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The New Gold Rush: The Last Frontier of the Securities Laws

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THE NEW GOLD RUSH: THE LAST FRONTIER OF THE SECURITIES LAWS?*

I. INTRODUCTION

State and federal securities laws are designed to protect prospective investors against fraud. The laws accomplish this by requiring complete disclosure of information and providing for civil and criminal penalties in cases of fraud or noncompliance.[1] In order for the securities laws to apply, however, a transaction must first be defined as a security.[2] Much securities caselaw is therefore devoted to deter-

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1. The Securities Act of 1933 (current version 15 U.S.C. §§ 77(k), (l), (q) (1982)); The Securities Exchange Act of 1934 (current version 15 U.S.C. § 78j (1982)); CAL. CORP. CODE §§ 25000-25600 (Deering 1979).

2. Both state and federal securities laws contain sections defining securities. For example, The Securities Act of 1933 section 2 contains the principle definition:

> When used in this subchapter, unless the context otherwise requires—
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> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or in general, any interest or instrument commonly known as a "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.

15 U.S.C. § 77b (1982) (emphasis added).

The Securities Exchange Act of 1934 section 3(a) gives a slightly different definition:

> When used in this chapter, unless the context otherwise requires:
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> (10) the term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit, for a security, . . . 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.

mining the types of transactions properly characterized as securities. This determination is important to both investors seeking protection from investment swindles and promoters seeking to raise capital through the use of investments.

Historically, courts have been willing to broadly interpret some of the more vague statutory terms defining securities in order to keep pace with an increasingly complex financial world.[3] The most useful of these terms found in both federal and state securities statutes has been the term "investment contract."[4] This term has been used by the courts as a catch-all definition, reaching transactions that cannot traditionally be characterized as a security. Thus the cutting edge of securities law is based on cases dedicated to deciding whether the transaction in question is an investment contract and hence a security to which both federal and state securities laws apply.[5]

A short hypothetical will illustrate the type of transaction normally involving the securities laws. Suppose that X owns a gold mine but has no processing or refining capabilities. The ore must be shipped elsewhere to be processed and refined in order to yield marketable gold. Since it usually takes several tons of ore to produce a few ounces of gold, the cost efficiency of transporting the ore to a refining plant is quite low. Most mining operations, therefore, process and refine their ore "on site." Suppose further that X has stockpiles of dump ore,[6] but has no profitable method for refining it. X

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15 U.S.C. § 78c(a) (1982) (emphasis added).

The California securities law is similar to the federal:

> "Security" means any note; stock; treasury stock; membership in an incorporated or unincorporated association; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; *investment contract*; voting trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; put, call straddle, option, or privilege on any security . . . .

CAL. CORP. CODE § 25019 (Deering Supp. 1989) (emphasis added).

3. *See, e.g.,* SEC v. W. J. Howey Co., 328 U.S. 293 (1946) (citrus groves); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir.) (self-improvement seminars), *cert. denied*, 414 U.S. 821 (1973); SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973) (cosmetic sales), *rev'd and remanded*, 497 F.2d 473 (5th Cir. 1974). *See infra* notes 37-44, 58-60 and accompanying text.

4. *See supra* note 2.

5. *See, e.g.*, SEC v. Glen-Arden Commodities, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,142 at 94,604 (E.D.N.Y. 1973); *In re* Worm World, Inc., 3 Blue Sky L. Rep. (CCH) ¶ 71,414 (S.D. Dept. of Commerce and Consumer Affairs 1978).

6. Dump ore is a term of art in mining that refers to ore, which has already been processed. The ore still contains a small concentration of the desired mineral. Extraction of the mineral after processing is difficult and expensive. Moreland v. Dept. of Corporations, 194

also wishes to build the necessary refinery plant to increase overall profit. How may X raise the necessary capital?[7]

Under current law, X may sell the dump ore directly to the public, thus raising the capital necessary for construction of the new facilities without being subject to the regulatory provision of the securities laws.[8] X can set a price for the ore above the cost of mining, but well below the market price of refined gold, and realize profit on the difference between the cost of mining the ore and its sale price. Prospective buyers will anticipate a profit only if they can sell the gold after at a market price higher than the cost of purchasing the ore plus the cost of processing it. Using this approach, the mining company can raise enough capital to satisfy its goal of expanding its operations. All the promoter need do to induce buyer interest is to guarantee a minimum gold content in the ore.

In two recent cases, *SEC v. Belmont Reid & Co.*[9] and *Moreland v. Department of Corporations*,[10] both federal and California courts have held that the direct sale of a commodity under facts similar to the hypothetical above is not a sale of a security and is therefore outside the purview of the securities laws. These cases mark a new trend toward slowing the expansion of securities regulation by limiting the scope of the term investment contract. There is also a developing inconsistency among the courts in defining the proper role of securities law.

Prior to these decisions, the growth of this area of law was unimpeded and showed a concern for the practical reality of each transaction.[11] In the above hypothetical X can raise money quickly and

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Cal. App. 3d 506, 239 Cal. Rptr. 558 (1987).

7. The traditional means of raising capital, such as stock offerings, debt instruments, and partnership interests are effective but expensive expenditures of time and money. The offeror must relinquish some ownership interest in the venture or go into debt obtaining the capital. Both options generally necessitate expensive legal assistance. Additionally, in some cases, review by an appropriate state or federal regulatory agency is required. From a mine owner's perspective, the traditional methods of raising capital may be prohibitive due to cost and inconvenience. GERALD ROBINSON, GOING PUBLIC, 8-10 (SECURITIES LAW SERIES, VOL. 1, 1978).

8. SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. 1986) (sale of gold coins on a prepayment basis from defendant's mining operation). *See infra* notes 137-43 and accompanying text. Moreland v. Department of Corps., 194 Cal. App. 3d 506, 239 Cal. Rptr. 558 (1987) (sale of gold ore to the public not a security). *See infra* notes 113-14 and 144.

9. 794 F.2d 1388 (9th Cir. 1986). *See infra* notes 109-12 and accompanying text.

10. 194 Cal. App. 3d at 506, 239 Cal. Rptr. at 558. *See infra* note 118-20 and accompanying text for a discussion of *Moreland*.

11. *See generally* SEC v. W. J. Howey Co., 328 U.S. 293 (1946); SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943); SEC v. Goldfield Deep Mines Co., 758 F.2d 459 (9th Cir. 1985); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414

inexpensively, while remaining outside the scope of the securities laws under the *Belmont Reid* and *Moreland* decisions. This approach has serious shortcomings. Problems arise since the public seeking to buy the ore must rely solely on the owner's representations about its value. This occurs in nearly every investment opportunity. Since these representations are made to a relatively unsophisticated investing public, the potential for fraud is extreme. Unfortunately, the courts that until recently have demonstrated a willingness to broadly construe the securities laws for the protection of the public have begun to refuse to extend the protection of securities law to these situations.

This comment examines the current definition of investment contract in determining the applicability of the securities law in the context of financing gold production. Precious metals have traditionally been a popular investment in financially uncertain times. As the price of gold rises along with inflation, there has been a revival in gold investments, ranging from mining stock to coins.[12] Along with the heightened public interest in such investments comes the usual assortment of get rich quick schemes. As the law now stands, selling any form of interest in future profits of a mine will fit easily under the current definition of investment contract.[13] Difficulties arise when the mining company sells assets or the raw commodity itself to the public. Recent cases suggest that a direct sale of an underlying commodity lies outside both federal and state securities law.[14] This general rule means that a producer of a commodity may raise capital by selling the mined raw material directly to a buyer.[15] In the case of a gold mine, unrefined ore may be sold at a fair margin over cost, but still well below the spot market price for processed gold.[16]

U.S. 821 (1973); SEC v. International Mining Exch., Inc., 515 F. Supp. 1062 (D. Colo. 1981). *See infra* notes 49-68 and accompanying text for discussion pertaining to the historical expansion of the Howey test.

12. *See* Wall St. J., Dec. 7, 1987, at 34, col. 1. Gold production and price have increased as demand increases.

13. Both state and federal securities laws expressly provide for coverage of interests in mineral rights. 15 U.S.C. § 77(b)(1) (1982); 15 U.S.C. § 78(c)(a)(10) (1982); CAL. CORP. CODE § 25019 (Deerings 1979). Any agreement to share in anticipated profits also meets the *Howey* investment contract test. *See, e.g., Goldfield*, 758 F.2d 459 (9th Cir. 1985). *See infra* notes 37-44 for discussion of the *Howey* test.

14. SEC v. Belmont Reid & Co., 794 F.2d 1388 (9th Cir. 1986); *Moreland*, 194 Cal. App. 3d 506, 239 Cal. Rptr. 558 (1987). *See generally* T. HAZEN, THE LAW OF SECURITIES REGULATION (1985).

15. Since a direct sale is a commercial transaction, the securities laws are unnecessary. However, in cases where the promoter solicits capital in exchange for goods plus a future promise to perform, the securities laws should apply. HAZEN, *supra* note 14, at 20.

16. *Moreland*, 194 Cal. App. 3d at 506, 239 Cal. Rptr. at 558. While an investor may

Straight commercial transactions are, and should be, outside the scope of the securities laws. However, some transactions contain both commercial and investment qualities. It has been the latter area into which the definition of investment contract has traditionally been expanded.

This comment will first examine the federal securities statutes and the test developed in *SEC v. W. J. Howey & Co.*[17] to show how the courts have developed an expanding definition of "investment contract" over the last fifty years. It will then turn to California's securities law and attempts to apply the *Howey* test to enforce the state statutes. These efforts have culminated in the formulation of the "risk capital" test, which has since been adopted by a growing number of states.[18] A reading of the background of the laws and the decisions interpreting the state statutes will clearly illustrate how the term investment contract has been fashioned to cover transactions with investment characteristics. Until recently, courts have attempted to effectuate the spirit and policy of the securities laws by examining the investment market and determining whether investor protection is needed.

Finally, this comment proposes that courts return to a constantly expanding definition of investment contract, while approaching each case from a firm public policy standpoint (i.e., is there sufficient danger to warrant investor protection?). Since no legislative effort could satisfactorily encompass the myriad of factual situations in which investor protection is needed, the best solution is for the courts to approach the definition of securities pragmatically. This method requires courts to find whether or not investment characteristics exist in a transaction and to apply investment contract analysis when these characteristics are found. In this way, there will be sufficient flexibility for the courts to exclude situations in which application of the securities laws would hinder investment more than would

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be eager to enter into what appears to be a profitable investment, costs of transporting, refining, and marketing the purchased ore could eventually result in a substantial loss.

17. 328 U.S. 293 (1946). *See infra* notes 37-44 and accompanying text.

18. California and Hawaii have adopted a judicial risk capital test. *See* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); State v. Hawaii Market Center, Inc., 52 Haw. 642, 485 P.2d 105 (1971). Alaska, Georgia, Michigan, Oklahoma, and Washington have adopted a statutory risk capital test. *See* ALASKA STAT. § 45.55.130(12) (1980); GA. CODE ANN. § 10-5-2 (1988); MICH. COMP. LAWS § 451.801(2) (1978); OKLA. STAT. tit. 71, § 2(20) (Supp. 1980); WASH. REV. CODE § 21.20.005(12) (1979). *See also* Carney & Fraser, *Defining A "Security": Georgia's Struggle with the "Risk Capital" Test*, 14 SEC. L. REV. 503 (1980).

promote it.[19] It is therefore up to the courts to overturn prior decisions that have confused the law and approach investment contract cases from the perspective of the investor's need for information and the possibility of fraud. In order to effectuate this result, it is suggested that California courts adopt the combined *Howey*-risk capital test stated in *State v. Hawaii Market Center, Inc.*[20]

II. Background

A. *The Federal Securities Statutes*

Congress passed the 1933 Securities Act[21] and the 1934 Securities Exchange Act[22] to remedy the popular notion that the financial markets caused the Great Depression.[23] It was thought that the individual investor needed government protection from fraudulent investment schemes.[24] Public confidence in the financial markets was significantly eroded by the "wild speculation" resulting from worthless and fraudulent schemes and it was thought that by encouraging investment, the Depression would end more quickly.[25] Congress therefore passed laws requiring public registration and disclosure of information for all securities issued to the public.[26] This placed the potential investor in a stronger bargaining position versus the issuer and provided a clear legal remedy for fraud.[27] Enforcing the policy aim of these laws, the United States Supreme Court stated, "[The purpose was] to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of bus-

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19. Securities laws would be unnecessarily burdensome if applied to commercial transactions. In addition to being costly and time-consuming, the disclosure requirements would prevent many transactions. However, securities law does attempt to balance the competing interest between the necessity of investor protection and the difficulty in adhering to statutory terms.

20. 52 Haw. 642, 485 P.2d 105 (Haw. 1971).

21. 15 U.S.C. § 77b (1982).

22. 15 U.S.C. § 78 (1982).

23. H.R. Rep. No. 85, 73d Cong., 1st Sess. 2-3 (1933); *See generally* T. Hazen, *supra* note 14.

24. H.R. Rep. No. 85, 73d Cong., 1st Sess. 2-3 (1933).

25. S. Rep. No. 47, 73d Cong., 1st Sess. (1933) ("The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation . . . to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities . . . .").

26. *See* 15 U.S.C. § 77b (1982); 15 U.S.C. § 78 (1982).

27. Legal redress for securities misrepresentation is generally provided for in 15 U.S.C. §§ 77k, l, q (1982) and in 15 U.S.C. §§ 78j, n, p, r (1982). A more complete compilation may be found in Chang, *Meaning, Reference and Reification in the Definition of a Security*, 19 U.C. Davis L. Rev. 403. *See generally* L. Loss, Fundamentals of Securities Regulation (1983).

iness ethics in the securities industry."[28] Thus the securities laws sought to protect the investor from the dangers of investing without complete and accurate information. To effectuate this policy, Congress provided, inter alia, a comprehensive definition of a security in both the Securities Act and the Securities Exchange Act.

Both statutes provide slightly different definitions of a security.[29] The United States Supreme Court decided, however, that both definitions are to be construed as "virtually identical."[30] Since the Acts are remedial legislative efforts, courts must construe them broadly, emphasizing the substance over the form of the transaction.[31] Though the definitions are quite detailed, courts have used them primarily as guidelines and have not limited construction of the statutory terms.[32] Since most of the definitions in the Acts are fairly specific, both state and federal courts have found it useful to use the term investment contract as a catch-all provision to regulate novel types of transactions that may endanger the public. The original *Howey* test defining investment contract has become the primary means for implementing the securities laws to limit economic fraud on both federal and state levels, and has been clarified and refined over its forty-year existence.

B. *The Development of the* Howey *Test*

The United States Supreme Court first attempted to define "investment contract" in *SEC v. C. M. Joiner Leasing Corp.*[33] This case involved a public sale of oil and gas lease assignments, combined with a promise by the seller to drill test wells on the leased land. The Court based its decision on an analysis of the effects of the seller's promise of test drills on potential buyers. It found that "[h]ad the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well, it would have been a quite different proposition. Purchasers then would have been left to their own devices for realizing upon their rights."[34] The Court further found that these promises contained "all the evils inherent in

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28. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (italics in original).

29. *See supra* note 3.

30. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

31. SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943); SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588, 590 (N. D. Ga. 1973), *rev'd on other grounds*, 497 F.2d 473 (5th Cir. 1973).

32. *Joiner*, 320 U.S. at 344, 350-51.

33. 320 U.S. 344 (1943).

34. *Id.* at 348.

the securities transactions which it was the aim of the Securities Act to end."[35] The Court did not formulate a definitive test. Rather, it held that economic reality was a crucial factor in determining whether the instrument in question was a security.[36] *Joiner* is one of the earliest examples of judicial willingness to broadly construe the provisions of the Securities Act.

Three years later, in *SEC v. W. J. Howey Co.*,[37] the United States Supreme Court announced a formal test for determining the existence of an investment contract. The defendant in the case owned tracts of citrus trees in Florida. Ownership of small parcels in these tracts were offered to outside parties to help finance the company's growth.[38] The purchasers were offered an additional service contract under which an affiliated company would cultivate and harvest the sold tracts for the purchaser.[39] The service contract gave the company full authority to harvest and sell the crop, with each owner receiving a pro rata share of their contribution to the crop profits from the entire harvest.[40] The Court relied on existing state securities laws to form a definition of investment contract that previously had been unexplained in the federal statutes.[41] The Court concluded that an investment contract means: "(1) a contract, transaction or scheme whereby a person (2) invests his money in a (3) common enterprise and is (4) led to expect profits solely from the efforts of the promoter or a third party."[42] Again, the Court expressed a willingness to expand this definition as necessity demanded, since it was "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."[43] The test, therefore, was designed to be modified as required to

35. *Id.* at 349.

36. *Id.* at 353.

37. 328 U.S. 293 (1946).

38. *Id.* at 295.

39. In over 85% of the sales, the service contract was purchased with the land sales contract. The Court stressed that the investors were out-of-state tourists who had no knowledge of the citrus business and were almost entirely dependent on the seller's skill for a profit. *Id.* at 295.

40. *Id.* at 296.

41. The Court cited a Minnesota case, State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920). The court in *Gopher Tire* defined an investment as the "placing of capital or laying out of money in a way intended to secure income or profit from its employment." *Id.* at 56, 177 N.W. at 938. *See also* SEC v. W. J. Howey Co., 328 U.S. 293, 298 (1946).

42. *Id.* at 298-99.

43. *Id.* at 299.

achieve the ends sought by the securities laws. Since it fails to cover various situations in which an informed investment decision is essential, there are fundamental problems with the test in this form. Nevertheless, the *Howey* test proved to be effective in reaching many exotic types of investments.[44]

Howey and *Joiner*, taken together, indicate an expansive approach to defining an investment contract. The rather rigid and formulaic test advanced in *Howey*, however, eventually demonstrated a need for modification.[45] In *United Housing Foundation, Inc. v. Forman*,[46] the United States Supreme Court finally acknowledged the need to reinterpret the *Howey* test. In *Forman*, persons interested in becoming tenants in a low-income housing co-op were required to buy shares in the management company that owned the building.[47] Although the instruments were referred to as "stock," the Court reasoned that the purchaser's expectations were not sufficiently financial in nature since they only wanted housing,[48] and that any expected "profits" did not result from the managerial efforts of the issuer.[49] The case in effect modified the *Howey* test to also require an expectation of financial return and that the issuer's efforts be primarily "entrepreneurial or managerial."[50] *Forman* also signalled a willingness of the Court to stress the "economic reality" of the transaction,

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44. *See* Carney & Fraser, *supra* note 18.

45. In the years following *Howey*, lower federal and state courts were forced to change the test to reach fair results.

46. 421 U.S. 837 (1975).

47. *Id.* at 842.

48. *Id.* at 851.

49. *Id.* at 854.

50. *Id.* at 852. The Court in *Forman* stated:

> The Court of Appeals also found support for its concept of profits in the fact that Co-op City offered space at a cost substantially below the going rental charges for comparable housing. Again, this is an inappropriate theory of "profits" that we cannot accept. The low rent derives from the substantial financial subsidies provided by the State of New York. This benefit cannot be liquidated into cash; nor does it result from the managerial efforts of others. In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps, or other government subsidies.
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> The final source of profit relied on by the Court of Appeals was the possibility of net income derived from the leasing by Co-op City of commercial facilities, professional offices and parking spaces . . . . The income, if any, from these conveniences . . . is to be used to reduce tenant rental costs . . . . [T]his income . . . is far too speculative and insubstantial to bring the entire transaction within the Securities Acts.

Id. at 855-56. *See also* FitzGibbon, *What Is A Security?—A Redefinition Based on Eligibility To Participate in the Financial Markets*, 64 MINN. L. REV. 893, 902 (1980).

whether or not an investment contract was involved.[51] In other words, securities law would only apply if a court felt that regulation was necessary.

The *Howey* test soon proved too limited in scope to cover all transactions in which the public was at risk. Courts began to expand the *Howey* elements in order to cover an increasing array of investment opportunities. One of the first elements to be expanded was the requirement of a "common enterprise" between the investor and the seller.[52] The concept was defined and expanded in cases subsequent to *Howey*. The common enterprise test examines the financial relationship between the investor/buyer and the promoter/seller in the transaction.[53] This element is designed to exclude purely commercial transactions from the securities laws by requiring that the consideration for the transaction is somehow merged, not exchanged.[54] The character of the link is crucial to a finding that the requisite commonality exists. The explosive growth in this area has caused a formulation of two differing forms of common enterprise. Courts are split, however, as to the type of commonality required to satisfy *Howey*.[55]

The two types of commonality developed by the court are vertical and horizontal. Vertical commonality refers to the linked fortunes of investor and promoter.[56] Horizontal commonality requires a pool-

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51. Carney & Fraser, *supra* note 18.

52. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). *See infra* notes 137-40 for an analysis of this requirement.

53. The traditional or vertical common enterprise approach is defined as one "in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." SEC v. Glenn Turner Enters., Inc., 474 F.2d 476, 482 n.7 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). The central concept is whether the investors future profits depend on the success of the enterprise of which the transaction is a part.

54. *See infra* notes 118-29 and accompanying text. This requirement assumes a great significance in commodity trading account cases, where courts have analyzed the degree of commingling of broker and investor funds. *See also* SEC v. International Mining Exch., Inc., 515 F. Supp. 1062, 1067 (D. Colo. 1981) (a broker-client relationship satisfies commonality if broker uses money pooled from other investors).

55. Vertical commonality has been accepted in the fifth, eighth, ninth and tenth circuits. *See, e.g.*, Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974); *Turner*, 474 F.2d 476 (9th Cir. 1973); *International Mining Exch.*, 515 F. Supp. 1062 (D. Colo. 1981); SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973), *rev'd and remanded*, 497 F.2d 473 (5th Cir. 1974). Horizontal commonality, on the other hand, is found only in the sixth and seventh circuit. *See, e.g.*, Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216 (6th Cir. 1980); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972), *cert. denied*, 409 U.S. 887 (1972).

56. *See* SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 463 (9th Cir. 1985).

ing of investors' money with other investors.[57] This type of commonality is apparently limited to cases involving discretionary brokerage accounts, especially in the commodity futures market. Courts have been reluctant to apply securities laws to situations involving commodities, noting that specialized legislation already covers that subject.[58]

The fourth element of the *Howey* test, requiring that profits be expected solely from the efforts of others, also required change.[59] Under the original formulation of the *Howey* test, any participation, however minimal, on the part of the buyer precluded the finding of an investment contract. This had the effect of completely excluding from securities law regulation pyramid schemes: transactions in which an investor only receives a return from subsequent investors.[60]

The case of *SEC v. Glenn W. Turner Enterprises, Inc.*[61] remedied this nagging problem. *Turner* involved a pyramid scheme in which a person invested in a self-improvement course and was then induced to sell the program to others, thereby receiving a bonus for each recruitment. Thus, the investor could also be characterized as a promoter since he directly participated in the formation of future profits from his own investment. The Ninth Circuit Court of Appeals noted the narrow scope of the original *Howey* test and ruled that the "efforts of others" need only be significant and essential.[62] The court concluded that the policy considerations of protecting the public from dubious money making schemes warranted the broader

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57. *Milnarik*, 457 F.2d at 278.

58. *See* Commodities Exchange Act of 1934 (current version at 7 U.S.C. §§ 1-26 (1988)).

59. 328 U.S. 293, 299 (1946).

60. A pyramid scheme is when the investor receives a return not from the profits accruing from the enterprise but rather from the investments of subsequent investors. The few investors at the "top" of the pyramid have a good chance of realizing a return on their investment. On the other hand, those in the chronologically bottom layers of the pyramid will seldom realize any profit. Pyramid schemes are dependent on a investor inducing others to follow. *See* Long, *infra* note 74.

61. 348 F. Supp. 766 (D. Or. 1972), *aff'd on other grounds*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

62. The court in *Turner* stated:

> It would be easy to evade (the Securities Laws) by adding a requirement that the buyer contribute a modicum of effort. Thus the fact that the investors here were required to exert some efforts if a return were to be achieved should not automatically preclude a finding that the Plan or Adventure is an investment contract. To do so would not serve the purpose of the legislation. Rather we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.

Id. at 482.

application of the test.[63] This decision was successful in extending the potential criminal liability of securities fraud to pyramid schemes. However, other types of investments still remained outside the reach of the securities laws and confusion developed as to the scope of the definition of investment contract.

The case of *Noa v. Key Futures, Inc.*[64] indicated that the courts were no longer willing to expand the definition of investment contracts. In *Noa*, the defendants offered investors a chance to buy silver bars as an investment, and would buy the silver back at the investor's option at any time at the then current market price.[65] The court decided that this arrangement was not a security under *Turner*, reasoning that the seller had no impact upon the success or failure of the investment.[66] Instead, the market price for silver would be the determining factor.[67] The court felt that the commonality requirement was not met because the person soliciting the investment had no impact on the market at large. Because it is one of the only cases not to hold that a questionable transaction is a security, *Noa* indicates possible limits to the further expansion of the definition of investment contracts.

In *SEC v. International Mining Exchange, Inc.*,[68] the court was confronted with determining whether the sale of concessions in a mining operation was essentially an investment contract under *Howey*. Investors initially contributed toward the development of the mine, which allegedly qualified under a federal tax deduction concerning natural resource development.[69] The defendants then issued options to investors on the gold not yet extracted. The court rejected the defendant's contentions that the case fit under *Forman* because the investor's expected profit was not monetary in nature, but was rather a tax benefit.[70] Instead, the court found the options constituted an investment contract, since the investors had placed money in control of the promoter in anticipation of future return. The *International Mining Exchange* court applied an expansive view of the *Howey* test.

63. *But see* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) (holding that a pyramid scheme was not a security).

64. 638 F.2d 77 (9th Cir. 1980).

65. *Id.* at 79.

66. *Id.*

67. *Id.* at 79.

68. 515 F. Supp. 1062 (D. Colo. 1981).

69. *See* I.R.C. § 616 (1987) (allowing deductions up to five times the investor's cash outlay).

70. *International Mining Exch.*, 515 F. Supp. at 1068.

Other decisions clearly demonstrate the need for courts to expand the definition of a security through the use of the *Howey* test. *SEC v. Goldfield Deep Mines Co.*[71] involved a purchase agreement for gold ore that would be produced using a new extraction technique developed by the sellers. The company in *Goldfield* had publicly traded stock, but nevertheless attempted to finance a new operation through the ore purchase program.[72] Buyers would pay for the ore mining and refinement while the sellers were responsible for processing, refining, and storing the gold. The court found that the 25% royalty fee for the use of the new processing technique developed by defendants and the speculative nature of the technique itself was risky enough to bring the transaction within the scope of the securities law.[73] The royalty fee arrangement satisfied the common enterprise element. Likewise, the *Howey* test requiring profits from the promoter's efforts was met because any return on investment depended on the success of the extraction technique.

As these prior decisions demonstrate, although many courts have found it necessary to modify the elements of the *Howey* test, it remains effective in reaching most cases of investor fraud and is still the federal test used to determine the presence of an investment contract. The *Howey* test is also used successfully at the state level. State securities regulation is premised on slightly different policies than federal securities law. This has forced state courts and legislatures to alter or supplement the *Howey* test in order to effectuate the state policy behind securities regulation. One such state is California.

C. *California: The Howey and Risk Capital Tests*

State securities laws serve a more direct role in attempting to control investor fraud than the federal statutes. Where the federal laws are directed towards the national market and large corporations with access to it, state securities laws are designed to protect its residents from smaller and riskier enterprises.[74] State regulation of securities, known as "Blue Sky Laws,"[75] antedated the federal Acts of

71. 758 F.2d 459 (9th Cir. 1985).

72. *Id.* at 461.

73. The court stated that, "a common enterprise exists if a direct correlation has been established between success or failure of Goldfield's efforts and success or failure of the investment." *Id.* at 463.

74. Long, *State Securities Regulation—An Overview*, 32 OKLA. L. REV. 541 (1979).

75. State securities statutes were known as Blue Sky Laws after the United States Supreme Court decision in Hall v. Geiger-Jones Co., 242 U.S. 539 (1917). In *Hall*, the Court referred to the schemes that the state laws attempted to restrict as having no more substance than so many feet of blue sky. Long, *supra* note 74, at 542.

1933 and 1934 and were in effect "the first consumer protection statutes."[76] Prior to the federal acts, it was the state legislatures that attempted to keep pace with rapidly evolving financial markets by constantly expanding the scope of the laws.[77] Once the Securities Act of 1933 was passed, many states used it as a model in revising their own securities laws.[78] States, therefore, have a great interest in devising a comprehensive regulatory scheme to protect their residents from economic fraud.

The California Corporate Securities Act is closely patterned after the federal Securities Act of 1933.[79] Like its federal counterpart, the California statute has a large definitional section.[80] Other sections provide for disclosure and registration of every security offered to the public unless specifically exempted.[81] The legislative purpose of the Corporate Securities Act is "to protect the public against spurious schemes, however ingeniously devised, to attract risk capital."[82] The transaction in question must come within the regulatory purpose of the securities laws.[83] Another aim of the Corporate Securities Act is to afford the state some control over the types of investments or securities offered to the general public.[84] As in the federal system, the means of regulating questionable transactions is accomplished primarily through the definition of an investment contract.

The *Howey* test is used extensively in California to enforce the antifraud provisions of the Corporate Securities Act. One example is *People v. Park*,[85] in which the defendant convinced two elderly women to invest money in a condominium building project. Their investment was misappropriated by the defendant and the project was never completed.[86] The trial court decided that the women had

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76. Long, *supra* note 74, at 543.

77. *Id.*

78. *Id.*

79. People v. Schock, 152 Cal. App. 3d 379, 387, 199 Cal. Rptr. 327, 331 (1984), *See* CAL. CORP. CODE §§ 25000-25805 (Deering 1979).

80. CAL. CORP. CODE §§ 25000-25022 (Deering 1979). *See also supra* note 2.

81. CAL. CORP. CODE § 25110 makes it illegal to offer securities that are unqualified under §§ 25111, 25112, 25113 or not exempted under § 25100.

82. Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 814, 361 P.2d 906, 907, 13 Cal. Rptr. 186, 187 (1961).

83. Sarmento v. Arbax Packing Co., 231 Cal. App. 2d 421, 424, 41 Cal. Rptr. 869, 870-71 (1964).

84. Hayden Plan Co. v. J. M. Friedlander, 97 Cal. App. 12, 16, 275 P. 253, 255 (1929).

85. 87 Cal. App. 3d 550, 151 Cal. Rptr. 146 (1978).

86. *Id.* at 559, 151 Cal. Rptr. at 150.

become partners with the defendant, absolving him of liability for securities fraud.[87] In overturning the lower court's decision, the Court of Appeal applied the *Howey* test and found an investment contract since the women's sole contribution was money and that any return depended on defendant's efforts.[88] Since the women had provided the money to build the condominium, the common enterprise element was met. Defendant was thus found guilty of securities fraud.

Tomei v. Fairline Feeding Corp.[89] was a California case similar to *Howey*. *Tomei* involved a program in which an investor could buy cattle from a feed operation. The feeding company offered to provide care facilities for the animals, like the orange trees in *Howey*, that were essential to the investment and not really an option for the average investor.[90] The court found that the investors were entitled to the disclosure and protective provisions of the California securities laws.

California courts, however, found that the *Howey* test could not completely effectuate the public policy of protecting investors since the test is limited to situations in which the investor expects a financial gain as a return on the investment. This limitation effectively excluded a large number of investment schemes from coverage of the securities laws. In order to include such schemes, the California Supreme Court formulated a "risk capital" test in the case of *Silver Hills Country Club v. Sobieski*.[91]

This case involved the formation of a country club relying on membership sales for the capital needed to construct the facilities. Under the *Howey* test, there would have been no sale of securities since what was offered was only a right to use a service and there was no expectation of financial gain. The Court rejected this analysis, noting that the sellers were

> soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize.[92]

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87. Partnership offerings are exempted from securities registration under CAL. CORP. CODE § 25102(f). *See infra* note 92.
88. *Park*, 87 Cal. App. 3d at 563, 151 Cal. Rptr. at 152.
89. 67 Cal. App. 3d 394, 137 Cal. Rptr. 656 (1977).
90. *Id.* at 399, 137 Cal. Rptr. at 659.
91. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).
92. *Id.* at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

Therefore, the court announced a new test to determine the existence of an investment contract. The elements of the test include: (1) funds solicited for a business venture or enterprise; (2) random solicitation of the funds; (3) passive investors, those powerless to affect the success of the venture; and (4) funds substantially "at risk."[93] Where the *Howey* test focuses on the relationship between investor and promoter, the risk capital test measures the degree of risk inherent in an investment scheme. The perspective of the risk capital test enables courts to bring many more schemes under the securities laws. Thus, as a means of enforcing the legislative intent behind the securities laws, California courts use both the risk capital test and the *Howey* test alternatively to define an investment contract.[94]

Subsequent use of the risk capital test by California courts demonstrates the usefulness of the new test in reaching transactions the *Howey* test could not. In *Hamilton Jewelers v. Department of Corporations*,[95] the public was offered unmounted diamonds for sale with an option to return the diamonds after three years for the price paid plus 5% interest. The court adopted a narrow definition of "risk capital" and concluded that since the diamonds were already offered at fair market value, purchaser's funds were not at risk.[96] The court decided that, if a transaction was adequately secured by the seller, the investor's money was not at risk, thus negating any need to protect investors through coverage of the securities statutes. In dicta, the *Hamilton Jewelers* court indicated that non-secured and under-

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93. *Id.*

94. The court in *Silver Hills* stated:

> It bears noting that the act extends even to transactions where capital is placed without expectation of any material benefits. Thus from its exemption of securities of certain nonprofit companies the act specifically excepts "notes, bonds, debentures, or other evidence of indebtedness, whether interest-bearing or not. "Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another. Hence the act is as clearly applicable to the sale of promotional memberships in the present case as it would be had the purchasers expected their return in some such familiar form as dividends. Properly so, for otherwise it could too easily be vitiated by inventive substitutes for conventional means of raising risk capital.

Id. at 815-16, 361 P.2d at 908-09, 13 Cal. Rptr. at 188. *See also* People v. Figueroa, 41 Cal. 3d 714, 715 P.2d 680, 224 Cal. Rptr. 719 (1986).

95. 37 Cal. App. 3d 330, 112 Cal. Rptr. 387 (1974).

96. *Id.* at 336, 112 Cal. Rptr. at 390. "[T]he purchase price advertised in connection with the warranty ($500) was no greater than the value of the diamond which would serve, in effect, as security for the refund of the purchase price if the customer sought reimbursement." *Id.*

secured transactions may constitute a sufficient degree of risk to warrant protection of potential investors.[97] Therefore, an approach that closely follows the concept of risk is useful, but incomplete. Although it protects the public from some spurious transactions, it fails to focus on the investor's need for information and is thus limited to situations in which the transaction itself bears an undue amount of risk.

Later decisions further explored the potential of the risk capital test. One case, *People v. Schock*,[98] extended the scope of the risk capital test to promissory notes. Fractional interests in promissory notes were offered by a mortgage loan brokerage company. The court applied the risk capital test and found that the arrangement was a security since the notes themselves were unsecured, placing the monies paid "at risk."[99] *Schock*, like *Silver Hills*, marked the movement of state securities regulation beyond the limits of federal securities regulation. Under the *Howey* test, it is difficult to find an investment contract in promissory note transactions, since the nature of the transaction resists application of the *Howey* test elements. Therefore, federal courts have usually held that promissory notes are not securities, while state courts using the risk capital test have increasingly applied it to cases involving these types of transactions.[100]

In *Leyva v. Superior Court*,[101] California courts further extended the scope of the California Corporate Securities Act to assignments of fractional interests in promissory notes secured by deeds of trust. Although courts only apply the Act to transactions containing promissory notes when certain criteria are met, the defendants sold fractionalized interests in one trust deed to over 200 people.[102] It is important to note that in cases in which the transaction is somehow secured, the *Howey* test, rather than the risk capital test, will usually determine the existence of an investment contract.[103] However, it is the state courts, not the federal courts, that have used both tests in

97. *Id.* at 336, 112 Cal. Rptr. at 390-91.

98. 152 Cal. App. 3d 379, 199 Cal. Rptr. 327 (1984).

99. The court in *Schock* noted, "The Corporate Securities Act is designed to regulate the transactions by which promoters go to the public for risk capital." *Id.* at 386, 199 Cal. Rptr. at 330 (citing People v. Walberg, 263 Cal. App. 2d 286, 69 Cal. Rptr. 457 (1968)).

100. Long, *supra* note 74, at 546.

101. 164 Cal. App. 3d 462, 210 Cal. Rptr. 545 (1985).

102. *Id.* at 474, 210 Cal. Rptr. at 552. "[I]t plainly was not the legislative intent that "every" note or evidence of indebtedness, regardless of its nature and of the circumstances surrounding its execution, should be considered as included within the meaning and purpose of the act." People v. Davenport, 13 Cal.2d 681, 686, 91 P.2d 892, 895 (1939). However, selling or assigning notes or interests to more than ten persons will trigger the application of the securities laws under CAL. ADMIN. CODE tit. 10, § 260.105.30(e)(1) (1984).

103. *See* Long, *supra* note 74.

expanding the purview of the securities laws.

The possibilities of broader application of the risk capital test soon extended into other areas. The case of *People v. Graham*[104] held limited partnerships to be a security under the risk capital test in certain situations. Traditionally, limited partnerships are exempt from the California securities laws as long as they are not offered to the public indiscriminately.[105] *Graham* established the application of the risk capital test to any non-exempt limited partnership transaction. In determining whether a transaction is a public offering in the context of partnership or venture, the number of people to which the offering is made may not exceed twenty five and a maximum of only ten may accept the offer.[106] A "preexisting relationship" test and a "sophisticated investor" test are also required to exempt the transaction.[107] In this way, the court tests the necessity that a prospective investor be protected from what may prove to be a dubious investment scheme in a partnership context. Therefore, the tests required to apply the limited partnerships exemption further the policy aims of the California securities laws by drawing a distinction between the usual limited partnership and an exotic investment scheme containing one.

The facts of *People v. Stewart*[108] provide a clear example of the complexity of today's financial transactions, which are confusing even to sophisticated investors. The defendant, who held an interest in a mining supply business that leased equipment and services to already developed mines, entered into a joint venture with others to start a mining company. The defendant was required to supply only the necessary start-up capital while the other partners were responsible for management. The other partners eventually left, leaving de-

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104. 163 Cal. App. 3d 1159, 210 Cal. Rptr. 318 (1985) (following People v. Woodson, 78 Cal. App. 2d 132, 177 P.2d 586 (1947)).

105. CAL. CORP. CODE § 25102(f) (Deering Supp. 1989) states:

> The following transactions are exempted from the provisions of section 25110:
> (f) Any offer or sale, in a transaction not involving any public offering, of any bona fide general partnership, joint venture or a limited partnership interest
> . . . .

Id. See also CAL. ADMIN. CODE tit. 10, § 260.102.2 (1987).

106. 163 Cal. App. 3d at 1170, 210 Cal. Rptr. at 326.

107. A preexisting relationship exists when the parties to the transaction know each other sufficiently to "enable a reasonably prudent purchaser to be aware of the character, business acumen, and general business and financial circumstances of the person with whom the relationship exists." 1 H. MARSH & R. VOLK, PRACTICE UNDER THE CAL. SECURITIES LAWS § 4.02A(2)(c)(ii) (1983). The sophisticated investor test evaluates the business judgment of the investor. *Id.* at § 4.02A(c)(iii).

108. 182 Cal. App. 3d 222, 227 Cal. Rptr. 275 (1986) (not officially published per order of the California Supreme Court).

fendant and the supply company with sole equity in the mine. In order to raise money, the defendant used a technique called "factoring" in which he would buy accounts receivable from other companies at a discount and resell them to investors for a higher amount.[109]

The defendant represented to various financial planners that he held paper in the form of accounts receivable from major corporations, due in thirty days, and would secure their value by guaranteeing a redemption for twenty-one days after the initial thirty days had expired.[110] The planners then involved clients in the mining company, but the clients received paper only from the mining company, not from the major corporations.[111] The security for the paper was provided by the mining company itself, which had no equity and eventually filed for bankruptcy.

The investors lost all of their investment, after having received worthless paper from a bankrupt company. The court decided that the sale of paper to the public was a security based on the finding that the accounts receivable issued were a "sham."[112] Furthermore, there was also inadequate security given for the paper, since the mines were running at a loss and there was nothing to ensure that the mines would ever produce.[113]

The preceding cases demonstrate only a portion of the myriad of investment opportunities offered to the public. In most cases, application of either the *Howey* or risk capital tests have brought the transactions within the purview of the securities laws and limited the investing public's exposure of the public to questionable financial schemes. Unfortunately, as stated before, new and more complex opportunities for investment continue to appear. However, the recent trend has been to contract rather than expand the protection of these doctrines. Several recent cases seem to permit transactions that endanger the public. These cases should have required the application of the disclosure and antifraud provisions of state and federal securities laws, but they did not.

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109. For example, many companies who need quick assets are willing to sell their receivables for 92 cents on the dollar. The purchaser then resells for 96 cents and pockets the difference. In short term speculation, the factoring is generally given a maximum of 30 days maturity. *Id.*

110. *Id.*

111. *Id.* at 279.

112. *Id.* at 282.

113. *Id.* at 283.

D. *The Current State of Securities Law*

Two recent cases, one from the Ninth Circuit Court of Appeals, the other a California appellate court case, depict the present trend toward restricting the application of the securities laws to novel investment schemes. These cases have created increasing confusion in both state and federal courts.

The first case is *SEC v. Belmont Reid & Co., Inc.*[114] There, the Ninth Circuit first signalled an intent to retreat from vigorous application of protective securities regulation. In order to raise capital to develop what was thought to be gold-bearing property, the defendant corporation offered investors the opportunity to purchase gold coins that would be minted from the expected future gold production. The transaction was in effect a futures contract, but the money solicited was to be used to produce the coins themselves.[115] The mines were found to have no gold, and bankruptcy proceedings soon were initiated against defendants. In holding that the transaction was not a security, the court stated,

> This case is a close one. It is clear that the issue before us is whether . . . [the] profits come "solely" from the efforts of others. [I]t is easy to assert that the failure or success of the enterprise in which the prepayment purchaser was engaged depended significantly on the managerial efforts of [defendant].[116]

After noting that the common enterprise requirement of *Howey* was met, the court refused to judge the transaction a security because of dangers that any sale of goods, whether commercial in nature or not, would conceivably come within the scope of the securities acts.[117] By departing from the precedent established by the earlier *Howey* line of cases, *Belmont Reid* initiated a backward trend in the growth of securities regulation.

The reluctance to further expand the scope of the securities law soon appeared in state decisions as well. The California case of

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114. 794 F.2d 1388 (9th Cir. 1986).

115. In a futures contract, a party promises to either make a delivery or take delivery of a commodity or item at an agreed price and time. They are traditionally used to give value to goods that do not yet exist. For example, a farmer can "lock-in" a particular price for an unharvested crop already given a market value. The farmer thus speculates that the market price will not rise before delivery. If the market price rises, the farmer will be forced to sell at the lower contract price. However, if the market price drops, the farmer will get the higher contract price in excess of what the prevailing spot cash market price is at the time. *See generally* Chicago Board of Trade, Commodity Trading Manual (1985).

116. 794 F.2d at 1391.

117. *Id.*

Moreland v. Department of Corporations[118] is one of the most recent. The defendant advertised the sale of already mined and processed ore to raise capital for a new processing plant.[119] In addition to the sales contract, buyers could enter into a second contract under which the defendant would refine the ore and then deliver it to another company to certify the gold purity. A third contract secured the defendant's performance under the first two contracts by the assets of the company. The court refused to hold the transaction a security, despite a close factual resemblance to *Goldfield*. The court based its decision on *Belmont Reid*, noting that the buyer kept almost full control over his purchase regardless of the series of contracts entered into. Essentially, the court felt that unless a greater degree of commonality was present, the sales and refinement agreements could not properly be called securities. Turning to the risk capital test, the court found that the transaction was adequately secured under *Hamilton Jewelers* since the ore sold had some gold content.

A case factually similar to *Moreland*, but which reached a different result, is *Hentzner v. State*.[120] The defendant in this case was pre-selling gold below the market price in order to raise the capital to mine what he had already sold. The Alaska Supreme Court took a different view than the *Moreland* court, finding all the elements of the *Howey* test, and concluding that the transaction was an investment contract. Rejecting the argument that there was no common enterprise, the court stated that "the money received from investors was to be pooled in order to buy mining equipment and supplies so that Hentzner could mine the gold he was contracting to sell."[121] The court also found the reliance on the efforts of others requirement, noting that "[s]ince the investors were in a position of continuing dependency on Hentzner's efforts to extract gold from the ground, the efforts of others test was satisfied."[122] These cases illustrate the split among states as to the ultimate aims of the securities laws and contrast the results between a jurisdiction which aggressively expands the definition of a security and one that has stopped expanding the definition.

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118. 194 Cal. App. 3d 506, 239 Cal. Rptr. 194 (1987).

119. Present processing techniques cannot remove all of the ore. Dump ore may retain up to a 25% or greater gold content after an initial processing depending on the efficiency of the processing technique.

120. 613 P.2d 821 (Alaska 1980).

121. *Id.* at 824.

122. *Id.*

In addition to modifying the *Howey* test and risk capital tests, some states have simply fused the two. This new test was first announced in *State v. Hawaii Market Center, Inc.*[123] This test retains the main points from both the *Howey* and risk capital tests. Many states quickly adopted this test to determine investment contracts for their securities laws, since the use of two co-existing tests has led to confusion.[124]

III. Analysis

Both state and federal securities laws, as the preceding section has illustrated, are not concerned with controlling every speculative transaction. Securities laws instead attempt to regulate situations in which a promoter solicits funds from an investor for capital only and the investor has no function beyond supplying the capital.[125] One example is where an investor plays an active role in the venture, such as in a partnership. Securities laws are likewise not concerned with the person who buys a passive asset in anticipation of an increase in value.[126] Instead, there must be some type of shared enterprise in which the investor contributes money to a promoter in return for a future benefit. This shared enterprise concept is the basic purpose underlying stocks, bonds, and other traditional forms of securities.

Many capital raising transactions, however, cannot be easily classified as a security. Besides the more obvious types of securities such as stocks and bonds, securities laws also mention, but do not define, the term investment contract.[127] It is this catch-all concept which courts have interpreted to extend coverage of the securities laws to transactions which cannot be characterized as a more traditional form of security, but nevertheless require regulation.

Securities law is an area in which there is a large amount of diverse case law which has limited use as precedent. Because of the constant efforts of issuers to structure transactions to be outside the

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123. 52 Haw. 642, 485 P.2d 105 (Haw. 1971).

124. *See, e.g.*, Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 552 S.W.2d 4 (Ark. 1977); State v. George, 50 Ohio App. 2d 397, 362 N.E.2d 1223 (Ohio Ct. App. 1975); Pratt v. Kross, 276 Or. 483, 555 P.2d 765 (Or. 1976).

125. Long, *supra* note 74.

126. For example, buying a parcel of land anticipating that its value will rise in the future is a personal investment. However, it is not considered an investment under the securities laws since there is no outside party soliciting capital in order to realize the increase in value. *See, e.g.*, Long, *supra* note 74.

127. 15 U.S.C. § 77b (1982); 15 U.S.C. § 78 (1982); Cal. Corp. Code § 25019 (Deering 1979). *See supra* note 2 and accompanying text.

current state of securities law, the cases are valuable only to the extent that the precedent can be easily extended to following cases. The courts are necessarily forced to react to new transactions on a case by case basis, drawing distinctions between those schemes which require investor protection and those schemes that are purely commercial transactions. By emphasizing the policy aims of the securities laws over a rigid and formal application of the black letter rules, courts will generally be more successful in properly defining what is a security. Defining an investment contract requires not only applying either the *Howey* or risk capital tests, but also recognizing the larger context of securities regulation.

Securities law is concerned only with transactions where there is an enterprise in which the investor plays a passive role while leaving active management to the party to whom the capital is given. Both the *Howey* test and the risk capital test reflect this. For example, the two *Howey* test requirements of common enterprise and benefit from the efforts of someone other than the investor prevents the test from being applied to purely commercial transactions. If the investor simply buys undeveloped land, the transaction is entirely passive and there is no common enterprise.[128] On the other hand, if the investor is active in the investment in a significant way the "efforts of others" element is not met. The *Howey* element of common enterprise means that both parties pool resources to achieve a common goal. In a commercial transaction, the only enterprise common to all parties is the transaction itself, since each party gains a benefit on nearly equal terms. The securities laws are thus confined to situations where the investor's role is simply to supply capital for others to manage.[129] This situation is where the need for investor information is at its greatest.

Furthermore, there is also a difference between state and federal interests in the ends sought by the securities laws. On the federal level, the laws attempt to regulate and watch over the national securities markets, where state interest is mainly oriented towards protection of individual investors.[130] A further complication arises as the SEC today does not appear to have the resources to enforce the securities laws against isolated transactions. Therefore, the number of federal investment contract cases brought by the SEC appears to

128. Long, *supra* note 74, at 564. *See also* J. LONG, BLUE SKY LAW § 2.03(2)(b) (1986). *See generally* L. LOSS, SECURITIES REGULATION 489 (2d ed. 1961).

129. Long refers to this as a separation of the capital supplying function from the operational of managerial function. *See generally* Long, *supra* note 74.

130. Long, *supra* note 74, at 547.

be declining.[131] This vacuum will have to be filled by the states, which have a more direct involvement with protecting its residents. Most state securities laws are comprehensive enough to compensate for a decline in federal enforcement. There is a danger for a state court to rely too heavily on federal securities decisions, since the policy aims of the two are different.[132] The result of this differing policy will be inconsistent decisions regarding similar types of transactions between state and federal courts.[133] State enforcement, therefore, must be more stringent than federal in order to effectuate a protective policy rather than a regulatory one merely requiring disclosure.

There is a final but crucial difference between the concepts of federal and state securities regulation. The federal system is predicated only on the premise of full disclosure.[134] As long as all material facts are given to the investor, the antifraud provisions of the securities acts do not apply, regardless of the nature of the scheme itself. Under no circumstances may the SEC refuse to register the security if there is full disclosure. The investor is entitled only to complete information, not qualitative protection.[135] Many states, including California, go much further than the federal laws and apply a concept of merit regulation, where a security may be deemed too dangerous for a public offering and refused registration by the appropriate agency.[136]

Since the purpose of securities law is to protect the public, the definition of a security should be expanded to cover transactions regarding certain sales of commodities to give speculators the legal protection they do not have otherwise.[137] Futhermore, state interest in enforcing its securities laws is increasing as the federal government reduces its role of investor protection.[138] The unsophisticated investor, often blinded by the lure of quick and easy profits, will usually bargain from a position of weakness since the information on which the investor relies can easily be manipulated or omitted by the pro-

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131. *See* Long, *supra* note 74. Due to increasingly limited resources, in addition to changes in Administration policy, the SEC is refusing to prosecute individual cases along the lines of *Howey*.

132. Long, *supra* note 74, at 547. Long states that although prior federal decisions are useful in state courts, the state policy in many cases may be contrary to the federal cases.

133. *See generally* Long, *supra* note 74, at 546.

134. Long, *supra* note 74, at 548.

135. Long, *supra* note 74, at 548.

136. *See generally* Long, *supra* note 74.

137. *See* THE LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1934 AND SECURITIES EXCHANGE ACT OF 1934 (1973) for the complete legislative history of the Federal Securities Acts.

138. Long, *supra* note 74, at 545.

moter. The securities laws offer the most logical solution to the problem of economic fraud because they are designed to give the investor both adequate information and legal redress in cases of fraudulent misrepresentation. Indeed, many securities laws are in effect consumer protection statutes.[139] Although certain securities will be exempted by statute from registration, the antifraud provisions of securities laws are always available to the public. The laws list specific instruments as securities, such as stocks and bonds, but also mention nebulous terms like "investment contracts."[140] It is the definition of these terms to which the courts have extended securities laws to schemes which do not involve the more obvious types of securities investments such as stocks or bonds but nevertheless merit investor protection. A court decision which holds a particular transaction not to be a security in effect endorses the use of the scheme to raise capital. Therefore, courts must necessarily avoid an inflexible application of the tests used in finding an investment contract.

The *Noa* case illustrates the difficulty of distinguishing the type of transaction which merits securities law coverage from purely commercial ones. Since defendants had no influence over the value of the bars after purchase, the transaction was indisputably commercial in character. But this is also true for stock and bond investments. Transactions which contain both commercial and investment aspects require careful scrutiny. The court in *Noa* apparently overlooked the fact that it is not the object of the transaction which needs to be regulated but the transaction itself. Extending the securities law to this type of transaction would not burden speculative selling of precious metals. It would instead afford protection against fraud based on the circumstances underlying the manner of the transaction itself. If the deal is fair and the promoters are merely acting as brokers, then the securities law is unnecessary regarding that sale. It is when there is unequal bargaining power between the investor and the promoter, and the value of the object of the transaction cannot be determined by an external factor, that the public needs protection from exotic investment opportunities. Courts are well equipped to decide questions of fairness. Recently, however, fear of encroachment into commercial activities has led to inflexibility.

Examples of this inflexibility are found in both *Belmont Reid* and *Moreland*. The courts in these cases seemed overly concerned with rigidly applying both the *Howey* and risk capital tests to the

139. Long, *supra* note 74, at 543.

140. *See supra* note 2 and accompanying text.

facts and, in general, ignored the protective policy behind securities law. Both cases replaced this policy with a concern for judicial overreaching. This fear is unnecessary, especially considering holdings from earlier cases with nearly identical facts situations. A transaction which contains both commercial and investment elements must be evaluated in light of the policy behind the securities laws.

For example, the trial court in *Belmont Reid* applied the *Howey* test and found that there was no common enterprise between investors and the mining company and that the expected profits would come from price moves in the world gold market, not the managerial efforts of the promoters.[141] The court of appeal focused solely on the managerial efforts argument in affirming the trial court.[142] The court of appeal further stated that the *Howey* test was satisfied but refused to reverse the decision, fearing that the scope of the securities laws would extend too far.[143] This decision may be a result of the diverging goals of securities regulation between state and federal courts.

To reach its decision, the court in *Belmont Reid* ignored the reality of the transaction in that the money solicited and invested was to be used to produce the object of the transaction itself. Without the invested money, the gold could not be produced and the coins could not be minted. In all previous cases, a direct connection between invested money and its intended use was sufficient to meet the common enterprise requirement of *Howey*. The use of the invested capital to produce the object of the investment further distinguishes *Belmont Reid* from *Noa*,[144] where the object of the transaction already existed, making the transaction purely commercial. Since the sale of the metals in *Noa* came from inventory, the value of the silver was influenced only by fluctuations in the world market and not by defendant's affirmative act.[145]

In addition to the reasons above, the *Belmont Reid* court also

141. 794 F.2d 1388, 1390 (9th Cir. 1986). *See supra* notes 105-06 and accompanying text.

142. *Id.* at 1390.

143. The court in *Belmont Reid* stated:

> The difficulty we have with this analysis is its ready applicability to any sale-of-goods contract in which the buyer pays in advance of delivery and the ability of the seller to perform is dependent, in part, on both his managerial skill and some good fortune. Perhaps the SEC views such contracts as covered by *Howey*. If so, we must express our doubts.

Id. at 1391.

144. 638 F.2d 77 (9th Cir. 1980).

145. *Id.* at 80.

relied heavily on the case of *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.,*[146] in which the sale of sugar futures contracts was held not to satisfy the investment contract test. This case dealt only with the sale of the contract to a buyer who wished to speculate on sugar prices. In a purely commercial transaction the investor is simply buying something which the solicitor possesses and, most importantly, over which the seller has no influence on value. In cases where an investor opens a discretionary trading account with a solicitor, the scenario changes. Now the investor has placed money with one whose actions will have an impact on the value of the expected return for the investor.

Belmont Reid seems even more incongruous when compared with *Goldfield.* The only factual difference between the two cases is that the defendants in *Goldfield* touted a new technique in gold reclamation from dump ore, whereas *Belmont Reid* involved only standard processing to produce the gold. In both cases, investors placed money with defendants so that gold could eventually be produced with the solicited capital. It was the efforts of the defendants, revolutionary technology or not, which could produce the gold necessary to complete the transaction. Over three million dollars solicited from investors in *Belmont Reid* was lost when the corporation went bankrupt.[147] No coins were ever issued. It is apparent that the investor's desire to speculate on the price of gold was an inducement to the initial investment, as was the fact that the coins were sold at a discount.[148] The courts must be careful to distinguish between the often separate motivations of both parties in entering the transaction. This will help provide a determination of whether the investor is merely supplying capital for the promoters use or simply exchanging money for goods and services.

The *Moreland* decision suffers from many of the same difficulties as *Belmont-Reid.* This case has a great degree of similarity to *Howey.* The optional refining and security agreements are in their practical effects virtually identical to the facts of *Howey.* In *Howey,* the citrus groves were offered to people who had no expertise in cultivation. This made the option of choosing the additional service agreements a sham. In reality there was no option, for the investor was forced to depend on the defendants to care for the investment itself. The fact that a "choice" was given to the investor does not

146. 253 F. Supp. 359 (S.D.N.Y. 1966).

147. 794 F.2d 1388 (9th Cir. 1986).

148. The coins were priced from 33% to 48% below the current spot cash price of gold. *Id.* at 1389.

abrogate the need for investor protection.

An illusory choice was also apparent in *Moreland*, where the investor had the option of just buying the ore, in which case there would not have been an investment contract. Most investors, however, lacked the ability to transport the ore themselves to the refinery of their choice. The defendants in *Moreland* stipulated in the trial court that the nearest refinery which investors could use was located in El Paso Texas, almost two thousand miles away. Most investors, therefore, would choose the "optional" agreements which bring the entire transaction within the scope of the securities laws. The use of all three agreements would place the investor in a sufficiently passive role to satisfy the *Howey* test.

The decision in *Moreland* espoused an extremely narrow view of the *Howey* test's second element requiring a common enterprise. The court based its reasoning on the *Goldfield* case, noting that the defendants in that case were entitled to a royalty fee for processing the gold and further retained control over the investor's ore. There is an additional commonality present in that the money paid for the ore would construct a refinery to process it. After *Moreland*, investment contracts require the promoters to somehow share directly in the investor's profits in order to satisfy the common enterprise element of *Howey*. This view of common enterprise nearly eliminates the possibility of finding the necessary interrelationship between seller's efforts and the success of buyer's investment to establish a common enterprise. Lastly, the fact that the defendants in *Moreland* increased the value of the investment would also prove the existence of a common enterprise.[149]

The *Moreland* court also concluded that since the marketing and control of the refined product was in the hands of the investor, there could be no reliance on the efforts of others and thus the fourth element of the *Howey* test was not met. This interpretation completely disregards the fact that it is the efforts of processing and refining by defendants, which converted the ore into gold for the investor's benefit. As in the common enterprise element, a correlation between the seller's actions and the eventual success of the investor's purchase establishes the investor's reliance on others.

Turning to a risk capital analysis, the *Moreland* court felt that the investor's funds were not substantially at risk enough to merit

149. It is interesting to note that the sales agreement in *Moreland* specified that any gold over a certain percentage would be kept by the defendants. This serves the same purpose as the royalty fee used in *Goldfield*. Thus a common enterprise was present even using the stricter approach.

application of the securities laws through the risk capital test. The court decided that the guarantee agreement offered by the defendants adequately secured the transaction. However, this view of risk capital may be too restrictive. The adequacy of the secured transaction is necessarily subjective. Thus the courts must decide to what degree of risk the investor's money should be subject to before an investment contract is found.

Justice Traynor's opinion in *Silver Hills* provides some explanation. Although the *Silver Hills* case concerned initial capital, the logic serves as a useful guide in later cases. Any reasoning used to find risk capital is necessarily circular, since all investment capital may be considered "at risk." Therefore, the question becomes one of degree. One answer in finding a high enough degree of risk may be to consider risk capital as invested money with a less than fair chance of return.[150] As Justice Traynor stated in *Silver Hills* the "objective is to afford those who risk their capital at least a fair chance of realizing their objectives . . . ."[151] However, the concept of a fair chance of return remains elusive, since the courts would then determine a venture's chance of success in determining fair chance. The better approach would be to measure the amount of risk by determining the investor's need for information and the risk involved if the information is faulty. A secured transaction should not be removed from the scope of the risk capital test since the security itself may be dubious, rendering the guarantee worthless.[152]

The *Moreland* court relied upon the *Hamilton Jewelers* case for its analysis of the adequacy of the security in the context of the risk capital test. In *Hamilton Jewelers,* investors had bought diamonds with a value outside the contract arrangement. This would be adequate security because the investor is assured nearly a complete return on the investment by selling the diamonds. *Moreland* is quite different in that the security was a physical asset which had unknown value. As there is no ready market to value the dump ore, the investors security was substantially at risk. Courts, therefore, must analyze the extent to which an alleged investment contract is secured to decide the degree of risk involved.

The major problem with the decisions in *Belmont Reid* and *Moreland* is that they expose the public to a growing amount of

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150. This suggestion may be found in Note, *Franchise Regulation under the California Securities Law,* 5 SAN DIEGO L. REV. 140, 152-54 (1968).

151. 55 Cal. 2d 811, 815, 361 P.2d 906, 908-09, 13 Cal. Rptr. 186, 188-89 (1961).

152. Obvious investment instruments such as stocks and bonds are secured and while this makes them less risky, they are not risk-free.

dubious investment offerings. The unsophisticated public is always targeted, in part, because those who invest in the more traditional capital markets possess a sufficient degree of knowledge to render these markets unavailable to promoters who favor exotic schemes.[153] The economic loss to society as a whole as well as the individual makes vigorous enforcement of the securities laws essential. Investor confidence, once lost, is difficult to revive. The purpose behind securities law is to protect the public from unscrupulous promoters. It appears that recent decisions bode ill for that goal and may foreshadow an increasingly laissez-faire approach in the future.

IV. Proposal

Both federal and state courts must endeavor to protect the public by regulating the offers and sales of dangerous investment schemes. In doing so, the courts should always look to public policy before applying the black letter tests. Although both the *Howey* and risk capital tests are fairly effective in reaching most types of schemes, both fail to focus on the investor's need for information before the investment decision is made. By expanding the definitions of a security, The public is capable of obtaining information about the prospective investment. Courts will focus more easily on this need for information, if they evaluate an investment contract from a public policy standpoint. Applying a black letter test without recognition of the underlying legal principles will lead to more decisions along the lines of *Belmont Reid* and *Moreland.*

California courts should also adopt the modified investment contract test formulated in *State v. Hawaii Market Center, Inc.*,[154] which combined the best elements of both the risk capital and the *Howey* tests. The elements are: (1) an offeree furnishes initial value to an offeror; (2) a portion of this initial value is subject to the risks of the enterprise; (3) the furnishings of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.[155] This test, broadly applied, should prove effective in advancing the protective aims behind the securities law.

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153. *See* Carney & Fraser, *supra* note 18, at 505.
154. 52 Haw. 642, 485 P.2d 105 (1971).
155. *Id.* at 649, 485 P.2d at 109.

Any test used by the courts must be applied with due concern for the policy aims behind the securities laws. In achieving this end, the courts should attempt to evaluate the investor's need for information and protection. This perspective has been historically successful in regulating transactions traditionally outside securities law. Both *Belmont Reid* and *Moreland* represent an abandonment of this approach in favor of a more caveat emptor ideal. As responsibility for individual protection of investors shifts to the states, decisions must reflect a return to a more activist methodology to protect investors. The modified test applied with sound regard for the protective policy behind the securities laws will give the courts and the enforcement agencies a comprehensive tool for reducing investor fraud.

V. CONCLUSION

Judicial enforcement of the securities laws has been generally effective over the previous fifty years. This effectiveness is directly attributable to the willingness of the courts to advance the public policy underlying the securities laws. This willingness was expressed in a constant expansion of the definition of investment contract to cover novel investment schemes. As consumer protection increasingly becomes a primary aim of state securities law enforcement, the need for courts to maintain pace with exotic transactions increases also. Once the resolve to keep pace with a rapidly expanding financial market weakens, the public will be inundated with various deals promising quick wealth.

It has been observed that though the schemes which the securities laws attempt to control have not really changed, their complexity has increased. Although the courts have kept up with this change admirably, some recent confusion has arisen as to the court's proper role in enforcing the securities laws. This confusion is easily remedied by a firm adherence to the principles behind the laws themselves. Any transaction which receives approval by the courts will invite an explosive growth of more potentially harmful investment opportunities. The honest businessman will usually obtain financing from the more traditional capital markets. The exotic and easy methods of raising capital attract a more questionable type of businessman. If potentially dangerous investment schemes are allowed to proliferate unchecked, it is the public alone who stands to lose. So long as the courts emphasize the policy behind the securities laws by determining the need for investor protection, the public will be well insulated from these schemes.

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