements of material facts, as well as omitting to state other material facts. Rather than contest the Commission's allegations that an unregistered security in the form of an investment contract was being offered, the defendants consented to an order of permanent injunction.

90 Civil No. 73-472 (C.D. Cal., Oct. 29, 1973). See SEC v. Continental Commodities Corp., Civil No. CA-3-6976 (N.D. Tex., April 9, 1973), appeal docketed, No. 73-2429, 5th Cir., June 25, 1973, which contended that the purported sale of naked options on commodities futures under circumstances similar to those in Goldstein, Samuelson was in fact the sale of a security. Naked commodities options are options written when the firm has not appropriately hedged in the futures market. Thus, the buyer assumes the risk of the seller's enterprise since the seller does not actually have the commodity available when the buyer exercises his option. This practice has been analogized to a bucket shop which is defined as "[a]n office or place (other than a regularly incorporated or licensed exchange) where persons engage in pretended buying and selling of commodities." BLACK'S LAW DICTIONARY 243 (rev. 4th ed. 1968). In refusing to issue a preliminary injunction, the district court determined that the "essential element of commonality" was insufficient to establish the existence of an investment contract. However, the case has yet to be tried on the merits. See also In re Traders Int'l, Ltd., Civil No. 7350 (D. Nev., Aug. 23, 1973), wherein the court ordered the receiver of the debtor in a chapter XI reorganization to cease doing business. Prior to the bankruptcy filing, Traders Int'l, Ltd. had been selling options on commodity contracts in circumstances similar to those described above. The receiver, noting that the lawfulness of the debtor's business was the subject of litigation in other jurisdictions, questioned the court about the scope of his authority. The court, determining that the debtor had in fact been selling investment contracts, ordered the termination of the debtor's business until further notice as a serious question existed as to its legality. The SEC, a party in interest, supported that decision on review.

91 Further, the Commission advanced the argument that investors were in fact subjecting themselves to the overall risks of the corporate enterprise which was able to use the funds received for any purpose it saw fit. The firm's obligation and measure of payment were solely dependent on the commodities market movement; in fact, all the investor received by his purchase of these purported commodities options, written naked, was a conditional promise to pay. However, payment was contingent upon the firm's successful management of the funds received from investors. This contention was also made in SEC v. International Commodities Exch., Civil No. 74-481 (C.D. Cal., filed Feb. 22, 1974); SEC v. Continental Commodities Corp., Civil No. CA-3-6976 (N.D. Tex., April 9, 1973), appeal docketed No. 73-2429, 5th Cir., June 25, 1973; SEC v. Commodity Options Int'l, Civil No. 73-761 (C.D. Cal., April 6, 1973); and in In re Traders Int'l, Ltd., Civil No. 7350 (D. Nev., Aug. 23, 1973).
However, there have been a number of cases in which the courts have reached an opinion as to when the sale of commodities constituted the sale of an investment contract. In most instances, the plaintiff, a commodities investor, sought to recover under the broad provisions of the federal securities acts. To do so the existence of the offer and sale of a security must be proven. To date, courts in different jurisdictions have reached opposite conclusions on similar facts.

In *Sinva v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* the court rejected the plaintiff’s argument that the sales of commodities futures were investment contracts under the Securities Acts. On the facts, the court concluded that there was “no reliance upon the efforts of promoters, managers, employees or any third party.” Subsequently, however, in *Maheu v. Reynolds & Co.*, where a plaintiff maintained a discretionary commodities account with a brokerage firm and relied exclusively on the broker’s expertise to realize a profit, the same court concluded that an investment contract existed under the test espoused in *Howey*. The court held that the account “may constitute a security even if there was no pooling arrangement or common enterprise among investors.” The following year a similar position was taken in *Berman v. Orimex Trading, Inc.*, where the defendant represented to the plaintiff “that it was especially knowledgeable and skilled in the business of speculating in cocoa futures, and that it could make a profit for him.” In denying a motion to dismiss, the court concluded that the *Howey* test was satisfied by the allegations that the defendants “would make all investment decisions” with respect to the plaintiff’s account and, as a result, would reap a profit for him. Citing the *Maheu* and *Berman* decisions, the court in *Johnson v. Espey* stated that “Courts in this Circuit have held that where the broker-dealer has control of investment decisions made for a commodities account and has represented that the profits will result from his efforts alone, then this ‘discretionary account’ is in effect an investment contract.” Further, the

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96 Id. at 429.
98 Id. at 702.
99 Id.
101 Id. at ¶ 91,927.
court held that no formal agreement specifying an account as discretionary was necessary to come within the above holding. 102

Other jurisdictions have taken a similar approach. In *Anderson v. Francis I. du Pont & Co.*, 103 the district court found an investment contract to exist where a co-defendant solicited customers through representations of his skill and expertise in the commodities market. In *Commercial Iron & Metal Co. v. Bache & Co.*, 104 the Tenth Circuit recently recognized the possibility that the sale of commodities may involve the sale of a security. Remanding to the district court, the court of appeals held that if nothing more than copper futures contracts were involved any disputes arising could be settled under the attached arbitration provision. If, on the other hand, the sale of copper futures constituted investment contracts, the federal forum could not be waived.

A very recent decision holding discretionary commodities accounts to be securities is *Marshall v. Lamson Bros. & Co.* 105 Unfamiliar with the futures market, the investor was induced to open a discretionary commodities account as a result of the broker's representations that "substantial profits could be made and that his account would be managed so as to limit [his] possible losses to approximately $400." 106 The district court held that it was "plausible to conclude that the element of 'common enterprise' is satisfied when a single investor commits his funds to a promoter in hope of making a profit," and that a "common enterprise may well have been nothing more than an attempt to require some sort of 'business' interest in an investment contract, nothing more than an attempt to distinguish investment contracts from such passive investment opportunities as time savings accounts in banks." 107

However, in *Milnarik v. M-S Commodities, Inc.*, 108 the Court of Appeals for the Seventh Circuit, affirming the district court, held that a discretionary trading account in commodity futures was not a security. This conclusion was based on the finding that a common enterprise was lacking despite the fact that the defendants had entered into similar arrangements with other investors. Although investors "were represented by a common agent . . . they were not joint participants in the same investment enterprise." 109 The court noted the trial court's

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102 *Id.*
104 478 F.2d 39 (10th Cir. 1973).
106 *Id.* at ¶ 95,323.
107 *Id.* at ¶ 95,325.
109 457 F.2d at 277.
rejection of Maheu and Berman and cited with approval its finding that each contract is "unitary in nature" and will succeed or fail without regard to the other contracts. Further, the court concluded that the Commission was of the same opinion, as it had never proceeded against any broker-dealer offering discretionary securities or commodities accounts.\footnote{Id. at 278.}

It is interesting to note that subsequent to Milnarik, the Commission, as discussed previously, sought and was successful in gaining injunctive relief against Goldstein, Samuelson which sold a "Planned Commodity Option Account." Although the defendants intentionally avoided assuming any discretion over their accounts, the Commission nevertheless felt that an investment contract was being offered.\footnote{See text accompanying note 90 supra.} It can only be conjectured as to what effect this Commission enforcement action would have had on the Milnarik court. Further, whether that court would have been influenced by recent decisions in Commission enforcement actions against the sale of whiskey warehouse receipts where the underlying res is a commodity is unknown. Moreover, the Ninth Circuit's astute decision in interpreting investment contracts in the Turner case was rendered almost immediately after Milnarik.

However, it is clear that most of the cases in which discretionary commodities accounts have been determined to be securities were commenced by investors seeking to recover their losses. It is, therefore, understandable why the majority of courts have concluded that sales of securities were involved. It is also understandable that, as a practical matter, the Seventh Circuit, located at the home of the Chicago Board of Trade, may have reached the opposite conclusion.

Unfortunately, the Milnarik court disregarded existing case law in concluding that a common enterprise was lacking as a result of the unitary nature of each contract. In Howey, the Supreme Court found a common enterprise to exist between the purchaser and promoter, despite the fact that each investor, in the words of the Fifth Circuit, looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole. . . . [E]ach purchaser's income was in no sense dependent upon the purchase or development of other tracts than his own. . . .\footnote{SEC v. W.J. Howey Co., 151 F.2d 714, 717 (5th Cir. 1945), rev'd, 328 U.S. 293 (1947).}

Again confronted with a similar orange grove scheme, wherein there was no pooling of interests, the Fifth Circuit, in Blackwell v. Bentsen,\footnote{203 F.2d 690 (5th Cir. 1953).}
nevertheless held a security to be involved. More recently, in *Los Angeles Trust Deed & Mortgage Exchange v. SEC*, the Court of Appeals for the Ninth Circuit determined that a common enterprise existed between investors and the issuer in the sale of trust deed investment contracts. Clearly, since no pooling of interests is required to establish the existence of an investment contract, the unitary nature of each discretionary commodities account is irrelevant.

III. CONCLUSION

As the foregoing recent developments indicate, the courts, perceiving novel schemes to be within the ambit of the federal securities acts, have continued to maintain flexibility in the law. Equally significant is the Commission’s obvious intention to assure the investor the protection originally intended by Congress. Furthermore regardless of Commission action, more private litigants may now have the opportunity to seek redress under the federal securities acts. Although numerous investment devices may fall outside the common genre of securities, there is no investment so novel, unique, or atypical that the unsophisticated investor should be left to the wiles of the unscrupulous if in substance he has invested in a security.