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# Notes: Securities Law — Uncollateralized Promissory Notes Are Considered "Securities" to Be Regulated under Federal Securities Laws. *Reves v. Ernst & Young*, 494 U.S. 56 (1990)

Sheryl N. Stephenson  
*University of Baltimore School of Law*

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SECURITIES LAW - UNCOLLATERALIZED PROMISSORY NOTES ARE CONSIDERED "SECURITIES" TO BE REGULATED UNDER FEDERAL SECURITIES LAWS. *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

I. INTRODUCTION

Often, amid the intricate passages of federal securities regulation,<sup>1</sup> an important term or phrase escapes precise formulation.<sup>2</sup> Undoubtedly, the definition of a security contained in the securities acts<sup>3</sup> represents just such a passage. Before *Reves v. Ernst & Young*,<sup>4</sup> the Supreme Court had declined to address the issue of whether notes<sup>5</sup> are securities.<sup>6</sup> This allowed federal circuit courts to create and

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1. In this casenote, "securities regulation" or the "securities acts" refer to both the Securities Act of 1933, 15 U.S.C.A. §§ 77a-77aa (West 1988 & Supp. 1991) [hereinafter 1933 Act] and the Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78a-78kk (West 1988 & Supp. 1991) [hereinafter 1934 Act], as well as the applicable rules and regulations of each Act. The term "security" refers to the investment instruments which are regulated by the Security Act of 1933 or the Securities Exchange Act of 1934.
  2. See *United States v. National Ass'n of Sec. Dealers*, 422 U.S. 694, 720 (1975) (securities laws are interpreted in a manner most conducive to the effectuation of the statute's goals); *SEC v. National Sec. Inc.*, 393 U.S. 453, 466 (1969) (meaning of particular phrases in securities laws must be determined in context); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (the 1934 Act is remedial legislation which should be broadly construed).
  3. 15 U.S.C.A. §§ 77b(1) & 78c(a)(10) (West 1988 & Supp. 1991).
  4. *Robertson v. White*, 635 F. Supp. 851 (W.D. Ark. 1986), *rev'd sub nom. Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1988), *rev'd sub nom. Reves v. Ernst & Young*, 494 U.S. 56 (1990).
  5. For purposes of this casenote, the term "note" means an instrument commonly defined as a written promise to pay a specified amount to a certain entity either on demand or on a specified date. See J. DOWNES & J. GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* (1985).  
At common law, several cases attempted to define the term "note." See, e.g., *Kirkland v. Bailey*, 115 Ga. App. 726, 728, 155 S.E.2d 701, 703 (1967) ("[t]he word 'note' is defined as a written paper acknowledging a debt and promising payment"); *Bates-Crumley Chevrolet Co. v. Brown*, 141 So. 436, 439 (La. 1932) ("A note is a written engagement or promise to pay a certain sum of money at a time specified. It is the evidence of an obligation to pay."). See also Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233, 236 n.13 (1976) [hereinafter, Comment, *Notes as Securities*].
  6. See, e.g., *Futura Dev. Co. v. Centex Corp.*, 761 F.2d 33 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985); *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *C.N.S. Enters., Inc. v. G. & G. Enters., Inc.* 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

apply their own tests to determine whether a note is a security subject to federal regulation.<sup>7</sup> A variety of tests emerged from the federal circuits leading the Supreme Court in *Reves* to attempt to define the scope of the term in the context of notes.<sup>8</sup>

In *Reves*, the Eighth Circuit determined that the demand promissory notes in question were not securities because they lacked the characteristics of a security.<sup>9</sup> The Supreme Court reversed, holding that the demand notes were subject to federal securities regulation. The Court concluded that to hold otherwise would be inconsistent with congressional intent in enacting the securities laws.<sup>10</sup>

In its decision, the Court not only established the test for determining whether a note instrument is a "security" under the securities acts, but it also found that the promissory demand note at issue did not fall within the exemption under federal securities laws<sup>11</sup>

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7. Most federal courts agree that some notes definitely do not fall under securities regulation, such as notes securing home mortgages. On the other hand, notes issued as investments to the public in order to raise capital are usually held to be securities. Difficulty arises when attempting to develop a practical test for determining the status of notes that fall between these two obvious extremes. See Note, *The Economic Realities of Defining Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 34 U. FLA. L. REV. 400, 403 (1982) [hereinafter Note, *The Economic Realities of Defining Notes as Securities*]; see also Hammett, *Any Promissory Note: The Obscene Security, A Search for the Non-Commercial Investment*, 7 TEX. TECH L. REV. 25, 26 (1975) (tests used by the courts to define whether a note is a security are subjective and impractical). See *infra* notes 37-66 and accompanying text for discussion of the various tests applied by the federal circuit courts of appeals.
  8. Prior to the *Reves* decision, no common test was employed by the circuits to determine whether a note instrument was a security. See *infra* notes 37-66 and accompanying text for a discussion of the various tests applied. In order to avoid these problems, the Supreme Court applied a specific test in order to clarify what types of notes would *not* be considered to have the characteristics of securities. See *infra* notes 98-108 and accompanying text.
  9. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 52 (8th Cir. 1988), *rev'd sub nom. Reves v. Ernst & Young*, 494 U.S. 56 (1990). The Eighth Circuit applied the test developed in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (known as the *Howey* test) and found that the demand nature of the notes was "very uncharacteristic of a security." *Id.* Thus, the appellate court concluded that the notes were not securities within the meaning of either the federal or Arkansas securities laws. *Id.* at 54-55.
  10. *Reves*, 494 U.S. at 73. The application of the *Howey* test to notes was rejected by the Supreme Court, finding that the test was designed primarily for investment contracts and not notes. *Id.* at 64-67.
  11. In § 3(a)(3) of the 1933 Act, "[a]ny note, draft, bill of exchange, or bankers' acceptance . . . which has a maturity at the time of issuance of not exceeding nine months" is exempted from the provisions of the Act. 15 U.S.C.A. § 77c(a)(3) (West 1988 & Supp. 1991). However, in § 3(a)(10) of the 1934 Act, "[t]he term 'security' . . . shall not include currency or any note, draft, bill of

for notes with a maturity<sup>12</sup> exceeding nine months at the time of issuance. Although the determination of what test to apply will create uniformity, this test, as well as the plurality's<sup>13</sup> decision as to the maturity issue, creates more problems than it purports to resolve.

## II. BACKGROUND

### A. *The Securities Acts*

After the collapse of the stock market in 1929, Congress<sup>14</sup> enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 to bolster investor confidence in the securities markets by providing federal protection against fraudulent, deceptive and manipulative practices, which were thought to have contributed to the collapse.<sup>15</sup>

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exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months." 15 U.S.C.A. § 78c(a)(10) (West 1988 & Supp. 1991).

12. The term "maturity" refers to the date on which the principal amount of a debt instrument becomes due and payable. See DOWNES & GOODMAN, *supra* note 5.
13. Only four Justices (Marshall, Brennan, Blackmun and Kennedy) joined in the determination that the maturity of the Co-op's demand notes was not immediate and, therefore, the notes were not excluded from regulation under the securities acts. Justice Stevens wrote a concurring opinion on this issue.
14. State regulation of securities predated the adoption of the federal securities acts. Kansas was the first to adopt state securities regulation in 1911, followed by Arizona and Louisiana in 1912. The constitutionality of state regulation of securities markets through the blue sky laws was established in *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917). These state statutes are called "blue sky laws" due to the Kansas promoter who was selling "lots in the blue sky in fee simple absolute." See R. HAMILTON, *FUNDAMENTALS OF MODERN BUSINESS*, 334 (1989) (citing Mulvy, *Blue Sky Law*, 36 CAN. L. TIMES 37 (1916)); see also H. BLOOMENTHAL & S. WING, *SECURITIES LAW*, § 2.02 (1990-91) (fifty-one American jurisdictions require regulation of securities; the District of Columbia does not).
15. See 15 U.S.C.A. § 78b (Necessity for Regulation) (West 1988 & Supp. 1991); S. REP. NO. 47, 73d Cong., 1st Sess. 1-2 (1933), reprinted in 2 J. ELLENBERGER & E. MAHAR, *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934*, item 17 (1979); see also *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986) (aim of 1934 Act includes the deterrence of fraud and manipulative practices in securities markets and full disclosure of information material for investment decisions); *Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982) (1934 Act was adopted to restore investors' confidence); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (1933 Act was designed to provide investors with full disclosure of material information concerning public offerings of securities to protect investors against fraud); *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 155 (1976) (primary purpose of the 1934 Act was to provide fair and honest mechanism for pricing of securities and to assure that dealing in securities was fair); *United Housing Found., Inc. v.*

Both statutes emphasize disclosure by issuers of information material to investors, but regulate different securities markets.<sup>16</sup> Exemptions from registration are also available under both Acts.<sup>17</sup>

The threshold issue of whether a note is subject to federal securities regulations can be crucial to a defrauded investor, as well as the alleged fraud perpetrator.<sup>18</sup> Unless the instrument involved is a security, certain anti-fraud provisions of the 1934 Act are inapplicable<sup>19</sup> and no other federal regulation exists to determine liability.<sup>20</sup>

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Forman, 421 U.S. 837, 849 (1975) (fundamental purpose of the Securities Acts was "to eliminate serious abuses in a largely unregulated securities market"); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (central purpose of the 1934 Act was to protect investors by requiring full disclosure from issuers of securities).

16. The 1933 Act focuses on regulating public offerings of securities (the "primary market"). In contrast, the 1934 Act oversees trading on the "secondary market" by regulating those that are listed on national stock exchanges. HAMILTON, *supra* note 14, at 334-35 (1989).
17. Small corporations strive to structure their capital-raising to take advantage of an exemption to the registration requirements, due to the expense and complex nature of filing. See HAMILTON, *supra* note 14, at 335.
18. For an investor it is somewhat easier to establish fraud under the civil liability provisions of the federal securities acts than under common law theories of fraud. See Comment, *Notes as Securities*, *supra* note 5, at 233 n.4; Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1568 (1980) ("Parties seeking federal securities law jurisdiction in note cases do so primarily to avail themselves of the advantages afforded by the federal antifraud provisions as compared to remedies provided by state commercial law, contract law, blue sky law, corporation law, or common law fraud actions.').

Additionally, an action under the securities regulations provides access to a federal forum. Possible advantages of the federal forum include more liberal discovery procedures and the possibility for judges and juries that may have a greater degree of sophistication, due to the location of federal courts in large urban areas.

19. Although there are several anti-fraud provisions in the securities acts, the most frequently litigated provision is Rule 10b-5 of the 1934 Act, 15 U.S.C.A. § 78j (West 1988 & Supp. 1991) [hereinafter Rule 10b-5], which broadly prohibits employment of manipulative and deceptive devices in connection with the purchase or sale of securities. See also *infra* note 33 for application of the anti-fraud provisions under the 1933 Act.
20. See Comment, *Notes as Securities*, *supra* note 5, at 234. Before 1975, the most distinctive advantage to pursuing a private right of action under Rule 10b-5 was that a plaintiff's recovery did not depend upon proof of reliance or scienter. In 1976, however, the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), established a requirement of scienter. See Comment, *Notes as Securities*, *supra* note 5, at 234. Advantages of bringing suit under Rule 10b-5 are that: 1) the class of persons that may be sued is much broader than under a common law fraud action; 2) a plaintiff can obtain nationwide venue and service of process; and 3) shareholder derivative suits

*B. Definition of Security*

The definitions of securities in the securities acts merely list general types of instruments that are considered securities.<sup>21</sup> Judicial interpretation is required when an instrument does not precisely match an item on the list.<sup>22</sup> In fact, the problem of determining whether a particular instrument is a security is implied in Congress' inclusion of the phrase, "or, in general, any interest or instrument commonly known as a 'security,'"<sup>23</sup> at the end of the list of items in the definition. The use of this phrase has led courts to broadly construe the definition of a security.<sup>24</sup> Even though greater problems exist in using a broad (rather than a precise) definition,<sup>25</sup> the Supreme Court has respected Congress' approach.<sup>26</sup>

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may be brought without providing security for the expenses of the defendant. *Id.* at 233 (citations omitted).

In recent years, however, the requirements for successful civil liability actions under the anti-fraud provisions have been tightened by the Supreme Court. Currently, there are several requirements imposed for Rule 10b-5 private actions. For example, the plaintiff must be a purchaser or seller of the company's stock during the time of non-disclosure. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). A material fact which was relied upon by the plaintiff must have been misstated or omitted by the defendant, although materiality and reliance may be proved by a "fraud on the market" theory. *See, e.g., TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 245-47 (1988). Scienter or malicious intent on the part of defendant must be proved. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). Also, the transaction must have involved manipulative or deceptive practices. *See Santa Fe Indus. v. Green*, 430 U.S. 462, 473-74 (1977).

21. *See infra* note 27 for the definitions of a security contained in the 1933 and the 1934 Acts.
22. No actual test is provided in the statutory definitions, so the courts are left to establish their own criteria for determining whether an instrument falls within the definition of the statutes.
23. 15 U.S.C.A. §§ 77(b)(1) & 78(c)(a)(10) (West 1988 & Supp. 1991).
24. *See Note, Definition of a Security: Landreth Timber Co. v. Landreth*, 40 Sw. L.J. 879, 881 (1986) (because Congress has failed to describe the characteristics that distinguish securities from nonsecurities, courts have fashioned their own concepts of what the definitions cover); *see also Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1063, (10th Cir. 1976) (definition of a security is to be liberally construed, with the courts looking to the substance rather than the form of the transaction), *cert. denied*, 431 U.S. 965 (1977); *Llanos v. United States*, 206 F.2d 852, 854 (9th Cir. 1953) (definition of a security should not be narrowly construed), *cert. denied*, 346 U.S. 923 (1954).
25. In recent years, federal courts have been inundated with securities litigation. *See Note, The Economic Realities of Defining Notes as Securities, supra* note 7, at 402-03 n.17. This expanding caseload is a valid consideration when determining the scope of note transactions being defined as securities. *See*

Both Acts define "security" in a similarly broad manner.<sup>27</sup> In fact, the courts have consistently treated the definitions as substantially identical.<sup>28</sup> There are, however, two differences in the Acts that relate to notes.<sup>29</sup> First, the 1933 Act's definition includes the term

Comment, *The Status of the Promissory Note Under the Federal Securities Laws*, 1975 ARIZ. ST. L.J. 175, 183 (1975).

26. See *Reves v. Ernst & Young*, 494 U.S. 56, 63 n.2 (1990). This approach was adopted in an effort to ensure that both the SEC and the courts have sufficient flexibility to continue protection of investors through application of the securities laws to new instruments that may not be expressly listed in the statutory definition of a "security". *Id.*
27. The 1933 Act's definition of a security states:  
 When used in this subchapter, unless the context otherwise requires -  
 (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.  
 Securities Act of 1933, 15 U.S.C.A. § 77b(1) (West 1988 & Supp. 1991).  
 The 1934 Act's definition of a security states:  
 The term "security" means any note, stock, or treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, . . . or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.  
 Securities and Exchange Act of 1934, 15 U.S.C.A. § 78(c)(a)(10) (West 1988 & Supp. 1991).
28. See, e.g., *Reves*, 494 U.S. at 61 n.1; *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985); *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 776-77 (D.C. Cir. 1981); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 99 (7th Cir. 1977); *Zabriskie v. Lewis*, 507 F.2d 546, 550 (10th Cir. 1974); see also *Sonnenschein*, *supra* note 18, at 1573. *But cf.* *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (concluding that the anti-fraud provisions of the 1934 Act did not cover a certificate of deposit and "unique agreement, negotiated one-on-one by the parties," since these instruments were not considered securities). The *Weaver* Court, however, did not address the issue of whether it would reach the same conclusion when applying the 1933 Act definition of a security.
29. See *Sonnenschein*, *supra* note 18, at 1572-73.

"evidence of indebtedness" which is not present in the 1934 Act.<sup>30</sup> Second, the 1934 Act excludes from the definition of a security "any note . . . which has a maturity at the time of issuance of not exceeding nine months . . .",<sup>31</sup> whereas the 1933 Act definition includes such short-term notes, but exempts them from some of the more burdensome regulations of the 1933 Act, such as registration.<sup>32</sup> This exemption in the 1933 Act effectively provides the same type of exclusion of short-term notes as does the definitional section of the 1934 Act. The distinction between the exemption in the 1933 Act and the exclusion under the 1934 Act, however, is significant.<sup>33</sup>

Determining whether a specific note is a security is more arduous than ascertaining whether stocks fall within the definition; the latter being instruments more readily identified as securities.<sup>34</sup> Notes take on various forms based on the assorted types of transactions in which

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30. The significance of this technical difference is "probably negligible with respect to anti-fraud coverage." Sonnenschein, *supra* note 18, at 1573. The three reasons given for this conclusion are: 1) the definitions of security in the 1933 and 1934 Acts are virtually identical according to Supreme Court; 2) since the majority of actions are brought under Rule 10b-5 of the 1934 Act, parties would gain little by alleging the existence of an item which is not facially covered by the 1934 Act; and 3) the "evidence of indebtedness" language has been interpreted to provide equal statutory treatment for instruments which are deemed not to be notes. *Id.*

31. 15 U.S.C.A. § 78(c)(a)(10) (West 1988 & Supp. 1991).

32. The full text of § 3(a)(3) states:

(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

(3) Any note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and 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.

For further discussion of the "maturity exception," see *infra* text accompanying notes 67-76.

33. If an instrument is exempt under the 1933 Act from registration requirements, such a security would nonetheless remain subject to the anti-fraud provisions of the 1933 Act. See § 12(2) and § 17 of the 1933 Act, 15 U.S.C.A. §§ 771(2) & 77q. If an instrument is excluded under the 1934 Act from the definition of a security, however, the instrument is not subject to any provisions (including the anti-fraud provisions) of the 1934 Act. See BLOOMENTHAL & WING, *supra* note 14, § 4.04 at 64.

34. See BLOOMENTHAL & WING, *supra* note 14, § 4.01(1) at 48; Landreth Timber Co. v. Landreth, 471 U.S. 681, 693 (1985) (traditional stock is more susceptible to a plain-meaning approach than notes). *But see* United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975) (shares of stock entitling a purchaser to lease an apartment in co-op were not considered to be securities since the shares did not meet the investment contract criteria found in SEC v. Howey, 328 U.S. 293 (1946)).



they are issued; consequently, they have been troublesome to categorize.<sup>35</sup> Although not always agreeing as to the characterization of types of notes, most courts have concluded that there are some notes that definitely do not fit the "security" definition, such as notes securing home mortgages.<sup>36</sup>

### C. Two Problem Areas

#### 1. What Test Should be Applied to Notes?

The federal courts' use of a test by which notes should be characterized has varied over the years.<sup>37</sup> In cases decided before 1971, courts usually held all note instruments to be securities without applying any specific test.<sup>38</sup> Recently, federal courts have applied as

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35. See, e.g., *Smith Int'l., Inc. v. Texas Commerce Bank*, 844 F.2d 1193, 1201 (5th Cir. 1988) (promissory notes issued by debtor corporation were not "securities" within meaning of federal securities laws, where notes were issued for corporation's pre-existing debt under financial restructuring plan); *Union Nat'l Bank of Little Rock v. Farmers Bank*, 786 F.2d 881, 884-85 (8th Cir. 1986) (bank's 100% participation in unsecured note held by another bank was not a "security" for purposes of federal securities law due to short-term nature); *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484, 493 (7th Cir. 1984) (note bearing fixed rate of interest and having only a one year term to maturity was a "security" within the meaning of federal law); *Davis v. Avco Fin. Services*, 739 F.2d 1057, 1063 (6th Cir. 1984) (promissory notes executed to finance company by investors, evidencing loans to them by finance company, were not considered "securities" within the meaning of federal securities law), *cert. denied*, 470 U.S. 1005 (1985). See also Annotation, *Promissory Notes as Securities*, 39 A.L.R. FED. 357, 365 (1978) ("Transactions involving notes may generally be categorized as being either sales transactions or loan transactions.").
  36. See *infra* notes 105-06 and accompanying text for a discussion of notes which the courts do not consider to be securities.
  37. Until the *Reves* decision, the Supreme Court had never specifically addressed the issue of what test should be utilized in determining which note transactions are securities. The federal courts applied several tests in order to comply with the general Supreme Court guidelines for defining securities. See *infra* notes 38-66 and accompanying text.
  38. See Note, *The Economic Realities of Defining Notes as Securities*, *supra* note 7, at 406; see also Comment, *Notes as Securities*, *supra* note 5, at 235. See, e.g., *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953) (promissory notes exchanged for funds to be bet on "fixed" volley ball game), *cert. denied*, 346 U.S. 923 (1954); *Prentice v. Hsu*, 280 F. Supp. 384 (S.D.N.Y. 1968) (notes issued as loan to finance an expedition to retrieve "hidden monies"); *Olympic Capital Corp. v. Newman*, 276 F. Supp. 646 (C.D. Cal. 1967) (personal note issued by individual on behalf of corporation to another corporation); *SEC v. Addison*, 194 F. Supp. 709 (N.D. Tex. 1961) (notes as loan to fund mining operations); *SEC v. Vanco, Inc.*, 166 F. Supp. 422 (D.N.J. 1958), *aff'd per curiam*, 283 F.2d 304 (3d Cir. 1960) (note issued by corporation to stockholders).

many as five different tests to analyze note transactions. The various tests include: 1) *Howey* test; 2) literal approach; 3) family resemblance test; 4) commercial/investment application; and 5) risk capital analysis.

The Supreme Court first articulated the *Howey* test in the context of defining an "investment contract" in *SEC v. W.J. Howey Company*.<sup>39</sup> Under this approach, substance overrides form and the circumstances of a transaction govern whether the transaction falls under the control of the securities acts.<sup>40</sup> Viewing the "economic realities" of the transaction, the Court determined that the transactions were "investment contracts" within the meaning of the Securities Acts<sup>41</sup> because the scheme involved: 1) an investment of money, 2) in a common enterprise<sup>42</sup>, 3) where the investor is led to expect

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39. 328 U.S. 293 (1946). In *Howey*, land sale contracts involving small portions of a citrus grove were sold to business professionals as investments. Optional service contracts were offered, (and accepted by a majority of the investors) whereby the land remained in the possession of the grower to manage, operate and control. The investors were solely dependent upon the efforts of the growers for any profits from the investment. *Id.* at 299-301. See also Note, *The Continued Demise of the Howey Test: The Supreme Court Adopts the "Family Resemblance Test" for Identifying Notes as Securities*, 20 STETSON L. REV. 613, 620-25 (1990) for a detailed discussion of the elements of the *Howey* test.

40. See Comment, *Notes as Securities*, *supra* note 5, at 240-41; Note, *Federal Securities Laws Applicable to Sale of a Business Effectuated by a Stock Sale of All the Business's Stock*, 15 U. BALT. L. REV. 310, 315 (1986).

41. The term "investment contract" is included in the definition of a security under both the 1933 and 1934 Acts. See 15 U.S.C.A. §§ 77(b)(1) & 78(c)(a)(10). The *Howey* test was the first case to articulate a definition for the term "investment contract" and, thereby, expanded the federal securities laws to include instruments that had not currently been viewed to fall within the popular definition of a security. See *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

42. The circuits are split as to the meaning of this test. See COX, HILLMAN & LANGEVOORT, *SECURITIES REGULATION* 134 (1991). The two approaches include the "vertical" and "horizontal" commonality tests. The vertical commonality approach emphasizes the relationship between investors and the promoter. The principal inquiry is whether the profits of the investor are dependent upon the efforts of the promoter. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (fortunes of the investors were "inextricably tied to the efficacy" of the promoters, since the promoters provided scripts for the meetings to be conducted by investors and the guidelines on recruiting prospects and consummating a sale).

On the other hand, the horizontal commonality approach emphasizes the relationship between the investors. This approach usually entails a pooling of investors' funds. See, e.g., *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 216, 222 (6th Cir. 1980) (court determined that pooling of investors' interests is essential factor to the finding of an investment contract), *aff'd on other grounds*, 456 U.S. 3-3 (1982); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 100-01 (7th Cir. 1977) (discretionary trading account was

profits, 4) which come solely from the efforts of the promoter or a third party.

The *Howey* test has been applied to many types of instruments.<sup>43</sup> In fact, the Court in *United Housing Foundation, Inc. v. Forman*<sup>44</sup> stated that the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security."<sup>45</sup> Since the *Forman* case, the Eighth<sup>46</sup> and the District of Columbia<sup>47</sup> circuits have utilized the *Howey* test in analyzing note instruments.

The Second Circuit developed the "literal approach"<sup>48</sup> and the "family resemblance test."<sup>49</sup> The "literal approach" followed statu-

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not considered an investment contract because there was no pooling of the funds of multiple investors).

43. See, e.g., *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (certificate of deposit and a business agreement between two families was not considered a security because the "unique agreement they negotiated was not designed to be traded publicly"); *International Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551 (1979) (non-contributory, compulsory pension plan was not considered a security within the meaning of the securities acts since the employee was not found to have made an "investment" in the plan, but was merely "selling his labor primarily to obtain a livelihood"); *Crowley v. Montgomery Ward & Co.*, 570 F.2d 875, 877 (10th Cir. 1978) (franchise agreement with agent to provide and maintain catalog store at agent's expense was not considered an investment contract since the franchisee's contributions significantly and substantially affected the profits expected from the enterprise); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974) (sale of chinchillas involved the offering of investment contracts in violation of securities acts, even though investors nominally participated in the raising of the animals).
44. 421 U.S. 837 (1975). In *Forman*, the Court determined that shares of stock entitling a purchaser to lease an apartment in Co-op City, a state subsidized, nonprofit housing cooperative, were securities within the meaning of the securities acts.
45. *Forman*, 421 U.S. at 852.
46. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 54-55 (8th Cir. 1988) (applied the *Howey* test and determined that Co-op demand notes did not fall under definition of security), *rev'd sub nom. Reves v. Ernst & Young*, 494 U.S. 56 (1990); *Union Nat'l Bank v. Farmers Bank*, 786 F.2d 881, 884-85 (8th Cir. 1986) (since participating bank, although holding 100% participation in unsecured note held by another bank, had no prospect of capital appreciation from any increased earnings in business of note's creator, the participation was not considered a "security"); *Kansas State Bank v. Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984) (loan participation interest was not a security within the meaning of the securities laws).
47. *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 778-79 (D.C. Cir. 1981) (short-term promissory note given in exchange for funds advanced in anticipation of securing a limited partnership interest was considered a "security" due to the investment nature of the transaction).
48. *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F. Supp. 806 (S.D.N.Y. 1970) (plaintiff gave long and short-term promissory notes in a financing arrangement for the purpose of acquiring defendant's optical business which the court

tory language closely, presuming all notes to be securities. This inflexible adherence to the literal language of the statute was at odds with *Howey*. As a result, the Supreme Court rejected the literal approach in the *Forman* decision.<sup>50</sup> The Court insisted that the "economic realities" of each transaction be assessed in determining the status of a note.<sup>51</sup>

The Second Circuit then developed the "family resemblance test" in *Exchange Nat'l Bank v. Touche Ross & Co.*<sup>52</sup> This test attempted to account for the economic realities of the transaction while increasing the predictability of whether the federal securities laws would apply to a particular instrument. Because of the mandate by the Supreme Court in *Forman* that the economic realities of a transaction must be considered, the Second Circuit stated that some notes, such as those evidencing consumer financing or home mortgage notes,

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considered to be a sale of securities subject to securities regulation), *aff'd per curiam*, 452 F.2d 662 (2d Cir. 1971) (per curiam). The court reasoned:

Upon turning to § 3(a)(10) of the 1934 Act, however, we find that it provides, in unequivocal and all embracing language, that "[t]he term 'security' means *any note . . .*" This plain language, literally read, clearly includes promissory notes of the type that are the subject of the present suit.

*Movielab, Inc.*, 321 F. Supp. at 808 (emphasis in original).

49. See *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976) (unsecured, subordinated notes purchased by bank considered to be securities).
50. 421 U.S. 837 (1975). The Court was faced with the problem of determining whether the purchase of shares of "stock" in a non-profit housing cooperative in New York City came within the definition of a security under the securities acts. The Supreme Court spurned the literal method and held that "the name given to an instrument was not dispositive." *Id.* at 850. The Court bolstered its decision by noting that the stock at issue lacked the attributes typically associated with stock. For example, the stock did not entitle the purchaser to anything more than a place to live, since the purpose was to provide the purchaser of the stock with living accommodations, not dividends or other benefits associated with the purchase of securities. Therefore, the *Forman* court determined that, even though the instrument was called "stock," it was not a security, within the meaning of the securities acts because it was purchased for consumption, not investment, purposes.
51. See *Forman*, 421 U.S. at 848-50. In another decision, *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973), the Second Circuit viewed the economic realities of the transaction to determine the status of a demand note. The court retreated from the strict literal approach, due to the recent reversal by the Supreme Court on that issue and the fact that demand notes are not covered literally under the securities regulations. The *Exchange* court found that a collection of unsecured, subordinated notes purchased from a brokerage firm by a bank which had maturity dates ranging from twelve to eighteen months from issuance were considered to be within the definition of a "security" under the federal securities laws. *Exchange*, 544 F.2d at 1138-39.
52. 544 F.2d 1126 (2d Cir. 1976).

would not be subject to federal securities regulation.<sup>53</sup> The court then stated that “[w]hen a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) [anti-fraud provisions] of the 1934 Act should generally be held to apply.”<sup>54</sup>

The “commercial/investment” test is similar to the *Howey* test.<sup>55</sup> The Federal Court of Appeals in the First,<sup>56</sup> Third,<sup>57</sup> Fifth,<sup>58</sup> Seventh,<sup>59</sup> Tenth,<sup>60</sup> and Eleventh<sup>61</sup> circuits have adopted this test. The “com-

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53. See *Exchange*, 544 F.2d at 1138. See *infra* note 101 for all of the types of instruments, listed by the *Exchange* court, that are not considered to be securities within the meaning of the securities acts.
54. *Exchange*, 544 F.2d at 1138.
55. See *Reves*, 494 U.S. at 63; BLOOMENTAL & WING, *supra* note 14, § 4.04, at 56.
56. See *Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33, 41-42 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985) (a promissory note given after one-on-one business negotiations that resulted in an agreement to sell property was considered primarily a commercial, rather than investment, transaction because it served as substitute for purchase price and, therefore, was not subject to securities regulation).
57. See *Goodwin v. Elkins & Co.*, 730 F.2d 99, 107-08 (3d Cir.) (general partnership interest in brokerage firm was not a “security” within the meaning of the Securities Acts), *cert. denied*, 469 U.S. 831 (3d Cir. 1984); *Lino v. City Investing Co.*, 487 F.2d 689, 694-96 (3d Cir. 1973) (licensee issuing personal promissory notes for purchase of franchise arrangement was not considered to be security).
58. See *Smith Int’l, Inc. v. Texas Commerce Bank*, 844 F.2d 1193, 1201 (5th Cir. 1988) (promissory notes issued for corporation’s pre-existing debt under financial restructuring plan by debtor corporation were not securities within meaning of the securities acts, since neither notes nor pre-existing debt, which they represented, had any investment nature apart from debtor’s obligation to pay the specified interest and principal); *Bellah v. First Nat’l Bank of Hereford*, 495 F.2d 1109, 1113-14 (5th Cir. 1974) (notes issued to obtain bank loan were not considered securities since the notes were issued in the context of a commercial loan transaction).
59. See *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484, 488-92 (7th Cir. 1984) (notes, bearing a fixed rate of interest and having a one-year term to maturity, were “securities” within the meaning of the securities acts, where the seller solicited members of the general public seeking passive return from their capital, sale of the notes did not resemble a commercial loan transaction, and in a series of communications, the seller referred to the note as an “investment”); *Canfield v. Rapp & Son, Inc.*, 654 F.2d 459, 465-66 (7th Cir. 1981) (sale of all stock in a business was not considered to be the sale of a “security” for purposes of federal and state securities law); *Lincoln Nat’l Bank v. Herber*, 604 F.2d 1038, 1040 (7th Cir. 1979) (promissory notes given in commercial loans were commercial rather than “investment” in character and, therefore, were not considered “securities” under the Securities Acts).
60. See *Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772, 779-83 (10th Cir. 1989) (passbook savings certificates and thrift certificates were considered to be investments through the character of the underlying transactions and were thus determined to be “securities”); *Christy v. Cambron*, 710 F.2d 669,

mercial/investment” test requires a note to have some investment characteristics. If the instrument has more of a “commercial” than “investment” nature, it will not be considered a security. Factors to consider in making this determination include: 1) the degree to which profit is in the hands of the maker rather than payee; 2) whether the purpose of the holder is to acquire interest in property or an enterprise; 3) whether note served as cash substitute for purchase price; and 4) whether the return on note was predetermined.<sup>62</sup>

Another test frequently used in fixing the definition of a security is the “risk capital analysis,” also known as the “corporate involvement test.” This test, like the *Howey* test, focuses on the relationship between the issuer of the note and the holder at the time the note is issued. For example, if the holder has incurred risk by contributing capital subject to the managerial or entrepreneurial efforts of others, that would indicate that the invested funds are “risk capital” and that the note in question is a security.<sup>63</sup> The Ninth Circuit developed the “risk capital” approach,<sup>64</sup> which was adopted by the Fourth<sup>65</sup> and Sixth<sup>66</sup> Circuits.

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- 672 (10th Cir. 1983) (shares in corporation which owned discotheque were not “securities” within meaning of securities law because shareholders were actively involved in operating and managing discotheque and thus their shares were not incidentals of an investment which derived profit from others).
61. See *King v. Winkler*, 673 F.2d 342, 345-46 (11th Cir. 1982) (the “economic realities” test is appropriate to determine whether transaction involving stock in corporation is “securities transaction” or an “investment contract” under federal securities laws).
62. See *Futura Dev. Corp. v. Centrex Corp.*, 761 F.2d 33, 40-41 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985).
63. See Note, *The Economic Realities of Defining Notes as Securities*, *supra* note 7, at 414.
64. *Amfac Mortgage Corp. v. Arizona Mall of Tempe*, 583 F.2d 426, 431-34 (9th Cir. 1978) (promissory note and other documents given to lender for commercial construction loan to finance shopping center was not a security within the meaning of the federal securities laws since there was no investment of risk capital); *United California Bank v. T.H.C. Fin. Corp.*, 557 F.2d 1351, 1358-59 (9th Cir. 1977) (notes given bank by climate control subcontractor were not securities since the totality of the deal was considered to be low risk, notes had only one-month maturity and there was an absence of risk capital since risk was limited to that associated with lending money); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1258-59 (9th Cir. 1976) (ten-month renewable note given to lender in connection with loan agreement did not constitute a security because the funding party did not invest “risk-capital”).
65. See *Tafflin v. Levitt*, 865 F.2d 595, 598-99 (4th Cir. 1989) (certificates of deposit issued by state-chartered savings and loan association in Maryland were not considered investments and, therefore, were not securities because the state had comprehensive regulatory system applicable to the association which limited risk associated with the transaction).

Prior to the *Tafflin* decision, the Fourth Circuit had applied both the “literal approach” and the *Howey* test in determining whether an instrument

## 2. Does Maturity Exemption Apply to Demand Notes?

As mentioned previously, both the 1933 and 1934 Acts have language which exempt notes possessing a short (less than nine months) maturity from some of the more rigorous regulatory provisions of those Acts.<sup>67</sup> The instruments listed in § 3(a)(10) of the 1934 Act, which are not considered securities if they have a maturity at the time of issuance not exceeding nine months, are currency, notes, drafts, bills of exchange, and banker's acceptances. The 1933 Act's short-term exemption, found in § 3(a)(3), lists the same instruments, but differs from the 1934 Act language by adding that the instrument must "arise out of a current transaction or the proceeds . . . used for current transactions . . . ." The short-term nature of these instruments is regarded as being a sufficient safeguard to investors, making application of the securities acts superfluous.<sup>68</sup> Many of the federal circuit courts have agreed that the basic inquiry of whether a note instrument falls within the maturity exception is whether the note constitutes an investment, since Congress' intent was to protect investors from fraud.<sup>69</sup>

Traditionally, the SEC has narrowly construed the 1933 Act's exemption for short-term debt instruments.<sup>70</sup> Using the legislative

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was a security under the federal securities definitions. See *Occidental Life Ins. Co. v. Pat Ryan & Assoc., Inc.*, 496 F.2d 1255, 1261 (4th Cir. 1974) (sale of all outstanding stock of insurance company strongly presumed to be a sale of a security since the term "stock" is found within the literal definition of a security); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1128 (4th Cir. 1970) (sale of production payment, a financing device frequently used in oil and gas industry, was an investment contract and, therefore, considered a security under Securities Acts).

66. See *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1179-81 (6th Cir. 1981) (loan participation agreement executed between a bank and another financial institution did not constitute a security under the "risk capital" test since it was characterized as a commercial loan and not an investment). The *Union Planters* court applied the "risk capital" test as a means of interpreting the economic reality factors of the *Howey* test. *Id.* at 1182.
67. See *supra* notes 37-66 and accompanying text.
68. See *BLOOMENTHAL & WING*, *supra* note 14, § 4.04[5] at 65.
69. See, e.g., *C.N.S. Enters., Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1359 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) ("The ultimate question is whether the plaintiffs are simply borrowers in a commercial transaction who are not protected by the 1934 Act or investors in a securities transaction who are protected."); *McClure v. First Nat'l Bank*, 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) (in order that investors might be protected, only promissory notes that are investments fall within the maturity exception); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir.) (the investment or commercial nature of a note entirely controls the applicability of the Act), *cert. denied*, 414 U.S. 908 (1973).
70. See *BLOOMENTHAL & WING*, *supra* note 14, § 4.04 at 65-66.

history of § 3(a)(3), the SEC has interpreted the maturity exemption to apply only to:

prime quality negotiable commercial paper of a type not ordinarily purchased by the general public . . . [and] issued to facilitate well-recognized types of current operational business requirements . . . .<sup>71</sup>

Commercial paper is designed to finance the short-term<sup>72</sup> credit needs of large corporations or banks.<sup>73</sup> As such, this instrument is usually issued by only top-rated<sup>74</sup> entities and purchased with large amounts of cash by only sophisticated investors. Therefore, regulation of these instruments has been considered unnecessary by Congress and the SEC. Although neither the 1933 Act nor the 1934 Act contain the term "commercial paper,"<sup>75</sup> the federal circuit courts have generally followed the SEC's interpretation.<sup>76</sup>

#### D. Blue Sky Laws

The issue of determining whether notes are securities and the application of the maturity exemption to demand notes have also arisen in the context of state securities acts (or "blue sky laws").<sup>77</sup> For example, each state has enacted its own definition of a security.<sup>78</sup>

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71. *Id.* (quoting Sec. Act Release No. 4412 (Sept. 20, 1961), Fed. Sec. L. Rep. (CCH) ¶ 2045).

72. The maturities for commercial paper typically range from 2 to 270 days. See DOWNES & GOODMAN, *supra* note 5, at 68.

73. *Id.*

74. Both Moody's Investors Service and Standard & Poor's Corporation assign ratings to commercial paper issuers. *Id.*

75. However, the 1933 Act states that, for the exemption to apply, the note must "arise[] out of a current transaction." Securities Act of 1933, 15 U.S.C.A. § 77c (1988). This wording, which does not appear in the 1934 Act, could be interpreted to refer to commercial paper.

76. See, e.g., *Holloway v. Peat Marwick, Mitchell & Co.*, 879 F.2d 772, 778 (10th Cir. 1989); *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 775-77 (D.C. Cir. 1981); *McClure v. First Nat'l Bank*, 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1080 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972). See also *Reves v. Ernst & Young*, 494 U.S. 56, 74-75 (Stevens, J., concurring); BLOOMENTHAL & WING, *supra* note 14, § 4.04 at 66.

77. See *supra* note 14.

78. E.g., CAL. CORP. CODE § 25019 (Deering 1968 & Supp. 1991); DEL. CODE ANN. tit. 6, § 7302(13) (1991); FLA. STAT. ch. 517.02(17) (1987 & Supp. 1991); 70 PA. CONS. STAT. ANN. § 1-102(t) (1992). However, the Uniform Securities Act aided in the standardization of state securities regulation. See 1 Blue Sky L. Rep. (CCH) ¶ 5601 for text of Uniform Securities Act. Regional variations existed in blue sky laws which led to the drafting of the Uniform Securities Act in the 1950's. See BLOOMENTHAL & WING, *supra* note 14, at § 4.04 at 64. Presently, thirty-seven jurisdictions, including Maryland, have adopted the Uniform Securities Act. *Id.*



However, the definition of a security under many state statutes closely parallels that found in the federal securities acts.<sup>79</sup> Both state and federal courts in Maryland, for example, have found that the definition of a security under the Maryland Act is identical to the definition found under the federal securities acts.<sup>80</sup>

The Maryland Act also contains an exemption for short-term securities which combines the wording of the 1933 and 1934 Acts, but specifically limits the exemption to commercial paper.<sup>81</sup> Before the *Reves* decision, no Maryland state court<sup>82</sup> had specifically dealt with the question of whether demand or promissory notes were considered securities under the Maryland Act. But an Attorney General's Opinion<sup>83</sup> had concluded that certain promissory notes were considered securities because the notes did not constitute commercial paper and, hence, the Maryland short-term maturity exemption was not applicable.<sup>84</sup> Recently, using the *Reves* criteria, the Court of

79. Compare 1933 Act § 3(a)(10) with MD. CORPS. & ASS'NS CODE ANN. § 11-601 (1985 & Supp. 1992) and Uniform Securities Act § 402(a) (contained in 1 Blue Sky L. Rep. (CCH) ¶ 5601).

80. See *O'Neil v. Marriott Corp.*, 538 F. Supp. 1026 (D. Md. 1982). The Maryland Securities Act is codified as MD. CORPS. & ASS'NS CODE ANN. § 11 (1985 & Supp. 1990) [hereinafter cited as the Maryland Act]. For a discussion of the history of the Maryland Act, see *Hohensee v. State*, 42 Md. App. 329, 400 A.2d 455 (1979). The Maryland Act defines a "security" at § 11-101(p) and lists exempt securities at § 11-601.

81. Section 11-601(10) of the Maryland Act states:

The following securities are exempted from §§ 11-205 and 11-501 of this title:

.....

(10) Any commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal.

MD. CORPS. & ASS'NS CODE ANN. § 11-601(10) (1985 & Supp. 1990).

82. The U.S. District Court for the District of Maryland specifically addressed the question of whether a promissory note is a "security" under the securities laws in *Oliver v. Bostetter*, 426 F. Supp. 1082 (D. Md. 1977). In *Oliver*, the district court held that a promissory note issued by the defendant in exchange for the purchase of the plaintiff's stock was not an "investment." The court found that the defendant was attempting to divest himself of his interest in the business and was not "investing" by acquiring the promissory notes. Consequently, the note was not considered a "security" within the meaning of the Securities Acts. *Oliver*, 426 F. Supp. at 1087.

83. See 57 Op. Att'y Gen. 377 (1972) (stating that promissory notes do not, *per se*, fall within the exemption provided for short-term securities in the Maryland Act).

84. Several commentaries have been written on the subject of determining whether notes are securities under the Maryland Act. See generally Comment, *Municipal*

Appeals of Maryland held that promissory notes issued by a non-profit corporation were considered securities under the Maryland Securities Act.<sup>85</sup>

### III. FACTS OF THE REVES CASE

The Farmer's Cooperative of Arkansas and Oklahoma, Inc. ("Co-op") raised operating funds by selling promissory notes instead of obtaining funds from traditional borrowing sources such as banks.<sup>86</sup> This "Investment Program" was offered to members of the Co-op and the general public through advertisements in the Co-op's newsletter.<sup>87</sup> Purchasers exchanged cash for promissory notes, which were payable on demand and offered higher interest rates than those paid by local financial institutions.<sup>88</sup>

Although Co-op advertised its note to prospective purchasers as "Safe . . . Secure . . . and available when you need it,"<sup>89</sup> it filed a petition for bankruptcy in 1984.<sup>90</sup> A class consisting of note holders filed suit against Arthur Young & Co. (the predecessor of Ernst & Young), auditors of the Co-op's 1981 and 1982 financial statements, charging that the auditors had "intentionally failed to follow generally accepted accounting principles in its audit."<sup>91</sup> The class alleged that these demand notes constituted securities and sought recovery through the anti-fraud provisions of both federal<sup>92</sup> and state law.<sup>93</sup>

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*Securities and State Securities Laws: A New Look*, 13 U. BALT. L. REV. 558 (1984); Comment, *Blue Sky Law & Practice: An Overview*, 4 U. BALT. L. REV. 1 (1974); Comment, *A Prospectus on Maryland Securities Act*, 23 MD. L. REV. 289 (1963).

85. *Caucus Distributors, Inc. v. Maryland Securities Commissioner*, 320 Md. 313, 577 A.2d 783 (1990). The Court of Appeals of Maryland determined that: 1) the investment was essentially motivated by the expected profit to be generated from the notes; 2) the plan of distribution of the instrument existed in a circumstance of common trading for speculation or investment; 3) a reasonable public expectation existed that the notes were securities and 4) there was a lack of another regulatory scheme that would reduce risk in acquiring the notes. *Caucus*, 320 Md. at 326-29, 577 A.2d at 789-91.
86. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 53 (8th Cir. 1986), *rev'd sub nom. Reves v. Ernst & Young*, 494 U.S. 56 (1990).
87. *Reves v. Ernst & Young*, 494 U.S. 56, 59 (1990).
88. The rate of interest changed periodically, but those changes were announced in Co-op's newsletters. *Arthur Young*, 856 F.2d at 53.
89. *Reves*, 494 U.S. at 59.
90. *Id.* The value of the notes at the time of bankruptcy totaled over \$10 million. *Id.*
91. *Id.*
92. 15 U.S.C.A. § 77q (West 1988 & Supp. 1991); 15 U.S.C.A. § 78j (West 1988 & Supp. 1991).
93. ARK. STAT. ANN. § 23-42-106 (1990).

At trial, the United States District Court for the Western District of Arkansas determined that the demand notes were securities under both federal and state law and awarded the class a \$6.1 million judgment.<sup>94</sup> On appeal, the Eighth Circuit held that the demand notes were not securities under federal law because they failed the *Howey* test, nor were they securities under state law because the "demand nature of the notes is very uncharacteristic of a security."<sup>95</sup> The Supreme Court granted *certiorari* "to address the federal issue" and reversed the Eighth Circuit.<sup>96</sup>

#### IV. HOLDING OF THE *REVES* CASE

##### A. *Test Applied to Notes*

The Supreme Court held that the demand notes issued by the Co-op were securities. In making this determination the plurality adopted the Second Circuit's "family resemblance" test because it "provide[d] a more promising framework for analysis" than the "investment versus commercial" test.<sup>97</sup> The Court rejected the *Howey* test because it merely determined whether an instrument was an "investment contract," which is an inappropriate measure for notes.<sup>98</sup>

Under the "family resemblance" test adopted by the Court, a rebuttable presumption<sup>99</sup> exists that a note is a security.<sup>100</sup> This presumption may be rebutted by proof that either the note resembles an instrument considered a non-security<sup>101</sup> or that the note possesses

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94. *Robertson v. White*, 653 F. Supp. 851, 852 (W.D. Ark. 1986), *rev'd sub nom.* *Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1988), *rev'd sub nom.* *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

95. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 55 (1988), *rev'd sub nom.* *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

96. *Reves v. Ernst & Young*, 494 U.S. 56, 59-60 (1990).

97. *Id.* at 65.

98. However, this rationale seems to be a departure from the Court's earlier statement that the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security." *Forman*, 421 U.S. at 852. See *infra* notes 137-142 and accompanying text for discussion of the Court's analysis on this issue.

99. *Id.* at 63 n.2, discusses the Second Circuit's interpretation of the "family resemblance" test. The test limited the presumption of notes as securities to only notes with a term of more than nine months. If a security had a term of less than nine months, it was not considered to be a "security." This interpretation was apparently based on the statutory exclusion for notes with a maturity of less than nine months found in § 3(a)(10) of the 1934 Act. *Id.*

100. *Reves*, 494 U.S. at 64.

101. In *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976), and *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984), the courts list several examples of

the characteristics of a non-security.<sup>102</sup> Applying this test to the Cop's notes, the Court concluded that they did not bear a "family resemblance" to a non-security; therefore, they retained the presumption of being securities.<sup>103</sup>

Bringing greater certainty to application of the "family resemblance" test, the *Reves* Court adopted four factors that characterize securities.<sup>104</sup> The first factor is the motivation of the sellers and buyers of a note. If the seller's purpose is to raise money for the general use of a business enterprise and the buyer's interest is primarily in the profit to be generated by the note, then the instrument is likely to be considered a security. If, on the other hand, the note is sold to aid in the purchase of a specific asset for commercial use or a consumer good (such as a residence), the note is not considered a security. The Court determined that only "investment-for-profit" motives would result in the investment being deemed a security. The second factor is the "plan of distribution." An instrument would not be a security if the "plan of distribution" does not include common trading for speculation or investment. Even if the notes are not traded on an exchange, the Court determined that instruments offered or sold to a "broad segment of the public" will satisfy the common trading element.<sup>105</sup> The reasonable expectations of the investing public constitutes the third factor. In order for a note not to be characterized as a security, the public must not be led to believe that the note is a security. The last factor is whether there exists an alternative regulatory scheme. If there is such a scheme which significantly reduces the risk of the instrument, the note is not considered a security.<sup>106</sup> If, upon evaluation of these four factors,

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notes that are "non-securities." The list includes notes evidencing consumer financing, home mortgages, or "character" loans to bank customers; short-term notes secured by a lien on a small business or an assignment of accounts receivable; notes which formalize an open-account debt incurred in the ordinary course of business; and loans by commercial banks for current operations. In deciding whether another category should be added to the list of "non-securities," courts should compare the characteristics of the questioned instrument to the four factors applied by the court in determining whether a transaction involves a "security." *Chemical Bank*, 726 F.2d at 939.

102. See *infra* notes 105-06 and accompanying text.

103. *Reves*, 494 U.S. at 67.

104. *Id.* at 67-69.

105. *Id.* This factor does not mean that the instrument must be traded on an exchange. See BLOOMENTAL & WING, *supra* note 14, § 4.04 at 59. The Supreme Court cited SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), which involved an investment contract for oil and gas leases. In citing this case, the *Reves* court implied that an instrument did not have to be traded on an exchange in order to be "commonly traded." *Id.*

106. See, e.g., *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (certificates of deposit issued were not considered to be securities, since they were insured by the

the note in question bears a family resemblance to something which is not a security, then the note is exempt from securities regulation.<sup>107</sup>

The Co-op demand notes were examined in light of the four factors to determine their "family resemblance." First, the Court found the notes were sold in an effort to raise capital and were purchased in order to earn interest.<sup>108</sup> This paralleled the "investment-for-profit" scenario which was considered to be characteristic of a security.<sup>109</sup> Second, as to the plan of distribution, the demand notes were not traded on an exchange, but over an extended period of time to a broad segment of the public. Such a plan of distribution was held to be all that was necessary to establish the requisite "common trading" of the instrument, which is indicative of a security. Third, the public's reasonable perception of the notes indicated that they were securities.<sup>110</sup> The notes were considered securities because the Court found persuasive the evidence that the Co-op characterized the notes to prospective purchasers as investments. The Court determined that the public's usual understanding of a note is that it is a security or investment.<sup>111</sup> Lastly, the Court found no risk-reducing factors, such as the existence of an alternative regulatory scheme, which would avoid the need for federal regulation.<sup>112</sup>

## B. *Application of Maturity Exception*

### 1. *Plurality Opinion*

While the entire Court agreed upon the formulation and application of the "family resemblance" test,<sup>113</sup> there was divergence of

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Federal Deposit Insurance Corporation and subject to substantial federal banking regulations).

107. *Reves*, 494 U.S. at 67.

108. *Id.* at 67-68.

109. *Id.* at 68.

110. *Id.* at 69.

111. Generally, this factor presents a much more complicated scenario. *See generally* BLOOMENTHAL & WING, *supra* note 14, § 4.04 at 61 ("A securities law professor would recognize that the sale of orange groves, chinchillas and the like under circumstances involving an investment contract is a security and expect to receive a prospectus, but would the average investor to whom securities of this nature are offered?").

112. The notes were uncollateralized, uninsured and, unlike the certificates of deposit in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), were not insured by the Federal Deposit Insurance Corporation. *Reves*, 494 U.S. at 69.

113. Both the majority and the dissent agree that the test to be applied for determining whether a note is a "security" is the "family resemblance" test. *See Reves*, 494 U.S. at 64-65 and 77.

opinion about the application of the maturity exception to the demand notes. The plurality concluded that the statutory exemption for notes with maturities of less than nine months did not apply to the Co-op's demand notes. Rejecting the dissent's interpretation<sup>114</sup> of the immediate maturity of the demand notes, the plurality found the dissent's conclusion to be incorrectly based on state<sup>115</sup> rather than federal law. The plurality determined that state law cannot be used to determine a federal question,<sup>116</sup> and that allowing state law to define a note's maturity would nullify Congress' intent that there be consistent application of the securities laws. The plurality reasoned that even if literal effect were given to the words of the maturity exception, the Co-op's demand notes did not fall within the statute's terms because "demand notes do not necessarily have short terms."<sup>117</sup> The Court explained a demand could be made on a demand note immediately or it could be made long after nine months.<sup>118</sup>

Because of this ambiguity, the plurality interpreted the exclusion in accordance with the statute's purpose.<sup>119</sup> The plurality stated that Congress' purpose in the securities acts was to ensure that investments, unless *specifically* excluded, were to be regulated by the

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114. See *infra* notes 124-129 and accompanying text for a discussion of the dissent's rationale.

115. Arkansas' statute of limitations law deems a demand note to be immediately due such that an action can be brought at any time without any other demand than the suit. *Reves*, 494 U.S. at 71-72. The plurality rejected the Co-op's argument that the demand notes fall within the "plain words" of the securities exemption because the argument was based on Arkansas' statute of limitations laws. *Id.* at 72-73.

116. *Reves*, 494 U.S. at 72. *But see*, *Tafflin v. Levitt*, 865 F.2d 595, 598-99 (4th Cir. 1989) (discussed *supra* note 65).

117. *Reves*, 494 U.S. at 72. The majority determined that "maturity" could be defined as being immediate, because demand could be made immediately.

118. *Id.* Maturity could be viewed as being longer than nine months, since demand could be made many months into the future.

119. Several circuit courts have reasoned that demand notes do not fall under the short-term exemptions of the Securities Acts. See, e.g., *Holloway v. Peat, Marwick, Mitchell & Co.*, 900 F.2d 1485, 1488-89 (10th Cir.) (relying on legislative history, the court held exception in statutory definition for short-term notes is limited to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public), *cert. denied*, 111 S. Ct. 386 (1990); *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484, 492 n.1 (7th Cir. 1984) (generally, a demand note does not fall under the short-term exemption of the Securities Acts); *SEC v. Am. Bd. of Trade, Inc.*, 751 F.2d 529, 539-40 (2d Cir. 1984) (notes with maturities of only three or six months, sold by defendants pursuant to their commercial paper program to small investors, were not considered exempt from registration under the short-term exception of the Securities Act); *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 777-79 (D.C. Cir. 1981) (promissory note given in exchange for funds advanced in anticipation of securing a limited partnership interest constituted a "security," even though it was less than nine months' duration).

securities acts. It then held that the Co-op notes did not specifically fall within the maturity exclusion and, therefore, should be regulated as securities.<sup>120</sup>

## 2. *Concurring Opinion*

Justice Stevens' concurring opinion followed the plurality in finding that the maturity exception did not apply to the demand notes, but his reasoning was based on the unanimous rejection of a literal reading of the maturity exception by the lower federal courts.<sup>121</sup> Justice Stevens noted that the courts of appeals have historically interpreted the maturity exceptions to include only commercial paper and not investment securities.<sup>122</sup> Justice Stevens concluded that if all circuits agreed that the maturity exception was reserved for only commercial paper, it was for Congress, not the Supreme Court, to disturb this settled construction.<sup>123</sup>

## 3. *Dissenting Opinion*

The four dissenters<sup>124</sup> believed the Co-op's demand notes fell within the short-term maturity exclusion of § 3(a)(10) and, therefore, should not be considered securities.<sup>125</sup> The dissent's conclusion was based on the common understanding of a demand note's maturity. Relying on legal dictionaries, treatises and case law, the dissent found a consensus that a note payable upon demand was considered to be immediately due.<sup>126</sup> This being the case, the dissent determined that demand notes would fall within the maturity exception, since their maturity would be, by definition, less than nine months.

The dissent applied statutory construction and "well settled state law" in formulating its opinion.<sup>127</sup> It maintained that the terms "note" and "maturity" have been "terms of art in the legal profession for centuries" and that in construing these terms, the "common understanding of those terms at the time of the statute's creation" should be used.<sup>128</sup> The fact that the vast majority of state courts adopted the view of the immediate maturity of demand notes is persuasive support for the dissent's reasoning.<sup>129</sup>

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120. *Id.* at 73.

121. *Reves*, 494 U.S. at 73-74 (Stevens, J., concurring).

122. *Id.* at 74.

123. *Id.*

124. The Justices in dissent included: Rehnquist, White, O'Connor and Scalia.

125. *See Reves*, 494 U.S. at 76-82 (Rehnquist, C.J., dissenting).

126. *Id.* at 76-78.

127. *Id.*

128. *Id.* at 77.

129. The dissent contends that "[w]ell settled state law can inform our understanding

## V. ANALYSIS

The Supreme Court has failed to establish predictability in determining whether demand notes are securities. *Reves* has contributed not only to the uncertainty which issuers of demand notes face, but also to that entailed in interpreting the maturity exceptions<sup>130</sup> of the 1933 and 1934 Acts. Unfortunately, it appears that too much attention was placed on the outcome particular to this case and not enough attention was placed on articulating tests which could be consistently applied to arrive at proper outcomes in the future.

A. *Likely Problems in the Application of the New Test*

In choosing the "family resemblance" test, the Supreme Court furnished an all encompassing method for determining if a note falls outside the securities regulations. Not only did the Court adopt a list of instruments that are to be considered non-securities, but it also allowed for expansion of the list if instruments meet the four-factor test. In choosing a new test, however, the Court created new problems of interpretation for courts attempting to apply the *Reves* decision.

A potential difficulty for courts that apply the *Reves* decision is determining the weight to assign each of the four factors described by the Court.<sup>131</sup> Because it used the qualifying terms "strong resemblance" and "sufficiently similar,"<sup>132</sup> the Court probably would not require each of the four factors to be present for a note instrument to be considered a non-security.<sup>133</sup> The *Reves* Court, however, failed to determine the status of a note instrument that possesses some, but not all of the factors. If all of the factors are not required for a note to bear a resemblance to something which is not a security, then which of the four factors *must* be present in order to come to this conclusion?

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of what Congress had in mind when it employed a term it did not define." *Reves*, 494 U.S. at 79 (quoting *Mississippi Band of Choctaw Indians v. Holyfield*, 490 U.S. 30 (1989)) (since no definition existed in the statute, the domicile status of twin babies born off the reservation was determined using Congressional intent for the word "domicile," which was considered federal and not state in nature).

130. The terms "maturity exclusion," "maturity exemption" or "maturity exception" are used interchangeably and refer to both § 3(a)(3) of the 1933 Act and § 3(a)(10) of the 1934 Act. See *supra* notes 68-76 and accompanying text for explanation of these statutes.

131. See BLOOMENTHAL & WING, *supra* note 14, § 4.04 at 62.

132. *Reves*, 494 U.S. at 67.

133. But, it is important to keep in mind that the *Reves* Court found that the Cop's notes satisfied *all* of the factors presented.



### B. *Similarity to Old Test*

*Reves'* rejection of the *Howey* test is unfounded. The Court reasoned that relying on the same test for analyzing notes as the test used to analyze investment contracts would "make the Acts' enumeration of many types of instruments superfluous."<sup>134</sup> The terms "investment contracts" and "notes," however, are both listed as separate instruments in the definition of security under the 1933 and 1934 Acts. This fact merely indicates "that the tests for the two instruments *need* not be the same, not that they *cannot* be the same."<sup>135</sup> Notes and investment contracts could both be viewed as types of contracts.<sup>136</sup>

The rejection of the *Howey* test is surprising in light of the similarity between the *Howey* test and the family resemblance test. The instructional factors added by the Court to the "family resemblance" test are surprisingly similar to the elements of the *Howey* test. The first factor in the *Reves* test questions whether the parties are seeking an investment from their outlay of funds or if there is another (commercial) purpose. The first element of the *Howey* test also asks if the purchaser of the instrument is seeking an investment through the outlay of money.<sup>137</sup>

The second factor of the *Reves* test requires a common trading of the instrument or, as the Court found in *Reves*, distribution to a broad segment of the public. This sounds similar to the second element of the *Howey* test which requires a common enterprise. Both factors involve offers or sales to a broad segment of the public.

The third *Reves* factor involves the reasonable expectation of the public that the notes are investments. This factor relates to the first and third prongs of the *Howey* test. Under the *Howey* test, if a purchaser of an instrument views the transaction as an investment, in that they are expecting profits, the first and third prongs would be met.

Although the *Howey* test does not contain a prong which looks to whether an alternative regulatory scheme exists to protect the investor, the Supreme Court has applied this test in several cases where the *Howey* test was also applied.<sup>138</sup> The reasoning is that the

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134. *Reves*, 494 U.S. at 64 (quoting *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985)).

135. *Gordon, Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383, 390 (1990) (emphasis in original).

136. A major difference between the two types of instruments is that notes usually pay a fixed rate of interest and investment contracts usually do not. *Id.*

137. See *supra* notes 39-42 for explanation of the *Howey* test.

138. See, e.g., *International Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551 (1979) (presence of ERISA "severely undercuts all arguments for extending the Securities Acts to noncontributory,

alternative regulation renders the protection of the Acts less necessary.

The only element of the *Howey* test not specifically mentioned in the *Reves* test was the need for the profits to be obtained "solely from the efforts of others." But, this test is inherent in the nature of promissory notes. The purchaser of a promissory note can only receive a return through the efforts of the seller of the note, when the purchaser is paid the interest due. Overall, the elements of the two tests appear to be the same.

Because the elements of the new test are essentially identical to the elements of the *Howey* test, the *Reves* court could have used the *Howey* test and avoided articulating a new test. The "family resemblance" test, as applied by the *Reves* court, consists of new, uninterpreted language. The *Howey* test has been applied for several years and requires less interpretation. There appears to have been little consistency gained, but much confusion added by applying a new test when the *Howey* test was suitable.

### C. *Application of Maturity Exemption to Demand Notes*

The second issue in the *Reves* decision which raised more questions than it answered was the plurality's interpretation of the maturity of the Co-op's demand notes. Relying on the interpretation that Congress intended to protect the public through regulating investments,<sup>139</sup> the Court held that the short-term exception of the Securities Acts did not cover the Co-op's demand notes. However, this interpretation of the maturity exclusion raises the question of how to determine when a demand note's maturity is short-term (less than nine months).

The *Reves* decision bequeaths a strong presumption that notes are securities, since it fails to specify guidelines for determining when the maturity exception applies. The plurality criticized the dissent for applying state law, rather than federal law, to determine the maturity of a note, because of the possibility of differing results in each state.<sup>140</sup> However, the plurality did not specify what criteria should

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compulsory pension plans"); *Marine Bank v. Webster*, 455 U.S. 551 (1982) (since certificate of deposit insured by the FDIC, it is unnecessary to subject issuers to liability under Securities Acts).

139. As stated previously, the Court's interpretation of Congressional intent in enacting a sufficiently broad definition of "security" was "to encompass virtually any instrument that might be sold as an investment." *Reves*, 494 U.S. at 61. The broad scope of the security definition was used to eliminate serious abuses in a largely unregulated securities market and provide the widest protection possible for the public. *Id.* at n.1 (quoting *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 847-48 (1975)).

140. *Reves*, 494 U.S. at 71.

be applied to determine whether a particular note would be "short-term" under *federal* law.

The only guidance offered is the list of instruments specified as falling within the short-term maturity exclusion of the statutes.<sup>141</sup> But just as in the case of the *Reves* demand notes, it may not be clear whether the instrument matches the Court's list. There is no longer an implicit understanding of the phrase "short-term." To further complicate the issue, the common understanding of an instrument may be overcome by public policy considerations to protect investors.<sup>142</sup> Any legitimate exemption from the securities' regulation is, therefore, more difficult to determine.

Some guidance might have been provided in the last sentence of the plurality's opinion, which suggested that the intent of the parties be examined.<sup>143</sup> But such a suggestion, without more explicit instruction, only causes additional confusion. The Co-op's demand notes were not considered to have an immediate maturity, presumably because the Court determined that the parties did not contemplate that demand would be made within nine months. The question then becomes how to determine a party's state of mind.<sup>144</sup> Should each purchaser's intent be scrutinized individually or, if sold to a broad segment of the public, should a "collective state of mind" be assessed?<sup>145</sup>

Even if intent can be proved, an agreement between the parties might preclude application of the Securities Acts entirely. To have the short-term maturity exemption apply, it must be precisely invoked. It appears that the Court would require that the maturity of the note be written into the instrument or that both parties contemplate demand be made within the statutory period.<sup>146</sup> In *Marine Bank v. Weaver*,<sup>147</sup> however, the Court concluded that the certificate of deposit given for a promise to pay a percentage of profits was a "unique agreement, negotiated one-on-one by the parties" and was not considered a security. Therefore, this type of "limited" arrangement would not fit the definition of a security, since it would not

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141. See *supra* note 11 for text of short-term maturity exemption of the 1933 Act.

142. See *supra* note 15 and accompanying text for discussion of investor protection rationale of Securities Acts.

143. The sentence states:

"[a]lthough the result might be different if the design of the transaction suggested that both parties contemplated that demand would be made within the statutory period, that is not the case before us."

*Reves*, 494 U.S. at 73. Since this statement goes beyond the facts before the Court, it would be considered dictum.

144. See COX ET AL., *supra* note 42, at 207.

145. *Id.*

146. *Reves*, 494 U.S. at 73.

147. 455 U.S. 551 (1982).

be a "common enterprise," under the *Howey* test, or "commonly traded," as required by the *Reves* test.

Although attempting to merely narrow the scope of the short-term maturity exception, the *Reves* opinion leads to an extreme position—either completely constricting or expanding the breadth of the exception. On one hand, *Reves* could be interpreted to have narrowed the maturity exception without disregarding it completely.<sup>148</sup> Complete dismantling of the maturity exception did not appear to be the *Reves* Court's intent. In light of the significance the plurality placed on protection of investors, however, if a situation arose where the short-term nature of the instrument was not a sufficient safeguard against unscrupulous activity, the Court might well disregard the maturity exception, in favor of the ultimate purpose of the Securities Act.<sup>149</sup> Also, lack of guidance on how intent is to be proved, coupled with the difficulty in proving intent, is likely to preclude any notes from falling within the maturity exception.

At the other extreme, the short-term maturity exception could be applied to all demand notes. There is no prohibition which would prevent circuit courts from creating an administrative rule of convenience that would view all demand notes as short-term, absent evidence of intent to the contrary.

## VI. IMPACT

Lack of clarity in the opinion defeats the Court's efforts to create uniformity. The *Reves* court was faced with choosing between a bright-line or a flexible rule when establishing the tests to be

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148. Some circuit courts have also applied a narrow construction of the maturity exemption. See, e.g., *Zabriski v. Lewis*, 507 F.2d 546, 550 (10th Cir. 1974) (maturity exceptions are limited to only prime quality negotiable commercial paper of the type not ordinarily purchased by the general public); *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 524 (5th Cir. 1974) (a literal reading of the definition of "security" is compatible with the policy of strictly construing exemptions from the coverage of the Acts); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 799-800 (2d Cir.), cert. denied, 409 U.S. 1009 (1972) (the mere fact that a note has a maturity of less than nine months does not take it out of the securities acts, unless the note fits into the general category of "commercial paper").

149. The prefatory language in § 2 of the 1933 Act and § 3 of the 1934 Act would likely be used to arrive at this conclusion. As Justice Stevens eloquently stated in his concurring opinion:

[p]ursuant to that language, definitions specified by the Acts may not apply if the 'context otherwise requires. . . .' The context clause thus permits a judicial construction of the statute which harmonizes the facially rigid terms of the 9-month exclusion with the evident intent of Congress.

*Reves*, 494 U.S. at 75-76 (Stevens, J., concurring).

applied to note transactions. A bright-line rule would have been easy to apply, but may not have consistently and accurately fulfilled congressional intent in each situation. On the other hand, a flexible rule, designed to consider the individual facts of each situation lacks clarity.<sup>150</sup> Each strategy has its strengths and weaknesses, but choosing one or the other adds predictability to courts attempting to apply a given test. Unfortunately, it appears the *Reves* court did not choose either option, thereby bestowing ineffective standards.

The *Reves* test does not create a simple analysis. By creating a new test for determining whether a note instrument is a security, without providing more detail in how the factors are to be applied, the test has little predictive value. The same criticism applies which respect to the lack of specificity revealed for determining whether a note has a short-term maturity. Predictability of the legal consequences of a company's actions is important in the context of capital raising by firms. Not knowing legal consequences flowing from issuance of a financial instrument will increase the costs of issuing such notes, as issuers seek to account for the uncertain, but potential, risks of misinterpretation. Knowing the bounds within which a note will be scrutinized would reduce uncertainty, and allow financial instruments to reflect true and known costs.

Even if any stability can be gleaned from this decision for the business community, the decision will likely result in less flexibility and more litigation for the Securities and Exchange Commission and the courts.<sup>151</sup> It is likely that investment schemes can be devised that could be limited in maturity to less than nine months and relate to current transactions. Under the *Reves* decision, these schemes would be exempt from federal securities regulation. Absent additional guidance in subsequent Supreme Court case law, the *Reves* court has created a situation that Congress will need to resolve. Removing the exemption for short-term securities altogether, or specifically limiting the exemption to a particular class of instruments, such as high-grade commercial paper,<sup>152</sup> are possible solutions.

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150. See *Reves*, 494 U.S. at 63 n.2.

151. As the Court commented, an approach founded upon something other than a *per se* rule is subject to criticism for lack of clarity. However, this type of approach has the corresponding advantage of allowing the SEC and the courts flexibility in clarifying any ambiguity. *Reves*, 494 U.S. at 63 n.2. The more rigid a rule, the less flexible the interpretation.

152. Even though the term "commercial paper" is not used in either the 1933 nor 1934 Act's "short-term" exemption/exclusion, both the SEC and federal circuit courts have regarded commercial paper as the only instrument to which the "short-term" legislation would apply. See BLOOMENTHAL & WING, *supra* note 14, § 4.04[5] at 65-66. The Commission has stated:

The legislative history of the Act makes clear that Section 3(a)(3) applies only to (1) prime quality negotiable commercial paper, (2) of

## VII. CONCLUSION

In its haste to provide investor protection, the Court has articulated hollow tests. The *Reves* court has left too much discretion with the circuit courts. This discretion could be productive, if contained within a flexible framework which the lower courts are comfortable in applying. Such a flexible framework is the *Howey* test. But the *Reves* court chose to articulate a new test, which requires new interpretation of factors.

Even if some clarity has been contributed by the factors, the effort required to apply them outweighs the possible benefits. Although inconsistency within the federal courts in determining whether a note should be considered a security within the securities acts, has been reduced by the *Reves* decision, it has not been eliminated. Furthermore, the debate over how to determine the maturity of a demand note has not been quelled, but intensified. The standards suggested by the plurality for classification of a note under the maturity exception are far from definite. In fact, this procedure leaves the investing public, as well as the courts, with indefinite criteria that had been previously rejected by the Supreme Court as "not articulating a meaningful distinction between notes that the Act purportedly covers and those it does not."<sup>153</sup> Overall, the *Reves* decision has not clarified, but only added to the controversy.

*Sheryl N. Stephenson*

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a type not ordinarily purchased by the general public, that is, (3) paper issued to facilitate well-recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve banks.

*Id.* (quoting Sec. Act Release No. 4412 (Sept. 20, 1961), Fed. Sec. L. Rep. (CCH) ¶ 2045).

153. BLOOMENTHAL & WING, *supra* note 14, § 4.04 at 50, (quoting Securities Indus. Ass'n v. Federal Reserve Bd., 468 U.S. 137, 152 (1984)).