

Winter 2012

Refocusing Commonality: An Economic Approach that Shares Something in Common with Howey

Travis Stegemoller

Follow this and additional works at: <https://scholar.valpo.edu/vulr>



Part of the [Law Commons](#)

Recommended Citation

Travis Stegemoller, *Refocusing Commonality: An Economic Approach that Shares Something in Common with Howey*, 46 Val. U. L. Rev. 657 (2012).

Available at: <https://scholar.valpo.edu/vulr/vol46/iss2/10>

This Notes is brought to you for free and open access by the Valparaiso University Law School at ValpoScholar. It has been accepted for inclusion in Valparaiso University Law Review by an authorized administrator of ValpoScholar. For more information, please contact a ValpoScholar staff member at scholar@valpo.edu.



REFOCUSING COMMONALITY: AN ECONOMIC APPROACH THAT SHARES SOMETHING IN COMMON WITH *HOWEY*

I. INTRODUCTION

It is the week before Mother's Day and while Lucas is filling up his coffee cup in the break room pondering whether he will get his mother anything this year, he overhears a co-worker excitedly talking about these new flowers the co-worker ordered for his mother.¹ The new flower goes by the name Zibby Star Gazers, and a dozen currently retail for fifty dollars, notwithstanding ancillary filler foliage.² Turns out, all the starlets in Hollywood have been spotted adorning them on the red carpet this season, including Lucas's mother's favorite actress.

Interested, Lucas conducts a Google search, bypassing any Wikipedia related information, and finds a credible news source that discusses the Zibby Star Gazers as the hot new flower destined to overtake the Rose for flower supremacy in a woman's heart. With this information, Lucas phones the nearest floral shop and orders a dozen Zibby Star Gazers. To his surprise, the florist informs Lucas that they have been sold out for weeks and recommends a dozen long stemmed roses for ten dollars because the demand for roses has plummeted. After calling several more florists, Lucas settles for the roses.

Several weeks later, Lucas overhears the very same co-worker speaking about a farm in California he invested in that provides him profits from the growth and subsequent sale of Zibby Star Gazer bulbs.³ Considering how much money he lost in the recent recession, Lucas decides to contact the company, Triple S. Bulbs. The company sends him brochures and directs him to its website, where Lucas learns the flower,

¹ This hypothetical is loosely based on true events. See generally MIKE DASH, TULIPOMANIA 1 (1999) (detailing the events that lead to the Dutch financial bubble of 1637 involving tulip bulbs). Tulips became increasingly popular during 1621 amongst Dutch society's elite. *Id.* at 175. As a result, prices for individual tulip bulbs and bulbs by the pound skyrocketed before crashing in February of 1635. *Id.* at 106-29. After February of 1635, the aggregate market value of tulip bulbs dropped to a value approximately 1-5% of the original aggregate. *Id.* at 166. Compare this with America's greatest financial collapse, the Great Depression, which saw an aggregate market value crash that resulted in a remaining value of twenty percent of the original value. *Id.*

² As demand for tulip bulbs increased, prices of tulip bulbs gradually rose to the point that families were exchanging their houses and farmland for a handful of tulip bulbs. *Id.* at 106-07. At the height of the tulip boom, the price paid for one pound of average quality tulip bulbs equaled an average working man's yearly salary. *Id.* at 157.

³ Such a scheme, where the investor "purchases" a lot of uncultivated land or crops and the promoter cultivates and distributes the crops, was the basis for the decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 294-96 (1946).

praised as the most beautiful flower made by Mother Nature, was recently discovered by a botanist off the coast of Bora Bora. With the little research Lucas gathered, he decides to attempt to recoup his recent investment losses by buying into the flower bulb market. Lucas sends three thousand dollars to Triple S. Bulbs, and in return, receives his packet of ownership information detailing the transaction.⁴ In exchange for his investment, Lucas now owns rights to receive profits from the cultivation and distribution of bulbs farmed on a small parcel of land he “purchased.” Triple S. Bulbs will handle aspects of the business and Lucas’s profits will be derived solely from his parcel.

Unfortunately, the information about the botanist discovering the Zibby Star Gazer is misleading. A national news syndicate runs a story about how Zibby Star Gazers are really man-made in laboratories that test chemicals on animals. As a result, the Screen Actors Guild issues a statement requiring all members of Hollywood’s elite to cease their love affair with Zibby Star Gazers immediately. Within hours, demand for the once cherished flower wilts away. Lucas’s investment is now worthless.

Although this story may seem far-fetched, outlandish investment schemes have existed for centuries.⁵ Moreover, the number of new predatory investment schemes tends to increase after times of war and economic hardship.⁶ To combat these fraudulent practices, Congress created a federal system that mandates disclosure and regulates the exchange of securities.⁷ Although the law was designed to be broad in its authority, courts have struggled to define what precisely constitutes a security as it relates to nontraditional investment schemes.⁸

⁴ Typical investment schemes tempt investors with a small requisite investment price and easy access to the scheme. See DASH, *supra* note 1, at 112 (discussing how the tulip bulb schemes of the 1630s required little money, in relation to other investment schemes of the time, and access to such schemes was relatively easy for novice investors). For interested persons, one need only visit the local floral nursery to purchase tulip bulbs as many new nurseries opened to accommodate the demand. *Id.*

⁵ 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 5 (3d ed. 1989) [hereinafter LOSS & SELIGMAN, SECURITIES REGULATION] (quoting STEPHEN KILLIK, THE WORK OF THE STOCK EXCHANGE 12 (2d ed. 1934)). In the late seventeenth century, thousands of people invested in companies for which they had no idea what type of business the company conducted. *Id.*

⁶ See K. FRED SKOUSEN, AN INTRODUCTION TO THE SEC 3 (4th ed. 1987) (discussing the optimism of investors after WWI and WWII and how new investment schemes were regularly introduced).

⁷ Securities Act of 1933, 15 U.S.C. § 77a (2006).

⁸ See *infra* Part II.C (discussing the cases that started securities law jurisprudence).

Under relevant jurisprudence, a nontraditional investment scheme is classified as a security if it qualifies as an “investment contract.”⁹ However, investment contract analysis often turns on whether the investment scheme in question qualifies as a “common enterprise” under the applicable commonality test.¹⁰ Since 1964, courts have disagreed on the appropriate definition of a common enterprise and have created competing tests.¹¹ To date, the U.S. Supreme Court has declined to resolve the issue of defining “commonality.”¹² Although recent trends suggest courts are acquiescing to the inconsistencies surrounding the existence of multiple tests, the legal field will likely relive the confusion surrounding the current commonality tests given society’s passion for taking greater risks after times of economic hardship.¹³

This Note chronicles the circumstances that gave rise to the conflicting commonality tests and presents a solution that is rigid enough to provide guidance, but also workable enough to be utilized in an ever changing financial environment. Part II looks at the historical repetition of financial collapses, subsequent government regulation, and commonality jurisprudence.¹⁴ In Part III, this Note analyzes the three different commonality tests and their respective strengths and weaknesses.¹⁵ Next, Part IV proposes a return to the original intent of

⁹ See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 297–302 (1946) (internal quotation marks omitted) (creating the landmark test for what is considered an investment contract); see also *infra* Part II.D (discussing this test in detail).

¹⁰ *Howey*, 328 U.S. at 301.

¹¹ See *infra* Part II.E (outlining the three tests that circuits have devised to analyze and define commonality); see also *infra* Part II.F (summarizing each circuit’s preferred commonality test).

¹² See *Mordaunt v. Incomco*, 469 U.S. 1115, 1115 (1985), *denying cert. to* 686 F.2d 815 (9th Cir. 1982). Although the majority did not voice its reasoning for denying certiorari, Justice White dissented and highlighted contradictory holdings from various circuits to argue that the Supreme Court should have resolved the circuit split. *Id.* at 1116–17 (White, J., dissenting); see also *SEC v. Edwards*, 540 U.S. 389, 391 (2004) (analyzing whether an investment scheme promising a fixed rate of return can qualify as an investment contract under the *Howey* test without discussing, in depth, the commonality element).

¹³ See CHARLES P. KINDLEBERGER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* 85 (4th ed. 2000) (noting that America’s prosperous times of the late 1990s produced many subsequent “scams, swindles, frauds, or actions of bad judgment”). The author provides historical examples of investors taking greater chances during times of over inflated markets followed by the subsequent economic recovery period. *Id.* at 223–32; see also GEORGE COOPER, *THE ORIGIN OF FINANCIAL CRISES* 151 (Vintage Books 2008) (noting the economic phenomenon that occurs when industry creates a limited number of risk products available to investors, which inadvertently encourages investors to seek excessive risk-taking).

¹⁴ See *infra* Part II (providing a historical perspective as a foundation for analyzing the three commonality tests).

¹⁵ See *infra* Part III (examining the strengths and weaknesses of each commonality test).

660 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46

Howey by abandoning the current tests' fundamental focus and applying an economic-based standard.¹⁶ Finally, Part V of this Note applies the proposed standard to the hypothetical presented above in the hope that Lucas will be able to recover his failed investment.¹⁷

II. BACKGROUND

Prior to 1933, American financial markets were regulated on a state-by-state basis.¹⁸ Spurred by the Great Depression, Congress passed legislation to regulate the financial markets at the federal level after learning just how powerful and widespread the depression's effects were on the nation.¹⁹ Even after legislation defined which investment schemes and markets were regulated, questions arose regarding whether certain nontraditional investment schemes were covered.²⁰ The U.S. Supreme Court created a four-pronged test to handle non-traditional investment schemes, but the commonality requirement within that test only served to further confuse participants in the financial markets and the courts that adjudicated their grievances.²¹ To better understand the current state of commonality jurisprudence, it is helpful to examine the historical events that led to the need for federal regulation.

A. Historical Synopsis of Economic Conditions Demanding Regulation

There exists a general misconception that securities regulation in the United States began with the Securities Act of 1933 ("1933 Act").²² In fact, dating as far back as 1285, King Edward I laid the foundation for

¹⁶ See *infra* Part IV (promoting an economic-based commonality test).

¹⁷ See *infra* Part V (attempting to vindicate, if appropriate, the character in the introductory hypothetical).

¹⁸ See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 11-12 (5th ed. 2004) [hereinafter LOSS & SELIGMAN, FUNDAMENTALS] (acknowledging that before the enactment of the 1933 Act, securities were governed by individual state legislatures).

¹⁹ See *infra* Part II.B (outlining Congress's first attempt to regulate securities on a federal level).

²⁰ See SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (noting that the 1933 Act and any relevant legislative history do not provide a definition for "the term 'investment contract'").

²¹ See *id.* at 298-99 (declaring that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party"); see also Part II.D (compartmentalizing the *Howey* test into four elements).

²² See SKOUSEN, *supra* note 6, at 3 (specifying that rather than being the starting point for securities regulation in the United States, the financial collapse of 1929 coupled with the hardships endured in the 1930s acted more like the tipping point in a long line of financial disarray). Thus, the financial collapse was more of a catalyst, which solidified the need for regulation more so than the original ingredient. *Id.*

modern day securities laws when he attempted to control failing financial markets by requiring licenses for brokers located in London.²³ Thereafter, in 1696, Parliament not only required licensing for brokers, but also mandated the first recording system for financial market transactions in England.²⁴ It was not until 1720 that England passed its first comprehensive piece of securities legislation.²⁵ The legislation was enacted in response to “The South Sea Bubble,” which, like modern day financial market bubbles, was caused by an inflated market value with a deficiency in valuable underlying assets to match the valuation.²⁶

American securities regulation began to take shape during the Nineteenth Century when Congress grew concerned about the need to issue federal licenses to companies that operated in interstate commerce.²⁷ In 1902, the Industrial Commission suggested to Congress that there was a pressing need for uniform regulation with respect to securities; however, Congress ignored the recommendations.²⁸ Meanwhile, state governments took it upon themselves to protect the citizens of their sovereigns by enacting what later became known as

²³ See *id.* at 2 (quoting STEPHEN KILLIK, *THE WORK OF THE STOCK EXCHANGE* 12 (2d ed. 1934)).

²⁴ See *id.* at 3–4 (describing how Parliament passed a statute penalizing unlicensed trading, required a recording system for every transaction, and set a limit on commissions at one half of one percent). Parliament was compelled to enact the statute because it felt that the privileges given to investment promoters were being abused for profit at the expense of “ignorant [m]en, drawn in by the Reputation, falsely raised and artfully spread concerning the thriving [s]tate of their [s]tock.” *Id.* (quoting 11 *PARL. HIST. ENG.* 595 (1696)).

²⁵ See *id.* at 2. After several years of relaxed regulatory oversight of England’s financial markets, the country experienced a bursting bubble market effect and passed what has become known as the Bubble Act of 1720. *Id.*

²⁶ See *id.* at 4 (summarizing the story of The South Sea Bubble, which occurred when the British Government granted a trading monopoly to both the Mississippi Company and the South Sea Company). The two companies had exclusive rights to the trading, which occurred between South America and the British. *Id.* With the monopoly in hand and apparently feeling generous, leaders of the two companies attempted to pay off the public debt of both France and England. *Id.* However, the economy fell under financial stress throughout Europe causing the value of the two shipping companies to sink. *Id.* From July of 1720 to December of that same year, the value of the South Sea Company fell from over £1,000 to just £125. See generally MALCOLM BALEN, *THE SECRET HISTORY OF THE SOUTH SEA BUBBLE: THE WORLD’S FIRST GREAT FINANCIAL SCANDAL* 1 (2003) (taking an in-depth look behind the story summarized by Professor Loss).

²⁷ SKOUSEN, *supra* note 6, at 3.

²⁸ See *id.* (suggesting that the financial climate was not right for a change and that Congress was not inclined to act until it was forced to by a serious financial plight). The Commission suggested mandatory disclosure rules and annual financial reports. *Id.* During the two decades after the Industrial Commission’s findings, three separate bills were introduced to Congress to implement the suggestions. *Id.* None of these bills made it to the House or Senate. *Id.*

662 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

“blue sky” laws.²⁹ In 1911, Kansas instituted the first of these laws and within two years, twenty-two other states passed similar laws designed to regulate the sale of securities.³⁰ With many states passing their own versions of securities regulations, the world of securities transactions was inconsistent from one state to another.³¹ Unfortunately, the inadequacy of blue sky state laws and their inability to curb fraudulent investment practices contributed to the Great Depression, and ultimately, the need for federal regulation of securities.³²

B. *The 1933 Act*

“[T]he Roaring Twenties” is a catchy phrase that has been used to describe a time in American history when the post-war economy grew fast and society’s appetite for money grew even faster.³³ To fuel this

²⁹ See WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: AGENCY, PARTNERSHIPS, AND CORPORATIONS 404 (7th ed. 2009) (suggesting the name “blue sky” came “from the claim that such [state laws] protect[ed] investors from ‘speculative schemes which have no more basis than so many feet of “blue sky”” (quoting *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917))). *But see* LOSS & SELIGMAN, FUNDAMENTALS, *supra* note 18, at 9–10 (offering the idea that the name “blue sky” came from the notion that “promoters . . . ‘would sell building lots in the blue sky in fee simple” (quoting Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37 (1916))); Nathan W. Drage, *Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act*, 18 PAC. L.J. 125, 129 (1986) (suggesting the name “blue sky” actually came from state laws that were designed to protect farmers in Kansas from being sold their very own piece of the great blue sky).

³⁰ SKOUSEN, *supra* note 6, at 3; see KLEIN ET AL., *supra* note 29, at 404 (noting that state blue sky laws were limited in their jurisdiction to the state border). The author also points out that many of the states that implemented “blue sky law[s]” actually had limited resources to enforce them. *Id.* at 404. Also, presumably to attract business, states often included special interest exemptions. *Id.*

³¹ See LOSS & SELIGMAN, FUNDAMENTALS, *supra* note 18, at 11–12 (noting the diversity amongst state securities laws before unification was introduced).

³² Philip A. Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214, 216–17 (1959).

³³ See Richard B. Freeman, *Reforming the United States’ Economic Model After the Failure of Unfettered Financial Capitalism*, 85 CHI.-KENT L. REV. 685, 704 (2010) (using “[R]oaring [T]wenties” when describing the parallels between the behavior exhibited today by high level executives and other participants in securities markets as compared to the 1920s); Brent J. Horton, *In Defense of Private-Label Mortgage-Backed Securities*, 61 FLA. L. REV. 827, 849 (2009) (identifying the 1920s as “the Roaring Twenties” while describing the period as a time when the general investor was not content with simply doubling his or her money). See generally Christine Sgarlata Chung, *From Lily Bart to the Boom-Boom Room: How Wall Street’s Social and Cultural Response to Women Has Shaped Securities Regulation*, 33 HARV. J.L. & GENDER 175, 198–99 (2010) (utilizing the classic phrase “Roaring Twenties” when discussing the effect of gender bias in the field of securities); Daniel J. Morrissey, *The Securities Act at its Diamond Jubilee: Renewing the Case for a Robust Registration Requirement*, 11 U. PA. J. BUS. L. 749, 755 (2009) (referencing the 1920s as “the [R]oaring [T]wenties” and as the decade when the stock market rose steadily while cries for federal securities regulation went unheeded).

demand, more than fifty billion dollars worth of new securities were introduced in the United States.³⁴ To capitalize on this increase, investment promoters devised techniques to profit from the abuse of the free market system.³⁵ Several common abusive techniques included wash sales, issuing false and misleading financial statements, excessively buying “on margin,” and the misuse of inside information by corporate officers.³⁶ All of these practices positioned the promoter or corporate officer to take advantage of the volatile stock price created by his own malfeasance by purchasing low and selling high before the price fell back down.³⁷

As it turns out, over half of the fifty billion dollars worth of new securities proved to be worthless.³⁸ Before the depression, the aggregate worth of all securities listed on the national exchange markets equaled eighty-nine billion dollars.³⁹ After the stock market crash, the aggregate value of stock in the country fell to fifteen billion dollars.⁴⁰ Seeking solutions to compliment Roosevelt’s New Deal, Congress investigated the reasons behind the catastrophic failure of the stock market and discovered that the lack of oversight in the securities markets directly caused the depression.⁴¹

The solution Congress crafted came in the form of a federal system capable of tracking securities, and it implemented requirements designed to curb the kinds of fraudulent practices that ruined the national economy in the previous decade. On May 27, 1933, Congress passed the 1933 Act.⁴² The main purpose of the 1933 Act was to protect

³⁴ H.R. REP. NO. 73-85, at 2 (1933).

³⁵ Cf. SEC, 25TH ANNUAL REPORT XV-XVII (1959) (providing valuable information regarding the need for and subsequent organization of the SEC).

³⁶ See SKOUSEN, *supra* note 6, at 4 (discussing various types of abusive techniques). Wash sales occurred when investors would successively buy and then sell the same security repeatedly to create a false demand, and thus drive the price up. *Id.* One is said to buy “on margin” when they finance their speculative investment with excessive credit as opposed to the typical cash or cash equivalent. *Id.* (internal quotation marks omitted).

³⁷ *Id.* at 4.

³⁸ H.R. REP. NO. 73-85, at 2.

³⁹ See SKOUSEN, *supra* note 6, at 5 (discussing the beginning of the market collapse in the fall of 1929).

⁴⁰ See *id.* (detailing the rise and fall of the aggregate value of stock in the United States). In the fall of 1929 alone, the market fell \$18,000,000,000. *Id.* After a short false recovery, the market then declined over the course of two and a half years until 1932. *Id.* The total amount of the collapse was a staggering \$74,000,000,000, eighty-seven percent % of the aggregate market value before the collapse. *Id.*

⁴¹ See Loomis, *supra* note 32, at 216–17 (discussing Congress’s investigation behind the cause of the Great Depression).

⁴² Securities Act of 1933, 15 U.S.C. § 77a (2006).

664 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

the market and investors from fraudulent practices by requiring the full disclosure of all material relevant information.⁴³

The immediate effect of the 1933 Act was felt by all persons who dealt in the securities industry. The 1933 Act requires all investment products that do not qualify for exempt status to be registered before such products can be sold to investors.⁴⁴ To further Congress's aim of providing investors with adequate information to aid their potential decisions, promoters must provide an accurate prospectus free of misrepresentations prior to the sale of a new investment product.⁴⁵ However, both the legal and business communities still struggled to determine if unique, less traditional investment schemes fell within the scope of the 1933 Act.

C. Defining a Security

The 1933 Act defines "security" by enumerating traditional products, such as stocks and bonds, as well as including several nontraditional products like "investment contracts."⁴⁶ The subsequent enactment of the

⁴³ *Id.* § 77e-j; Senate Committee on Banking and Currency, S. REP. NO. 73-47, at 1 (1933). Stating:

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 . . .

Id.; see also *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (recognizing that exemptions such as the private offering exemption apply to investors who are in need of protection and not to investors who have access to information); *Van Dyke v. Coburn Enters., Inc.*, 873 F.2d 1094, 1098 (8th Cir. 1989) (explaining that the private offering exemption allows a promoter to avoid the 1933 Act's registration and disclosure regulations if he is dealing in close relationship with his investors); *Doran v. Petrol. Mgmt. Corp.*, 545 F.2d 893, 903 (5th Cir. 1977) (holding that the private offering exemption applies if an investor has a close relationship with the promoter—employment, family, superior bargaining power).

⁴⁴ See 15 U.S.C. § 77c (outlining the requirements that must be met before a financial transaction can be classified as exempt); *id.* § 77e (requiring registration before the sale of a security); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (stating the 1933 and 1934 Acts "protect investors against fraud"); *SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943, 953 (S.D.N.Y. 1971) ("[T]he spirit and purpose of . . . the 1933 Act . . . is 'to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.'" (quoting *Ralston Purina Co.*, 346 U.S. at 124)); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 428 (N.D. Cal. 1968) (explaining that the 1934 Act protects investors). *But see Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) (explaining that the antifraud protections are not unlimited).

⁴⁵ 15 U.S.C. §§ 77e, 77j, 77q.

⁴⁶ *Id.* § 77b(a)(1). The 1933 Act's definition for "security":

The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of

Securities Act of 1934 (“1934 Act”) also uses the phrase “investment contract” when defining “security”; however, because slightly different terms are used, some confusion arose as to which definition should be applied.⁴⁷ For the sake of clarity, the U.S. Supreme Court addressed the subtle difference and held that the phrase “security” within each statute was, in effect, the same.⁴⁸

It is commonly understood that investment products explicitly listed in the 1933 Act generally fall within the ambit of the 1933 Act.⁴⁹

interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id.

⁴⁷ *Id.* § 78c(a)(10). The 1934 Act’s definition of “security”:

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

Id.

⁴⁸ See *Tcherepnin v. Knight*, 389 U.S. 332, 335–36 (1967) (finding that the definition of “security” found in the 1933 Act is “virtually identical” to the definition found in the 1934 Act).

⁴⁹ See *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 350 (1943). The Court recognized that Congress had not created a definition generally applicable to a wide range of investment schemes. *Id.* Rather, Congress simply enumerated known investment schemes they wished to be covered by the Acts. *Id.* Most of the investment schemes listed in the definition were “pretty much standardized and the name alone carries well settled

666 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

Congress solidified this concept by including the phrase “or instrument[s] commonly known as a ‘security.’”⁵⁰ Therefore, it is understood that traditional investment products, which automatically qualify as securities, need no definition because their characteristics are self-evident.⁵¹ However, Congress failed to provide any definition for “[t]he term ‘investment contract.’”⁵²

D. *The Landmark Howey Test*

It quickly became apparent in cases involving nontraditional investment schemes that there was a need to define an investment contract. Noting the Congressional intent behind the 1933 Act, courts subsequently interpreted investment contracts as a catch-all phrase designed to bring within its authority more types of creative investment schemes, as opposed to limiting the phrase’s reach.⁵³ Although the Court had several opportunities to define what constitutes an investment contract, it was not until the Court’s holding in *SEC v. Howey* that the business and legal communities received concrete direction.⁵⁴

The case before the *Howey* Court concerned a company that sold small plots of land that, when harvested, yielded citrus fruits for distribution.⁵⁵ In addition to the simple real estate transaction,

meaning. Others are of more variable character and were necessarily designated by more descriptive terms, such as . . . ‘investment contract’ . . .” *Id.* at 351; *see also* 14 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 6833 (Rev. vol. 2012) (acknowledging that the specific types of securities listed in the 1933 Act are well-settled as being common, while on the other hand, untraditional financial instruments and business schemes are uncommon and fall under investment contract).

⁵⁰ 15 U.S.C. § 77b(a)(1).

⁵¹ *See* FLETCHER, *supra* note 49, § 6833 (recognizing that Congress did not need to elaborate on certain types of securities).

⁵² *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (internal quotation marks omitted) (noting the void in the legislative record regarding a definition for “investment contract”).

⁵³ *See* Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982) (recognizing that Congress included catch-all phrases in the definition of a security to cover financial instruments and business schemes not easily classified within traditional categories of securities); *see also* H.R. REP. NO. 73-85, at 11 (1933) (noting the definition of security is broad enough to bring various investments within the traditional scope of a security); Bradley D. Johnson, Note, *Discretionary Commodity Accounts as Securities: An Application of the Howey Test*, 53 FORDHAM L. REV. 639, 643 (1984) (discussing how the *Howey* test’s flexible approach is in synch with Congressional intent to make investment contracts a catch-all phrase).

⁵⁴ *See* *Howey*, 328 U.S. at 298–99 (proclaiming the first definition for an investment contract as a “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”).

⁵⁵ *See id.* at 295–96 (explaining the business structure involved in the case). The promoter, W.J. Howey, consisted of two separate corporations. *Id.* W.J. Howey and Company owned the real estate on which the citrus groves were planted, while Howey-in-

purchasers also entered into a contract, which gave the company full discretion and authority over the harvesting, marketing, and the subsequent sale of yielded citrus fruits.⁵⁶ The deal entitled the purchaser to a portion of the entire enterprise's net profits in exchange for monetary investment in the company's citrus business.⁵⁷ Given the unique business model, the Court analyzed the facts to determine if it could be considered an investment contract, and therefore, a security subject to the regulations of the 1933 Act.⁵⁸

The Court began its analysis by acknowledging that Congress had provided little guidance in its legislative history as to what it meant by the phrase investment contract.⁵⁹ However, the Court identified existing blue sky laws, which had incorporated the phrase "investment contract" into their securities analysis.⁶⁰ Therefore, Congress merely solidified the phrase in the 1933 Act, and the Court could use state law precedent to derive the meaning of investment contracts.⁶¹ As a result, the Court articulated a four-pronged test for determining an investment contract: (1) an investment of money; (2) into a common enterprise; (3) with the expectation of profiting; (4) solely from the efforts of the enterprise's promoter or a third party.⁶² The Court then applied this newfound test

the-Hills Service engaged in cultivating the citrus groves and marketing the crops. *Id.* On a yearly basis, approximately five hundred acres of citrus groves were planted. *Id.*

⁵⁶ *See id.* at 295-97 (noting that it was the company's practice to lure vacationers from the adjacent resort, which the company also owned, to sell the out-of-state residents on the idea of investing in an effortless investment).

⁵⁷ *See id.* at 295-96 (noting the company annually planted 250 acres of citrus for its own use and sold the remaining 250 acres to the public to finance additional development). Investors could expect a ten percent annual return over a ten year period. *Id.* "[I]ndividual development of the plots of land that . . . would seldom be economically feasible due to their small size." *Id.* at 300. This is an example of economies of scale. *See* RONALD C. FISHER, STATE & LOCAL PUBLIC FINANCE 121-22 (3rd ed. 2007) (defining economies of scale as "a decrease in average cost as the quantity of output rises" allowing "individual consumers can reduce their costs by sharing the good and its total cost with others"); Jack Alan Kramer, *Vouching for Federal Educational Choice: If You Pay Them, They Will Come*, 29 VAL. U. L. REV. 1005, 1015 (1995) ("Economies of scale occur when the average total cost of producing a good or service declines as output expands.").

⁵⁸ *Howey*, 328 U.S. at 297.

⁵⁹ *Id.* at 298. The Court stated "[t]he term 'investment contract' is undefined by the Securities Act or by relevant legislative reports." *Id.*

⁶⁰ *Id.*; *see* *State v. Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn. 1920) (holding that an investment contract was "[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment").

⁶¹ *Howey*, 328 U.S. at 298. The Court noted that the term investment contract had been steadfastly used judicially before the enactment of the 1933 Act; therefore, it can be reasonably inferred that the same meaning state courts used was the meaning Congress intended to adopt when codifying the phrase. *Id.*

⁶² *Id.* at 301.

668 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

to hold that the unique business model at bar was indeed a security.⁶³ Although the test was intended to answer the question “what is an investment contract,” it actually added to the confusion by not specifying the requirements for a common enterprise.⁶⁴

E. *Subsequent Creation of the Commonality Tests*

The common enterprise element of the *Howey* test has begotten three subtests, which appear minutely different; yet, the differences can have dramatic effects when analyzing an investment product to determine if it is a security.⁶⁵ Compared to the other three elements of *Howey*, the divide among the circuits as to how the common enterprise element should be interpreted is understandable given the nature of the words used.⁶⁶ There is little dispute when attempting to interpret investment of money, expectation of profits, or efforts of others.⁶⁷ However, the notion of a common enterprise, within the landscape of securities, has led circuits to disagree on whether the focus is between the investors themselves or between investors and the promoters.⁶⁸ Furthermore, is it

⁶³ *Id.* at 300.

⁶⁴ *See id.* at 297, 298 (recognizing that Congress did not provide a definition for “investment contract” and that the Court would need to create a test to decide whether the investment scheme at bar was a security under the 1933 Act).

⁶⁵ *See infra* Part II.E.1–3 (stating that when analyzing commonality, it is important to recognize the subtle change in the use of the word “fortunes”). With horizontal commonality, the key issue focuses on whether the *fortunes* of each investor rise and fall with the *fortunes* of all other investors. *Revak v. SEC Realty Corp.*, 19 F.3d 81 (2d Cir. 1994). Unlike horizontal commonality, vertical commonality shifts this question to whether the *fortunes* of each investor correlate with either the *efforts* or *fortunes* of the promoter. *Brodts v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1978); *SEC v. Kosot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974). Thus, for broad vertical commonality, the *fortunes* of the investor must be tied to the *efforts* of the promoter. *See Brodts*, 595 F.2d at 461 (holding no commonality existed because strong efforts by the promoter does not necessarily equate to success for the investor). But for strict vertical commonality, the focus turns on the *fortunes* of the investor as it relates to the *fortunes* of the promoter, instead of the *efforts*. *See Kosot Interplanetary, Inc.*, 497 F.2d at 478 (focusing on the *impact* of the promoter’s efforts rather than the effort itself). For clarity, horizontal is investor fortunes/investor fortunes; broad vertical is investor fortunes/promoter efforts; and strict vertical is investor fortunes/promoter fortunes. *Infra* Part II.E.

⁶⁶ *See supra* note 65 (outlining the overlapping language used in the commonality test in an attempt to clarify the inherent confusion).

⁶⁷ *See* FLETCHER, *supra* note 49, § 6833 (recognizing that Congress did not need to elaborate on certain types of securities).

⁶⁸ *See* *SEC v. Cont’l Commodities Corp.*, 497 F.2d. 516, 521–22 (5th Cir. 1974) (disagreeing with the court in *Milnarik* and holding that commonality turns on the degree of reliance an investor places on the promoter); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 279 (7th Cir. 1972) (focusing on the relationship between the investors themselves by holding that “[w]e do not believe an investor who grants discretionary authority to his

necessary to have more than one investor involved in order for commonality to exist?⁶⁹ When taking the broad scope of the 1933 Act into account, one may also question what degree of relationship between the promoter and investor begins to offend even the broad reading of the 1933 Act.⁷⁰ The Court bypassed several opportunities to answer these inquiries raised by the inherent conflict within the phrase “common enterprise” and left it to the circuit courts to work out the proper test.⁷¹ To date, the courts have articulated three different tests: horizontal commonality; broad vertical commonality; and narrow vertical commonality.

1. Horizontal Commonality

Horizontal commonality exists when the success of each individual investor in an enterprise is tied to the success of every other individual investor.⁷² Typically, the fortunes of each investor fluctuate in harmony with every investor who contributes money to the same enterprise.⁷³ Horizontal commonality is defined as the pooling or pro-rata

broker thereby joins the broker’s other customers in the kind of common enterprise that would convert the agency relationship into a statutory security”).

⁶⁹ See James D. Gordon III, *Defining a Common Enterprise in Investment Contracts*, 72 OHIO ST. L.J. 59, 66–67 (2011) (distinguishing horizontal commonality which “focuses on the horizontal relationship among investors” from the types of vertical commonality, which “focus[] on the vertical relationship between the investor and the promoter”); Maura K. Monaghan, Note, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135, 2156 (1995) (arguing that the horizontal commonality test is very restrictive because it limits securities to those involving more than one investor at the expense of ignoring “parallel frauds,” which occurs when a promoter is conducting his business in a fraudulent manner with respect to each individual investor); see also Marc G. Alcer, Comment, *The Howey Test: A Common Ground for the Common Enterprise Theory*, 29 U.C. DAVIS L. REV. 1217, 1233–34 (1996) (discussing the heightened need for disclosure in situations involving only one investor).

⁷⁰ *Milnarik*, 457 F.2d at 275–76. The court in *Milnarik* adamantly rejected the plaintiff’s position that the words in the 1933 Act should be read literally as to include the scheme in which the plaintiff had invested. *Id.* Instead, the court retorted “we do not believe every conceivable arrangement that would fit a dictionary definition of an investment contract was intended to be included within the statutory definition of a security.” *Id.*

⁷¹ See *supra* note 12 (discussing the reasons behind the Court’s decisions to pass upon the opportunity to resolve the circuit split regarding commonality). Most notably, the Court denied certiorari to a case posing the specific question of commonality. *Mordaunt v. Incomco*, 469 U.S. 1115, 1115 (1985), *denying cert. to* 686 F.2d 815 (9th Cir. 1982).

⁷² *Milnarik*, 457 F.2d at 276.

⁷³ See *Revak v. SEC Realty Corp.*, 18 F.3d 81, 87–88 (2d Cir. 1994) (holding that horizontal commonality did not exist in a scheme involving condominium properties because the success of each condominium unit investment, which was owned separately, did not fluctuate in harmony with the success of other condominium units investments within the same property).

670 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

distribution of income derived from the operation of the enterprise, or the pooling or pro-rata sharing of expenses when purchasing or constructing an asset.⁷⁴ Generally speaking, horizontal commonality can be shown when the success of the individual's investment is tied to the success of the enterprise as a whole.⁷⁵ By its very nature, horizontal commonality requires more than one investor be involved for a common enterprise to exist.⁷⁶

In its landmark opinion, *Milnarik v. M-S Commodities*, the Seventh Circuit Court of Appeals elevated the pooling of investor's interests requirement to the level of primary guidepost when it solidified its adherence to the horizontal commonality test.⁷⁷ The investment scheme in *Milnarik* consisted of individuals that deposited money with a common broker, who in turn, used its own discretion to invest the deposited funds in various futures commodities.⁷⁸ Each depositor had

⁷⁴ See *id.* at 87 (noting that the pooling of assets is usually combined with the pro-rata distribution of profits to show horizontal commonality).

⁷⁵ *Milnarik*, 457 F.2d at 276-77.

⁷⁶ See *Curran v. Merrill Lynch*, 622 F.2d 216, 222-23 (6th Cir. 1980) (holding no horizontal commonality existed because the agreement was solely between one investor and one promoter as opposed to multiple investors).

⁷⁷ *Milnarik*, 457 F.2d at 276-77. The Seventh Circuit later affirmed its stance on horizontal commonality when it expressly stated, "[t]his [c]ircuit has strictly adhered to a 'horizontal' test of common enterprise, under which multiple investors must pool their investments and receive pro rata profits." *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144, 146 (7th Cir. 1984). The court found no horizontal commonality existed when an investor purchased valuable paintings from an art gallery with an attached agreement that obligated the gallery to purchase the artwork back within five years. *Id.* at 146-47. The court reasoned that the agreement contained neither pooling of funds nor pro rata sharing of profits. *Id.* Interestingly, the plaintiff argued in the alternative that the court should adopt vertical commonality instead of horizontal commonality. *Id.* The court turned down the invitation but still exercised the vertical commonality test to reiterate to plaintiff that he had no case. *Id.* It is apparent from the opinion that the court was just as interested in admonishing the plaintiff for bringing a nearly baseless claim as they were in reaffirming their unwavering devotion to horizontal commonality analysis. *Id.*

⁷⁸ *Milnarik*, 457 F.2d at 275; see *Curran*, 622 F.2d at 220 (defining a commodity future as "a standardized contract for the purchase and sale of a fixed quantity of a commodity to be delivered in a specified future month at a price agreed upon when the contract is entered into"); see also 7 U.S.C. § 1a(4) (2006), for the definition of "commodity":

The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.

Id.

an individual contract with the common broker and was entitled to receive profits derived from their funds alone.⁷⁹ In exchange, the broker retained a commission from any profits manufactured via the speculative trading.⁸⁰ Citing previous Seventh Circuit precedent, the *Milnarik* court held that this type of investment scheme was not an investment contract under the 1933 Act because the success and failure of each investor did not impact the success of other investors who also had agreements with the common broker.⁸¹

Following the Seventh Circuit's lead in *Milnarik*, the Sixth Circuit Court of Appeals accepted the horizontal commonality test when it faced a similar fact pattern involving futures commodities.⁸² In *Curran v. Merrill Lynch*, the court also focused on the pooling of investor's interests while at the same time expressly denouncing the vertical commonality test.⁸³ The court recognized that situations can arise where the underlying product involved, in this case futures commodities, may not be securities, but the overarching investment scheme may still satisfy *Howey*'s requirement.⁸⁴

Two years later, in yet another case involving discretionary futures commodities and Merrill Lynch, the Third Circuit Court of Appeals followed suit and illustrated the high level of acceptance the pooling of investor's interest requirement had achieved.⁸⁵ Treating the requirement as the fulcrum in horizontal commonality analysis, Judge Hunter, in one sentence of reasoning, found that the discretionary accounts involved did not exhibit the requisite characteristics of an investment contract.⁸⁶

2. Broad Vertical Commonality

Instead of examining the synergy between investors' fortunes, vertical commonality generally shifts the focus to the relationship

⁷⁹ *Milnarik*, 457 F.2d at 275. Commodities themselves are not securities. *Curran*, 622 F.2d at 221. However, courts have determined that when commodity accounts are managed by a third party on behalf of an investor, the agreement between the investor and the promoter—in this case the commodity account manager—is an investment contract. *Id.* Thus, as an investment contract, it is subject to regulation under the 1933 Act. See 15 U.S.C. § 77b(a)(1) (2006).

⁸⁰ *Milnarik*, 457 F.2d at 275.

⁸¹ *Id.* at 276.

⁸² *Curran*, 622 F.2d at 222.

⁸³ *Id.*

⁸⁴ *Id.*; see *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 520 n.9 (5th Cir. 1974) (noting the distinction between an underlying product not being a security, but the overarching scheme designed to invest in such products for the production of money may be a security).

⁸⁵ *Salcer v. Merrill Lynch*, 682 F.2d 459, 460 (3d Cir. 1982).

⁸⁶ *Id.*

672 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

between the individual investor and the promoter of the investment product.⁸⁷ More specifically, broad vertical commonality looks closely at the relationship between the promoters' efforts in conjunction with the investors' fortunes.⁸⁸ Courts that follow horizontal commonality are quick to point out that shifting the analysis from the relationship between investors' fortunes to the relationship between investors' fortunes and the promoter's efforts, blends the second and fourth prongs of *Howey*.⁸⁹ Consequently, a lower standard for commonality is created in comparison to the horizontal commonality test.⁹⁰

One of the earliest cases developing the foundation for broad vertical commonality came out of the Ninth Circuit Court of Appeals in a case that involved the resale of second trust deeds and second mortgages.⁹¹ The Ninth Circuit held that such investments met the commonality element of *Howey*, and thus qualified as an investment contract because the fortunes of the investors were "inextricably woven" with the efforts of the promoter, not that of other investors.⁹² The Fifth Circuit Court of

⁸⁷ See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974) (declaring the most important factor in vertical commonality is "the uniformity of impact of the promoter's efforts" on the investor's fortune). The court in *Koscot Interplanetary* went on to interpret *Howey* as applying a form of vertical commonality. *Id.* Its interpretation centered around the notion that investors only bought into the investment scheme in *Howey* because of their ability to rely on the management company to produce profits. *Id.*

⁸⁸ *Id.*

⁸⁹ See *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994) (recognizing that by allowing commonality to be satisfied by showing the fortunes of the investor are tied to the efforts of the promoter, the second and fourth prongs are simply combined into one question); *Berman v. Bache*, 467 F. Supp. 311, 319 (S.D. Ohio 1979); see also *supra* Part II.D (stating the fourth prong evaluates the nature of the effort the promoter must put forth in order for the investors to make their intended profit); *infra* Part III.B (explaining if the commonality prong also incorporates an analysis of the promoter's efforts, a degree of redundancy can be found).

⁹⁰ See LARRY D. SODERQUIST & THERESA A. GABALDON, *SECURITIES LAW* 5 (4th ed. 2011) (describing the more restrictive requirements for horizontal commonality and the less restrictive requirements for strict vertical commonality and broad vertical commonality); Shawn Hill Crook, Comment, *What is a Common Enterprise? Horizontal and Vertical Commonality in an Investment Contract Analysis*, 19 CUMB. L. REV. 323, 329-30 (1989) (considering strict vertical commonality to be less restrictive than horizontal commonality but more restrictive than broad vertical commonality); see also, *Hocking v. Dubois*, 839 F.2d 560, 567 (9th Cir. 1988) (stipulating that the Ninth Circuit Court of Appeals has endorsed strict vertical commonality, but not to the full exclusion of horizontal commonality).

⁹¹ See *L.A. Trust Deed & Mortg. Exch. v. SEC*, 285 F.2d 162, 172 (9th Cir. 1960) (laying down the foundational reasoning for the subsequent development of the broad vertical commonality test).

⁹² *Id.*

We find 'a common enterprise' in which the appellants and the purchasers of second trust deed notes have an economic interest... [that] is inextricably woven with the ability of [the promoter] to locate by the exercise of its independent judgment a

Appeals, widely credited with creating broad vertical commonality, relied on the same reasoning when it derived the broad vertical commonality test.⁹³

In *SEC v. Koscot Interplanetary, Inc.*, the Fifth Circuit applied the broad vertical commonality test to a case involving a pyramid scheme.⁹⁴ The *Koscot Interplanetary* court held that the critical element of the scheme providing commonality was similar to the citrus grove scheme in *Howey* in that each individual participant's fortunes were dependent upon the efforts of the promoter.⁹⁵ If there was any question as to whether the

sufficient number of discounted trust deeds, and the ability of [the promoter] to subsequently meet its commitments

Id. This language actually speaks to both the *efforts* and the *fortunes* of the promoter as they relate to individual investors. *Id.* As such, it subsequently became the basis for both broad and strict vertical commonality. See *Koscot Interplanetary, Inc.*, 497 F.2d at 478 (formulating broad vertical commonality); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973) (adopting strict vertical commonality).

⁹³ *Koscot Interplanetary, Inc.*, 497 F.2d at 478; see *Curran v. Merrill Lynch*, 622 F.2d 216, 222 (6th Cir. 1980) (denouncing broad vertical commonality). While adopting horizontal commonality, the court made it a point to expressly disassociate with the broad vertical commonality test by stating, "we necessarily reject the vertical commonality approach primarily championed by the Fifth Circuit's decision . . ." *Id.*; see also *Meredith v. Conticommodity Servs., Inc.*, No. 79-1282, 1980 WL 1465, at *3 (D.D.C. Nov. 14, 1980) (acknowledging that the vertical commonality requirement was championed primarily by the Fifth Circuit Court of Appeals).

⁹⁴ See *Koscot Interplanetary, Inc.*, 497 F.2d at 475 (describing how a pyramid scheme works). The scheme in *Koscot Interplanetary* consisted of a structured hierarchy that rewarded larger profits as a participant ascended through the ranks. *Id.* At the bottom of the pyramid structure, numerous entry-level "beauty advisor[s]" could invest in the scheme for the right to purchase cosmetic products at a forty-five percent discount, and then sell those products on margin for a profit. *Id.* (internal quotation marks omitted). If a participant wished, they could elevate to the second level of the pyramid and become a "supervisor or retail manager." *Id.* At the second level, the participant had to make an investment of \$1,000 in exchange for a greater discount on the same cosmetic products, usually fifty-five percent, and then the participant could increase their profit potential. *Id.* Additionally, any participant on the second level could recruit a first level "beauty advisor" and receive an additional \$600. *Id.* The highest level was that of a distributor, at which point, discounts reached sixty-five percent. *Id.* Plus, the distributor received \$600 or \$3,000 for each recruit they brought into the *Koscot Interplanetary* scheme. *Id.* The scheme rewarded those who could recruit and retain subordinate participants and promoted the scheme in a veil of secrecy. *Id.*

⁹⁵ See *id.* at 478. (giving a broad characterization to the investment scheme in *Howey* by saying the only way an individual investor's fortunes were tied to other investors' fortunes, were through the generalization that each investor would prosper if the whole enterprise prospered). Such a generalization would give rise to horizontal commonality, but because of the court reading the *Howey* facts as individual investors receiving profits in relation to their individual plot, vertical commonality can be derived therein. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946) (stating that each investor's "respective shares in th[e] enterprise [were] evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits").

674 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

Fifth Circuit would adhere to broad vertical commonality, it was put to rest just two days later when it decided *SEC v. Continental Commodities Corp.*⁹⁶ The Fifth Circuit expressly rejected the Seventh Circuit's reasoning in *Milnarik*, which solidified horizontal commonality.⁹⁷ Instead, the Third Circuit held the exact opposite, claiming that the *Milnarik* view was incompatible with views of the Supreme Court.⁹⁸ Distinguishing itself from *Milnarik*, the court furthered the notion that a promoter's expertise is a key factor to consider when evaluating the promoter's efforts.⁹⁹

Through the interpretations rendered by both the Ninth Circuit and the Fifth Circuit, it is clear that in order for broad vertical commonality to exist, the fortunes of the investor must be directly tied to the efforts of the promoter.¹⁰⁰ Those efforts can be evidenced by a showing that the investor relied on a high level of promoter expertise in the industry for which the investor placed his money.¹⁰¹

3. Strict Vertical Commonality

Strict vertical commonality is distinguishable from broad vertical commonality in that the former shifts the focal point from the *efforts* of the promoter to the *fortunes* of the promoter.¹⁰² Thus, the commonality

⁹⁶ *Koscot Interplanetary, Inc.*, 497 F.2d at 473; *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 516 (5th Cir. 1974). *Koscot Interplanetary* was decided on July 15, 1974. 497 F.2d at 473. *Continental Commodities* was decided on July 17, 1974. 497 F.2d at 516.

⁹⁷ *Cont'l Commodities Corp.*, 497 F.2d at 521.

⁹⁸ *Id.*

⁹⁹ *See id.* at 522 (defining the key question to whether the investors' success is dependent upon the promoter's expertise because the investors lack the necessary expertise to produce the profits they seek); *Long v. Shultz Cattle Co.*, 881 F.2d 129, 142 (5th Cir. 1989) (explaining that an investor can meet the broad vertical commonality test if he lacks knowledge or expertise of the investment scheme).

¹⁰⁰ *See supra* note 91 and accompanying text (discussing *L.A. Trust Deed & Mortg. Exch. v. SEC*, 285 F.2d 162, 172 (9th Cir. 1960)); *see also Cont'l Commodities Corp.*, 497 F.2d at 522 (defining the key question to whether the investors' success is dependent upon the promoter's expertise because the investors lack the necessary expertise to produce the profits they seek).

¹⁰¹ *See Cont'l Commodities Corp.*, 497 F.2d at 522 (finding an investment contract because the investors lacked the necessary business skills to handle such accounts, and therefore must rely heavily on the expertise of the promoter).

¹⁰² *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978); *see SEC v. R.G. Reynolds Enters., Inc.*, 952 F.2d 1125, 1131 (9th Cir. 1991) (reasoning that because the promoter's fortunes were contingent upon the fortunes of his investors, vertical commonality existed and the second prong of *Howey* was satisfied); DAVID BARROWS & JOHN SMITHIN, *FUNDAMENTALS OF ECONOMICS FOR BUSINESS* 22-26, 66-67 (2d ed. 2009) (explaining that a promoter utilizing a flat rate commission structure would demand an amount roughly equal to that which the promoter would garner under a percentage based commission structure).

element is met when an investor's fortune fluctuates in harmony with the promoter's fortunes.¹⁰³ This is not to be confused with horizontal commonality because, under that analysis, the focus would be an investor's fortune versus other individual investors' fortunes.¹⁰⁴ Unlike horizontal commonality, strict vertical commonality allows for an investment scheme to exist even if there is only one investor.¹⁰⁵ Strict vertical commonality carries a slightly greater standard than its next in kin, broad vertical commonality, but still a much lower standard than horizontal commonality.¹⁰⁶

Although the Ninth Circuit Court of Appeals laid the foundation for vertical commonality in general, it has followed strict vertical commonality in subsequent cases.¹⁰⁷ Most notably, the Ninth Circuit applied strict vertical commonality to an investment scheme involving discretionary commodities trading accounts.¹⁰⁸ The court held the investment scheme was not an investment contract, and thus not a security because there lacked a correlation between the success of the

¹⁰³ See *SEC v. Eurobond Exch., Ltd.*, 13 F.3d 1334, 1340 (9th Cir. 1994) (holding that strict commonality existed because both the investor and the promoter shared the risk of profits and losses in the same enterprise).

¹⁰⁴ See *supra* Part II.E.1 and accompanying text (discussing the requirements of horizontal commonality).

¹⁰⁵ See *Hector v. Wiens*, 533 F.2d 429, 433 (9th Cir. 1976) (accepting the proposition that commonality is required between the investor and the promoter, not multiple investors).

¹⁰⁶ See *SODERQUIST & GABALDON*, *supra* note 90, at 5 (explaining that horizontal commonality requires "multiple investors and a sharing or pooling of funds," making it more restrictive than strict vertical commonality, which requires a linking of investors' and promoters' fortunes or broad vertical commonality, which only requires a linking of efforts); *Crook*, *supra* note 90, at 329-30 (considering strict vertical commonality to be less restrictive than horizontal commonality, but more restrictive than broad vertical commonality).

¹⁰⁷ *L.A. Trust Deed & Mortg. Exch. v. SEC*, 285 F.2d 162, 165 (9th Cir. 1960); see *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973) (pulling language from *L.A. Trust Deed*). But see *Hocking v. Dubois*, 839 F.2d 560, 567 (9th Cir. 1988) (stipulating that the Ninth Circuit Court of Appeals has endorsed strict vertical commonality, but not to the full exclusion of horizontal commonality).

¹⁰⁸ *Brodts v. Bache & Co.*, 595 F.2d 459, 460 (9th Cir. 1978). The investment scheme in *Brodts* is the same type of investment scheme analyzed by the Seventh Circuit Court of Appeals. *Id.* However, the Seventh Circuit used horizontal commonality to find no investment contract existed since the fortunes of the investors did not rise and fall together in harmony. See *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276-77 (7th Cir. 1972) (adopting horizontal commonality). *Brodts* is a good illustration of how courts can use any of the three commonality tests to analyze the same type of investment scheme and still reach the same conclusion. 595 F.2d at 460; see also *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144, 146 (7th Cir. 1984) (illustrating an investment scheme that fails multiple commonality tests and as such, is not a security).

676 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

investor and the success of the promoter.¹⁰⁹ Furthermore, the court took the added step of clarifying any confusion regarding whether or not an investment scheme must have an element of substantial risk of loss to meet the commonality requirement.¹¹⁰ Apparently recognizing a rising use of the substantial risk test, the court rejected such a requirement and thus limited the analysis to the relationship between the fortunes of the investor and the fortunes of the promoter.¹¹¹

F. *Summary of the Circuit Split*

To date, the horizontal commonality test has been adopted and regularly used by the Third, Sixth, and Seventh Circuits.¹¹² Broad vertical commonality is mostly confined to the Fifth Circuit.¹¹³ The Eighth Circuit favors vertical commonality; however, it is unclear

¹⁰⁹ *Brodts*, 595 F.2d at 461. The court noted that the promoter could still reap large commissions and be considered successful while the investor actually loses his investment. *Id.* If, however, the promoter's commission had been tied directly to the success or failure of investor's account, the investment scheme would most likely have been considered an investment contract under strict vertical commonality. *Id.* For illustrative effect, such a scheme, where the commission of the promoter is dependent upon the success or failure of the investor, would likely qualify under broad vertical commonality because the investor's fortunes are heavily dependent upon the efforts of the promoter to successfully invest in the right commodities. See *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974) (finding a similar commodities trading account scheme to be an investment contract because the investors lacked the necessary business skills to handle such accounts, and therefore must rely heavily on the expertise of the promoter). However, the investment scheme would still lack the requisite pooling of funds or pro-rata distribution of profits to qualify under horizontal commonality. See *Milnarik*, 457 F.2d at 275-76 (holding similar commodities trading accounts were not investment contracts).

¹¹⁰ See *Brodts*, 595 F.2d at 461 (recognizing that in a previous case, the court had inadvertently given greater weight to the fact that investors were not involved in a substantial risk of losing their money to find commonality existed); see also *United States v. Carman*, 577 F.2d 556, 563-64 (9th Cir. 1978) (neglecting the fact that no common enterprise existed, as defined by either vertical commonality test, the court still held a common enterprise was present since the investors experienced a substantial risk of loss on their investment). The substantial risk of loss factor had not been present in prior commonality precedent, which is why the court elected to correct itself in *Brodts*, 595 F.2d at 461.

¹¹¹ See *supra* note 108 (discussing the Ninth Circuit's reasoning in *Brodts*); see also *supra* note 110 (noting that the court recognized it had inadvertently bolstered the substantial risk test).

¹¹² See *Salcer v. Merrill Lynch*, 682 F.2d 459, 460 (3d Cir. 1982) (adopting horizontal commonality); see also *Curran v. Merrill Lynch*, 622 F.2d 216, 222 (6th Cir. 1980) (dispensing vertical commonality in favor of horizontal commonality); *Milnarik*, 457 F.2d at 276 (evaluating the various commonality approaches before settling on horizontal commonality).

¹¹³ See *supra* note 87 (discussing *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974)).

whether broad vertical or strict vertical commonality is preferred.¹¹⁴ Although the Ninth Circuit first laid the foundation for both broad and strict vertical commonality, it has since applied the strict vertical commonality test more often than the broad vertical commonality test.¹¹⁵ Interestingly, the Tenth Circuit Court of Appeals has used a combination of both vertical commonality tests while expressly rejecting horizontal commonality.¹¹⁶ In the Eleventh Circuit, it appears broad vertical commonality is favored.¹¹⁷ As for the remaining circuits—the First, Second, and Fourth Circuits—the issue has yet to be decided as all have declined the opportunity to clarify the matter even though the district courts within their circuits are inconsistent in applying one test over the others.¹¹⁸

¹¹⁴ See *Miller v. Cent. Chinchilla Grp.*, 494 F.2d 414, 416 (8th Cir. 1974) (citing a Ninth Circuit holding, which based its decision on strict vertical commonality, even though the majority of reasoning focused on the efforts of the promoter: typically indicative of broad vertical commonality).

¹¹⁵ See *supra* note 91 (discussing *L.A. Trust Deed & Mortg. Exch. v. SEC*, 285 F.2d 162, 165 (9th Cir. 1960)); see also *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973) (pulling language from *L.A. Trust Deed*, 285 F.2d at 165). But see *Hocking v. Dubois*, 839 F.2d 560, 567 (9th Cir. 1988) (stipulating that the Ninth Circuit Court of Appeals has endorsed strict vertical commonality, but not to the full exclusion of horizontal commonality).

¹¹⁶ See *McGill v. Am. Land & Exploration Co.*, 776 F.2d 923, 925 (10th Cir. 1985) (“The rigid ‘horizontal commonality’ requirement . . . has never been a part of the law of this circuit.”).

¹¹⁷ *Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 915 (11th Cir. 1987). Although the court focused its holding on the efforts of the promoter under the fourth prong of *Howey*, the court nonetheless cited a Fifth Circuit case to help guide its decision. *Id.* The Fifth Circuit follows broad vertical commonality. *SEC v. Cont’l Commodities Corp.*, 497 F.2d 516, 516 (5th Cir. 1974); *Koscot Interplanetary, Inc.*, 497 F.2d at 478; see also *supra* Part II.E.2. (identifying which circuits follow broad vertical commonality).

¹¹⁸ See *Crook*, *supra* note 90, at 332–49 (comprising an excellent list of cases from each circuit court of appeals and the district courts within each circuit). For example, within the First Circuit, the District of Massachusetts originally adopted horizontal commonality only to switch to strict vertical commonality later. See *Gaudette v. Panos*, 644 F. Supp. 826, 834 (D. Mass. 1986) (adopting strict vertical commonality); *Schofield v. First Commodity Corp.*, 638 F. Supp. 4, 6 (D. Mass. 1985); *Holtzman v. Proctor, Cook & Co., Inc.*, 528 F. Supp. 9, 15–16 (D. Mass. 1981) (exclaiming a preference for horizontal commonality while still acknowledging that the scheme at bar would not fit horizontal or either vertical commonality tests). The use of varying tests also occurs in the Second Circuit. See *In re Gas Reclamation, Inc. Sec. Litig.*, 659 F. Supp. 493, 502 (S.D.N.Y. 1987) (applying strict vertical commonality); *Silverstein v. Merrill Lynch*, 618 F. Supp. 436, 438–39 (S.D.N.Y. 1985) (utilizing horizontal commonality). The discrepancy between tests is evident in the Fourth Circuit as well. See *Waterman v. Alta Verde Indus., Inc.*, 643 F. Supp. 797, 802–03 (E.D.N.C. 1986) (finding broad vertical commonality more persuasive); *Burton v. Heinold Commodities, Inc.*, 646 F. Supp. 360, 361–62 (E.D. Va. 1986) (applying horizontal commonality).

III. ANALYSIS

Allowing three separate tests to exist offends the basic reasoning behind implementation of the 1933 Act.¹¹⁹ In theory, a financial product either qualifies as a security and is subject to federal regulation, or does not qualify and escapes such regulation. In reality, the disagreement among the circuit courts causes a financial product to be classified as a security in one circuit while not being considered a security in others.¹²⁰ Part III analyzes the weaknesses and pitfalls of each commonality test. More specifically, Part III.A illustrates the overly restrictive nature of the horizontal commonality test used predominantly by the Third, Sixth, and

¹¹⁹ See *supra* note 31 and accompanying text (discussing how blue sky laws were inconsistent in their approaches as either pro-business or pro-investor and how such approaches helped fuel the need for federal securities regulation that would be more consistent).

¹²⁰ See *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 521 (5th Cir. 1974). Unlike the Seventh Circuit, the court held that a discretionary trading account in commodities futures was a security and thus allowed plaintiffs to continue their suit seeking damages for fraud. *Id.* at 522–23. The court analyzed the accounts by asking whether the profits of the investments collectively were dependent on the promoter's expertise and then buttressed its point by stating:

[t]hat it may bear more productive fruits in the case of some options than it does in cases of others should not vitiate the essential fact that the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of [the promoter].

Id. at 522–23; see also *supra* note 79 (discussing the definition of a commodities future). *But see* *Curran v. Merrill Lynch*, 622 F.2d 216, 222 (6th Cir. 1980) (following the Seventh Circuit's lead by denouncing vertical commonality in favor of horizontal commonality to find that discretionary commodity trading accounts lack the requisite commonality demanded by the court's reading of *Howey*); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276–77 (7th Cir. 1972) (holding that a discretionary trading account in commodities futures was not a security, and as a result, petitioners could not recover their initial deposit amount of \$13,662 from the promoter who fraudulently squandered it away). The Sixth Circuit held that the discretionary commodity trading accounts involved were not investment contracts, and thus not securities. *Curran*, 622 F.2d at 222. The Sixth Circuit also directly attacked the Fifth Circuit's reasoning by quoting its language in *Continental Commodities* before countering that “[a]lthough [the Fifth Circuit's] approach has attracted some support, we believe that no horizontal common enterprise can exist unless there also exists between discretionary account customers themselves some relationship which ties the fortunes of each investor to the success of the overall venture.” *Id.* at 223–24 (footnote omitted). The Sixth Circuit felt commonality based solely on the relationship between the promoter and an individual investor was inconsistent with *Howey*. *Id.* Following this line of cases, an investor living in the Fifth Circuit will potentially be able to recover based on statutory causes of actions while an investor residing in the Sixth Circuit is barred from similar claims even though the underlying investment product is identical, equally as risky, and equally as open to fraudulent promoter deception worthy of disclosure. See cases cited *supra*.

Seventh Circuits.¹²¹ Next, Part III.B discusses the repetitive requirement utilized by broad vertical commonality to weigh an investor's reliance on the promoter's expertise.¹²² Finally, Part III.C discusses strict vertical commonality's departure from *Howey* by relying on form over substance and ignoring the economic realities of the given transaction.¹²³

A. *The Overly Restrictive Horizontal Commonality Test*

Horizontal commonality requires the success of each individual to be tied to the success of every other individual investor in an enterprise.¹²⁴ Consequently, if an enterprise only involves one investor, that investor's success can never be tied to the success of other investors as no other investors exist.¹²⁵ As a result, investment schemes involving only one investor are not covered by the horizontal commonality test.¹²⁶ Commentators have argued that this fact alone is enough to characterize the test as overly restrictive.¹²⁷ However, some investment schemes involving one promoter and one investor may be organized in a way that does not mandate the federal government's involvement.¹²⁸ The

¹²¹ See *infra* Part III.A (discussing the overly restrictive nature of horizontal commonality).

¹²² See *infra* Part III.B (discussing the redundancy that is an inherent characteristic of broad vertical commonality).

¹²³ See *infra* Part III.C (arguing that strict vertical commonality produces inconsistent results).

¹²⁴ See *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144, 146 (7th Cir. 1984) (“[The] ‘horizontal’ test of common enterprise . . . [is when] investors . . . pool their investments and receive pro rata profits.” (citing *Milnarik*, 457 F.2d 274)).

¹²⁵ *Id.*

¹²⁶ See *Curran v. Merrill Lynch*, 622 F.2d 216, 225 (6th Cir. 1980) (characterizing the relationship between the promoter and investor as a one-on-one relationship whereby the investor's monies were compartmentalized into an individual account separated from other investors so as to not trigger horizontal commonality).

¹²⁷ See *Gordon III*, *supra* note 69, at 91 (“[H]orizontal commonality is a restrictive test that excludes many instruments sold as investments.”); *Monaghan*, *supra* note 69, at 2156 (suggesting that horizontal commonality “is unduly restrictive” because it limits the types of investment schemes to those which include “more than one investor”); see also *Alcser*, *supra* note 69, at 1233–34 (discussing the heightened need for disclosure in situations involving only one investor based on the economic theory of diversification).

¹²⁸ See *Hector v. Wiens*, 533 F.2d 429, 433 (9th Cir. 1976) (finding that a relationship between a grain farmer, a feedlot operator, and a bank could satisfy the common enterprise requirement if both the farmer and the bank were dependent upon the success of the feedlot for generating a return on their investments). The facts of this case are a great illustration of the ways in which promoters devise creative investment schemes potentially worthy of federal regulation. *Id.* at 431. In *Hector*, a grain farmer entered into an agreement with a feedlot and a bank. *Id.* The feedlot agreed to buy, feed, and sell cattle and hogs on behalf of the farmer's account in exchange for the grain farmer supplying grain to the feedlot. *Id.* As such, the consideration in this agreement was a commodity as opposed to cash. *Id.* Additionally, the bank agreed to finance all livestock purchases by

680 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

following explores the requisite relationship between promoters and investors necessary to trigger horizontal commonality and how the test promotes circumvention.

In scenarios involving transactions where the parties are closely acquainted, the investor presumably has a relationship with the promoter whereby the investor can demand the necessary information required to make educated decisions and evaluate for himself whether fraud exists in the transaction.¹²⁹ In this sense, horizontal commonality is logical because mandating that the promoter disclose information would be paternalistic in such scenarios.¹³⁰ If a promoter were to enter into multiple transactions involving closely acquainted parties of similar construction, the scheme would be of a different character.¹³¹ In the former, the investor has a more intimate relationship with the promoter that creates less of an opportunity for fraud.¹³² In the latter, the size of the promoter's operation has increased, which may allow him to hide information from individual promoters, and thus increases the likelihood of fraud.¹³³ Unfortunately, horizontal commonality would allow these investment schemes to go unregulated even though it appears to qualify as the type Congress intended to thwart by requiring

issuing notes to the farmer with the underlying collateral being the livestock themselves. *Id.* The arrangement in *Hector* would likely fail other elements of *Howey*, but the court made it clear that commonality could exist even though the investment scheme only involved one investor. *Id.* at 433.

¹²⁹ 15 U.S.C. § 77d(2) (2006). The 1933 Act allows an exemption for "transactions by an issuer not involving any public offering." *Id.* This exemption is known as the private offering exemption and allows promoters dealing in close relationship with his investors to forgo adherence to registration and disclosure regulations imposed by the 1933 Act. *Van Dyke v. Coburn Enters., Inc.*, 873 F.2d 1094, 1098 (8th Cir. 1989). Courts have recognized that the exemption applies to investors who are in need of protection and not to investors who have access to such information. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). However, if an investor has a close relationship with the promoter—employment, family, superior bargaining power—the private offering exemption does apply. *Doran v. Petrol. Mgmt. Corp.*, 545 F.2d 893, 903 (5th Cir. 1977).

¹³⁰ *See supra* note 43 and accompanying text (detailing the purpose of the 1933 Act and noting that Congress intended to promote disclosure).

¹³¹ *See Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276-77 (7th Cir. 1972) (acknowledging that by engaging in similar discretionary arrangements with other investors, the character of the promoter's scheme was different than what it would be if all of the investors' monies had been put together to finance the scheme).

¹³² *See supra* note 108 (noting cases involving transactions that resulted in fraud).

¹³³ *See supra* Part II.A (discussing the historical business schemes that contributed to the need for federal regulation). Note that the schemes discussed in Part II.A involved business structures of large size, which arguably contributed to their ability to hide material information investors needed to make accurate investment decisions. *See LOSS & SELIGMAN, SECURITIES REGULATION, supra* note 5, at 4 (describing two companies so large, Mississippi Company and South Sea Company, that the British government granted them a monopoly over the shipping and trading industry).

disclosure.¹³⁴ This analysis is consistent with *Howey's* substance over form approach.¹³⁵

Furthermore, some argue horizontal commonality places too much value on the need for an investment scheme to utilize pooling of investor funds.¹³⁶ As courts applying either of the vertical commonality approaches have illustrated, investment schemes that lack the pooling feature exist and, nonetheless, need to be regulated by mandatory disclosure.¹³⁷ A promoter can easily circumvent the pooling requirement by simply keeping his investors' monies separate from one another.¹³⁸

The mere use of preferred accounting techniques shares no correlation with the need for disclosure of information.¹³⁹ Even more, a fraudulent investment scheme is no less worthy of regulation simply because the invested monies are compartmentalized.¹⁴⁰ The inability of the horizontal commonality test to capture promoters crafty enough to keep investors' monies separated, even though the essence of the scheme mirrors a common enterprise, renders the test overly restrictive.¹⁴¹

¹³⁴ See *supra* note 43 (discussing Congress's intent to mandate disclosure of material information).

¹³⁵ SEC v. W.J. Howey Co, 328 U.S. 293, 299 (1946). The Court considered its approach to be one that "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." *Id.*

¹³⁶ See Gordon III, *supra* note 69, at 91 (arguing that "horizontal commonality is . . . restrictive . . . [because it] excludes many instruments sold as investments"); Monaghan, *supra* note 69, at 2156 (suggesting that "[h]orizontal commonality is also overly exclusive" because it places too great an emphasis on the pooling).

¹³⁷ See *Salcer v. Merrill Lynch*, 682 F.2d 459, 461 (3d Cir. 1982) (involving the resale of second trust deeds and second mortgages); *Brodt v. Bache & Co.*, 595 F.2d 459, 460 (9th Cir. 1978) (involving discretionary commodity trading accounts); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 475 (5th Cir. 1974) (involving a multi-level pyramid scheme); *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 521 (5th Cir. 1974) (involving discretionary commodity trading accounts).

¹³⁸ See *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 277 (7th Cir. 1972) (recognizing that the investment scheme involved does not meet commonality because the promoter set up individual contracts with each investor thereby "creating [a] relationship [that] is unitary in nature" (quoting *Milnarik*, 320 F. Supp. at 1151-52)).

¹³⁹ See *supra* notes 44-45 and accompanying text (noting that Congress intended to compel and regulate the disclosure of information, not monitor accounting practices).

¹⁴⁰ See *Cont'l Commodities Corp.*, 497 F.2d at 521 (finding commonality existed in a situation that involved a promoter who set up an individual account for each investor and made trades in commodities futures for one account irrespective of the other accounts).

¹⁴¹ See *supra* note 127 (providing articles, which argue that horizontal commonality is overly restrictive).

682 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

B. *The Inherent Redundancy in Broad Vertical Commonality*

If an individual investor's fortunes are dependent upon the efforts of the promoter, the scheme in which the investor has joined meets broad vertical commonality and is an investment contract under the 1933 Act.¹⁴² The test only requires that an investor rely on the promoter's expertise, not that the investor be uneducated in the business for which he has invested.¹⁴³ However, the test's reliance on the promoter's expertise seems to blend several prongs of the *Howey* test and place extra weight upon the investor's reliance on the efforts and expertise of the promoter to produce returns on his investment.¹⁴⁴ Even though some argue broad vertical commonality properly protects investors, it is clear the protection and the reasoning behind it are misguided.

Congress may have intended to protect investors from fraudulent investment schemes, but it did not intend to protect investors from themselves.¹⁴⁵ Even still, some commentators trumpet congressional intent while arguing that broad commonality penalizes knowledgeable

¹⁴² See *supra* Part II.E.2 (discussing broad vertical commonality).

¹⁴³ Cases discuss the increased need for federal protection when an investor is not knowledgeable about a given industry or business in which the investment scheme may operate, but no cases take the converse logical step of holding that a knowledgeable investor is precluded from relying on the expertise of a promoter. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299–300 (1946) (noting that the investors that bought into the citrus grove lacked the requisite knowledge to cultivate and market the crops produced on their individual parcels of land). This reasoning is grounded on the presumption that an uneducated investor is less capable of detecting fraudulent practices of the promoter. *Id.* Moreover, it is precisely the efforts and expertise of the promoter that attract knowledgeable investors because the investor, although knowledgeable, may not have the ability, time, desire, or equipment to perform the necessary actions required to create a return on their investment. See *id.* at 296 (noting that the investors involved were actually business and professional people). Furthermore, the investor may be knowledgeable regarding the business in which the scheme operates, but it does not follow that the knowledge possessed by the investor includes the ability to detect fraud and manipulative practices of the promoter, especially if the promoter is keen in the art of deception. *Id.* It is the protection from deception that securities laws were designed to provide, not protection from losses suffered because a knowledgeable investor relied on an incompetent promoter. See *supra* note 43 and accompanying text (quoting Congress during the promulgation of the 1933 Act, "[t]he aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation").

¹⁴⁴ See *infra* note 151 and accompanying text (providing the Second Circuit's identification of the blending problem that occurs when broad vertical commonality is used).

¹⁴⁵ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (stating the purpose of the 1933 and 1934 Acts was "to protect investors against fraud"); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 428 (N.D. Cal. 1968) (stating that Congress intended "to protect the innocent investor, as distinguished from one who loses his innocence and waits to see how his investment turns out before he decides to invoke the act . . .").

investors to protect ignorant investors.¹⁴⁶ Courts indicate that an investor satisfies the broad vertical commonality test if she lacks knowledge and experience in the underlying investment scheme.¹⁴⁷ However, the converse is not true in that a knowledgeable investor is not precluded from recovering losses incurred in a fraudulent investment scheme.¹⁴⁸ So long as the knowledgeable investor relies on the promoter's expertise in the given field, she too can recover.¹⁴⁹ Therefore, broad commonality protects ignorant and knowledgeable investors alike.¹⁵⁰

Notwithstanding the knowledgeable investor argument, broad commonality is flawed because it reapplies the same reliance analysis already mandated by the fourth prong of the *Howey* test.¹⁵¹ The fourth prong requires that an investor rely solely on the efforts of others to make the desired return on investment.¹⁵² Implicit in this requirement is that an investor who relies on the efforts of someone else assumes that person has the requisite ability to generate a return.¹⁵³ The promoter's ability to generate return is fundamentally made up of his own knowledge of the given business environment, expertise in operating the investment scheme, and performance capabilities.¹⁵⁴ As such, the fourth

¹⁴⁶ See Alcser, *supra* note 69, at 1236-37 (inferring that because a court finds commonality in light of an investor's lack of expertise it would not find commonality in light of an investor's expertise).

¹⁴⁷ Long v. Shultz Cattle Co., 881 F.2d 129, 142 (5th Cir. 1989).

¹⁴⁸ See *Howey*, 328 U.S. at 296 (noting that most of the investors in the citrus grove scheme were business and professional people). The investors were thus knowledgeable regarding general business practices, but not specifically in the citrus industry. *Id.* Furthermore, the Court relied more on the fact that they lacked the desire, skill, and equipment necessary to actually work in the fields and market the fruits produced by cultivation. *Id.* at 296, 299-300.

¹⁴⁹ See *supra* note 109 and accompanying text (discussing courts' emphasis on investors relying on promoters' expertise). If an investor relies on the expertise of the promoter and an investor does not possess business acumen in the relevant industry, commonality will be found. SEC v. Cont'l Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974).

¹⁵⁰ See *supra* Part III.B (discussing broad vertical commonality).

¹⁵¹ See Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994) (recognizing that by allowing commonality to be satisfied by showing the fortunes of the investor are tied to the efforts of the promoter, the second and fourth prongs are simply combined into one question).

¹⁵² See *supra* Part II.D (outlining the four elements of the *Howey* test).

¹⁵³ See *Howey*, 328 U.S. at 299-300 (recognizing that in order for the investors to achieve their return on investment, it is essential for the promoter to possess the requisite capabilities to generate the expected profits).

¹⁵⁴ See *id.* (implying that promoters were able to sustain their operation because they possessed the necessary ability to cultivate and harvest citrus fruit and the ability to market the yielded crops to purchasers).

684 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

prong already incorporates weighing the degree of an investor's reliance on the expertise of the promoter.¹⁵⁵

When promulgating the *Howey* test, the Court expressly dictated four separate requirements that must be present before an investment scheme can be classified as a security.¹⁵⁶ Using broad commonality erodes the independent significance of the commonality element in favor of doubling the need to weigh an investor's reliance on the promoter.¹⁵⁷ Had the *Howey* Court intended to place so much emphasis on the reliance among parties, it could have done so and not included a need to analyze the structural characteristics of the scheme. Indeed, it is the substance of an investment scheme that separates those investment schemes that are worthy of regulation from those that are not.¹⁵⁸ Without a separate requirement of a common enterprise, many investment schemes not deserving of regulation would fall under the 1933 Act.¹⁵⁹ This results in the broad commonality being what its name suggests, broader than even Congress's intended scope of the 1933 Act.¹⁶⁰

¹⁵⁵ See *supra* Part II.D (outlining the fourth element of the *Howey* test).

¹⁵⁶ See *Howey*, 328 U.S. at 301 (creating a four part test to determine whether an investment contract is a security).

¹⁵⁷ To be sure, consider the fact pattern in *Koscot Interplanetary*. 497 F.2d 473, 475-76 (5th Cir. 1974). Individuals invested in the defendant's multi-level pyramid scheme whereby the defendant promoter would sell the investor cosmetic merchandise at a discount price and encouraged the investor to recruit more investors to sell the discounted cosmetics to in turn. *Id.* at 475-76. The SEC brought suit to enjoin the defendant from marketing its scheme based on the fact that the promoter practiced fraudulent sales techniques including high-pressure sales seminars. *Id.* at 474-75. The case turned on whether or not the scheme utilized by the promoter was an investment contract, and thus a security within the reach of the 1933 Act. *Id.* at 474. Application of the *Howey* test revealed that there most definitely was an investment of money with an expectation of profiting in reliance solely on the efforts of others—satisfying prongs one, three, and four. *Id.* To determine if the scheme is a common enterprise—the second prong—the court then looked to whether the investor relied on the expertise and knowledge of the promoter. *Id.* at 478-79. In doing so, this was the court's second pass at determining the degree of reliance the investor had on the promoter. *Id.* By inquiring into the investor's reliance two times, the court placed an exaggerated amount of weight on the second and fourth prongs of *Howey* while at the same time deemphasizing the significance of the other prongs. *Id.*

¹⁵⁸ See *supra* note 135 and accompanying text (discussing the substance over form approach outlined in *Howey*).

¹⁵⁹ See *supra* note 129 (noting Congress included a "private offering exemption" for situations involving a close relationship between the promoter and the investor). Without a common enterprise requirement, investment schemes specifically exempted by Congress would nonetheless fall under federal protection. See *Doran v. Petrol. Mgmt. Corp.*, 545 F.2d 893, 903 (5th Cir. 1977) (confronting the issue of applying securities to investment schemes between closely related parties).

¹⁶⁰ See *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982) (emphasizing that Congress placed some limitations on the broad scope of the 1933 Act). The Court stated, "we are

C. *The Inconsistencies of Strict Vertical Commonality*

At first glance, strict vertical commonality appears similar to horizontal commonality; however, the only thing shared is an inability to produce results consistent with the intent of *Howey*. One reason for such results is that strict vertical commonality, more so than either of the two prior tests, places a higher value on form over substance—the antithesis of *Howey*.¹⁶¹ For any investment scheme to be classified as a security under strict vertical commonality, the investor’s fortunes must fluctuate in harmony with the promoter’s fortunes.¹⁶² In effect, it is only when the investor realizes a profit that the promoter too realizes a profit from the enterprise.¹⁶³ Given that there is a multitude of ways a promoter could conceivably structure the compensation for his efforts, strict vertical commonality promotes form over substance.¹⁶⁴ Moreover, by emphasizing an investment scheme’s form as it looks on paper, strict vertical commonality produces inconsistent results hinging on the promoter’s compensation structure as opposed to the economic realities driving the investment scheme.¹⁶⁵

An illustrative example of such a venture is a scheme whereby the promoter receives a percentage commission based on the performance of the enterprise.¹⁶⁶ Assuming the other three prongs of *Howey* are met, such an arrangement would undoubtedly be the type Congress intended

satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all . . .” *Id.*

¹⁶¹ See *id.* (stressing that the Supreme Court has “repeatedly held that the test ‘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’” (quoting *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943))).

¹⁶² See *supra* notes 109–11 and accompanying text (discussing the requirements of the strict vertical commonality test).

¹⁶³ This is unlike what occurs when a promoter structures his commission on a flat fee basis, thus allowing himself the ability to reap gains while the investor loses money. *Brodv. v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978).

¹⁶⁴ See *supra* note 140 (describing a case involving a promoter that compartmentalized his investors’ accounts).

¹⁶⁵ See *supra* note 140 (describing one form of derivatives commodities accounts); see also *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975) (acknowledging that securities transactions are economic in character and for that reason, Congress intended the application of the 1933 Act to turn on the economic realities of the underlying investment scheme, not the form).

¹⁶⁶ *SEC v. R.G. Reynolds Enters., Inc.*, 952 F.2d 1125, 1130 (9th Cir. 1991). In *Reynolds*, the court held commonality existed because the promoter took a management fee based on a percentage of the profits created by the investment scheme. *Id.* at 1130–31. The court reasoned that because the promoter’s fortunes were contingent upon the fortunes of his investors, vertical commonality existed and the second prong of *Howey* was satisfied. *Id.* at 1131.

686 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

to classify as a security when it chose the phrase “investment contract.”¹⁶⁷ However, in reality, a promoter can circumvent the 1933 Act’s reach by structuring their business model to include a flat rate commission instead of a percentage basis.¹⁶⁸ In doing so, the promoter would assure himself a monetary gain regardless of the investor’s financial outcome.¹⁶⁹

It is not the promoter’s gain or loss that triggers a need for investor protection; rather, it is the deceptive nature of the investment scheme, which necessitates disclosure.¹⁷⁰ So, although the economic results of both a percentage based commission and flat rate commission differ slightly, the underlying financial product does not change.¹⁷¹ If, as in *Brodts*, the product is a commodities derivative, the investor will maintain the same level of risk while the promoter can deflect risk by utilizing a flat rate commission, which promotes form over substance.¹⁷²

The Court in *Howey* expressly denounced such an approach to analyzing an investment contract when it constructed a test that emphasized substance over form.¹⁷³ Moreover, the Court mandated that lower courts look to the “economic realit[ies]” of the investment scheme to determine whether it is properly classified as an investment

¹⁶⁷ *Id.* The *Reynolds* court further found that, in addition to the commonality requirement, the investment scheme utilized by the promoter satisfied all prongs of *Howey*. *Id.*

¹⁶⁸ *Brodts*, 595 F.2d at 461. Unlike the promoter in *Reynolds*, the promoter in *Brodts* structured his compensation as a flat fee with no correlation to the fortunes of the investor. *Id.* Moreover, the promoter could make large profits as he watched the money in his investors’ accounts be “wiped out.” *Id.* Although the investment schemes in both *Reynolds* and *Brodts* were similar, the promoter in the latter was able to side step liability because he structured his scheme on a flat fee commission basis as opposed to a percentage basis. *Id.*

¹⁶⁹ See *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478 (5th Cir. 1974) (involving a promoter who utilized a flat fee rate system to make profits regardless of individual investors’ fortunes); see also *Brodts*, 595 F.2d at 461 (involving a promoter charging flat fees and reaped large profits while his investors suffered significant losses).

¹⁷⁰ See *supra* note 43 and accompanying text (quoting Congress’s intent to protect the public and its markets from deceptive practices).

¹⁷¹ Regardless of how the commission is structured, basic principles of economics suggest that a promoter will not offer services unless she is adequately compensated to accommodate the costs of rendering the services sought by the consumer. Cf. BARROWS & SMITHIN, *supra* note 102, at 22–26, 66–67 (discussing the relationship between the basic theory of supply and demand and the cost of production as they work in conjunction to define the market price of a product or service). Thus, it can be assumed that a promoter utilizing a flat rate commission structure would demand an amount roughly equal to that which the promoter would garner under a percentage based commission structure. *Id.*

¹⁷² See *supra* note 168 (outing the flat fee scheme in *Brodts*).

¹⁷³ See *supra* note 135 and accompanying text (noting the flexibility of the *Howey* test).

contract.¹⁷⁴ That being the case, strict vertical commonality ignores economic realities by allowing promoters to alter their risk on the surface while leaving the underlying product unchanged.¹⁷⁵ Such an analysis does not protect investors in accord with the spirit of the 1933 Act because the true nature of the investment product, assuming it is deceptive, would go untested.¹⁷⁶

Another weakness of strict vertical commonality is the inconsistent results it may produce despite the economic realities behind an investment scheme. Assume two separate investors invest in two separate schemes, each with an identical underlying business model—a commodities derivative—yet only the investor whose promoter takes a percentage based commission would receive federal protection.¹⁷⁷ More currently, it is unlikely that promoters will structure their business models on a percentage basis. Effectively, these types of schemes have been taken out of the 1933 Act's regulatory reach, leaving those who invest in such schemes unprotected.¹⁷⁸ Given that federal securities laws were introduced as a means of curing the inconsistencies of state's blue

¹⁷⁴ See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946) (acknowledging the importance of economic realities when evaluating an investment contract for presence of commonality).

¹⁷⁵ See *Brodts v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978) (finding no commonality in a discretionary trading account solely because the promoter received a flat fee commission as opposed to a percentage based commission). It can be inferred that had the promoter taken a percentage based commission, commonality would have been found even though the underlying investment scheme remained unchanged. *Id.* This is form over substance in violation of the Supreme Court's guidance. See *supra* note 135 (noting the doctrine of *Howey* to place substance over form).

¹⁷⁶ *SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943, 953 (S.D.N.Y. 1971) (stating "the spirit and purpose of . . . the 1933 Act . . . is 'to protect investors by promoting full disclosure of information thought necessary to informed investment decisions'" (quoting *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953))). The court in *Harwyn* was tasked with analyzing the unrelated practice of "spinning-off," which consists of a company giving the subsidiaries stock to its parent company in an effort to avoid the registration requirement of the 1933 Act. *Id.* at 945. Although "spinning-off" is unrelated to commonality, the Court nonetheless recognized that the spirit of the 1933 Act required companies to disclose pertinent information to investors for the sake of thwarting fraudulent practices in the marketplace. *Id.* at 953 (internal quotation marks omitted).

¹⁷⁷ See *supra* note 157 (discussing a case in which the promoter of a discretionary trading account escaped commonality by charging a flat fee commission). But see *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 521 (5th Cir. 1974) (holding that commonality existed in a discretionary trading account scheme).

¹⁷⁸ *Brodts*, 595 F.2d at 461. Investors participating in a scheme involving a flat rate commission are precluded from federal protection in jurisdictions utilizing strict vertical commonality. *Id.* However, investors in those jurisdictions, which subscribe to either broad vertical commonality or horizontal commonality, will likely be protected as the scheme will meet the requirements set forth by either test for commonality. *Cont'l Commodities Corp.*, 497 F.2d at 521.

688 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

sky laws, strict vertical commonality appears to ignore this overarching aim in favor of a more arbitrary approach that breathes new life into those inconsistencies.¹⁷⁹

Disharmony among the circuits regarding the choice of one commonality test is understandable given each circuit's justifications.¹⁸⁰ However, all three tests fail to implement the intent of *Howey* to have one workable standard and the intent of Congress that securities laws be consistent throughout the nation.¹⁸¹ Horizontal commonality is flawed because it is overly restrictive and does not afford protection to classes of investors that Congress intended to protect.¹⁸² Broad vertical commonality also is flawed because it blends the third and fourth prong of the *Howey* test together, causing courts to give extra weight to an investor's reliance on the promoter, thus devaluing the independent significance of the commonality element.¹⁸³ Additionally, because strict vertical commonality places form over substance, it too is flawed.¹⁸⁴ Allowing three flawed tests to exist amongst the circuits will continue to cause inconsistent results, which is counter to the goal behind federal securities laws.¹⁸⁵

IV. CONTRIBUTION

Given the problems that exist with each version of the commonality tests, it is clear that a fresh perspective on the matter is needed.¹⁸⁶ Suggesting that circuits should select one test over the other two is futile because, by now, each circuit is heavily entrenched and supportive of their chosen test.¹⁸⁷ Simply combining the tests into a hybrid commonality test is impractical because there are irreconcilable differences amongst each commonality test regarding which investors

¹⁷⁹ See *supra* Part II.B (outlining Congress's first attempt to regulate securities on a federal level).

¹⁸⁰ See *supra* Part II.E.1 (discussing circuits that subscribe to horizontal commonality and their reasons for doing so); *supra* Part II.E.2 (noting the circuits that apply broad vertical commonality and their justifications); *supra* Part II.E.3 (detailing those circuits in favor of strict vertical commonality and the basis for their allegiance).

¹⁸¹ See *supra* Part II.B (providing insight to Congress's intent to stabilize securities regulation among the states and provide for a consistent federal regulatory scheme).

¹⁸² See *supra* Part III.A (analyzing the weakness of horizontal commonality).

¹⁸³ See *supra* Part III.B (criticizing broad vertical commonality).

¹⁸⁴ See *supra* Part III.C (pointing out the inconsistent results produced by strict vertical commonality).

¹⁸⁵ See *supra* Part II.B (acknowledging that Congress wanted to create consistency among states regarding the regulation of securities).

¹⁸⁶ See *supra* Part III (critiquing each commonality test).

¹⁸⁷ See *supra* Part II.E (discussing each circuit's preference for a particular commonality test).

would receive protection or not.¹⁸⁸ This Part calls for a return to the original intent of both the Court and Congress while suggesting an economics based solution to identifying whether an investment contract has the requisite commonality to be considered a security.

To be consistent with both the Court in *Howey* and Congress, any new test must be mindful of the intent of each. According to *Howey*, such a test should be flexible enough to adapt to the rapidly innovative investment schemes that are created in the markets.¹⁸⁹ Additionally, any commonality test should evaluate substance over form and dig deep to unearth the economic realities involved in a particular investment scheme.¹⁹⁰ Furthermore, any commonality test should be consistent with Congress's goal of protecting investors through disclosure and creating consistent results across the nation, as well as being broadly applicable to a wide range of investment schemes.¹⁹¹ Currently, each commonality test runs counter to one or a combination of these intentions.¹⁹²

To begin, a new commonality test should focus on whether the investment is made in a product that gains utility when developed as component parts of a larger whole.¹⁹³ Utility means that the product would gain an economic purpose beyond or in addition to that which is present at the time of, or before, initial investment.¹⁹⁴ This test can be referred to as the increased utility test. Utility is essential if the investors are to achieve their paramount aim of a return on their investment.¹⁹⁵ Any intrinsic personal value or personal utility that exists when the product stands alone is inconsequential. Additionally, for a product to be developed, the promoter must supply some type of effort to increase the product's value.¹⁹⁶ This piece of the test would most likely be met in

¹⁸⁸ See Monaghan, *supra* note 69, at 2156 (arguing for a hybrid commonality test).

¹⁸⁹ SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946); see *supra* Part III.A and accompanying notes (discussing *Howey's* intent).

¹⁹⁰ *Howey*, 328 U.S. at 298.

¹⁹¹ See *supra* note 53 (discussing the construction of federal securities laws and how Congress intended for the laws to be broadly applicable so as to cover as many financial instruments as possible).

¹⁹² See *supra* Part III (critiquing each of the three current commonality tests).

¹⁹³ This proposed test is derived directly from *Howey*. See *Howey*, 328 U.S. at 300 (basing the Court's reasoning on the principle that the underlying product gained utility once it was developed as component parts of a larger whole).

¹⁹⁴ *Id.*

¹⁹⁵ See *id.* (identifying the utility in that case as the adequacy of the personnel and equipment implemented by the promoter to create profits for investors).

¹⁹⁶ Unlike other commonality tests and the fourth prong of *Howey*, the increased utility test does not require that courts analyze the degree of reliance on the promoter's efforts. See *supra* Part II.E.2 (discussing the requirements of each broad vertical commonality); *supra* Part II.D (discussing the fourth element of *Howey*). The test simply acknowledges the economic reality that some source of effort is required to increase the value of the

690 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

all challenges considering the nature of financial products involving investments.

The increased utility test shifts the focus from the relationship between the promoter and the investor to the relationship between the underlying product and the larger enterprise.¹⁹⁷ This is logical given the economic realities of investments: Investors are primarily concerned with the value of the underlying product they are purchasing compared to the potential for an increase in that product's future value. Beyond the impact an investment scheme may have on the underlying product's value, an investor would likely not be influenced by the structure so long as the promise of returns is present. If the product incurs a new or increased economic purpose when combined within a larger system, it will satisfy the economic utility test and be classified as a common enterprise.¹⁹⁸ The relationship between the promoter and the investor will not go unchecked as the fourth prong of *Howey* still mandates investor reliance on the promoter.¹⁹⁹ This eliminates any issues of blending between the commonality element and the third party reliance element.²⁰⁰

Take, for example, the orange groves involved in the *Howey* case.²⁰¹ The average plot for sale consisted of parcels slightly larger than one acre and each had approximately twenty to forty orange trees.²⁰² Alone, this small amount of acreage will have little to no economic value—aside from the real estate value—to its owner because such a small number of cultivated oranges will produce negligible profits once cultivation expenses are deducted.²⁰³ In comparison, if the oranges from one small parcel, and the expenses involved in cultivating it, are combined with those of numerous, similarly situated owners, the owner of each small parcel now has potential for realizing an increase in economic value. The latter scenario creates a new economic purpose, which would be

investment and that, in the spirit of *Howey*, the effort should come from the promoter. *Howey*, 328 U.S. at 300. To require otherwise would defeat the purpose of investing in an investment scheme. See *supra* Part II.D (discussing the four requirements of the *Howey* test, including an expectation of profits).

¹⁹⁷ See *supra* Part II.E (outlining each of the three current commonality tests, including the fact that each test frames its analysis in terms of the relationship between the promoter and the investor).

¹⁹⁸ See *supra* Part IV (laying forth the elements of the increased utility test).

¹⁹⁹ See *supra* Part II.D (outlining the four elements of the *Howey* test).

²⁰⁰ See *supra* Part III.B (highlighting broad vertical commonality's tendency to blend together the third and fourth prongs of the *Howey* test).

²⁰¹ *Howey*, 328 U.S. at 295.

²⁰² *Id.*

²⁰³ *Id.* at 300. The Court recognized that "individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size." *Id.*

large scale production and supply distribution as opposed to the original purpose of personal use and enjoyment. Due to the economies of scale theory, the profits increase in relation to the number of owners involved in the enterprise.²⁰⁴ Therefore, the scheme involved in *Howey* would be a common enterprise under the increased utility test because the underlying product—small parcels of orange producing land—gained a new economic utility when combined with other similar parcels of orange producing land.²⁰⁵

To further test the validity of the economic utility test, consider the discretionary commodity derivative accounts involved in both *Milnarik v. M-S Commodities* and *SEC. v. Continental Commodities Corp.*²⁰⁶ Both cases involved promoters who used investor accounts to make trades in commodities futures.²⁰⁷ Keeping in mind that the underlying commodities do qualify as securities, the question arises whether the agreements between the account holders and the promoters are considered securities.²⁰⁸ Intuition would indicate that a discretionary commodities account is not a security, and the increased utility test would agree.²⁰⁹ The initial value of buying into a discretionary commodity derivatives account is equal to the value after purchasing the

²⁰⁴ See FISHER, *supra* note 57, at 121 (providing the definition for the economies of scale theory). Fisher states:

Economies of scale . . . refers to a decrease in average cost as the quantity of output rises. . . . This concept of economies of scale is sometimes referred to as the advantage of joint consumption: individual consumers can reduce their costs by sharing the good and its total cost with others.

Id. at 121–22.

²⁰⁵ Under the horizontal commonality test, the facts of *Howey* were considered a common enterprise. See *supra* Part II.D (discussing the facts, holding, and reasoning of *SEC. v. Howey*); *supra* Part II.E.1 (stating the horizontal commonality test). If the same facts were analyzed under broad vertical commonality, it is likely that a common enterprise would be found because the investor's fortunes are tied directly with the efforts of the promoter. See *supra* Part II.E.2 (presenting elements of broad vertical commonality). Also, because the profits of the investor are tied to the fortunes of the promoter on a percentage basis, the same facts would also qualify as a common enterprise under strict vertical commonality. See *supra* Part II.E.3 (presenting the development of strict vertical commonality).

²⁰⁶ *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 518–19 (5th Cir. 1974); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 275 (7th Cir. 1972).

²⁰⁷ See *supra* note 206 (noting the importance of *Milnarik* and *Continental Commodities Corp.*).

²⁰⁸ See *Cont'l Commodities Corp.*, 497 F.2d at 520 n.9 (noting the importance of distinguishing between the underlying commodity and the discretionary trading accounts that deal in commodities).

²⁰⁹ See *Milnarik*, 457 F.2d at 277 (declaring that the discretionary account scheme at bar resembled "an agency-for-hire rather than constituting the sale of a unit of a larger enterprise" (internal quotation marks omitted)).

692 VALPARAISO UNIVERSITY LAW REVIEW [Vol. 46]

account.²¹⁰ The economic realities that drive an increase in value for the underlying commodities—and thus a profit for investors—are not the true “efforts” of the promoter, but the market value of each commodity in the portfolio. Thus, although an investor’s account value may increase, it bears no relevance whether one investor’s account is part of a larger whole. An independent discretionary commodity derivatives account, holding the same commodities as one involved in a large investment scheme, would see the same results simply due to market fluctuations.²¹¹ Therefore, the increased utility test would hold that discretionary commodity derivatives accounts are not securities.

Both above examples prove that the increased utility test conforms to the intent of *Howey* and Congress. First, the test is flexible because it allows courts to consider the individual facts of each case. Orange groves and discretionary commodities accounts share no correlation, yet the increased utility test apply to both and produce principled results. Second, courts would not have to consider the different types of profit sharing agreements or accounting techniques, which have been designed to thwart current commonality tests.²¹² This allows the courts to focus on the economic realities that affect and result from the financial product in question as opposed to focusing on the form of each agreement. Additionally, the increased utility test meets Congress’s intent because it can be broadly used on a variety of investment schemes from the known, such as discretionary commodity accounts and fractional agricultural ownership, to the unknown types yet to be conceived by the unscrupulous. Given its ability to handle innovative investment schemes within the intent of both *Howey* and Congress, the increased utility test is a more applicable test capable of producing consistent results.

V. CONCLUSION

The current state of commonality jurisprudence is inconsistent and in need of a fresh perspective.²¹³ Circuits across the country have differed as to which of the three commonality tests is more capable of

²¹⁰ This is to be distinguished from the initial value of the commodities in the account versus the future value of said commodities. *Cont'l Commodities Corp.*, 497 F.2d at 522.

²¹¹ This assumes the promoter makes identical portfolio choices for each account. *See Milnarik*, 457 F.2d at 275 (involving an investment scheme that consisted of one promoter making varying trades on separate and individual accounts).

²¹² *See supra* Part III.C (examining different investment schemes that keep investor accounts separate so as to not trigger broad vertical commonality).

²¹³ *See supra* Part II.F (noting the current disarray among the circuits regarding which aspects of the three available commonality tests are best for evaluating an investment contract).

accurately assessing whether a financial product has the requisite characteristics to be considered a common enterprise.²¹⁴ Such a disagreement among the circuits has and will continue to cause the same investment scheme to be a security in one jurisdiction but not a security in others.²¹⁵ This problem runs absolutely counter to the very aims of federal securities law.

Each commonality test is a product of creative legal thinking, but that process has taken each test far away from the original analysis principled in *Howey*. Each test is flawed: horizontal commonality is overly restrictive; broad vertical commonality blends the third and fourth prongs of the *Howey* test together; and strict vertical commonality values form over substance.²¹⁶ A new, economic-based, approach would refocus the commonality analysis to the most important factors, which are the economic realities. The proposed increased utility test does this by shifting the focus from the relationship between investors and promoters to the underlying reasons the investor initially placed his money in an investment scheme. If the reasons were to increase the economic purpose of the underlying product by incorporating it into a large whole, then the overarching investment scheme is a common enterprise. This analysis, coupled with the flexibility of the proposed test, make it a viable solution to the current commonality conundrum.

Returning to the introductory hypothetical, Lucas subsequently seeks counsel from an attorney in hopes that he can recover his investment from the fraudulent Zibby Star Gazer promoters. The attorney will inevitably encounter the *Howey* test and question whether the investment scheme Lucas entered into was a common enterprise.²¹⁷ If Lucas's case is heard in a horizontal commonality jurisdiction, he will not be able to recover because his success is not tied to the success of other investors.²¹⁸ If the jurisdiction follows strict vertical commonality,

²¹⁴ See *supra* Part II.F (summarizing the circuit splits regarding commonality tests).

²¹⁵ Compare *Milnarik*, 457 F.2d at 275 (holding that discretionary commodities accounts were not securities), with *Cont'l Commodities*, 497 F.2d at 522 (holding the discretionary commodities accounts were securities).

²¹⁶ See *supra* Part III (criticizing each commonality test).

²¹⁷ The attorney will conclude that Lucas's investment meets the remaining three criteria: He made an investment of money, with an expectation of profit, and relied on the efforts of others. See *supra* Part II.D (outlining the four elements of *Howey*).

²¹⁸ This is because the profits Lucas would receive are derived solely from the cultivation and distribution of bulbs grown specifically in his parcel. See *supra* Part I (describing the structure of the financial product involved). Recovery is based on the assumption that all other elements necessary for recovery are met, such as 10b-5 fraud and an investment of money with the expectation of profits derived from the efforts of a third party. See *supra* Part II.D (discussing the remaining elements of *Howey*); see also 15 U.S.C. § 78j (2006) (outlining the statutory requirements for establishing a securities fraud claim); 17 C.F.R.

Lucas will also be unsuccessful in recovering because the promoter can still reap profits from other successful parcels even though Lucas may not see success in his own parcel. However, if Lucas is fortunate enough to have his case heard in a jurisdiction that applies broad vertical commonality, he will be able to recover because his fortunes are tied directly to the efforts of the promoter. The federal securities laws did not intend to let the fortunes of individual investors turn on the location of their trial. If that were the intention, Congress would have left securities regulation to the already established blue sky laws.²¹⁹

Lucas would be better served if all jurisdictions followed the increased utility test. Under this proposed test, Lucas would likely be able to recover because the underlying product—the small parcel of land where Zibby Star Gazer bulbs would be cultivated—would only gain a new economic purpose if it were combined with those of similar characteristics. When the small parcel is combined with a larger whole, it shares in the benefits of economies of scale and thus Lucas would receive profits derived therefrom. This economic purpose is in addition to the independent value the bulbs would have if Lucas cultivated the land himself and sold the bulbs at a local farmer's market. Because Lucas's small parcel gains an additional economic purpose, separate from any relationship between his failure and the success of the promoter or other similarly situated investors, the investment scheme Lucas invested in is a common enterprise, deserving of protection under federal securities laws.²²⁰ This result seems more appropriate given

§ 240.10b-5 (2010) (promulgating the requirements one must satisfy to bring a securities fraud claim). The requirements for a 10b-5 claim are:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

²¹⁹ See LOSS & SELIGMAN, *FUNDAMENTALS*, *supra* note 18, at 11-12 (noting the state-by-state approach to securities regulation that produced inconsistent results depending on the state in which a case was heard).

²²⁰ See *supra* note 175 (stating that this reasoning is consistent with the foundational principle in *Howey*). In addition to being a common enterprise under the increased utility test, Lucas made an investment of money with an expectation of profits derived from the efforts of a third party. As such, his investment in the investment scheme meets the *Howey*

2012]

Refocusing Commonality

695

Lucas is unlikely to be in a leveraged bargaining position to demand the necessary information from the promoter he would need to discover that Zibby Star Gazers are really man-made. The increased utility test would allow Lucas to recoup his investment from the fraudulent investment scheme and give him a second chance to use that money more wisely: on next year's gift for Mother's Day.

Travis Stegemoller*

test and would be classified as a security under the 1933 Act. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

* J.D. Candidate, Valparaiso University School of Law (2012); B.S., Purdue University (2007). The Author would like to thank Professor Rebecca Huss for providing scholastic critique and guidance regarding securities law. The Author would also like to thank his wife for her enduring support throughout *their* legal journey.