Missouri Law Review

Volume 43
Issue 4 *Fall 1978*

Article 11

Fall 1978

Securities Regulation--Investment Contracts and the Common Enterprise Requirement--Hirk v. Agri-Research Council, Inc.

Lloyd J. Bandy Jr.

present. In the absence of a writing, property should be found to have been transmuted very infrequently. The result in *Daniels* is not disturbing because only the ownership of cash was involved and the court obviously believed the wife had a right to her contributions. Unfortunately, the legal reasoning used to achieve that result may have created bad precedent. Continued misuse of the principle of transmutation might result in separate property other than cash being taken from its rightful owner. Consideration should be given to established gift and contract law in transmutation cases like *Daniels.*

CRAIG A. SMITH

SECURITIES REGULATION— INVESTMENT CONTRACTS AND THE COMMON ENTERPRISE REQUIREMENT

Hirk v. Agri-Research Council, Inc. [1]

Plaintiff Hirk was induced to enter into a trading agreement with Agri-Research Council, Inc., a company engaged in the management of discretionary commodity futures accounts.[2] Pursuant to this agreement,

1. 561 F.2d 96 (7th Cir. 1977).

2. In contrast to a stock market investor, a commodities futures investor does not actually purchase or sell commodities; he merely trades in commodity futures contracts. A futures contract obligates its holder to buy or sell a certain quantity of a specific commodity at a future date for a fixed price. These contracts are traded on futures exchanges via futures brokers or advisors. The purchaser of a commodity futures contract makes his profit by attempting to predict the rise or fall of commodity prices. To illustrate, assume that an investor purchases a futures contract which entitles him to buy a certain commodity at a fixed price. If before the delivery date of the contract the price of this specific commodity rises, the investor can reap a profit in one of two ways. He may take actual delivery of the commodity and sell it over the market at its now higher price, or, as is more likely, he may merely sell his futures contract over the exchange to another investor. On the other hand, if the investor purchases a futures contract to sell, he is gambling that the price of the underlying commodity will go down. If this occurs, the other party to the contract is obligated to take delivery of the commodity for the previously agreed-upon price even though the commodity is being sold more cheaply on the open market. Of course, the purchasing party may avoid taking delivery of the commodity by making an offsetting transaction (*i.e.,* by purchasing a contract to sell) before the delivery date.

Hirk deposited $10,000 in an account with the defendant and executed a power of attorney authorizing the company's vice-president to trade for his account. The trading agreement stipulated that the company was entitled to twenty-five per cent of the monthly profits accrued in the account as compensation for its management services. Using the $10,000 for margin deposits,[3] the defendant effected numerous transactions in Hirk's account and losses of nearly $28,000 allegedly resulted. Hirk subsequently initiated suit, claiming that he was fraudulently induced into opening the account with the defendant. He further contended that the discretionary trading agreement was in essence a security[4] and that the defendant's failure to register the agreement with the Securities and Exchange Commission violated section 5 of the Securities Act of 1933.[5] The district court dismissed Hirk's complaint and the Seventh Circuit affirmed,[6] holding that without a showing of a pooling of funds by mul-

---

See generally Smith, *Commodity Futures Trading*, 25 DRAKE L. REV. 1, 4–5 (1975); Note, *The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Act of 1974*, 73 MICH. L. REV. 710, 711–12 (1975).

In the typical futures trading account situation the individual investor determines which futures contracts he will buy or sell. However, in the discretionary account situation the investor authorizes his broker to make all decisions concerning which contracts to trade in.

3. A margin deposit is the amount of money which a commodity broker is required to deposit with the futures exchange in order to guarantee that his customer will fulfill his obligations under the futures contract. *See* Smith, *supra* note 2, at 13–14.

4. A security is defined in § 2(1) of the Securities Act of 1933 as "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security'. . . ." 15 U.S.C. § 77b(1) (1970). Hirk's complaint alleged that the discretionary account constituted a security on the ground that it was either a "certificate of interest or participation in [a] profit-sharing agreement" or an "investment contract." However, as the court correctly pointed out, most courts have made no real distinction between these two types of securities. 561 F.2d at 102. As a practical matter, the terms are used interchangably and treated as possessing identical elements. *See* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 138 (1971).

5. 15 U.S.C. § 77e (1970). A prima facie violation of § 5 is established by showing that a registration statement was not in effect at the time securities were offered or sold to the public through use of the mails or the facilities of interstate transportation. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 686 (5th Cir. 1971); Swank Fed. Credit Union v. C. H. Wagner & Co., 405 F. Supp. 385, 387–88 (D. Mass. 1975).

6. Hirk's complaint charged in the alternative that the defendant had violated § 4b of the Commodity Exchange Act of 1936, 7 U.S.C. § 6b (1970), which prohibits any fraudulent or deceptive practices or attempts to defraud or deceive "in or in connection with" commodity futures transactions. The appellate court reversed the lower court's dismissal of this portion of Hirk's complaint and held that he had stated a valid cause of action under the Commodity Exchange Act. 561 F.2d at 103–04. In this respect, the *Hirk* opinion is in line with the decisions

tiple investors the "common enterprise" requirement for an investment contract security was not satisfied.[7]

Although it is generally accepted that commodity futures contracts themselves are not securities[8] and thus need not be registered under the federal securities laws,[9] two distinct lines of authority have emerged as to whether a discretionary trading account in commodities futures constitutes an investment contract and hence a security.[10] The split among the cases primarily has resulted from a disagreement over what meaning to attribute to the words "common enterprise" which appear in the Supreme Court's definition of an investment contract in *SEC v. W. J. Howey Co.*[11] This note will analyze the differing interpretations of common enterprise and then attempt to draw a conclusion as to which interpretation is more consonant with the purposes of the securities laws.

The basic test for an investment contract under the federal securities laws[12] was enunciated by the United States Supreme Court in *Howey.* In

---

of other courts which have held that a private right of action exists for violations of § 4b even though there is no express statutory provision granting a private right for damages. *See* Booth v. Peavey Co. Commodity Servs., 430 F.2d 132, 133 (8th Cir. 1970) (similar right under § 6d); Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764, 766 (S.D.N.Y. 1972); Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 710 (D. Minn. 1968); Goodman v. H. Hentz & Co., 265 F. Supp. 440, 447 (N.D. Ill. 1967).

7. 561 F.2d at 101.

8. *See, e.g.,* SEC v. Commodity Options Int'l. Inc., 553 F.2d 628, 632 (9th Cir. 1977); E. F. Hutton & Co. v. Lewis, 410 F. Supp. 416, 418 (E. D. Mich. 1976); Golding v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 385 F. Supp. 1182, 1183 (S.D.N.Y. 1974); Berman v. Dean Witter & Co., 353 F. Supp. 669, 671 (C.D. Cal. 1973); Schwartz v. Bache & Co., 340 F. Supp. 995, 998–99 (S.D. Iowa 1972).

9. Transactions in commodity futures contracts are, however, subject to regulation under the Commodity Exchange Act of 1936, 7 U.S.C. §§ 1–17 (1970).

10. The courts generally agree that a nondiscretionary trading account (*i.e.,* one in which the investor determines which futures contracts to buy and sell) is not an investment contract. *See, e.g.,* E. F. Hutton & Co. v. Burkholder, 413 F. Supp. 852, 860 (D.D.C. 1976); Berman v. Dean Witter & Co., 353 F. Supp. 669, 671 (C.D. Cal. 1973); McCurnin v. Kohlmeyer & Co., 340 F. Supp. 1338, 1341 (E.D. La. 1972), *aff'd,* 477 F.2d 113 (5th Cir. 1973). At least one court, however, had held that even if there is no formal agreement designating the plaintiff's commodities account as discretionary, an investment contract nonetheless exists if the defendant has such control over the account that profits, if any, will result from his efforts alone. Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764, 765 (S.D.N.Y. 1972).

11. 328 U.S. 293 (1946).

12. The *Howey* definition of an investment contract also has been adopted by numerous state courts. *See, e.g.,* Gallion v. Alabama Mkt. Centers, Inc., 282 Ala. 679, 213 So. 2d 841 (1968); Georgia Mkt. Centers, Inc. v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969); State v. Hodge, 204 Kan. 98, 460 P.2d 596 (1969); Garbo v. Hilleary Franchise Systems, Inc., 479 S.W.2d 491, 497 (Mo. App., D. St. L. 1972). A number of state courts, however, have rejected the *Howey* formula in

that case small parcels of land in citrus groves were sold to members of the public. Contemporaneously with the sale, the purchasers were offered an opportunity to enter into a service agreement with a subsidiary of the vendor. This agreement vested in the service company complete control over the purchaser's acreage and "full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops."[13] Upon considering the circumstances surrounding the entire transaction, the Court held that this arrangement was an investment contract under the following test:

> The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value.[14]

Although the Supreme Court has reiterated its support for the *Howey* test on several occasions,[15] it has done little to clarify the scope or the meaning of the test. As a result, the lower federal courts have reached conflicting conclusions as to the meaning of certain segments of the test. The words "common enterprise" have given the courts special difficulty.[16] A number of courts have held that a common enterprise is a

---

favor of the "risk capital" test. Under the "risk capital" test the critical inquiry is whether the investor's money is subjected to the risks of an enterprise over which he has no managerial control. *See, e.g.,* Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 13 Cal Rptr. 186, 361 P.2d 906 (1961); State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971); State *ex rel.* Healy v. Consumer Business System, Inc., 5 Or. App. 19, 482 P.2d 549 (1971). *See also* Coffey, *The Economic Realities of a "Security": Is There a more Meaningful Formula?,* 18 CAS. W.L. REV. 367 (1967).

13. 328 U.S. 293, 296 (1946).

14. *Id.* at 301.

15. *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975); Tcherepnin v. Knight, 389 U.S. 332, 338–39 (1967).

16. The courts also have been troubled by the terms "investment of money" and "profits to come solely from the efforts of others." As to the former phrase, there is a general consensus that the investment need not actually be in cash; it is sufficient if the investor contributes something of monetary value. Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities,* 25 HASTINGS L.J. 219, 236 (1974); Long, *supra* note 4, at 161. However, the courts have been unable to agree upon the interpretation to be given the words "solely from the efforts of others." Some courts have literally construed the word "solely" so as to preclude the finding of an investment contract if the investor participates in the management or control of the enterprise. Gallion v. Alabama Mkt. Centers, Inc., 282 Ala. 679, 213 So. 2d 841 (1968); Georgia Mkt. Centers, Inc. v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969). Other courts have rejected this literal interpretation and have held that this element of the *Howey* test is satisfied if "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973). *Accord,* SEC v. Koscot In-

relationship between multiple investors in which their monies or investment funds are pooled in an enterprise controlled by the promoter or a third party. These courts maintain that a pooling of funds or a pro rata sharing of the profits of the venture is a prerequisite to the existence of a common enterprise as that term was used in *Howey.*[17] This view is sometimes called the "horizontal" approach, *i.e.,* the commonality required is among investors similarly situated.[18] Several other courts, however, have construed common enterprise to mean an interrelationship between the investor and the promoter whereby the investor provides the capital for a mutual venture controlled by the promoter. Under this "vertical" approach, the commonality requirement is satisfied whenever the investor's financial interests are "inextricably tied" to the efforts of the promoter.[19] Although the vertical approach probably has been more widely accepted,[20] the horizontal approach also has a substantial following[21] and reflects the position adopted in *Hirk.*

In *Hirk* the court principally relied on their previous decision in *Milnarik v. M-S Commodities, Inc.,*[22] which held that both multiple investors and a pooling of funds or sharing of profits were required in order to have a common enterprise. In *Milnarik,* which involved essentially the same fact situation as presented in *Hirk,* the court ruled that a discretionary commodities trading account was not a security on the

---

terplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974); Jenson v. Continental Financial Corp., 404 F. Supp. 792, 804–05 (D. Minn. 1975).

17. *See, e.g.,* Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972); Glazer v. National Commodity Research and Statistical Servs., Inc., 388 F. Supp. 1341 (N.D. Ill. 1974), *aff'd,* 547 F.2d 392 (7th Cir. 1977); Stevens v. Woodstock, Inc., 372 F. Supp. 654 (N.D. Ill. 1974); Stuckey v. duPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd without opinion,* 491 F.2d 752 (3d Cir. 1973), *cert. denied,* 416 U.S. 994 (1974).

18. Securities Investor Protection Corp. v. Associated Underwriters, Inc., 423 F. Supp. 168, 178 (D. Utah 1975). *See also* Hannan & Thomas, *supra* note 16, at 236–37.

19. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974). *See also* Hannan & Thomas, *supra* note 16, at 236–37.

20. *See, e.g.,* Hector v. Wiens, 533 F.2d 429 (9th Cir. 1976); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 416 U.S. 821 (1973); Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), *cert. denied,* 391 U.S. 905 (1968); Plunkett v. Francisco, 430 F. Supp. 235 (N.D. Ga. 1977); Jones v. International Inventors Inc. East, 429 F. Supp. 119 (N.D. Ga. 1977); Securities Investor Protection Corp. v. Associated Underwriters, Inc., 423 F. Supp. 168 (D. Utah 1975); Swank Fed. Credit Union v. C. H. Wagner & Co., 405 F. Supp. 385 (D. Mass. 1975); SEC v. Brigadoon Scotch Distribs., 388 F. Supp. 1288 (S.D.N.Y. 1975); SEC v. Lake Havasu Estates, 340 F. Supp. 1318 (D. Minn. 1972).

21. *See* cases cited note 17 *supra.*

22. 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972).

ground that the discretionary arrangement merely created an agency-for-hire relationship.[23] Although the defendant managed discretionary accounts for a number of investors, the court found that its relationship with each investor was that of agent and principal because each account was unitary in nature and the success or failure of one account had no direct impact on the others.[24]

Despite the fact that *Milnarik* did not directly address the pooling issue, the *Hirk* court stated that it was apparent that *Milnarik* was based on the assumption that there must be a pooling or sharing of funds in order for a common enterprise to exist.[25] The court then went on to hold that a showing of ostensible pooling did not meet the commonality requirement; there must be an *actual* pooling of investments. The court reached this result in response to the plaintiff's allegation that his monies and those of other investors were treated as if commingled because the defendant made substantially similar transactions in all the accounts, and profits and losses for all accounts flowed at a uniform rate.[26] The court ruled, however, that this was insufficient to fulfill the pooling requirement because it did not overcome the fact that the accounts were segregated and that each had a success or failure rate independent of the others.

Hirk's emphasis on a pooling of investments and a sharing of profits appears to be misplaced in light of the facts of the *Howey* case. Although in *Howey* the investors' funds apparently were commingled by the defendant, the Supreme Court did not indicate that this was a determinative factor in its decision. Instead, the Court stressed the extent of the defendant's control over the enterprise[27] and the fact that the investors' returns on their investments hinged upon the effectiveness of the defendant's management of the enterprise.[28] Furthermore, although *Hirk* and other cases which purport to follow *Howey* have stated that a pro rata sharing of profits among investors is critical to a finding of a common enterprise,[29] an examination of *Howey* clearly shows that no sharing

23. *Id.* at 277.

24. *Id.* at 276–77. The court further stated that even though the various customers were represented by a common agent, "they were not joint participants in the same investment enterprise." *Id.*

25. 561 F.2d at 101.

26. *Id.*

27. *See* note 13 and accompanying text *supra*. In addition, the Court noted that investors could neither market the harvest from their land nor pick specific fruit without first obtaining the service company's consent. 328 U.S. at 296.

28. The Court found that the investors were "predominantly business and professional people who lack[ed] the knowledge, skill and equipment necessary for the care and cultivation of citrus trees." 328 U.S. at 296. "A common enterprise managed by respondents or third parties with adequate personnel and equipment [was] therefore essential if the investors [were] to achieve their paramount aim of a return on their investments." *Id.* at 300.

29. *See* cases cited note 17 *supra*.

of profits occurred in that case. Each investor's profit depended solely upon the amount of fruit harvested from his individual and identified plot.[30]

Other courts confronted with the question whether a discretionary commodities trading account possesses the commonality necessary to qualify as an investment contract have reached conclusions contrary to that reached in *Hirk*.[31] In *SEC v. Continental Commodities Corporation*[32] the district court relied on *Milnarik* in ruling that such an arrangement was not a common enterprise because the accounts of the individual investors were unrelated and there was no proportionate sharing in a mutual fund composed of the investors' profits. The Fifth Circuit reversed and expressly rejected both the pooling concept and the *Milnarik* view.[33] The court criticized "the elevation of a pooling ingredient to exalted status in inquiries concerning a common enterprise,"[34] and repudiated the notion that commonality requires a pro rata sharing of profits among investors. The court stated that the more significant factor was whether the success of the enterprise as a whole and the contributor's investment individually were contingent upon the expertise of those seeking the investment.[35]

---

30. The Court did state that all the elements of a profit-seeking venture were present in *Howey* because "[t]he investors provide the capital and share in the earnings and profits [while] the promoters manage, control and operate the enterprise." 328 U.S. at 300. However, this contradicts the Court's previous finding that each investor's net profit was based on the amount of fruit harvested from his individual tract of land. *Id.* at 296. Moreover, although the fruit from all the citrus groves was pooled for marketing purposes, the lower court specifically found

> that each purchaser looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole. It is quite clear, too, that each purchaser's income was in no sense dependent upon the purchase or development of other tracts than his own except in the sense that as grove owners generally prospered, each owner of a grove would.

SEC v. W. J. Howey Co., 151 F.2d 714, 717 (5th Cir. 1945), *rev'd,* 328 U.S. 293 (1946).

31. *See, e.g.,* SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Ramsey v. Arata, 406 F. Supp. 435 (N.D. Tex. 1975); Rochkind v. Reynolds Securities, Inc., 388 F. Supp. 254 (D. Md. 1975); Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968); Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967).

32. 497 F.2d 516 (5th Cir. 1974).

33. *Id.* at 521.

34. *Id.* at 522.

35. *Id.* at 523–24. The court also pointed out that because the investors lacked the business acumen possessed by the promoters, they were forced to "inexorably rely on Continental Commodities' guidance for the success of their investment." *Id.* at 522.

This view—that a common enterprise exists whenever the fortunes of the investor are interwoven with and dependent upon the efforts and success of the promoter—not only has gained wide acceptance,[36] but is also more consistent with both the remedial purposes of the securities laws[37] and *Howey*[38] than is the *Hirk-Milnarik* approach. In addition, the Supreme Court's recent decisions in *Tcherepnin v. Knight*[39] and *United Housing Foundation, Inc. v. Forman*[40] further support the vertical approach to the definition of common enterprise.

In the *Knight* case the Court held that withdrawable capital shares in a state savings and loan association were investment contracts.[41] The Court found that the plaintiffs were participants in a common enterprise because the success of the operation and the plaintiffs' profits depended upon the skill and efforts of the association's management. Moreover, the rate of return on the plaintiffs' investments was "tied directly to the amount of profits City Savings [made] from year to year. Clearly, then, [these] shares have the essential attributes of investment contracts as that term ... was defined in *Howey*."[42] In *Forman* the Court emphasized that even though an interest offered to the public might be labled a "stock," it did not necessarily follow that this interest was a security within the meaning of the federal securities laws. The distinguishing feature of a security transaction is "an investment whereby one parts with his money in the hope of receiving profits from the efforts of others."[43]

These decisions suggest that contrary to the view expressed in *Hirk*, the basic component of a common enterprise is not a pooling of funds

36. *See* cases cited note 20 *supra.*

37. It is well established that remedial legislation such as the federal securities laws "should be construed broadly to effectuate its purposes." Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). Further, in SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943), the Supreme Court stated that the term "security" was intended to encompass not only the obvious and commonplace, but also "[n]ovel, uncommon, or irregular devices ... if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts'. ..."

38. In *Howey* the Court stated that its definition of an investment contract embodied "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. at 229.

39. 389 U.S. 332 (1967).

40. 421 U.S. 837 (1975).

41. The plaintiff's complaint had alleged that a withdrawable capital share was a security as that term was defined in § 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1970). Although the statutory definition of a security under the 1934 Act differs slightly from the definition of a security under the 1933 Act, the Supreme Court held that for present purposes the coverage of the two Acts was virtually identical. 389 U.S. at 335–36.

42. *Id.* at 339.

43. 421 U.S. at 858.

by multiple investors, but rather the dependency of the investor's fortunes upon the ability of the promoter or of a third party to make the undertaking a success.[44] Therefore, there is no apparent reason why a common enterprise cannot exist between a single investor and a single promoter. Indeed, this conclusion was reached in *Jones v. International Inventors Incorporated East.*[45] In *Jones* the plaintiff responded to an advertisement in which the defendant offered to evaluate the feasibility of inventions for $250. The defendant advised the plaintiff that if his invention received a positive evaluation, the defendant would undertake to market the invention and share the profits with the plaintiff. When the defendant refused to take any action after the agreement was entered into, the plaintiff brought suit alleging that this transaction constituted an investment contract. After first noting that the state of the law concerning what comprises a common enterprise was somewhat unsettled, the court concluded that it was unnecessary for the plaintiff to show a pooling of funds or pro rata sharing of profits in order to maintain his securities claim.[46] The court held that the commonality requirement may be fulfilled by showing that the fate of the individual's investment was dependent upon the effectiveness of the promoter's efforts.[47] That burden had been satisfied because the plaintiff's success was obviously tied to the success of the defendant's promotional and marketing efforts.[48]

44. This same conclusion was intimated in *Howey. See* text accompanying notes 27 & 28 *supra.*

45. 429 F. Supp. 119 (N.D. Ga. 1976). *Contra,* Sunshine Kitchens v. Alanthus Corp., 403 F. Supp. 719 (S.D. Fla. 1975).

46. "It is not significant whether the profits of the enterprise will be pooled and distributed among all the investors and the promoter, but rather the emphasis should be on 'the uniformity of impact of the promoter's efforts' on the fate of all the investors." 429 F. Supp. 119, 123 (N.D. Ga. 1973).

47. It may be difficult to determine whether the relationship between two individuals is that of investor and promoter or that of principal and agent. The fundamental distinction is that the investor/promoter situation gives rise to a common enterprise because the promoter makes those essential managerial decisions that determine the success or failure of their venture. On the other hand, no common enterprise exists in a principal/agent relationship because "the fortunes of the investor, by virtue of his right to control his agent—the promoter—are dependent solely upon the investor's personal efforts." Newton, *What is a Security?: A Critical Analysis,* 48 MISS. L.J. 167, 177 (1977). It is this notion of dependency that governs the finding *vel non* of a common enterprise. Factors which tend to establish the requisite dependency include the personal expertise of the person asked to finance the undertaking and his chances for profit should he endeavor to make the venture a success on his own. If the investor has little or no individual expertise in the subject matter of the investment and therefore must rely heavily upon the promoter for the success of the enterprise, the conclusion is strong that a common enterprise exists. *Id.*

48. *See also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974). In that case the court stated that "the requisite commonality is evidenced by the fact that the fortunes of all investors are inextricably tied to the efficacy" of the promoter's efforts. *Id.* at 479.

The rationale of the *Hirk* decision is further weakened by the fact that although the court stubbornly defended the pooling concept, it did not adequately explain why a pooling of funds by multiple investors is so critical to the existence of a common enterprise. The court simply stated that *Milnarik* had assumed that *Howey* required such a pooling and it was unwilling to overrule that decision.[49] However, as previously mentioned, *Howey* placed little, if any, emphasis on the pooling concept as amplified in *Milnarik.*[50] Even assuming that *Hirk* was correct in holding that a common enterprise requires a pooling of funds, the court was not justified in differentiating between actual pooling and ostensible pooling.[51] While the accounts may have been technically distinct, if as a practical matter they were managed as one large discretionary account there was no basis for requiring the funds to be actually commingled. Analytically, the impact on the investors' fortunes is the same whether identical transactions are simultaneously effected in numerous separate accounts or one transaction is effected in an account composed of the contributions of multiple investors. Yet under the reasoning adopted by the *Hirk* court, the former situation would not constitute an investment contract, while the latter presumably would.[52]

Finally, in mechanically sustaining the restrictive *Milnarik* test the court ignored the economic factors that are essential to the proper identification of a security. If the court had undertaken to consider the economic realities of a discretionary commodities trading account, it would have realized that such an arrangement possesses all the inherent evils the securities laws were intended to combat.[53] It is well established that the

---

49. 561 F.2d at 101.

50. *See* text accompanying notes 27 & 28 *supra.*

51. "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946).

52. *But see* Arnold v. Bache & Co., 377 F. Supp. 61 (M.D. Pa. 1973), where the court held that an investment contract did not exist even though the defendant controlled a discretionary trading account funded by multiple investors. Relying on *Milnarik,* the court found that in essence the defendant was merely managing a single unitary account which had been opened by joint investors. *Id.* at 63–64.

53. Congress enacted the federal securities provisions to remedy the practices and abuses which precipitated the stock market crash of October 1929. To correct these abuses, Congress sought to implement a two-fold policy. Initially, an attempt was made to place investors on an equal footing with respect to investments decisions through full and fair disclosure of all relevant information concerning the future of the issuer and the value of the offered security. . . . Also, Congress attempted to prevent further exploitation of the public by misrepresentation through the sale of unsound, fraudulant and worthless securities. To fully implement these policies, the federal courts have placed substance over form to analyze the economic realities underying a given transaction. In doing so, the term

particular form a transaction takes is not nearly as important as "the determination of who, in reality, bears the principal risk of loss."[54] Where a scheme such as that presented in *Hirk* exists, there can be no doubt that the person who provides the capital for the account bears this risk. Consequently, the courts should not be reluctant to find that this type of arrangement is encompassed by the definition of a security and that the individual persuaded into financing this enterprise is entitled to the protection of the securities laws.

LLOYD J. BANDY, JR.

"security" has been expanded beyond its traditional definition. (footnotes omitted)

Newton, *supra* note 47, at 168–69.

54. Hannan & Thomas, *supra* note 16, at 242. *See generally,* Coffey, *supra* note 12, at 375 (risk to initial investment is the single most important economic characteristic which distinguishes a security from the universe of other transactions); Long, *Commodity Options—Revisited,* 25 DRAKE L. REV. 75, 87 (1975) (particular form of transaction is virtually irrelevant; test for "securitiness" based on economic substance of transaction). *See also* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), where the Supreme Court stated that "in searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality."