

# Expanding the Investment Company Act: The SEC's Manipulation of the Definition of Security

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*The definition of "security" in the Investment Company Act is virtually identical to the definition in the Securities Act of 1933. Nevertheless, the Securities and Exchange Commission takes the position that "security" is defined more broadly in the Investment Company Act than in the other federal securities laws, and, in particular, that certificates of deposit and commercial notes are securities for purposes of the Investment Company Act. The practical effect of this position is to turn into investment companies many investment programs that otherwise would not be covered by the Act.*

*Professor Bradford points out that the SEC's current position is inconsistent with the SEC's own pre-1982 position that "security" had the same meaning in all the federal securities statutes. The SEC's position changed as the Supreme Court limited the definition of security in the Securities Act of 1933 and the Securities Exchange Act of 1934. The SEC's non-equivalence position is also inconsistent with both the legislative history of the Investment Company Act, including statements from the SEC's own counsel, and the limited case law. Finally, Professor Bradford shows that the SEC's policy argument for a more expansive interpretation of "security" in the Investment Company Act is flawed.*

## I. INTRODUCTION

The Securities and Exchange Commission (SEC) is sometimes accused of using the administrative process "to graft new, substantive standards and obligations onto existing statutes or SEC rules."<sup>1</sup> Through the use of the no-action letter process,<sup>2</sup> the SEC staff sometimes creates substantive securities law which is inconsistent with the relevant federal securities statutes and case law.<sup>3</sup> Many of

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<sup>1</sup> Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 961 (1998).

<sup>2</sup> The no-action procedure allows securities lawyers and others to solicit the SEC staff's views on whether proposed transactions would violate the federal securities laws. The typical no-action request describes the transaction proposed and expresses counsel's view that the transaction will not violate the particular statutory provisions or rules with respect to which no-action relief is requested. If the SEC staff concurs, its response indicates that, if the transaction proceeds as outlined (or as modified to meet the staff's concerns), the staff will not recommend that the SEC take any enforcement action. See generally Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 BUS. LAW. 1019 (1987).

<sup>3</sup> See Lewis D. Lowenfels, *SEC No-Action Letters: Conflicts with Existing Statutes, Cases, and Commission Releases*, 59 VA. L. REV. 303, 304, 319 (1973) [hereinafter *Conflicts*]; Lewis

these staff positions “go far beyond reasonable and fair explanations of existing statutes or SEC rules.”<sup>4</sup> However, in substantive areas lacking definitive case law or rules, these no-action letters assume an extraordinary importance to securities lawyers and regulated entities.<sup>5</sup> For all practical purposes, the SEC position becomes the law, whether or not the position is faithful to the statute.

The SEC’s interpretation of the term “security” in the Investment Company Act of 1940<sup>6</sup> (Investment Company Act or Act) is a particularly egregious example of law-making by SEC administrative fiat. The SEC’s authority under the Investment Company Act, like its authority under the other federal securities statutes, turns on the presence of “securities.” The Act regulates “investment companies,” and, to be an investment company, an investment fund or program usually must both issue securities to its investors and invest in securities itself.<sup>7</sup>

It is not surprising that a number of no-action requests have raised this issue.<sup>8</sup> Investment companies are heavily regulated and the sponsors of investment funds naturally want to avoid the cost of such regulation. The SEC and its staff, mimicking similar attempts under other federal securities statutes,<sup>9</sup> have attempted to expand their jurisdiction by broadening the definition of “security” in a way that goes beyond the bounds of fair statutory interpretation.

Originally, the SEC took the position that the definition of “security” in the Investment Company Act was coextensive with the virtually identical definitions in the Securities Act of 1933<sup>10</sup> (Securities Act) and the Securities Exchange Act of 1934<sup>11</sup> (Exchange Act). As the Supreme Court narrowed its reading of the Securities Act and Exchange Act definitions, the SEC reversed course. In 1982, the SEC “discovered” that the Investment Company Act definition of “security,” despite the similar language, is broader than the definitions in the earlier federal securities statutes.<sup>12</sup> This non-equivalence position turns into regulated “investment companies” many investment programs that would not be subject to

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D. Lowenfels, *SEC No-Action Letters: Some Problems and Suggested Approaches*, 71 COLUM. L. REV. 1256, 1266 (1971) [hereinafter *Problems*]; Nagy, *supra* note 1, at 960–62.

<sup>4</sup> Nagy, *supra* note 1, at 961.

<sup>5</sup> See Lemke, *supra* note 2, at 1019; Nagy, *supra* note 1, at 947; *Problems*, *supra* note 3, at 1257.

<sup>6</sup> 15 U.S.C. §§ 80a-1 to 80a-64 (1994 & Supp. III 1997).

<sup>7</sup> See *infra* text accompanying notes 14–17.

<sup>8</sup> See, e.g., *infra* notes 37, 40, 55, 57.

<sup>9</sup> See ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 189–90 (1982) (offering the SEC’s attempt to expand the scope of the term “security” as an example of an instance “when the securities laws were applied to a set of facts in a manner that stretches the provisions of the statutes beyond generally accepted bounds”).

<sup>10</sup> 15 U.S.C. §§ 77a to 77aa (1994).

<sup>11</sup> 15 U.S.C. §§ 78a to 78kk (1994 & Supp. III 1997).

<sup>12</sup> See *infra* Part II.B.

the Investment Company Act if the Securities Act and Exchange Act definitions were followed.

In this Article, I examine the SEC's expansive interpretation of the meaning of "security" under the Investment Company Act, and the legislative, judicial, and policy underpinnings of that interpretation. Part II begins with a review of the relevant statutory language and the SEC's position. Part III concludes that the SEC's position is inconsistent with the legislative history of the Act, including the testimony of its own counsel. It is reasonably clear that Congress (and the SEC) in 1940 intended the term "security" in the Investment Company Act to be defined the same as in the Securities Act and the Exchange Act. Since the SEC's change of position, Congress has amended the Investment Company Act in a way that bolsters the SEC's position with respect to one particular type of instrument—certificates of deposit. But, even broadly construed, the amendment does not otherwise support the SEC's position that "security" is different under the Investment Company Act. Part IV shows that the SEC's position is also inconsistent with the limited case law construing the Act's definition of "security." Almost no judicial authority supports the SEC's position; the case law treats the various definitions of security as equivalent. Part V reviews the limited policy arguments made by the SEC and its staff to justify its broader interpretation of "security" under the Investment Company Act. These policy arguments provide the strongest support for the SEC's arguments, but I conclude they are unconvincing. Moreover, a policy argument alone cannot justify the SEC's attempt to override the language of the Act, the clear legislative history, and the limited case law.

Much of the development discussed in this Article has come through the responses of the SEC staff to no-action requests, which do not represent the official position of the SEC. However, there is significant evidence that both the Commission and its staff expect no-action letters to have a policymaking effect.<sup>13</sup> Moreover, the position discussed in this Article does not arise from a single, isolated no-action response. It is difficult to believe that such a consistent position was taken without the Commissioners' knowledge and approval. In any event, some of the actions detailed in this Article are Commission-approved actions. Therefore, it is not unfair to charge the SEC with responsibility for exceeding its statutory authority.

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<sup>13</sup> See Nagy, *supra* note 1, at 950.

## II. THE SEC'S CHANGING INTERPRETATION OF THE DEFINITION OF "SECURITY" IN THE INVESTMENT COMPANY ACT

### A. *The Statutory Definitions*

The definition of "security" is crucial to determining the scope of the Investment Company Act. The Act regulates "investment companies" and the term "security" factors into the definition of "investment company" in two ways. First, an investment company must be an "issuer,"<sup>14</sup> which the Act defines as "every person who issues or proposes to issue any *security*, or has outstanding any *security* which it has issued."<sup>15</sup> Second, except for companies in the business of issuing face-amount installment certificates,<sup>16</sup> the issuer must engage or propose to engage "in the business of investing, reinvesting, owning, holding, or trading in *securities*. . . ."<sup>17</sup> Thus, an investment company must both issue and own "securities," as defined by the Act. If the instruments a company sells to its investors are not securities or the instruments it purchases are not securities, the company is not an investment company and is not subject to the Act. Of course, not all companies that fall within these basic definitions are covered by the Act. The Investment Company Act contains many exceptions to these basic definitions,<sup>18</sup> and it also exempts some investment companies from the statutory requirements.<sup>19</sup>

Section 2(a)(36) of the Investment Company Act defines a "security" as:

[A]ny 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,

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<sup>14</sup> "When used in this subchapter, 'investment company' means *any issuer* . . . ." 15 U.S.C. § 80a-3(a)(1) (1994 & Supp. III 1997) (emphasis added).

<sup>15</sup> 15 U.S.C. § 80a-2(a)(22) (1994) (emphasis added).

<sup>16</sup> See 15 U.S.C. § 80a-3(a)(1)(B) (Supp. III 1997). For a definition of "face-amount certificate," see 15 U.S.C. § 80a-2(a)(15) (1994). This part of the definition of "investment company" has little contemporary significance. See 1 THOMAS P. LEMKE, ET AL., REGULATION OF INVESTMENT COMPANIES § 4.02 (1999).

<sup>17</sup> 15 U.S.C. § 80a-3(a)(1)(C) (Supp. III 1997) (emphasis added). If the issuer is "in the business of investing, reinvesting or trading in securities," no additional requirements need be met for the issuer to be an investment company. 15 U.S.C. § 80a-3(a)(1)(A) (Supp. III 1997). Subsection (C) adds "owning" and "holding" securities to the definition, with an additional requirement that "investment securities" must exceed 40% of the value of the issuer's total assets, exclusive of government securities and cash items. See 15 U.S.C. § 80a-3(a)(1)(C) (Supp. III 1997). The term "investment securities" includes most securities, with some exceptions. See 15 U.S.C. § 80a-3(a)(2) (Supp. III 1997).

<sup>18</sup> See 15 U.S.C. § 80a-3(b),(c) (1994 & Supp. III 1997).

<sup>19</sup> See 15 U.S.C. § 80a-6 (1994).

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 (including a certificate of deposit) or on any 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.<sup>20</sup>

The definitions of "security" in the Securities Act,<sup>21</sup> the Exchange Act,<sup>22</sup> and the Investment Advisers Act<sup>23</sup> are essentially the same.<sup>24</sup> The four definitions differ in some respects, but most of the differences are in the Exchange Act definition and most of those are minor.<sup>25</sup> In spite of these differences, the courts

<sup>20</sup> 15 U.S.C. § 80a-2(a)(36) (1994). The definitions section of the Investment Company Act, like the definitions sections of the other federal securities statutes, contains a context clause at the beginning: "unless the context otherwise requires." 15 U.S.C. § 80a-2 (1994 & Supp. III 1997).

<sup>21</sup> See 15 U.S.C. § 77b(a)(1) (Supp. III 1997) (definitions section of the Securities Act).

<sup>22</sup> See 15 U.S.C. § 78c(a)(10) (1994) (definitions section of the Exchange Act).

<sup>23</sup> See 15 U.S.C. § 80b-2(a)(18) (1994) (definitions section of the Investment Advisers Act).

<sup>24</sup> See also 15 U.S.C. § 80a-2(a)(36) (1994) (definitions section of the Investment Company Act); 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 171 (3d ed. 1995) ("The Investment Company Act . . . contains basically the same definition of securities as that in the Securities Act of 1933 and the 1934 Exchange Act.").

<sup>25</sup> The key substantive difference is language at the end of the Exchange Act definition excluding certain short-term indebtedness. Section 3(a)(10) of the Exchange Act provides that the term security "shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 15 U.S.C. § 78c(a)(10) (1994). This does not appear in any of the other definitions, although the Securities Act contains an exemption with similar language. See 15 U.S.C. § 77c(a)(3) (1994).

Most of the other differences are minor. The Exchange Act definition does not include the term "evidence of indebtedness" that appears in the other three definitions. See 15 U.S.C. § 80a-2(a)(36) (1994). The other three definitions include "any interest or instrument commonly known as a 'security' . . ." See 15 U.S.C. § 77b(a)(1) (Supp. III 1997); 15 U.S.C. § 78c(a)(10) (1994); 15 U.S.C. § 80a-2(a)(36). The Exchange Act definition just says "any instrument commonly known as a 'security'[,]" and leaves out the word "interest." 15 U.S.C. § 78c(a)(10) (1994). The other three definitions include "fractional undivided interest[s] in oil, gas, or other mineral rights." See 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10); 15 U.S.C. § 80a-2(a)(36). The Exchange Act definition does not contain this phrase, but adds "certificate of interest or participation . . . in any oil, gas, or other mineral royalty or lease." 15 U.S.C. § 78c(a)(10). The other three definitions conclude with the following catch-all phrase: "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." See 15 U.S.C. § 77b(a)(1); 15 U.S.C.

have concluded that the Exchange Act definition is to be interpreted as identical to the Securities Act definition.<sup>26</sup> The only relevant difference between the Securities Act and Exchange Act definitions, on the one hand, and the definitions in the Investment Company and Investment Advisers Acts, on the other hand, arose from amendments to all of these statutes in 1982. Those amendments are discussed later in this article.<sup>27</sup>

### B. *The SEC's Changing Position—From Equivalence to Non-equivalence*

Given the similarity of the statutory definitions, it is not surprising that the SEC and its staff initially took the position that the definition of "security" in the Investment Company Act was coextensive with the definitions in the other federal securities laws.<sup>28</sup> At the time, the courts were expansively construing the federal securities laws, particularly the definition of security. Later, however, the federal courts, particularly the United States Supreme Court, began to read the term "security" in the Securities and Exchange Acts more restrictively,<sup>29</sup> and the SEC abandoned its then-troublesome equivalence position. The SEC now contends that the definition of "security" in the Investment Company Act is broader than

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§ 78c(a)(10); 15 U.S.C. § 80a-2(a)(36). The Exchange Act definition includes this clause except for the "guarantee of" language. *See* 15 U.S.C. § 80a-2(a)(36).

<sup>26</sup> *See* *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 335 (1967); *see also* Lewis D. Lowenfels & Alan R. Bromberg, *What is a Security Under the Federal Securities Laws?*, 56 ALBANY L. REV. 473, 478 (1993).

<sup>27</sup> The Securities Act and the Exchange Act include in their respective definitions of 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) . . ." 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (1994 & Supp. III 1997) (emphasis added). The Investment Company Act and the Investment Advisers Act reword this as follows: "[A]ny put, call, straddle, option, or privilege on *any security (including a certificate of deposit)* or on any group or index of securities (including any interest therein or based on the value thereof) . . ." 15 U.S.C. §§ 80a-2(a)(36) (1994), 80b-2(a)(18) (1994) (emphasis added). This difference is discussed *infra* in Part III.B.

<sup>28</sup> *See* American Express Income Shares, Inc., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,074, at 85,021 (Sept. 13, 1974); *see also* Brief for the Petitioner SEC at 50, *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (arguing first that the contracts sold were "securities" under the Securities Act, then, in arguing that the issuer was an investment company, simply cross-referencing the Securities Act discussion as having "shown that the contracts sold by appellees are securities").

<sup>29</sup> The Supreme Court opinions defining "security" have gone through three phases. From 1943 to 1967, the Court focused on the securities laws' broad remedial purpose, and read the definitions broadly. From 1975 to 1982, the Court created judicial exceptions for instruments even though they were named in the definitional paragraph. Since 1985, the Court has retreated some from its aggressive creation of exceptions. *See* Park McGinty, *What Is a Security?*, 1993 WIS. L. REV. 1033, 1040-42.

the definitions in the Securities Act and the Exchange Act.

The SEC's change of position came in 1982. In *Marine Bank v. Weaver*,<sup>30</sup> the Supreme Court considered whether a federally insured certificate of deposit was a security for purposes of Section 10(b) of the Exchange Act.<sup>31</sup> Prior to this case, the SEC had filed several amicus briefs arguing that federally insured certificates of deposit were securities under the federal securities laws.<sup>32</sup> In *Marine Bank*, however, the United States filed an amicus brief conceding that the certificate of deposit was not a security.<sup>33</sup> However, the brief argued that the Investment Company Act "presents a significantly different context"<sup>34</sup> and that certificates of deposit should be securities under that Act.<sup>35</sup> According to the amicus brief, the exclusion of certificates of deposit from the Investment Company Act definition "would seriously undermine the protections contemplated by Congress . . ."<sup>36</sup> The government asked the Court to limit its holding to the particular facts of the case, and not to resolve whether the federal securities laws would apply in other contexts.<sup>37</sup>

The Supreme Court's response in *Marine Bank* was ambiguous. The Court did not directly address the government's argument for a different interpretation of the term "security" under the Investment Company Act. However, a footnote at the end of the opinion noted that certificates of deposit do not invariably fall outside the definition of "security" in the federal statutes.<sup>38</sup> According to the Court, "[e]ach transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole."<sup>39</sup>

Prior to *Marine Bank*, the SEC staff had refused to grant no-action relief to companies that were pooling investor funds to purchase federally insured bank

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<sup>30</sup> 455 U.S. 551 (1982).

<sup>31</sup> The term "certificate of deposit, for a security" found in the various definitions of "security" does not refer to ordinary bank certificates of deposit. *See id.* at 557 n.5; Arnold S. Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. SCH. L. REV. 211, 326 (1984). The instruments that most commonly fall within this part of the definition are American Depository Receipts for foreign securities and instruments issued by protective committees in the course of corporate reorganizations. *See id.* at 325-26.

<sup>32</sup> *See* Werner Kronstein, *SEC Practice: The CD Muddle*, 9 SEC. REG. L.J. 395, 395 (1982).

<sup>33</sup> *See* Brief for the United States as Amicus Curiae at 6-7, *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (No. 80-1562).

<sup>34</sup> *Id.* at 22.

<sup>35</sup> *See id.* at 23-24.

<sup>36</sup> *Id.* The policy basis for this argument is discussed *infra* in Part V.

<sup>37</sup> *See* Brief for the United States as Amicus Curiae, *supra* note 33, at 24.

<sup>38</sup> *See* *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982).

<sup>39</sup> *Id.*

certificates of deposit.<sup>40</sup> According to the staff, the participations in the certificates of deposit offered by these programs were securities, making the programs issuers.<sup>41</sup> Furthermore, the certificates of deposit were themselves securities and therefore the issuers were investment companies.<sup>42</sup> The SEC staff had similarly rejected no-action requests from companies pooling investments in commercial paper, even though commercial paper clearly was excluded from the Securities Act and the Exchange Act. The staff concluded that the commercial instruments these funds were purchasing could be securities and, therefore, the funds were, or could be, investment companies.<sup>43</sup>

Shortly after *Marine Bank* was decided, each of these positions was challenged. First, Merrill Lynch filed a no-action request challenging the staff's view that certificates of deposit were securities under the Investment Company Act.<sup>44</sup> Merrill Lynch planned to purchase portfolios of large-denomination, short-term, federally insured certificates of deposit and sell investors fractional, undivided interests in those portfolios. Merrill Lynch argued that the portfolios would not be investment companies because, after *Marine Bank*, the certificates

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<sup>40</sup> See North Carolina State Employees' Ass'n, Inc., SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,344 at 76,456 (Mar. 13, 1980); Bank of Oregon, SEC No-Action Letter, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,320 at 76,397 (Dec. 20, 1979); American Deposit Trust Corp., SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,805 at 87,101 (Oct. 8, 1976); Underwood, Neuhaus & Co., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,156 at 85,272 (Feb. 13, 1975); Arthur E. Fox, SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,082 at 85,037 (Dec. 12, 1974); Josephthal & Co., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,116 at 85,126 (Nov. 25, 1974); Warren W. York & Co., SEC No-Action Letter, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,758 at 84,040 (Apr. 4, 1974); Maynard Merel, SEC No-Action Letter, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,652 at 83,762 (Jan. 9, 1974).

<sup>41</sup> See, e.g., Arthur E. Fox, *supra* note 40, at 85,037; Josephthal & Co., *supra* note 40, at 85,126.

<sup>42</sup> See North Carolina State Employees' Ass'n, Inc., *supra* note 40, at 76,456. Of course, at the time, the SEC's position was that certificates of deposit were securities under all of the federal securities statutes. See *supra* note 32.

<sup>43</sup> See Omni Management Corp., SEC No-Action Letter, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,416 at 82,742 (May 10, 1979); World Evangelical Dev., Ltd., SEC No-Action Letter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,057 at 81,697 (Apr. 5, 1979); National Ass'n of Sec. Dealers, Inc., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,130 at 85,156 (Feb. 23, 1975). Commonwealth Fund, SEC No-Action Letter, *available in* 1971 WL 11098 at \*2 (July 15, 1971). *But see* Prudential-American Sec., Inc., SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,106 at 85,102 (Jan. 26, 1975) (allowing no-action relief where company was buying bankers' acceptances from banks for the accounts of several clients).

<sup>44</sup> See Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,310 at 78,146 (Oct. 28, 1982) [hereinafter Merrill Lynch].



of deposit were not securities.<sup>45</sup>

The SEC staff's unusually detailed response rejected Merrill Lynch's position. The staff first argued that certificates of deposit, like notes, debentures, and evidences of indebtedness, fall within the statutory definition unless the context otherwise requires.<sup>46</sup> According to the staff, footnote 11 in *Marine Bank* "seems to recognize the validity of the SEC's concern that the term 'security' not be construed in a way that would call into question the applicability of the securities laws in other contexts."<sup>47</sup> The context of Merrill Lynch's proposal "does not require the certificates of deposit to be deemed outside the definition of 'security' for purposes of the . . . [Investment Company Act]."<sup>48</sup> To the contrary, the context requires that the certificates of deposit be considered securities: they are negotiable and liquid, presenting the opportunities for misappropriation that Congress sought to prevent when it passed the Investment Company Act.<sup>49</sup> The banking regulation and deposit insurance that the Supreme Court relied on in *Marine Bank* would not protect investors in this context,<sup>50</sup> so the certificates of deposit must be treated as securities.

A year later, another no-action response made it clear that this non-equivalence position extended not just to certificates of deposit, but to other instruments as well. Bank of America Canada, a wholly-owned Canadian subsidiary of Bank of America National Savings Association, submitted a no-action request arguing that it should not be treated as an investment company.<sup>51</sup> The Canadian subsidiary's assets included notes evidencing loans it had made; if these notes were securities, the Canadian subsidiary could be an investment company, because the SEC had determined that foreign banks were not entitled to the exception from the definition of investment company available to domestic banks.<sup>52</sup> The bank pointed out that the courts, for purposes of the Securities Act

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<sup>45</sup> See *id.* at 78,146-48. Merrill Lynch also argued that the participation interests sold to investors were not securities; therefore, the portfolios were not issuers. See *id.* at 78,147.

<sup>46</sup> See *id.* at 78,150.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> See *id.* For further discussion of this policy argument, see *infra* Part V.

<sup>50</sup> See Merrill Lynch, *supra* note 44, at 78,151.

<sup>51</sup> See Bank of America Canada, SEC No-Action Letter (July 25, 1983) available in 1983 WL 29858, at \*4. This letter is sometimes cited by the name of the parent company, Bank of America National Savings Association.

<sup>52</sup> See *id.*; see also Michael Gruson & Phillip L. Jackson, *Issuance of Securities by Foreign Banks and the Investment Company Act of 1940*, 1980 U. ILL. L.F. 185, 195-201 (1980). In 1991, the SEC adopted Rule 3a-6, which excepts foreign banks and foreign insurance companies from the definition of "investment company." See 17 C.F.R. § 270.3a-6 (1998); Exception from the Definition of Investment Company for Foreign Banks and Foreign Insurance Companies, Investment Company Act Release No. 18381, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,846, at 82,200 (Oct. 29, 1991).

and the Exchange Act, had “uniformly rejected” the view that notes such as these were securities: “The case law is now completely settled that an evidence of indebtedness created in connection with a borrowing from a financial institution in the ordinary course of such institution’s business is not a security, at least while in the hands of the lending institution.”<sup>53</sup> The bank argued that the result should be the same under the Investment Company Act, and asked the staff to reconsider its earlier position to the contrary.<sup>54</sup>

The SEC staff refused. The staff pointed out that none of the cases cited by the bank, including *Marine Bank*, arose under the Investment Company Act.<sup>55</sup> The staff argued that footnote 11 in *Marine Bank* was consistent with the SEC’s position that the Investment Company Act context was different, and therefore none of the cases cited by the bank applied.<sup>56</sup> The staff also rejected the commercial/investment dichotomy that had been used in the Securities Act and Exchange Act cases to decide if notes were securities. The staff indicated that even purely commercial notes were securities for purposes of the Investment Company Act.<sup>57</sup>

The SEC staff’s responses to subsequent no-action requests have generally been consistent with the *Merrill Lynch* response: for purposes of the Investment Company Act, certificates of deposit are securities.<sup>58</sup> With little analysis, the staff has rebuffed attempts to apply *Marine Bank* to the Investment Company Act.<sup>59</sup> Consistent with the *Bank of America Canada* position, the staff has also refused

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<sup>53</sup> Bank of America Canada, *supra* note 51, at \*1.

<sup>54</sup> The bank conceded that, if investment money was pooled to be invested in commercial loans, it might be treated differently under the SEC’s argument in the *Marine Bank* brief. *See id.*

<sup>55</sup> *See id.* at \*4.

<sup>56</sup> *See id.*

<sup>57</sup> *See id.* at \*5. The staff noted that, in two places where the Investment Company Act referred to an issuer’s “outstanding securities,” a parenthetical excluded “short term paper.” *See id.*; 15 U.S.C. § 80a-3(b)(3), (c)(1) (1994). “Short-term paper” is defined to include commercial notes. *See* 15 U.S.C. § 80a-2(a)(38) (1994).

<sup>58</sup> *See* Pacific Heritage Assurance Co., SEC No-Action Letter (Sept. 26, 1985) *available* in 1985 WL 54352, at \*6; International Venture Fin. Ltd., SEC No-Action Letter, [1983–1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,527 at 78,697 (July 1, 1983); NEA-New Hampshire Payroll Inv. Plan, SEC No-Action Letter, [1982–1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,429 at 78,572 (Apr. 29, 1983).

<sup>59</sup> *See* Pacific Heritage Assurance Co., *supra* note 58, at \*6; International Venture Fin. Ltd., *supra* note 58, at 78,697; NEA-New Hampshire Payroll Inv. Plan, *supra* note 58, at 78,572. Possible exceptions are the staff’s no-action positions in College Assurance Plan, SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,492 at 77,510 (Sept. 8, 1989) and E.F. Hutton & Co., [1984–1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,909 at 79,442 (Mar. 28, 1985). However, those responses are better distinguished on the basis that, even if the underlying certificates of deposit were securities, the plans were not “issuers” because they were not offering separate securities to investors.

to grant no-action relief to issuers investing in notes.<sup>60</sup>

The SEC has revisited its non-equivalence position in one additional context since *Marine Bank*. In 1992, the SEC's Division of Investment Management prepared a report, *Protecting Investors: A Half Century of Investment Company Regulation* (*Protecting Investors* report), discussing several investment company issues.<sup>61</sup> One of the issues the report addressed was how to deal with structured financings, backed by instruments such as mortgage notes and consumer receivables. The *Protecting Investors* report recommended a rule exempting structured financings from the Investment Company Act registration requirements.<sup>62</sup> The Division rejected an alternative suggestion—to interpret the definition of “security” in the Investment Company Act, like the definitions in the Securities Act and the Exchange Act, to exclude “commercial” instruments.<sup>63</sup> The Division pointed out that many registered investment companies invest in such securities, and argued that those companies should continue to be subject to the Investment Company Act.<sup>64</sup> Thus, since the *Marine Bank* brief, the SEC and its staff have not wavered from the non-equivalence position.

### III. LEGISLATIVE HISTORY

The language of the Investment Company Act does not support the SEC's non-equivalence position, since that language is almost identical to the language in the Securities Act and in the Exchange Act. But, even though the language is

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<sup>60</sup> See Harrell Int'l, Inc., SEC No-Action Letter (May 24, 1989) available in 1989 WL 246259, at \*5; Education Loan Mktg. Ass'n, Inc., SEC No-Action Letter, [1985–1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,215 at 76,851 (Mar. 6, 1986); Gins Capital Corp., SEC No-Action Letter, [1985–1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,151 at 76,665 (Sept. 9, 1985). But see Harvest Real Estate Variable Annuity Account, SEC No-Action Letter (Feb. 23, 1983) available in 1983 WL 31030, at \*5 (offering annuity contracts and investing in commercial mortgage loans and real estate sale-leaseback investments).

<sup>61</sup> See generally DIVISION OF INVESTMENT MANAGEMENT, SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (1992).

<sup>62</sup> See *id.* at 77. Such a rule was eventually adopted. See Exclusions from the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,062, at 83,499 (Nov. 19, 1992).

<sup>63</sup> See DIVISION OF INVESTMENT MANAGEMENT, SEC, *supra* note 61, at 96.

<sup>64</sup> See *id.* at 97. According to the report:

[W]hile excluding commercial instruments from the disclosure requirements of the Securities Act and the Exchange Act is consistent with the purposes of those Acts, issuers that pool these instruments nevertheless may be functionally equivalent to, and present the same investor protection concerns as, investment companies that invest in securities that are registered under those Acts.

*Id.* at 97 n.339 (citing the government's *Marine Bank* amicus brief).

the same, the SEC's non-equivalence position might still be justified if the legislative history of the Investment Company Act supports it. Legislative history is important in determining the scope of the federal securities laws; it plays an important and sometimes decisive role in Supreme Court securities decisions.<sup>65</sup>

Unfortunately for the SEC, the legislative history of the Investment Company Act is inconsistent with the current SEC position. The legislative history instead supports the view that the term "security" in the Investment Company Act was meant to be identical to the same term in the earlier federal securities statutes. To support its contrary view, the SEC has ignored the most directly relevant legislative material and has focused instead on general policy language in the legislative record. The resulting position is contrary to the SEC's own intent when it drafted the statute in 1940. The history of the 1982 amendments to the Act bolsters the SEC's position, at least as to certificates of deposit, but even here, the legislative history is surprisingly clouded.

### A. *The 1940 Legislative History*

The legislative history of the Investment Company Act really begins in 1935. In that year, Congress enacted the Public Utility Holding Company Act; Section 30 directed the SEC to study investment trusts.<sup>66</sup> The study, commonly called the Investment Trust Study, was submitted to Congress in several parts beginning in 1938, and was accompanied by six supplemental reports.<sup>67</sup> On March 14, 1940, a bill drafted by the SEC was introduced simultaneously in the Senate as S. 3580 and in the House of Representatives as H.R. 8935.<sup>68</sup> The Securities Subcommittee of the Senate Banking and Currency Committee held extensive hearings on S. 3580 in April 1940.<sup>69</sup> Those hearings revealed that the SEC and the investment company industry were "strongly divided" over the contents of the bill,<sup>70</sup> but, after five weeks of negotiation, a compromise bill emerged.<sup>71</sup> That compromise bill was introduced in the Senate as S. 4108 and in the House as H.R. 10065.<sup>72</sup> A subcommittee of the House Committee on Interstate and Foreign

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<sup>65</sup> See Randall W. Quinn, *The Supreme Court's Use of Legislative History in Interpreting the Federal Securities Laws*, 22 SEC. REG. L.J. 262, 268-75 (1994).

<sup>66</sup> See 15 U.S.C. § 79z-4 (1994).

<sup>67</sup> See Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677, 678 (1969); see also 1 LEMKE ET AL., *supra* note 16, § 2.03.

<sup>68</sup> See North, *supra* note 67, at 679; 1 LEMKE ET AL., *supra* note 16, § 2.04.

<sup>69</sup> See generally *Hearings on S. 3580 Before A Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong. (1940) [hereinafter *Senate Hearings*].

<sup>70</sup> See 1 LEMKE ET AL., *supra* note 16, § 2.04. See generally *Senate Hearings*, *supra* note 69.

<sup>71</sup> See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 228 (1995).

<sup>72</sup> See 1 LEMKE ET AL., *supra* note 16, § 2.04.

Commerce held hearings on H.R. 10065 on June 13 and 14, 1940.<sup>73</sup> House Report 10065 was subsequently reported with numerous amendments, mostly of a technical and clerical nature,<sup>74</sup> and, after amendment, the final Investment Company Act was signed by the President on August 22, 1940.<sup>75</sup>

Neither the original SEC bill nor the compromise bill support the SEC's non-equivalence position. In S. 3580, the original bill drafted by the SEC, the proposed Investment Company Act simply made a cross-reference to the definition of "security" in the Securities Act: "'Security', 'prospectus', and 'underwriter' have the *same meanings* as in the Securities Act of 1933."<sup>76</sup> At the Senate hearings on S. 3580, David Schencker, Chief Counsel for the SEC's Investment Trust Study, discussed the proposed bill section by section, but he did not elaborate on the definitions section.<sup>77</sup> Arthur Bunker, an industry representative who outlined a proposed rewrite of the bill at the end of the Senate hearings, was the only other witness to mention the Section 45 definitions. He merely noted that "[m]any of these definitions need revision, but this is a matter for detailed drafting."<sup>78</sup>

It is clear that S. 3580, with its simple cross-reference to the Securities Act, does not support the SEC's non-equivalence position. It provided quite plainly that the term "security" would have the "same meaning" as in the Securities Act. If the SEC's current interpretation has any support in the legislative history, that support must come from the compromise bill, H.R. 10065.

The compromise bill eliminated S. 3580's direct cross-reference to the Securities Act, and instead included its own stand-alone definition of "security." Section 2(a)(35) of the Investment Company Act, as it appeared in H.R. 10065, defined security as:

[A]ny 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

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<sup>73</sup> See generally *Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong., (1940) [hereinafter *House Hearings*].

<sup>74</sup> See North, *supra* note 67, at 680 n.11.

<sup>75</sup> See 1 LEMKE ET AL., *supra* note 16, § 2.04.

<sup>76</sup> *Senate Hearings*, *supra* note 69, at 26 (quoting S. 3580, tit. I, § 45(a)(3)) (emphasis added). The proposed Investment Advisers Act, in turn, incorporated the Investment Company Act definition. See *id.* at 30 (quoting S. 3580, tit. II, § 203 and incorporating, *inter alia*, Section 45 of the Investment Company Act).

<sup>77</sup> See *Senate Hearings*, *supra* note 69, at 318. However, an outline Schencker prepared for a January 1940 meeting with industry representatives reflected S. 3580's eventual language: "For the purpose of defining securities, underwriters, etc., the definitions will in general be the same as described in the 1933 act, the 1934 act, and the 1935 act." *Id.* at 400.

<sup>78</sup> *Id.* at 1058.

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.<sup>79</sup>

It is clear that the addition of a full definition of "security" to the Act had nothing to do with the SEC's current position that "security" in the Investment Company Act does not have the "same meaning" as in the other federal securities statutes. The definition in H.R. 10065 is identical in every respect to the definition that appeared in the 1940 version of the Securities Act.<sup>80</sup> Instead of incorporating the Securities Act definition by reference, as the SEC's original bill did, the compromise bill simply repeated the Securities Act definition verbatim. This change was not intended to change the original proposal's intent that "security" have the "same meaning" as in the Securities Act. David Schencker of the SEC, testifying about the definitions section of the compromise bill said:

I may say this, generally, that many of the definitions were incorporated from the 1933 act and the 1934 act, and that was done at the suggestion of the industry. They felt that they would like to have the entire bill in one volume instead of having to refer to one act and then to another, you see.<sup>81</sup>

In other words, the language of the definition was changed, not for substantive reasons, but simply so people using the statute would not have to go back and forth between the Investment Company Act and the Securities Act.

Given the compromises necessary to pass *any* investment company legislation, an argument that the compromise bill strengthened the definition of "security" is preposterous. It was clear that the legislation originally drafted by the SEC would not pass.<sup>82</sup> The eventual Investment Company Act was a "watered-down bill"<sup>83</sup> that one commentator has termed "[t]he SEC's greatest legislative

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<sup>79</sup> *House Hearings, supra* note 73, at 6 (quoting H.R. 10065, tit. I, § 2(a)(35)). The definition in the proposed Investment Advisers Act was identical, except that it used the spelling "guaranty" instead of "guarantee." *Id.* at 45 (quoting H.R. 10065, tit. II, § 202(a)(18)).

<sup>80</sup> See 15 U.S.C. § 77b(1) (1940).

<sup>81</sup> *House Hearings, supra* note 73, at 101. One of the industry representatives who helped negotiate and draft the compromise bill expressed a similar view. In 1941, noting that little in the definitions section calls for special comment, he stated: "Many of the definitions follow closely, if not verbatim, similar definitions in the Securities Act of 1933 and the Securities Exchange Act of 1934." Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 314 (1941). The definition of "security" was not one of the few definitions he flagged as calling for special attention. See *id.* If, as the SEC contends, the Investment Company Act definition was intended to be broader, one would expect one of the drafters, in a contemporaneous article, to point that out.

<sup>82</sup> See 1 LEMKE ET AL., *supra* note 16, § 2.04.

<sup>83</sup> SELIGMAN, *supra* note 71, at 229.

defeat during the Roosevelt administration.”<sup>84</sup> The Act “must be read in the light . . . of the fact that . . . [it] constituted in a sense compromise legislation.”<sup>85</sup> The idea that this compromise contained a stronger definition of the term “security” than the original bill is incredible, especially given the SEC’s own counsel’s admission that the language was suggested by industry representatives.<sup>86</sup>

The SEC’s use of the Act’s legislative history ignores the direct evidence that Congress (and the SEC) meant “security” to have the same meaning in the Investment Company Act as in the other federal securities statutes. Instead, the SEC staff focuses on broad, general statements in the legislative record about the problems associated with investment companies, and argues that a broader reading of “security” is necessary to further the Congressional policies underlying the Act. The SEC focuses on the liquid, negotiable nature of certificates of deposit and commercial paper and argues that those characteristics justify regulation under the Investment Company Act. Part V deals with the merits of this policy argument. The discussion here focuses on the support for this argument in the legislative history.

The liquid, negotiable nature of investment company assets is noted at several places in the legislative record. For example, SEC Commissioner Robert E. Healy testified before the House committee that:

[T]he problems [associated with investment companies] enter largely from the nature of assets. The assets usually . . . are cash and securities which are very liquid and readily negotiable. Because of these characteristics the control of these funds offers manifold opportunities for exploitation by unscrupulous managements wherever they have existed.<sup>87</sup>

Statements echoing Commissioner Healy’s comments appear in the House and Senate Reports. The Senate Report, for example, states:

Basically, the problems flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are completely liquid, mobile and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by the unscrupulous managements of some companies. These assets can and have been easily misappropriated and diverted

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<sup>84</sup> *Id.* at 222.

<sup>85</sup> Jaretzki, *supra* note 81, at 303.

<sup>86</sup> *See supra* text accompanying note 81.

<sup>87</sup> *House Hearings, supra* note 73, at 58.

by such types of managements, and have been employed to foster their personal interests rather than the interests of public security holders.<sup>88</sup>

The SEC argues that this unique concern with liquid, easily looted assets justifies including within the Investment Company Act definition of "security" instruments that are liquid and negotiable but would not be securities under other federal statutes.<sup>89</sup>

The SEC's argument overstates the legislative history. Just prior to his statement quoted above, Commissioner Healy indicated that most investment companies of the time had "the major portion of their investments in so-called blue chips, the securities that are readily salable on the exchanges . . ." <sup>90</sup> It was these assets—blue chip stocks—that Commissioner Healy was indicating were easy to loot.<sup>91</sup> In addition, many of the problems Commissioner Healy specifically mentioned as justifying the proposed investment company regulation had little to do with the liquidity of the underlying securities.<sup>92</sup> The same can be said of the House and Senate reports. The problems noted in each report have more to do with the structure of investment companies than with the liquidity of their assets<sup>93</sup> and each report mentions common stocks as the primary investment of investment companies.<sup>94</sup>

The SEC reports to Congress on the investment company industry also make it clear that the portfolios of investment companies and investment trusts, both in the U.S. and Britain, were concentrated in ordinary stocks and bonds.<sup>95</sup> In fact, the SEC reports, which one treatise has termed "an integral part of the Act's legislative history,"<sup>96</sup> sometimes use the term "security" to mean only stocks and bonds. For example, Part II of the SEC's Investment Trust Study, submitted to Congress in 1939, states:

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<sup>88</sup> S. REP. NO. 76-1775, at 6 (1940). The language in the House Report is similar. See H.R. REP. NO. 76-2639, at 7 (1940).

<sup>89</sup> See *infra* Part V.

<sup>90</sup> *House Hearings*, *supra* note 73, at 57.

<sup>91</sup> See *id.* at 57.

<sup>92</sup> See *id.* at 58-62.

<sup>93</sup> See S. REP. NO. 76-1775, *supra* note 88, at 7-11; H.R. REP. NO. 76-2639, *supra* note 85, at 8-9.

<sup>94</sup> See S. REP. NO. 76-1775, *supra* note 88, at 2; H.R. REP. NO. 76-2639, *supra* note 88, 6.

<sup>95</sup> See H.R. DOC. NO. 77-246, at 333-34 (1941); H.R. DOC. NO. 76-482, at 19 (1939); R. DOC. NO. 76-476, at 17 (1939); H.R. DOC. NO. 76-380, at 51-52 (1939); H.R. DOC. NO. 75-279, at 35 (1939); H.R. DOC. NO. 76-70, at 527 (1939); H.R. DOC. NO. 75-707, *passim* (1938).

<sup>96</sup> 1 LEMKE ET AL., *supra* note 16, § 2.03.



At the end of 1936, the estimated market value of the security investments of all 558 investment trusts and companies known to be then in existence, excluding investments in subsidiaries, amounted to approximately \$4,055,000,000, of which \$3,560,000,000 or 88% of the total security investments consisted of common stocks, \$245,000,000 or 6% of which was in preferred stocks, and \$250,000,000 or 6% was in bonds.<sup>97</sup>

Thus, both Congress and the SEC appear to have been most concerned about stocks and bonds. In any event, the general policy statements quoted by the SEC cannot overcome the clear, direct statements in the legislative history: the term "security" in the Investment Company Act was intended to have the "same meaning" as in the earlier federal securities statutes.

### B. The 1982 Amendments

In 1982, Congress amended the federal securities laws to make it clear that options on securities are also securities.<sup>98</sup> The amendments were part of an accord between the SEC and the Commodities Futures Trading Commission to resolve a jurisdictional dispute concerning options and futures.<sup>99</sup> The amendments added to the definition of "security," to quote from the House committee report, "options on securities, options on certificates of deposit, options on securities indices or groups, and, when traded on a national securities exchange, options on foreign currency."<sup>100</sup>

The Investment Company Act amendment differed slightly from the amendments to the Securities Act and the Exchange Act. The language added to the Securities Act and the Exchange Act covers, in relevant part, "any put, call, straddle, option, or privilege on any security, certificate of deposit, *or* group or index of securities."<sup>101</sup> The language added to the Investment Company Act, on the other hand, reads, "any put, call, straddle, option, or privilege on any security (*including* a certificate of deposit)."<sup>102</sup> The use of the alternative "or" in the Securities Act and the Exchange Act appears to recognize that, after *Marine Bank*, certificates of deposit may not be securities (any security *or* certificate of deposit). The language added to the Investment Company Act, on the other hand, seems to acknowledge that certificates of deposit are included within the term

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<sup>97</sup> H.R. DOC. NO. 76-279, at 35 (1939); H.R. DOC. NO. 76-70, at 527 (1939). *But see* H.R. DOC. NO. 76-70, at 64 n.49 (stating that in analyzing investment company assets, "notes secured by real estate mortgages have been treated as securities").

<sup>98</sup> *See* Act of Oct. 13, 1982, Pub. L. 97-303, 96 Stat. 1409 (1982).

<sup>99</sup> *See* H.R. REP. NO. 97-626, pt. 2, at 2 (1982); S. REP. NO. 97-390, at 4 (1982).

<sup>100</sup> H.R. REP. NO. 97-626, pt. 1, at 9.

<sup>101</sup> 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (1994 & Supp. III 1997) (emphasis added).

<sup>102</sup> 15 U.S.C. § 80a-2(a)(36) (1994). The language in the Investment Advisers Act is the same. *See* 15 U.S.C. § 80b-2(a)(18) (1994) (emphasis added).

“security.”

The 1982 amendments probably were meant to endorse the SEC's position that certificates of deposit are securities for purposes of the Investment Company Act,<sup>103</sup> but the statute and the legislative history are a little ambiguous even on this point. The amendment does not directly state that certificates of deposit are securities; it provides only that *options on* certificates of deposit are securities. The SEC's *Marine Bank* position is supported only by implication: since the parenthetical treats certificates of deposit as securities to determine when an option is a security, certificates of deposit must be securities for all purposes. The SEC was not bold enough to insert into its jurisdictional accord with the CFTC separate language unrelated to the options and futures dispute that led to the legislation.

The legislative history is also unclear, although the ambiguity may have been intended to bolster the SEC's position that certificates of deposit were securities even prior to the amendment. The Joint Explanatory Statement submitted by the SEC and the CFTC to accompany the 1982 amendments says that:

Although the status of certificates of deposit as securities under the . . . Securities Act . . . and the Exchange Act is not free from doubt, *certificates of deposit have consistently been considered "securities" for the purposes of the Investment Company Act of 1940. In order to emphasize that no change in current law is contemplated, the legislative language used in the two circumstances differs.*<sup>104</sup>

When the bill was submitted in 1982, it was true that the SEC's consistent position was that, for purposes of the Investment Company Act, certificates of deposit were securities.<sup>105</sup> However, the only two cases to consider the issue had held that certificates of deposit were not within the Investment Company Act definition of “security.”<sup>106</sup> Further, not a single reported case (including *Marine Bank*) had even stated in dictum that the definition of “security” under the Investment Company Act differed from the definitions under the Securities Act and the Exchange Act. Cases involving claims under the Investment Company Act and other federal securities laws had assumed without discussion that the definitions were the same.<sup>107</sup> Thus, the Joint Explanatory Statement is a little

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<sup>103</sup> See Jacobs, *supra* note 31, at 398 n.1197; George F. Jones, *Footnote 11 of Marine Bank v. Weaver: Will Unconventional Certificates of Deposit Be Held Securities?*, 24 HOUS. L. REV. 491, 507 n.109 (1987).

<sup>104</sup> *Securities-Commodities Accord Amendments of 1982: Hearing on S. 2260 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong. 9–10 n.3 (1982)* (emphasis added).

<sup>105</sup> See *supra* text accompanying notes 28–43.

<sup>106</sup> See *infra* text accompanying notes 118–21.

<sup>107</sup> See *infra* text accompanying notes 116–17.

disingenuous.

The difference in the statutory language was not discussed in any testimony before the committees considering the bill,<sup>108</sup> nor was it mentioned in floor debate.<sup>109</sup> The House and Senate reports on the bill mention the difference in the Investment Company Act language, but they merely echo the SEC/CFTC statement. The Senate Report merely notes that the Investment Company Act language “would recognize that the underlying certificates of deposit clearly are securities for the purpose of the Investment Company Act.”<sup>110</sup> The House Report adopts the SEC statement<sup>111</sup> with a slight modification that makes it more accurate. The House Report first recognizes that the status of certificates of deposit under the Securities Act and the Exchange Act “has not been completely free from doubt.”<sup>112</sup> It goes on: “However, certificates of deposit consistently have been considered ‘securities’ by the [SEC] for the purposes of the Investment Company Act. In order to emphasize that *no change in current law in this regard is contemplated*, the legislative language used in the two circumstances differs slightly.”<sup>113</sup>

This change indicates that the Congressional staffs dealing with the 1982 amendments probably were not misled by the Joint Explanatory Statement. But the effect of the 1982 amendments on the SEC’s position is still subject to some doubt. On the one hand, the language in the Investment Company Act implies that certificates of deposit are securities. On the other hand, the House Report indicates that “no change in current law . . . [was] contemplated,”<sup>114</sup> and the Senate Report expresses a belief that the result was already clear. Moreover, the amendment does not make certificates of deposit securities; the amendment is, at best, merely the 1982 Congress’s interpretation of what the rest of the definition means. In the *Central Bank* case, the Supreme Court cautioned that “the

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<sup>108</sup> See generally *Clarify Jurisdiction of SEC and Definition of Security: Hearings on H.R. 6156 Before the Subcomm. on Conservation, Credit, and Rural Development of the House Comm. on Agriculture*, 97th Cong. (1982); *SEC/CFTC Jurisdictional Issues and Oversight—Part 1: Hearings on H.R. 5447, 5515, and 6156 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance and the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 97th Cong. (1982); *Securities—Commodities Accord Amendments of 1982: Hearings on S. 2260 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 97th Cong. (1982).

<sup>109</sup> See 128 CONG. REC. 24,908 to 24,914 (1982) (House consideration of H.R. 6156); 128 CONG. REC. 26,861 to 26,863 (Senate consideration of H.R. 6156).

<sup>110</sup> S. REP. NO. 97-390, at 8 (1982).

<sup>111</sup> This statement should undoubtedly be attributed to the SEC even though it appears in a joint SEC/CFTC statement. The CFTC had no reason to be concerned about whether certificates of deposit are securities under the Investment Company Act.

<sup>112</sup> H.R. REP. NO. 97-626, pt. 1, at 10 (1982) (citing *Marine Bank v. Weaver*, 455 U.S. 551 (1982)).

<sup>113</sup> *Id.* (emphasis added).

<sup>114</sup> *Id.*

interpretation given by one Congress (or a committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute.”<sup>115</sup> If a court would have decided prior to the 1982 amendments that certificates of deposit were not intended by the 1940 Congress to be treated as securities, are the 1982 amendments really sufficient to change that conclusion? Even if the 1982 amendments make certificates of deposit securities for purposes of the Investment Company Act, neither the amendments nor their legislative history answer the broader question posed in this Article: for instruments other than certificates of deposit (such as commercial notes), does “security” have a different meaning in the Investment Company Act?

#### IV. JUDICIAL AUTHORITY FOR THE SEC’S POSITION

##### A. Introduction

Aside from the ambiguous language in footnote 11 of the *Marine Bank* opinion, not a single case supports the SEC position that the Investment Company Act definition of “security” differs from the definitions in the other federal securities statutes. To the contrary, the case law supports the view that “security” is the same under all the federal statutes, including the Investment Company Act.

Several lower federal court cases involving claims under the Investment Company Act and one or more of the other federal securities statutes have simply assumed that the definitions of “security” are coextensive, addressing whether an instrument is a security without distinguishing among the different statutory claims.<sup>116</sup> At least one case, noting that the Investment Company Act definition is identical to the Securities Act definition, has indicated that a determination that an instrument is a security for Securities Act purposes “applies with equal force under the Investment Company Act.”<sup>117</sup> Unless one accepts the SEC argument that the *Marine Bank* footnote adopts their position, not a single case has even hinted that the Investment Company Act definition of “security” differs from the other definitions of “security.”

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<sup>115</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 185 (1994) (quoting *Public Employees Retirement System of Ohio v. Betts*, 492 U.S. 158, 168 (1989)).

<sup>116</sup> See *Dubach v. Weitzel*, 135 F.3d 590, 592–93 (8th Cir. 1998) (discussing claims under the Securities Act, the Exchange Act, and the Investment Company Act); *SEC v. R.G. Reynolds Enter., Inc.*, 952 F.2d 1125, 1130–35 (9th Cir. 1991) (discussing claims under the Securities Act, the Exchange Act, the Investment Company Act, and the Investment Advisers Act); *Olpin v. Ideal Nat’l Ins. Co.*, 419 F.2d 1250, 1263 (10th Cir. 1969) (discussing claims under the Exchange Act and the Investment Company Act); *SEC v. United Benefit Life Ins. Co.*, 359 F.2d 619, at 621, 623 (D.C. Cir. 1966) (discussing claims under the Securities Act and the Investment Company Act); see also *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1077–80 (7th Cir. 1972) (looking to the other federal securities statutes, including the Investment Company Act, to help determine the meaning of “security” in the Exchange Act).

<sup>117</sup> *SEC v. American Bd. of Trade, Inc.*, 593 F. Supp. 335, 340 (S.D.N.Y. 1984).

## B. *Certificates of Deposit as Securities*

On the specific question that has troubled the SEC in many of its no-action letters—whether certificates of deposit are securities under the Investment Company Act—the only two cases to address the question prior to the 1982 amendment concluded that they were not. In *SEC v. Fifth Avenue Coach Lines, Inc.*,<sup>118</sup> the court held that certificates of deposit should be treated as cash items and not as “securities” for the purpose of calculating whether investment securities were forty percent of a company’s total assets.<sup>119</sup> And, in *Drovers Bank of Chicago v. SFC Corp.*,<sup>120</sup> Drovers Bank argued that two companies to which its predecessor sold certificates of deposit were investment companies required to register under the Investment Company Act. The court held that certificates of deposit issued by a federally regulated bank were not securities for purposes of the Investment Company Act.<sup>121</sup> The government even cited this case favorably in its *Marine Bank* amicus brief,<sup>122</sup> an inconsistency that another amicus brief noted.<sup>123</sup> The closest the SEC has come to obtaining a judicial holding that certificates of deposit are securities under the Investment Company Act was a pre-*Marine Bank* consent judgment involving the same parties as the *Drovers Bank* case.<sup>124</sup>

The cases involving certificates of deposit may have been implicitly overruled by the 1982 amendments, but they still reject the SEC’s more general non-equivalence position that the definition of “security” in the Investment Company Act differs from the definitions of “security” in the other federal securities statutes. Moreover, since the SEC adopted its non-equivalence position prior to the 1982 amendments, these cases show that the SEC position was contrary to the case law at the time.

## C. *Marine Bank Footnote 11 and the Meaning of the “Context” Language*

The only judicial support the SEC can muster for its non-equivalence position is footnote 11 in *Marine Bank*. Footnote 11 may be responsive to the government’s plea for different treatment under the Investment Company Act, or it may only recognize the government’s more general argument that some

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<sup>118</sup> 289 F. Supp. 3, 31–33 (S.D.N.Y. 1968), *aff’d*, 435 F.2d 510 (2d Cir. 1970).

<sup>119</sup> See 15 U.S.C. § 80a-3(a)(1)(C) (1994 & Supp. III 1997) (amending 15 U.S.C. § 80a-3(a)(3) (1994)).

<sup>120</sup> 452 F. Supp. 580 (N.D. Ill. 1978).

<sup>121</sup> See *id.* at 582.

<sup>122</sup> See Brief for the United States as Amicus Curiae, *supra* note 33, at 20 n.32.

<sup>123</sup> See Brief for Myra Ayala as Amicus Curiae in support of the Respondents at 18, *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (No. 80-1562).

<sup>124</sup> See *SEC v. American Deposit Trust Co.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,808, at 95,171 (Mar. 12, 1979).

instruments labeled “certificates of deposit” could be securities.<sup>125</sup> It is important to remember that footnote 11 does not say that “security” is defined differently under the Investment Company Act. It says, in its entirety:

It does not follow that a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a ‘security’ as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.<sup>126</sup>

Some of the elements of footnote 11 are not completely in accord with the SEC’s position. Notice the reference to “the definition of a ‘security’ as defined by the federal statutes.”<sup>127</sup> The Court seems to be referring to a single, unitary definition, not different definitions under different securities statutes. Moreover, the second sentence of footnote 11 calls for analysis and evaluation of “[e]ach transaction,”<sup>128</sup> implying that an instrument either is or is not a security within each transaction. This cuts against a necessary result of the SEC’s position—that a single instrument can be both a security and not a security in the same transaction.<sup>129</sup> Finally, the Court indicates three elements to be considered in evaluating each transaction: (1) the content of the instruments; (2) the purposes to be served; (3) “and the factual setting as a whole.”<sup>130</sup> The Court says nothing about the statute under which the claim is made, a curious omission if, as the SEC contends, footnote 11 was meant to adopt the position advocated in the government’s amicus brief. At best, footnote 11 merely leaves the issue open.

The context clause in the Investment Company Act and in the other federal securities statutes introduces the definitions with the qualifying phrase, “unless

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<sup>125</sup> See Brief for the United States as Amicus Curiae, *supra* note 33, at 21–22. The government’s amicus brief argued that:

The better reasoned decisions of the lower courts do not view the question whether a certificate of deposit is a security in the abstract, or in light of the labels attached to a given instrument, but instead turn to a careful consideration of the context . . . .

One context in which a different result might be appropriate is the issuance of certificates of deposit by bank-type entities that are not regulated. The SEC believes that, in such situations, bank-type institutions should not be treated differently than other business corporations that seek capital to conduct business operations through the sale of interest bearing debt obligations.

*Id.*

<sup>126</sup> *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982).

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> See *infra* Part IV.D.

<sup>130</sup> *Marine Bank*, 455 U.S. at 560 n.11.

the context otherwise requires.”<sup>131</sup> Other cases interpreting footnote 11 of *Marine Bank* and the related context language in the statute do not support the SEC’s position. Since *Marine Bank*, the Supreme Court “has . . . pretended that the context clause does not exist.”<sup>132</sup> In *Landreth Timber Co. v. Landreth*,<sup>133</sup> the Court mentioned “the context of the transaction,”<sup>134</sup> but ultimately held that ordinary corporate stock was a security, regardless of context.<sup>135</sup> In *Reves v. Ernst & Young*,<sup>136</sup> the majority did not discuss the context clause at all, although the *Reves* test for whether a note is a security depends on the transactional context.<sup>137</sup>

Other authorities differ in their interpretation of the context language, but none of these interpretations provides much support for the SEC’s position. One line of authorities interprets the clause narrowly to apply only when “in the case of a frequently occurring statutory term, its immediate context suggests that a literal application of the statutory definition would produce absurd consequences or run counter to the obvious thrust of the section . . . .”<sup>138</sup> This line of cases certainly does not support the SEC’s position: nothing in the Investment Company Act compels the conclusion that “security” must be defined more broadly to avoid an absurd result. Nor does the usual definition of “security” run counter to anything in the definition of “investment company” or other sections of the Investment Company Act that turn on the meaning of “security.”

The second line of authorities, of which *Marine Bank* is the most prominent example, interprets “context” to include market or regulatory circumstances outside the Act itself.<sup>139</sup> There is a split among those who support this broader

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<sup>131</sup> See, e.g., 15 U.S.C. § 80a-2(a) (1994 & Supp. III 1997).

<sup>132</sup> McGinty, *supra* note 29, at 1085 n.216.

<sup>133</sup> 471 U.S. 681 (1985).

<sup>134</sup> *Id.* at 687.

<sup>135</sup> See Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of “Security”: The “Context” Clause, “Investment Contract” Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 491 (criticizing *Landreth* for “forfeit[ing] an opportunity to elaborate the precise role of ‘context’ analysis.”).

<sup>136</sup> 494 U.S. 56 (1990).

<sup>137</sup> See *id.* at 66–67; see also McGinty, *supra* note 29, at 1085 n.216 (“[T]he context clause was the only plausible mechanism for reconciling *Reves*’ multi-factored test with the Acts’ statutory language.”).

<sup>138</sup> Lowenfels & Bromberg, *supra* note 26, at 484 (quoting *American Bankers Ass’n v. SEC*, 804 F.2d 739, 753 (D.C. Cir. 1986)). For arguments that this textual view of the context clause is more consistent with the legislative histories of the federal securities laws, see Gary S. Rosin, *Historical Perspectives on the Definition of a Security*, 28 S. TEX. L. REV. 577, at 579, 587–90 (1987); Steinberg & Kaulbach, *supra* note 135, at 504–05. *But see* 2 LOUISS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 874 (3d ed. 1989) (noting some support in the legislative history of the Securities Act for reading “context” to include factual context).

<sup>139</sup> See Lowenfels & Bromberg, *supra* note 26, at 483. Lowenfels and Bromberg conclude that either view of the context clause is supportable, and that a court’s choice will be influenced primarily by the result that the court wishes to reach for other reasons. *See id.* at 488;

view of the context language. Some authorities argue that the relevant inquiry is “into the factual context in which the subject transaction arises.”<sup>140</sup> Others characterize the Supreme Court’s approach “as testing the legislative and regulatory ‘context’ of the transaction, the question being whether in light of other federal protections affecting the transaction, Congress would have intended the securities laws to apply.”<sup>141</sup> Neither view supports the SEC’s position that “security” has a broader meaning under the Investment Company Act. When a fund purchases an instrument, the factual context is the same whether a claim arises under the Investment Company Act or another federal securities statute. The factual context might justify applying a broader or narrower definition of “security” to the particular transaction, but would not justify applying a different definition depending on the statute under which the claim is made.<sup>142</sup>

The Securities Act and the Exchange Act definitions sections also contain “context” language,<sup>143</sup> and those two statutes differ in their regulatory concerns. Initially, the Supreme Court relied on these context clauses to argue that the definitions in the Securities Act and in the Exchange Act were not necessarily identical. In *SEC v. Nat’l Securities, Inc.*,<sup>144</sup> the Court had to construe the meaning of the phrase “purchase or sale” in Section 10(b) of the Exchange Act. The Court rejected an argument based on an SEC Securities Act rule.<sup>145</sup> Conceding that “the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen,”<sup>146</sup> the Court noted that “Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities

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*see also* William J. Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311, 330–31 (1984) (approving this market context approach, but describing its context clause justification as “tenuous”); Williamson B. C. Chang, *Meaning, Reference, and Reification in the Definition of a Security*, 19 U.C. DAVIS L. REV. 403, 431–32 (1986) (approving the transactional context approach); McGinty, *supra* note 26, at 1087 (approving a narrow use of this approach “whenever the legislative purpose would be transgressed by a literal interpretation.”).

<sup>140</sup> M. Thomas Arnold, “*When Is a Car a Bicycle? And Other Riddles: The Definition of a Security Under the Federal Securities Laws*,” 33 CLEV. ST. L. REV. 449, 460 (1984–1985).

<sup>141</sup> *Adena Exploration, Inc. v. Sylvan*, 860 F.2d 1242, 1250 (5th Cir. 1988).

<sup>142</sup> The SEC has argued that the term “security” should include certificates of deposit because federal deposit insurance does not adequately protect investors in investment companies. *See, e.g.*, *Merrill Lynch*, *supra* note 44, at 78,151. The protection against the risk associated with the instrument itself is identical in the investment company context. If the bank fails, the certificate of deposit will still be paid. Having the investment company hold the certificate of deposit as an intermediary imposes additional risks, but those risks are irrelevant to the question of whether the certificate of deposit is a security. *See infra* Part V.B.2.

<sup>143</sup> *See* 15 U.S.C. §§ 77b(a), 78c(a) (1994 & Supp. III 1997).

<sup>144</sup> 393 U.S. 453 (1969).

<sup>145</sup> *See id.* at 465–66.

<sup>146</sup> *Id.* at 466.



laws; both the [Securities Act and the Exchange Act] preface their lists of general definitions with the phrase ‘unless the context otherwise requires.’”<sup>147</sup>

The Court has abandoned this early position, at least as to the definition of security. The Supreme Court has noted in several cases that the definition of security in the Exchange Act is “virtually identical” to the definition in the Securities Act, and has consistently treated the coverage of the two statutes as the same.<sup>148</sup> The Supreme Court has not expressly compared the definition of “security” in the Investment Company Act to these other definitions, but it also has made no attempt to distinguish the language in the Investment Company Act,<sup>149</sup> and, as pointed out earlier, the Investment Company Act definition of security tracks the Securities Act language even more closely than the Exchange Act definition does. It is therefore likely that the definitions of “security” in the Securities Act and the Investment Company Act will also be interpreted identically, at least as to everything other than certificates of deposit.

#### D. *Judicial Rejection of Oscillating Security/Non-Security Status*

Under the SEC’s position, the character of a particular instrument as a security changes from day to day, from transaction to transaction, and even within the same transaction. For example, assume an individual purchases a federally insured certificate of deposit from a regulated national bank and puts that certificate of deposit in a safe. *Marine Bank* tells us that the certificate of deposit is not a security. On the next day, the individual sells several friends instruments that grant the friends a percentage share of the certificate of deposit when it matures. Under the SEC’s view, the certificate of deposit, which sat unchanged in the safe the whole time, has been miraculously transformed into a security.<sup>150</sup> Or has it? It still is not a security as between the original purchaser and the bank. The certificate of deposit mystically oscillates between security and non-security status, depending on who examines it, when, and for what purpose.

The idea that identical instruments may be securities in one sale but not in

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<sup>147</sup> *Id.*

<sup>148</sup> See *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975); *Tcherepnin v. Knight*, 389 U.S. 332, 335–36 (1967); see also *Gustafson v. Alloyd Co.*, 513 U.S. 561, 573 (1995) (rejecting the idea that a term may mean one thing in one section of the Securities Act and something different in another).

<sup>149</sup> See *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959) (not distinguishing Securities Act and the Investment Company Act claims in discussing whether annuity contract are entitled to an insurance exemption).

<sup>150</sup> *But see* Brief for Myra Ayala as Amicus Curiae in support of the Respondents, *supra* note 123, at 18 (criticizing the SEC position for its result that “CD’s [sic] when bought and sold are not ‘securities,’ but once they come to rest and are held, they are magically transmuted into ‘securities.’”).

another is not unprecedented.<sup>151</sup> That is an inevitable result of *Marine Bank's* contextual approach to the definition of security. It is also not unprecedented for a court to consider what might happen to an instrument after its initial sale to determine if it is a security.<sup>152</sup> But the SEC's position results in the same instrument both being and not being a security in the same transaction. It is difficult to see how even the "context" language justifies differing treatment of the same instrument in the same transaction. The "context" is the individual's purchase of the certificates of deposit. That the issuer is also *selling* a separate security—in this case, the participations—has nothing to do with the context of what the issuer is *purchasing*. In essence, the SEC is attempting to collapse the statutory requirements that an investment company both issue and purchase securities into a single requirement that the company issue securities.<sup>153</sup>

The Supreme Court has strongly rejected the type of uncertainty that the

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<sup>151</sup> See Carl W. Schneider, *The Elusive Definition of a "Security"—1990 Update*, 24 REV. SEC. & COMMOD. REG. 13, 19 (1991); see also Robert C. Art, *Sell a Condominium, Buy a Securities Lawsuit: Unwarranted Liabilities in the Secondary Market*, 53 OHIO ST. L.J. 413, 435–38 (1992) (rejecting the "once a security, always a security" view with respect to condominium units, but indicating that the view could be correct for indivisible instruments such as bank certificates of deposit).

<sup>152</sup> See *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990) (determining whether a note is a security, by asking, inter alia whether there is "common trading for speculation or investment") (quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 353 (1943)).

<sup>153</sup> The SEC's argument in this regard is analogous to attempts to invoke Section 10(b) of the Exchange Act by bootstrapping a purchase or sale of a security to related fraudulent conduct that is not "in connection with the purchase or sale of any security." *Taylor v. First Union Corp.*, 857 F.2d 240, 245–46 (4th Cir. 1988); see also *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 941–44 (2d Cir. 1984); *Ketchum v. Green*, 557 F.2d 1022, 1027–28 (3d Cir. 1977); see generally Daniel A. McLaughlin, *The "In Connection With" Requirement of Rule 10b-5 as an Expectation Standard*, 26 SEC. REG. L.J. 3 (1998); C. Edward Fletcher, III, *The "In Connection With" Requirement of Rule 10b-5*, 16 PEPP. L. REV. 913 (1989). The fact that a security is being purchased or sold in proximity to the fraud does not make the fraud securities fraud. Similarly, the fact that an issuer is *selling* a security does not make the risk associated with what the issuer is *purchasing* an Investment Company Act risk. The SEC's policy argument to the contrary, based on Congress' desire to protect against investment risk, is analogous to an argument that Section 10(b) of the Exchange Act was designed to protect against fraud, and therefore, every instrument that presents a risk of fraud must be a security. However:

[T]he type of conduct that the Acts prohibit and the definition of "security" are unrelated, except to the extent that a security must be present for the antifraud provisions to apply. Observations about one have no bearing on conclusions about the other. A finding that fraud has occurred in a particular factual situation does not in itself qualify the transaction involved as a security; likewise, the mere presence of a security will not expose a party to a transaction to liability under the antifraud provisions absent evidence of prohibited conduct.

SEC's oscillating definition of security would create. In *Gould v. Rufenacht*,<sup>154</sup> the respondent argued that corporate stock should not be a security if the purchaser acquired control of the corporation. One of the reasons the court rejected this so-called sale-of-business doctrine was that its application "would lead to arbitrary distinctions between transactions covered by the [federal securities statutes] and those that are not."<sup>155</sup> The Court pointed out that, under the proposed doctrine, a corporation's stock could be a security as to one party to the transaction, but not as to the other.<sup>156</sup> Further, in several identical transactions involving the same individual, the stock could be a security in some of the transactions, but not in others.<sup>157</sup> The Court concluded that "[s]uch distinctions make little sense in view of the Acts' purpose to protect investors."<sup>158</sup>

*Marine Bank* rejected a similar transactional argument. The respondents in *Marine Bank* argued that, although the certificate of deposit may not have been a security when the Weavers purchased it from the bank, it became a security when it was pledged back to the bank to guarantee the bank's loan.<sup>159</sup> In a footnote, the Supreme Court summarily dismissed the argument that a single instrument could be a security in one transaction but not in another.<sup>160</sup>

Two circuit court cases since *Marine Bank* have held that federally insured certificates of deposit can be securities when those certificates are marketed by intermediaries.<sup>161</sup> In each case, the court concluded that the efforts of the company marketing the certificates of deposit added value to the product that made the program different from an ordinary certificate of deposit.<sup>162</sup> Similarly,

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<sup>154</sup> 471 U.S. 701 (1985). This was the companion case to *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) (rejecting the sale-of-business doctrine also).

<sup>155</sup> *Gould*, 471 U.S. at 705.

<sup>156</sup> *See id.* at 706.

<sup>157</sup> *See id.*

<sup>158</sup> *Id.*

<sup>159</sup> Respondent's Brief in Opposition to Petition for a Writ of Certiorari at 8-9, *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (No. 80-1562); Brief for Respondents at 34-38, *Marine Bank*, 455 U.S. at 551 (No. 80-1562).

<sup>160</sup> "We reject respondents' argument that the certificate of deposit was somehow transformed into a security when it was pledged, even though it was not a security when purchased." *Marine Bank*, 455 U.S. at 559 n.9.

<sup>161</sup> *See Olson v. E. F. Hutton & Co.*, 957 F.2d 622, 628-29 (8th Cir. 1992); *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 240-42 (2d Cir. 1985).

<sup>162</sup> In *Gary Plastic*, Merrill Lynch, the program sponsor, investigated and monitored the CD issuers, marketed the CDs, and maintained a resale market. *See* 756 F.2d at 240-41. The court concluded that "Plaintiff's decision to invest is obviously made in reliance upon the efforts, knowledge and skill of Merrill Lynch. This is a significant factor that sets this case apart from *Marine Bank*." *Id.* at 241. In *Olson*, the account representative provided expert advice to the plaintiffs concerning purchases and sales prior to maturity to profit from interest rate fluctuations. *See* 957 F.2d at 628-29.

commercial notes, or participations in commercial notes, that are resold to investors may in certain circumstances be securities even though the original notes were not.<sup>163</sup> The results in these cases often depend on the purchaser: if the purchaser is a member of the general investing public, rather than another commercial lender, the participation may be treated as a security.<sup>164</sup> An investment program that purchases certificates or notes, then sells participations in those instruments to investors, could be adding similar value and, therefore, be selling securities.<sup>165</sup>

These cases do not support the SEC's non-equivalence position, however. They deal with whether the investment the intermediary is selling to investors (*i.e.*, the participation or the "enhanced" certificate of deposit) is a security. To be an investment company, the fund must not only be issuing securities, but purchasing them as well. These cases do not hold that the intermediary is purchasing securities when it acquires the certificates of deposit or the notes. These cases concern only the product sold to the ultimate investor.

Moreover, if these cases applied, the SEC's non-equivalence position would be unnecessary. These cases involve the Securities Act and the Exchange Act definitions of "security." To the extent they apply, there is no need to argue that the Investment Company Act definition is broader. The SEC's non-equivalence argument is necessary only because the cases under the Securities Act and Exchange Act do *not* support its position.

## V. THE POLICY ARGUMENT FOR THE SEC'S POSITION

The SEC's argument that "security" has a broader meaning in the Investment Company Act than in the Securities Act or the Exchange Act is not based primarily on the language of the statutes, legislative history, or case law. As

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<sup>163</sup> See Nancy A. Brown & Jonathan E. Breckenridge, *Notes Qualifying as Securities in the Wake of Reves: Recent Developments*, 31 REV. SEC. & COMMOD. REG. 1, 2-5 (1998) and cases cited therein; Janet Kerr & Karen M. Eisenhauer, *Reves Revisited*, 19 PEPP. L. REV. 1123, 1155 (1992), and cases cited therein. See generally Robert F. Komegay, Jr., *Bank Loans as Securities: A Legal and Financial Economic Analysis of the Treatment of Marketable Bank Assets Under the Securities Acts*, 40 UCLA L. REV. 799 (1993); Richard Y. Roberts & Randall W. Quinn, *Leveling the Playing Field: The Need for Investor Protection for Bank Sales of Loan Participations*, 63 FORDHAM L. REV. 2115 (1995).

<sup>164</sup> See Carl W. Schneider & Joshua D. Cohen, *Reves v. Ernst & Young: A Note-Worthy Departure in Defining "Security,"* 23 REV. SEC. & COMMOD. REG. 191, 200-01 (1990); see also Brown & Breckenridge, *supra* note 163, at 8 ("The second factor highlighted by these cases is the identity of the buyer; in many of them, the more sophisticated the buyer, the less likely the transaction was to be characterized as a security.").

<sup>165</sup> See generally Harvey Bines & Steve Thel, *Investment Management Arrangements and the Federal Securities Laws*, 58 OHIO ST. L.J. 459 (1997) (discussing whether investment management services offered to investors are securities and whether companies offering such services are investment companies).

shown above, the SEC essentially ignores the statutory language, relevant case law, and directly relevant legislative history. The SEC's position is based instead on policy, bolstered by the general statements in the legislative history concerning the abuses the Investment Company Act was meant to control.

### A. *The SEC's Argument*

The SEC and its staff have not consistently provided policy arguments for the non-equivalence position. However, at least two potential policy arguments may be gleaned from the SEC's pronouncements. One argument is rather simplistic and does not really provide an independent policy justification for the SEC's position. The second policy argument is more substantial.

First, the SEC points out that many registered investment companies, especially money market funds, have their assets invested in instruments that would not be securities under the Securities Act or the Exchange Act. If these instruments, such as certificates of deposit and commercial notes, were not treated as securities, some funds would be freed from regulation under the Investment Company Act.<sup>166</sup> It is true that money market funds are an important part of the mutual fund world. As of September, 1999, the assets of U.S. money market funds totaled around \$1.5 trillion.<sup>167</sup> Undoubtedly, interpreting the term "security" as it is interpreted under the Securities Act and the Exchange Act would free some, but probably not all, perhaps not even most, of those funds from regulation under the Investment Company Act.<sup>168</sup> However, that alone does not justify the SEC's position. To complete the argument, the SEC must explain why, as a matter of policy, these funds should be regulated under the Investment Company Act.<sup>169</sup> Deregulation is detrimental only if there is some independent

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<sup>166</sup> See Brief for the United States as Amicus Curiae at 22-24, *supra* note 33; see also DIVISION OF INVESTMENT MANAGEMENT, SEC, *supra* note 61, at 97.

<sup>167</sup> See Investment Company Institute, Money Market Mutual Fund Assets: September 16, 1999 <[http://www.ici.org/facts\\_figures/trends\\_0999.html](http://www.ici.org/facts_figures/trends_0999.html)> (visited Oct. 28, 1999).

<sup>168</sup> Some, perhaps many, public funds might choose to remain regulated, if that choice was permitted. Regulation could signal these funds' continued soundness and safety to investors and differentiate them from unregulated funds. Investment company status would also allow them to use more favorable securities registration and marketing provisions available only to investment companies. See, e.g., 17 C.F.R. §§ 230.134(a)(3)(iii), 230.482 (1999); New Disclosure Options for Open-End Management Inv. Cos., Securities Act Release No. 7513, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,013 at 80,264 (Mar. 13, 1998).

<sup>169</sup> Even if the instruments in which they are investing are not securities, those funds would still be issuing securities to their own investors. Thus, they would not be freed of all federal securities regulation. Like other issuers, those funds would still be subject to regulation under the Securities Act and to antifraud liability pursuant to Section 10(b) of the Exchange Act.

policy justification for regulating them.<sup>170</sup>

The SEC's second argument attempts to provide a policy rationale for continuing to regulate funds investing in instruments like certificates of deposit and commercial paper. According to the SEC, the need for the Investment Company Act arose primarily out of two characteristics of investment companies: (1) the nature of their assets; and (2) the presence of the fund's management as an intermediary between those assets and the fund's investors. Investment companies' assets consist primarily of "assets [such as cash, stocks, and bonds] which are completely liquid, mobile, and readily negotiable."<sup>171</sup> The investment company stands as an intermediary between those liquid assets and the fund's public investors, giving the fund's managers and employees an opportunity to misappropriate or divert those assets.<sup>172</sup> The liquidity of those assets makes misappropriation easier. According to the SEC, certificates of deposit and certain other instruments not treated as securities under the Securities Act and the Exchange Act are equally negotiable and liquid. Since the intermediation function is the same, funds investing in those assets present the same risk to investors as funds investing in "true" securities,<sup>173</sup> and therefore, the same need for protective regulation exists.<sup>174</sup>

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<sup>170</sup> As a practical matter, these funds probably would not be freed from substantive regulation even if the SEC interpreted the term "security" properly. Congress might amend the Investment Company Act to cover money market funds. Congressional action is far from certain, however, given the current Congress's deregulatory mood with respect to securities regulation. See National Securities Market Improvement Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996); Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (1995). But, even if Congress would be willing to "fix" the Act to the SEC's liking, that would not excuse the SEC's present position. As an administrative agency, the SEC is charged with administering the statutory scheme adopted by Congress. Its task is not to rewrite the statute whenever it feels that what Congress adopted does not fulfill the statute's purpose.

If the SEC interpreted the term "security" to exclude the investments of money market funds, state regulation would also be a possibility, and that regulation could be even more restrictive than the Investment Company Act. In fact, a fear of state regulation may be why the investment company industry has not pressed the "security" issue more forcefully. But it is also not the SEC's job to rewrite federal statutes to preempt more restrictive state regulation. If state regulation concerns Congress, it is capable of dealing with it. See, e.g., 15 U.S.C. § 77r (1994 & Supp. III 1997) (preempting some state securities regulation); 15 U.S.C. §§ 80b-3a, 80b-18a (1994 & Supp. III 1997) (preempting some state regulation of investment advisers).

<sup>171</sup> Merrill Lynch, *supra* note 44, at 78,150 (quoting S. REP. NO. 76-1775, at 6 (1940)). For further discussion of the Senate Report, see *supra* note 88 and accompanying text; see also Brief for the United States as Amicus Curiae at 23, *supra* note 33.

<sup>172</sup> See Merrill Lynch, *supra* note 44, at 78,150.

<sup>173</sup> I use the term "true securities" to refer to instruments that are within the definitions in the Securities and Exchange Acts—securities as to which the SEC's non-equivalence argument is not necessary for Investment Company Act coverage.

<sup>174</sup> See Merrill Lynch, *supra* note 44, at 78,150; Brief for the United States as Amicus Curiae at 23, *supra* note 33; see also TAMAR FRANKEL, I THE REGULATION OF MONEY

## B. Problems with the SEC's Policy Argument

The SEC's policy argument provides the strongest support for its non-equivalence position, but it is flawed: "true" securities do pose greater investment risk than the types of instruments the SEC wants to expand the statutory definition to include. In any event, the SEC's application of the definition of "security" in the Investment Company Act is still overbroad, because it has treated even instruments that are neither liquid nor readily negotiable as securities. But the most important objection to the SEC's policy argument is that it is illegitimate. In construing the term "security," the SEC is not writing on a blank slate; it is constrained by what Congress has enacted. The SEC's policy argument is inconsistent with the structure of the Act, and is essentially an attempt to rewrite the statute through administrative interpretation.

### 1. A Comparison of Risks

The SEC argues that instruments such as certificates of deposit and commercial notes must be covered by the Investment Company Act because the risk to fund investors is identical to the risk when a fund invests in true securities such as stocks and bonds. To understand the flaws in that argument, one must first understand the types of investment risk faced by investors in investment companies, and how those risks differ from the risks faced by investors in other companies. What is it about investment companies that justifies their special regulation and, just as important, how did Congress structure the Investment Company Act to cover investment companies but not ordinary business corporations?

Investors in investment companies face two general types of risk. First, the investor is purchasing an interest in a company—the investment company's securities. Like any other corporate investor, an investment company investor faces the risk that the management of that company will mismanage the company's assets or divert those assets for personal gain. Call this corporate-level risk *primary investment risk*. The second type of risk faced by an investment company investor is that associated with the securities purchased by the investment company. The investment company will use the investor's money to purchase the securities of other companies, and those securities will fluctuate in value, in part due to what the managers of those other companies do. The risk associated with those securities is borne indirectly by the investment company's security holders. Call this risk *secondary investment risk*. Primary investment risk is internal to the investment company—it results mainly from the actions of the investment company's own management. Secondary investment risk is, at least in part, external. The securities owned by the investment company will fluctuate in

value for reasons external to the investment company.

Investments in any company, whether it is an investment company or an ordinary operating business, involve both primary and secondary investment risk. No matter what assets a company controls, there is a primary investment risk that those assets will be mismanaged or misappropriated. Corrupt managers can steal widgets just as they can steal securities. All types of companies also involve at least some secondary investment risk. Whether a company owns securities or widget-making machinery, the market value of those assets can fluctuate for exogenous reasons.

Investment companies are regulated not because they involve a different *type* of risk than other companies, but because they involve a greater *degree* of risk. On average, because of the nature of the assets an investment company owns, the magnitude of investment risks is greater in investment companies than in ordinary operating companies. Securities, because of their liquidity and negotiability, are more easily diverted by managers than many other assets. Because of this, an investor's primary investment risk is greater in an investment company. And securities fluctuate more in value for external reasons than many other assets. Thus, an investor's secondary investment risk is greater in an investment company.<sup>175</sup>

The SEC's policy argument for expanding the Investment Company Act definition of "security" recognizes the risk differential between investment companies and other companies. The SEC essentially argues that the assets of a company should be treated as "securities" whenever the level of risk to investors approaches that of a typical investment company. But the SEC is simply wrong: the risk to fund investors is less for instruments such as certificates of deposit and commercial notes than for true securities.

The courts' restrictive reading of the term "security" under the other federal securities statutes is due, at least in part, to the reduced risk of instruments such as certificates of deposit and commercial notes.<sup>176</sup> For example, a person purchasing a federally insured certificate of deposit from a federally regulated bank bears less risk than someone purchasing common stock because the federal regulation and insurance protects the purchaser of the certificate of deposit. That reduced risk carries over into the investment company context. An individual investing in a fund holding certificates of deposit bears less risk than an individual investing in a fund holding common stocks. The secondary investment risk is less because of

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<sup>175</sup> The liquidity of securities reduces this second risk differential to some extent. It is much easier to unload an investment in securities than to unload an investment in widget-making machinery.

<sup>176</sup> See, e.g., *Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990) (stating that one factor in determining whether a note is a security is "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument"); *Marine Bank v. Weaver*, 455 U.S. 551, 558-59 (1982). Of course, some particular certificate of deposit or note might be more risky than a particular stock, but, on average, stocks are riskier.



the federal insurance and bank regulation. The primary investment risk borne by an investment company investor may also be less for funds investing in at least some instruments that are not true securities. For example, a note is less likely to be a security under the *Reves* test if there is no secondary trading market for the note,<sup>177</sup> and the lack of a secondary market also makes it more difficult for an investment company's managers to misappropriate the note. Traditional securities like stocks or bonds, for which there are active trading markets, would be easier to convert into cash and misappropriate than such a note.

Obviously, it is riskier to hold certificates of deposit and commercial notes through an intermediary like an investment fund than it is to own them directly, but that does not bolster the SEC's argument. It is riskier to hold any asset, security or not, through an intermediary. The relevant comparison is between true securities held through a fund and other instruments held through a fund. The risk associated with the instruments that the SEC wants to expand the "security" net to include is, on average, less than the risk associated with true securities. Therefore, even if risk is relevant in determining whether an instrument is a "security" under the Investment Company Act, the SEC's argument that the risk to investment company investors is the same is simply wrong.

## 2. *Overbreadth*

Surprisingly, the SEC staff has sometimes ignored its own "liquid, negotiable asset" rationale when it proves too constricting. Its response to Harrell International's no-action request<sup>178</sup> is a prime example of this overreaching. Harrell International's main asset was a \$3.1 million note secured by the assets of another company, whose financial condition was shaky. Harrell argued that it should not be treated as an investment company, because the note was neither readily negotiable nor liquid, and therefore was not a security.<sup>179</sup> The SEC staff denied Harrell's no-action request, and its denial rejects the SEC's own rationale for treating such instruments as securities: "[T]he fact that a security is not readily marketable does not make it any the less a security for purposes of the 1940 Act."<sup>180</sup> Thus, it appears that the SEC staff is willing to use the "liquidity and marketability" test to broaden the definition of security and expand its jurisdiction, but it is not willing to be consistent and accept the contrary argument that illiquid and unmarketable instruments are not securities.

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<sup>177</sup> See *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990) (stating that one relevant factor in determining whether a note is a security is whether there is "common trading for speculation or investment") (citation omitted).

<sup>178</sup> See Harrell Int'l, Inc., *supra* note 60.

<sup>179</sup> See *id.* at \*1, \*3.

<sup>180</sup> *Id.* at \*5; see also Gruson & Jackson, *supra* note 52, at 209–12 (criticizing the SEC position that the commercial loans of foreign banks are securities, because those loans are not liquid or readily negotiable).

### 3. *The Legitimacy of Policy-Based Arguments*

The strongest objection to the SEC's policy argument is that it misconstrues the structure of the Investment Company Act. In determining what "security" means, the SEC and its staff are not writing on a blank slate; they are interpreting a statute. They are bound by the terms of that statute, no matter what policy concerns they may have.

The essence of the SEC argument is that, if the underlying assets owned by a company are liquid and negotiable, they must be treated as securities so investors can be protected. But many corporate assets are relatively liquid and present an opportunity for management misappropriation—not just securities and financial instruments, but also cash, accounts receivable, some types of intellectual property, and many types of inventory. Congress in the Investment Company Act did not choose to regulate the risks associated with all liquid assets, even though the policy concerns are similar; it chose to regulate only the risks associated with a company's investment in *securities*. And it used a familiar definition to limit the scope of its regulation—the definition of security that already appeared in both the Securities Act and the Exchange Act. Only investments in "securities" trigger the Investment Company Act.<sup>181</sup> Redefining the term "security" so that it includes every transaction where investor protection is needed does an injustice to the language in the definitional section and deprives regulated parties of fair warning about when the Act applies.<sup>182</sup>

Rewriting the statute so that the definition of "security" covers all of the investment risk that currently concerns the SEC is a job for Congress, not the SEC.<sup>183</sup> If Congress believes the current definition of "security" is insufficient to protect investors from investment risks, Congress may broaden the definition. Without direction from Congress, the SEC may not.

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<sup>181</sup> For example, Chang states:

Since only securities can trigger the securities acts, then, at least in part, a security must be an item or instrument defined by sources of law outside the securities acts. Otherwise, if the goals of the regulatory acts defined the triggering concept of a security, then the acts would apply when a judge decided in hindsight that the act's goals would be served thereby, rather than when the parties activated the regulatory scheme by use of a security.

Chang, *supra* note 139, at 421 (footnote omitted).

<sup>182</sup> *See id.* at 422–23.

<sup>183</sup> The Supreme Court may itself have rewritten the federal securities statutes by restricting the definition of "security" to something narrower than what Congress intended in 1933, 1934, and 1940, but judicial infidelity to Congressional wishes does not excuse administrative infidelity. The definitions in all of the statutes are functionally identical and, once the courts have construed those definitions, the SEC's recourse is either to follow the statute as construed or seek congressional expansion.

In recent cases, the Supreme Court has not been receptive to the use of policy arguments and even legislative intent to override the language of the federal securities statutes. The Court has indicated that the statutory language itself is “the starting point in every case involving construction of a statute.”<sup>184</sup> Congressional intent is important, but “[t]he ascertainment of congressional intent . . . must rest primarily on the language [of the particular section].”<sup>185</sup> The federal securities laws cannot be read “more broadly than [their] language and the statutory scheme reasonably permit.”<sup>186</sup>

The most recent example of a Supreme Court securities case rejecting policy arguments is *Central Bank v. Interstate Bank*.<sup>187</sup> In rejecting aiding-and-abetting liability for violations of Section 10(b) of the Exchange Act, the Court indicated that “[p]olicy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result ‘so bizarre’ that Congress could not have intended it.”<sup>188</sup>

Other cases have similarly rejected attempts to use policy arguments to overcome statutory language. In *Ernst & Ernst v. Hochfelder*,<sup>189</sup> for example, the SEC argued that liability under Section 10(b) of the Exchange Act should extend to negligent conduct. The SEC contended that this expansive view of Section 10(b) was consistent with “the overall congressional purpose in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them.”<sup>190</sup> Since the effect on investors was the same whether the conduct was negligent or intentional, the SEC argued that Congress “must have intended to bar all such practices and not just those done knowingly or intentionally.”<sup>191</sup> The Court rejected this argument because it was inconsistent with the statutory language: “[T]he Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning.”<sup>192</sup>

*Pinter v. Dahl*<sup>193</sup> rejected a similar type of argument. Pinter argued that expanding the meaning of “seller” in Section 12 of the Securities Act would

<sup>184</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)).

<sup>185</sup> *Central Bank v. First Interstate Bank*, 511 U.S. 164, 175 (1994) (quoting *Pinter v. Dahl*, 486 U.S. 622, 653 (1988)); see also *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1977).

<sup>186</sup> *SEC v. Sloan*, 436 U.S. 103, 116 (1978); see also *Central Bank*, 511 U.S. at 174; *Pinter*, 486 U.S. at 653; *Chiarella v. United States*, 445 U.S. 222, 234 (1980).

<sup>187</sup> 511 U.S. 164 (1994).

<sup>188</sup> *Id.* at 188.

<sup>189</sup> 425 U.S. 185.

<sup>190</sup> *Id.* at 198.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 199; see also *Central Bank*, 511 U.S. at 173–74 (approving this analysis).

<sup>193</sup> 486 U.S. 622 (1988).

protect investors and thereby serve the remedial purposes of the Act.<sup>194</sup> The Court acknowledged that policy concerns could be considered in construing the federal securities laws, but indicated that any policy analysis may not be conducted entirely apart from the statutory language.<sup>195</sup> The ultimate issue is one of congressional intent, and that intent must be ascertained primarily through the language of the statute.<sup>196</sup> The question is what Congress said in the statute, “not . . . whether this Court thinks it can improve upon the statutory scheme that Congress enacted into law.”<sup>197</sup>

The SEC’s policy argument in favor of broadening the Investment Company Act definition of “security” is hard to square with the identity of the definitions in the different statutes and, as we have seen, it is inconsistent with the Act’s legislative history. The Supreme Court’s treatment of policy arguments in securities cases has been uneven,<sup>198</sup> but the SEC’s attempt to expand the definition of “security” using a policy justification is inconsistent with the more recent cases cited above.

## VI. CONCLUSION

It is clear from the legislative history that Congress in 1940 intended the term “security” in the Investment Company Act to have exactly the same meaning that it had in the other federal securities statutes. No court has held to the contrary. Most courts simply assume that “security” means the same thing in all the federal securities statutes.

The SEC’s interpretation of the term “security” in the Investment Company Act shows that it is willing to overlook inconvenient legislative history and case law in order to further its policy goals. When the federal courts were defining “security” expansively under the Securities Act and the Exchange Act, the SEC and its staff were quite willing to piggyback on those interpretations for Investment Company Act purposes. When the courts, particularly the United States Supreme Court, began to narrow the definition under the Securities Act and

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<sup>194</sup> See *id.* at 652–53. According to the Court, Pinter based his argument solely on policy grounds and made no attempt to justify his position as a matter of statutory construction. See *id.* at 652.

<sup>195</sup> See *id.* at 653.

<sup>196</sup> See *id.*

<sup>197</sup> *Id.* (quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)).

<sup>198</sup> The result in *Marine Bank*, for example, ultimately rests on a policy conclusion: “It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws.” *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982). But the most prominent modern example of a policy-based securities opinion is probably *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723 (1975), holding that only purchasers or sellers of securities may sue under Section 10(b) of the Exchange Act. The majority opinion in that case contains several pages of policy discussion. See *id.* at 737–48.

the Exchange Act, the SEC abandoned its equivalence position, and, to preserve its Investment Company Act jurisdiction, suddenly “discovered” that the definition of security in the Investment Company Act was broader than the definitions in the other federal securities statutes. To support this sudden revelation, the SEC ignored the directly relevant legislative history and instead focused on general language about the dangers of liquid, easily negotiable investments: no matter what the language of the statute said, no matter how identical that language to the language in the other securities statutes, a broad interpretation of “security” was needed to prevent the evils the Investment Company Act regulates. When even that rationale has proven inconvenient, the SEC staff has rejected its own policy argument, extending the term “security” to instruments that are neither liquid nor easily negotiable.

The sole judicial authority for the SEC’s interpretation is the cryptic reference to “context” in footnote 11 of the *Marine Bank* opinion. The only statutory underpinnings for the SEC’s interpretation are the equally cryptic “context” language at the beginning of the Investment Company Act’s definitions section and, since 1982, the language implying that certificates of deposit are securities.

Perhaps the SEC is correct that “security” requires a broader definition under the Investment Company Act than under the other federal securities statutes. Certificates of deposit, commercial notes, and money market accounts may present dangers in this context not present in other contexts. If that is the case, the SEC should reach that result honestly by presenting its policy argument to Congress, not by stretching the Investment Company Act administratively beyond its intended scope.

