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The Common Enterprise Element of the *Howey* Test

Federal securities laws[1] provide special remedies and protection for investors.[2] The threshold inquiry to the jurisdictional reach of the Securities Acts is whether a particular scheme of financing is a security.[3] Under federal securities laws, "security" is defined to include standard[4] and catch-all instruments.[5] The investment contract has been classified as a catch-all instrument within the definition of

1. 15 U.S.C.A. §§ 77a-aa (West 1981) (Securities Act of 1933), 78a-kk (West 1981) (Securities Exchange Act of 1934). *See* 17 C.F.R. §§ 230.100-230.656 (1986) (regulations for the 1933 Act), 240.0-1 to 240.31-1 (1986) (regulations for the 1934 Act).

2. *See, e.g.*, 15 U.S.C.A. § 77e (West 1981). Issuers of securities must register with the Securities and Exchange Commission. *Id.* Any person who offers or sells a security without registering or qualifying for an exemption is liable for damages. *Id.* §§ 77l, 77k (1981).

3. *Id.* §§ 77b(1), 78c(a)(10) (1981). Section 2 of the Securities Act of 1933 provides that: "(1) [T]he 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 . . . ." *Id.* § 77b(1) (1981) (emphasis added). Section 3 of the Securities Exchange Act of 1934 provides that: "(10) [T]he term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting trust certificate . . . ." *Id.* § 78c(a)(10) (1981) (emphasis added).

4. *Id.* §§ 77b(1), 78c(a)(10) (1981) (examples of standard instruments include stock, notes, debenture, and treasury stock). *See* Mofsky, *Some Comments on the Expanding Definition of "Security,"* 27 U. MIAMI L. REV. 395, 396-97 (1973).

5. 15 U.S.C.A. §§ 77b(1), 78c(a)(10) (West 1981) (examples of catch-all instruments include investment contract and profit-sharing agreements). *See* Note, *Discretionary Commodity Accounts as Securities: An Application of the* Howey *Test*, 53 FORDHAM L. REV. 639, 643 (1984) (citing Goldon v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982) for proposition that Congress intended an investment contract to be a catch-all phrase).

a security.[6] Thus, a common litigation strategy is to characterize a transaction that is not clearly a standard instrument as an investment contract in order to invoke the special remedies and protections of the Securities Acts.[7] Consequently, a controversy has arisen among the federal courts regarding the meaning of "investment contract."

A definition of investment contract was set forth by the United States Supreme Court in *Securities & Exchange Commission v. W.J. Howey Co.*[8] According to the Court, an investment contract is a transaction[9] or scheme in which a person (1) invests money,[10] (2) in a *common enterprise*, (3) and is led to expect profits,[11] (4) solely from the efforts of a promoter or third party.[12] Since *Howey*, federal courts have struggled to define "common enterprise"[13] and are presently divided as to the precise meaning of the term.[14] One view

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6. *See* Comment, *Catch-All Investment Contracts: The Economic Realities Otherwise Require,* 14 CUMB. L. REV. 135, 136 (1984). *See also* Mofsky, *supra* note 4, at 397.

7. *See* Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis,* 33 EMORY L.J. 311, 318 (1984). *See generally* Prentice & Roszkowski, *The Sale of Business Doctrine: New Relief from Securities Regulations or a New Haven for Welshers?,* 44 OHIO ST. L.J. 473, 511 (1983) (noting substantive and procedural advantages of suing for fraud under federal security laws rather than state common law).

8. 328 U.S. 293, 298-99 (1946).

9. *See* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?,* 18 CASE W. RES. 367, 378 (1967).

> A transaction "describes a concatenation of separate but related events, such as transfers of money and property, written promises, oral promises and representations, and even surrounding circumstances. All occurences and events which can, in a broad sense, be properly considered as part of one bargain are welded together into one legally significant event for securities law purposes."

Id.

10. *See* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979) (extending the money requirement to include the investment of goods or services).

11. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (profit includes the anticipation of capital appreciation).

12. *Id.* The Court in dicta dropped the word "solely" from the *Howey* test. The Court noted a ninth circuit decision which held that the word "solely" should not act as a strict or literal limitation in the definition of an investment contract but should be read realistically so as to include schemes that involve securities in substance if not in form. *Id.* at 852 n.16 (citing S.E.C. v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973)). The court declined to express any view as to the interpretation by the ninth circuit of the *Howey* test. *Id.*

13. The common enterprise element of the *Howey* test has also been referred to as the commonality requirement. *See* Note, *supra* note 5, at 646-50.

14. Mordaunt v. Incomco, 469 U.S. 1115, 1116 (1985) (White, J., dissenting) (refusal to review the split in the lower courts as to the fulfillment of the common enterprise element of the *Howey* test). *See* Curran v. Merrill Lynch, Pierce, Fenner & Smith, 622 F.2d 216, 224 (6th Cir. 1980) (defining common enterprise in terms of horizontal commonality); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100-01 (7th Cir. 1977) (defining common enterprise in terms of horizontal commonality); Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978) (defining common enterprise in terms of strict vertical commonality); S.E.C. v. Koscot

imposes a strict interpretation of vertical commonality.[15] Under strict vertical commonality, the economic successes or losses of an investor and a promoter must be mutually dependent.[16] In contrast, another approach utilizes horizontal commonality.[17] Horizontal commonality requires a pooling of funds or a pro rata distribution of profits between all investors.[18] Finally, an intermediate position imposes a broad view of vertical commonality.[19] Under the intermediate approach, the requisite commonality is present if the success or failure of the investment is dependent on the expertise of the promoter.[20]

Initially, this comment will examine the legislative history of the federal securities laws.[21] Next, the United States Supreme Court's definition of an investment contract will be examined.[22] The approaches of the various federal courts of appeals defining common enterprise will be analyzed.[23] Finally, this comment will propose that the courts apply each of the commonality tests to the transaction since this analysis better comports with the legislative history and with the standard set forth in the *Howey* case. In addition, the differences among the lower courts will be reconciled through a single approach for determining whether the commonality element of the *Howey* test has been met.[24]

LEGISLATIVE HISTORY OF THE FEDERAL SECURITIES LAWS

By 1933, blue sky laws[25] existed in forty-seven of the forty-eight states.[26] Despite the state regulations, deplorable practices were com-

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Interplanetary, Inc., 497 F.2d 473, 478-79 (5th Cir. 1974) (defining common enterprise in terms of broad vertical commonality); S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (defining common enterprise in terms of broad vertical commonality).

15. *Brodt*, 595 F.2d at 461; Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 469 U.S. 1115 (1985). *See also infra* text accompanying notes 144-53 (discussion of strict vertical commonality).

16. *E.g., Brodt*, 595 F.2d at 461. The court did not find a common enterprise because success by Bache did not guarantee a return for Brodt. *Id.*

17. Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977). *See also infra* notes 87-119 and accompanying text.

18. *E.g., Hirk*, 561 F.2d at 101.

19. S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974). *See also infra* notes 120-43 and accompanying text (discussion of broad vertical commonalty).

20. *E.g., Koscot*, 497 F.2d at 479. *See also* Note, *supra* note 5, at 648-50 (broad view of vertical commonality also called dominance commonality).

21. *See infra* text accompanying notes 25-56.

22. *See infra* text accompanying notes 57-84.

23. *See infra* text accompanying notes 85-179.

24. *See infra* text accompanying notes 180-86.

25. State v. Gopher Tire & Rubber Co., 146 Minn. 52, 53, 177 N.W. 937, 938 (1920) ("speculative schemes having no more basis than so many feet of blue sky"). *See* Comment,

monplace in the securities industry.[27] Insider trading,[28] short sales,[29] wash sales,[30] failure of promoters to disclose information,[31] and false news accounts[32] were some of the practices prevalent in the securities markets.[33] As a direct result of these abuses and the ineffective enforcement of the blue sky laws, half of the $50 billion of new securities sold in the decade following World War I proved to be worthless.[34]

The Stock Exchange Hearings[35] conducted in 1932 by the Senate Banking Committee publicly revealed many of these lamentable practices within the securities industry.[36] Increased public awareness, combined with the 1929 stock market crash, transformed America's laissez-faire business ideology[37] to a regulatory reform ideology.[38]

Are Limited Partnership Interests Securities? A Different Conclusion Under the California Limited Partnership Act, 18 PAC. L.J. 125, 129 (1986) (state securities laws are referred to as blue sky laws because the purpose of the statutes was to protect farmers from buying a piece of the blue sky).

26. *See* Comment, *supra* note 6, at 139. *See generally* W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 602 (1975) (the philosophy of many states is that there are some offerings that the investor needs to be protected from whether or not the facts have been disclosed).

27. *See* J. SELIGMAN, THE TRANSFORMATION OF WALL STREET 16 (1982). Some commentators have suggested that the blue sky laws never had a chance to succeed because of the interstate nature of securities transactions. *Id.* at 45.

28. J. SELIGMAN, *supra* note 27, at 34. For example, Morgan & Co. offered stock to firm members and influential individuals at a cost lower than the value the stock was to be traded on the public market. The preferred investors were able to gain a sure profit. *Id.*

29. *Id.* at 9. A person selling short is counting on the stock decreasing in value. Stock is sold to a purchaser by a person that does not own the stock. The person then borrows stock from a broker to deliver to the purchaser. The person profits, if the price of the share drops, by purchasing the shares at a lower price to return to the lending broker. *Id.*

30. *Id.* at 17. A wash sale occurs when shares of a stock are bought and sold by the same persons or pool of persons to create the appearance of activity on the stock. The trading volume may increase the stock prices by luring new investors to trade in the security. *Id.*

31. *Id.* at 28 (information provided in prospectuses were often inaccurate and misleading).

32. *Id.* at 16-17. For example, in a 10 year period, publicist A. Newton Plummer had received $286,279, for deliberately printing favorable news stories to raise the prices of several separate stocks. *Id.*

33. *Id.*

34. *Id.* at 1. Between September 1929 and July 1932 the value of all stocks listed in the New York Stock Exchange declined from a total of $90 billion to just under $16 billion—a loss of 83%. *Id.*

35. *Stock Exchange Practices Hearings before the Senate Banking Comm.*, 72d & 73d Congs. (1932-1934). *See generally* J. SELIGMAN, *supra* note 27, at 1 (the Senate Banking and Currency Committee investigation of stock exchanges practices in 1932-1934 is also called Pecora hearings in recognition of the counsel of the committee, Ferdinard Pecora).

36. J. SELIGMAN, *supra* note 27, at 2 (purpose of the hearings was to determine what caused the decrease in the value of securities and to propose legislation to prevent another stock market crash). *See* Carney, *supra* note 7, at 348 ("Congress saw the crash of the securities market as a cause rather than an effect of the Great Depression").

37. *See* Balkin, *Ideology and Counter-Ideology from* Lochner *to* Garcia, 54 UMKC L. REV. 175, 178 (1985) (*laissez-faire* ideology emphasizes economic individualism). *See also*

This ideological shift culminated with the passage of the Securities Act of 1933 (hereinafter 1933 Act) and the Securities Exchange Act of 1934 (hereinafter 1934 Act). Legislative history is minimal due to the haste in which the Securities Acts were passed.[39] The scope of the federal securities laws, however, provides a basis for determining the protections Congress intended to provide the public through these statutes.

A. *The Securities Act of 1933*

The 1933 Act has two substantive provisions.[40] First, the registration and prospectus provision requires persons to disclose information to potential investors and to the Securities and Exchange Commission prior to selling or offering to sell any new securities.[41] Second, the general fraud provision provides a remedy for misrepresentations made by a promoter or an issuer in offering and selling new securities.[42] Through these disclosure provisions, Congress intended to protect investors against fraud and to promote ethical standards of honesty and fair dealing.[43]

WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1265 (1976) (the policy or practice of letting people act without interference or direction; the policy of letting owners of industry and business fix the rules of competition, the conditions of labor, etc. in their discretion without governmental regulation or control).

38. *See* Balkin, *supra* note 37, at 188 (regulatory reform ideology is a preference for uniform national governmental regulation of the economy). *See also* J. SELIGMAN, *supra* note 27, at 2, 13.

39. Comment, *supra* note 6, at 140. "Congress needed only 60 days with which to pass the most 'technical' and 'intricate' legislation theretofore introduced on Capitol Hill." *Id.* at 140 n.36. *See also* Landreth Timber Co. v. Landreth, 471 U.S. 681, 694-95 n.7 (1985). The Court acknowledged that the legislative history was silent as to whether Congress had contemplated the particular type of transaction involved in the case when enacting the Securities Acts. *Id.*

40. 15 U.S.C.A. §§ 77a-aa (West 1981). *See infra* text accompanying notes 41-42.

41. 15 U.S.C.A. §§ 77e-j (West 1981).

42. *Id.* § 77l (1981).

43. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975). The Senate outlined the purposes of the Securities Act of 1933 as follows:

> The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.
>
> The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point

The 1933 Act, however, did not vest the Securities and Exchange Commission with the power to make judgments about the investment quality of the security or the power to enforce blue sky laws.[44] Moreover, the 1933 Act only regulates the distribution of new issues of securities.[45] The 1933 Act does not regulate securities that are subsequently traded in the market. To address these problems, Congress passed the Securities Exchange Act of 1934.

B. The Securities Exchange Act of 1934

Congress intended the 1934 Act to protect investors against manipulation of stock prices by regulating transactions in securities exchanges and in over-the-counter markets.[46] The 1934 Act prohibits fraudulent acts and practices by specific participants[47] in specific markets[48] involved in specific transactions.[49] The 1934 Act imposes regular reporting requirements on companies whose stock is listed on nationally regulated securities exchanges.[50] In addition, the 1934 Act created the Securities and Exchange Commission and vested the Commission with authority to enforce both of the Securities Acts.[51]

The 1933 Act is a narrow statute that is chiefly concerned with disclosure and fraud in connection with the initial distribution of newly issued securities.[52] The 1934 Act is general in scope but chiefly

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> of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REP. No. 47, 73d Cong., 1st Sess. (1933). *See generally* Cohen, *Federal Legislation Affecting the Public Offering of Securities,* 28 GEO. WASH. L. REV. 119, 156 (1959) (the intent of Congress in enacting the Securities Act of 1933 was to impose a fiduciary standard on persons who solicit and take public money for investment purposes).

44. *See* Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review,* 25 HASTINGS L.J. 311, 322 (1974) (differentiating state security provisions from federal security provisions). *See also* Landis, *The Legislative History of the Securities Act of 1933,* 28 GEO. WASH. L. REV. 29, 34 (1959).

> Our [Landis-Cohen] draft remained true to the conception voiced by the President in his message of March 29, 1933 to the Congress, namely that its requirements should be limited to full and fair disclosure of the nature of the security being offered and that there should be no authority to pass upon the investment quality of the security.

Id.

45. Anderson, *supra* note 44, at 321.
46. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).
47. *E.g.,* 15 U.S.C.A. § 78c (West 1981) (brokers and dealers).
48. *E.g., id.* § 78i (1981) (exchange transactions).
49. *E.g., id.* § 78n(e) (1981) (tender offers).
50. *Id.* § 78l (1981) (prohibits the use of the facilities of an exchange unless the securities are registered with the Securities and Exchange Commission).
51. *Id.* § 78d (1981).
52. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728 (1975).

concerned with the regulation of trading on the stock exchanges and securities trading markets.[53] Both the 1933 Act and the 1934 Act constitute interrelated components of the federal regulatory scheme that governs many types of securities transactions.[54]

The applicability of either of the federal securities statutes depends on a finding that the transaction falls within the definition of a security. The definition of a security is similar in both Acts and includes the term investment contract.[55] Although Congress failed to define investment contract, the term has been described as a catch-all term that empowers the Securities and Exchange Commission to deal with new manipulative devices that fall within the ordinary concept of a security.[56] Precise definition of the term investment contract is therefore important in determining the jurisdictional reach of the acts.

THE INVESTMENT CONTRACT

The term investment contract originated in the blue sky laws.[57] Minnesota was the first state to use the term in a security statute.[58] The Minnesota Supreme Court, in *State v. Gopher Tire & Rubber Co.*,[59] interpreted investment contract as an investment of capital in a way intended to secure profits.[60] The court described the term investment contract as a broad concept encompassing the regulation of any transaction not expressly exempted by the Minnesota blue sky law.[61] Other states soon included investment contract within the

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53. *Id.*

54. *Id.* at 727-28.

55. *See* Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982) (the United States Supreme Court has consistently held that the definition of "security" in the 1934 Act is the functional equivalent to that in the Securities Act of 1933). *See also* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975) (the definition of security in both acts is almost identical and may be considered the same).

56. *See* Comment, *supra* note 6, at 135. *See also* H.R. REP. No. 85, 73d Cong., 1st Sess. (1933) (the definition was fashioned in "sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security").

57. State v. Gopher Tire & Rubber Co., 146 Minn. 52, 53, 177 N.W. 937, 938 (1920) (defining investment contract as a security). *See* Comment, *supra* note 6, at 137.

58. MINN. STAT. ANN. § 80A.14 subd. 18 (West 1986). *See also* Note, *Pension Plans as Securities*, 96 U. PA. L. REV. 549, 553 (1948) (early cases and statutes indicated the term investment contract primarily related to preventing abuses in the sale of land for speculative purposes).

59. 146 Minn. 52, 177 N.W. 937 (1920).

60. *Id.* at 53, 177 N.W. at 938 (interpreting an investment contract as a contract for the "placing of capital or laying out of money in a way intended to secure income or profit from its employment").

61. *Id.*

definition of a security and adopted the definition of investment contract promulgated by the Minnesota Supreme Court.[62] State blue sky laws guided Congress in drafting the Securities Acts.[63] In particular, Congress adopted the definition of security from the Uniform Sale of Securities Act of 1929.[64] Since the meaning of investment contract had been crystallized in prior state law,[65] the inclusion of the term in the federal definition of a security is indicative of congressional intent to reach many new types of commercial instruments that fall within the ordinary concept of a security.[66]

Following the enactment of the securities provisions, the federal courts attempted to define investment contract.[67] The first United States Supreme Court decision to interpret "investment contract" was *Securities & Exchange Commission v. C.M. Joiner*.[68] In *Joiner*, a corporation sold oil and gas leases for small acreages of land. The leases included an agreement to complete the drilling of a test well on the leased acreage.[69] Justice Jackson, writing for the majority, stated that the transaction was an offer to sell an "exploration enterprise" and not a mere leasehold right.[70] Jackson concluded that the agreements were investment contracts because the investor paid for a lease and for a development project.[71] The Court explained that the term "investment contract" included uncommon and irregular investment devices.[72] The *Joiner* Court looked to the terms of

62. *See, e.g.*, People v. White, 124 Cal. App. 548, 554-55, 12 P.2d 1078, 1081 (1932) (investment certificates evidencing receipt of money constituted an investment contract); Lewis v. Creasey Corp., 198 Ky. 400, 441, 248 S.W. 1046, 1049 (1923) (sale by wholesale grocer of service contracts to retail dealers not an investment contract).

63. Comment, *supra* note 6, at 139.

64. *See* Note, *supra* note 58, at 560 (citing *Hearings Before Comm. on Interstate & Foreign Commerce on H.R. 4314*, 73d Cong., 1st. Sess. 13 (1933)). *See generally* L. Loss & E. Cowett, Blue Sky Law (1958). The National Conference of Commissioners on Uniform State Laws and the American Bar Association approved the Uniform Sales of Securities Act of 1929. *Id.* at 230. The passage of the 1933 Act introduced problems between federal and state coordination of security regulations making the 1929 Uniform Act obsolete. *Id.* at 231. In 1944, the Conference struck the Uniform Act from the list of approved acts. *Id.*

65. S.E.C. v. W.J. Howey, Co., 328 U.S. 293, 298 (1946).

66. *Id.* at 298-99. The *Howey* test "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Id.* at 299.

67. *See, e.g.*, S.E.C. v. Bailey, 41 F. Supp. 647, 650 (S.D. Fla. 1941) (tung tree groves with management contracts); S.E.C. v. Pyne, 39 F. Supp. 434, 435 (D. Mass. 1941) (undivided interests in fishing boats).

68. 320 U.S. 344 (1943).

69. *Id.* at 345-46.

70. *Id.* at 348.

71. *Id.* at 349.

72. *Id.* at 351. Interpreting the language of the Securities Acts, the court found transactions

the contract, the plan for distribution of profits, and the economic inducements held out to attract potential investors.[73]

The *Joiner* case was followed by *Securities & Exchange Commission v. W.J. Howey Co.*[74] in which the United States Supreme Court further refined the definition of an investment contract.[75] In *Howey*, the Securities and Exchange Commission sought to enjoin two corporations from selling and offering to sell units of a citrus grove development.[76] The two corporations were under common control and management.[77] One corporation owned tracts of citrus acreage, while the other corporation was a service company engaged in cultivating, harvesting, and marketing orange crops.[78] The corporations offered each prospective customer a land sales contract and a service contract.[79] While purchasers were free to make arrangements with other service companies, eighty-five percent of the acreage was sold to investors who also purchased the service contracts.[80] The purchasers were predominantly business and professional people who lacked knowledge about cultivating citrus trees, but were attracted to the offer by the expectation of profit.[81]

The United States Supreme Court held that this transaction was an investment contract.[82] Noting that the term "investment contract" was not defined in statutes or legislative reports, the Court determined that Congress had intended that investment contract be defined in a manner consistent with the meaning reflected in prior state court decisions and blue sky laws.[83] Thus, the Court held that when money

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involving a named or described security as provided in the statutory definition of a security, are, as a matter of law, a security. *Id. But see* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975). "Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto." *Id.*

73. *Joiner*, 320 U.S. at 352-53. In determining the existence of an investment contract, this approach has been described as the market oriented approach and has been supplanted by the *Howey* test. Carney, *supra* note 7, at 320.

74. 328 U.S. 293 (1946).

75. *Id.* at 299.

76. *Id.* at 294-95.

77. *Id.* at 295.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* at 296.

82. *Id.* at 299.

83. *Id.* at 298 (quoting State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)). In addition, the *Howey* Court cited several cases which applied a definition of investment contract similar to that of the Minnesota Supreme Court. *Howey*, 328 U.S. at 298 n.4 (citing People v. White, 124 Cal. App. 548, 12 P.2d 1078 (1932); State v. Evans, 154 Minn. 95, 191 N.W. 425 (1922); State v. Heath, 199 N.C. 135, 153 S.E. 855 (1930); Klatt v. Guaranteed Bond Co., 213 Wis. 12, 250 N.W. 825 (1933)).

is invested in a common enterprise with the expectation of earning a profit solely from the efforts of others, an investment contract has been formed.[84] The *Howey* test continues to be the standard for determining whether a transaction is an investment contract.

COMMON ENTERPRISE

Authorities agree that the *Howey* test should be used to determine whether a transaction is an investment contract. The federal courts are divided, however, regarding the application of the common enterprise element of the *Howey* test.[85] Three different approaches to the meaning of common enterprise have been developed by the federal courts.[86] This section will delineate the various approaches and analyze the merits of each approach in terms of the purposes of the Securities Acts.

A. Horizontal Commonality

The horizontal approach, which can be traced to the *Howey* decision,[87] requires a pooling of investors' funds[88] or a pro rata distribution[89] of profits among investors.[90] Thus, by definition, this approach requires the scheme or transaction to involve the joint participation of more than one investor in the sharing of profits or the investing of money.[91] The focus of horizontal commonality is strictly limited to the relationship among the investors and does not

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84. *Howey*, 328 U.S. at 298-99.

85. *See supra* note 14. *Compare* S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (broad approach to vertical commonality) *and* Booth v. Peavey Co. Commodity Servs., 430 F.2d 132, 133 (8th Cir. 1970) (broad approach to vertical commonality) *with* Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982) (strict application of vertical commonality), *cert. denied*, 469 U.S. 1115 (1985) *and* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 278 (7th Cir.) (horizontal commonality approach), *cert. denied*, 409 U.S. 887 (1972).

86. *See supra* text accompanying notes 15-20.

87. S.E.C. v. W.J. Howey Co., 328 U.S. 293 (1946). In *Howey*, the fruit from the orange trees was collectively marketed and sold. The proceeds were distributed to the investors in proportion to the number of citrus trees owned by each investor rather than by the yield of each individual tree. *Id.* at 296. These facts have been interpreted as requiring pooling or pro rata distribution of profits. *E.g.*, Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 222 (6th Cir. 1980).

88. *See* Peloso & La Bella, *Determining if Discretionary Customer Accounts Are Securities*, 9 SEC. REG. L.J. 307, 318 (1982) ("investor funds" includes the assets pooled into a particular scheme by multiple investors).

89. *See* BLACK'S LAW DICTIONARY 637 (5th ed. 1983) (pro rata distribution allots profits or losses according to the proportion of ownership or interest).

90. *Curran*, 622 F.2d at 222-23.

91. *See id.*

inquire as to whether the promoter is involved in the scheme.[92]

In *Milnarik v. M-S Commodities, Inc.*,[93] seven family members deposited money[94] into a discretionary commodities trading account.[95] The Court of Appeals for the Seventh Circuit found that the common enterprise element of the *Howey* test had not been met.[96] According to the court, the broker was merely an agent representing the family.[97] Even though *all* of the customers of the broker were represented by a common agent, the common enterprise element was lacking because the customers did not jointly participate in a single investment enterprise.[98] Since the funds of all the customers had not been pooled or the profits had not been shared by all the customers, horizontal commonality was lacking.[99]

In a subsequent case, *Hirk v. Agri-Research Council, Inc.*,[100] the same court reaffirmed the horizontal theory of commonality despite the development of vertical commonality in the other circuits.[101] Hirk entered into a trading agreement with Agri-Research Council, a company engaged in managing discretionary future trading accounts.[102] Horizontal commonality was not found.[103] The *Hirk* decision was based on three principles: the remedial nature of federal securities laws, the legislative history that the federal securities laws should be construed liberally and flexibly to effectuate their purposes, and prior case interpretation that a securities transaction should be

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92. *See id. See also infra* text accompanying notes 120-53 (the broad and strict approaches to vertical commonality focus on the role of the promoter in the scheme).

93. 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

94. *Id.* at 275.

95. *Id.* For factually similar cases, see Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978); S.E.C. v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974). *See* Peloso & La Bella, *supra* note 88, at 308. A discretionary account is one in which the investor gives the broker power of attorney to make all trading decisions. The broker is empowered to manage the account for the benefit of the investor and does not have to consult or obtain permission to trade the accounts. *Id.* at 308 n.1.

96. Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 275 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). The plaintiff's claim was based on an alleged securities violation. The broker had failed to register the discretionary commodities trading account as a security. *Id.*

97. *Id.* at 278 (plaintiffs were just one principal of the broker agent).

98. *Id.* at 276-78 (quoting Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149, 1151-53 (N.D. Ill. 1970)). "Even if he [broker] had so uniformly traded, no pooling of funds for a common purpose is alleged." *Id.* at 278.

99. *Id.* at 276-77. The *Milnarik* court did not comment on the fact that a group of investors did exist in the form of family members.

100. 561 F.2d 96 (7th Cir. 1977).

101. *Id.* at 100.

102. *Id.* at 98. Pursuant to this agreement, Hirk placed $10,000 in the account and executed a power of attorney appointing Agri-Research as his agent. Hirk alleged that the discretionary trading account agreement was an investment contract. *Id.*

103. *Id.* at 101.

viewed in terms of the substance and economic realities underlying the transaction.[104] Despite these broad principles, the court interpreted the *Howey* test as requiring a sharing of profits or pooling of funds by multiple investors.[105] In justification of this position, the court emphasized that Congress did not intend to include every conceivable transaction into the statutory definition of a security.[106] The court, however, failed to provide authority for this limitation.[107]

In contrast to these two cases, the same court in *Stenger v. R.H. Love Galleries, Inc.*,[108] analyzed the common enterprise element of the *Howey* test by using both the strict vertical and the horizontal commonality tests.[109] In *Stenger*, twelve paintings were purchased from Love Galleries for $1.5 million.[110] By the terms of the sales agreement, either Stenger or Love Galleries could resell the paintings.[111] Since a pooling of funds or a sharing of profits by multiple investors was lacking, the court found that the transaction did not meet the horizontal commonality test.[112]

The court also applied the strict vertical commonality test.[113] According to the court, strict vertical commonality requires the successes and losses of the parties to be interrelated.[114] In this case, the parties had different financial interests in selling the art collection.[115] Stenger was free to sell the paintings and experience a personal gain or loss.[116] Love Galleries could also sell the paintings and collect the commission irrespective of whether Stenger benefitted from the sale.[117] Because Stenger and Love Galleries did not share the same financial risk, the court did not find the requisite vertical commonality.[118] The court,

104. *Id.* at 99-100 (referring to *Milnarik* court construction of term "security").
105. *Id.* at 101 (stating the *Milnarik* decision was based on the correct underlying assumption that a sharing of profits or pooling of funds was required by *Howey*).
106. *Id.* at 102. *See also* Note, *The Sale of Business Doctrine: A Decade After* Forman, 49 BROOKLYN L. REV. 1325, 1326 (1983) (noting Congress never intended the Acts to encompass all instruments that might be subjected to fraud).
107. *Hirk*, 561 F.2d at 101.
108. 741 F.2d 144 (7th Cir. 1984).
109. *Id.* at 146-47.
110. *Id.* at 145.
111. *Id.* at 145-46. The investor sued Love Galleries for violating federal securities laws by not registering the alleged investment contract as a security. *Id.* at 145-46.
112. *Id.* at 147.
113. *Id.*
114. *Id.* at 146-47.
115. *Id.*
116. *Id.* at 147.
117. *Id.*
118. *Id.*

however, did not discuss the reasons for considering both approaches to commonality.[119]

B. Vertical Commonality: Broad Interpretation

In determining the existence of a common enterprise, several courts have broadly applied the vertical commonality approach.[120] These courts have focused on the role of the promoter in the transaction.[121] The requisite commonality exists if the success or failure of the investment is dependent upon the expertise of the promoter.[122] This view does not consider the economic relationship between the promoter and the investor or between investors.[123] Instead, the focus is on the skill, judgment and knowledge of the promoter regarding the investment and how these factors influence the decisions made by the investor.[124]

The leading case illustrating the broad vertical commonality approach is *Securities & Exchange Commission v. Koscot Interplanetary, Inc.*[125] In *Koscot*, each investor paid a sum of money to become a representative for Koscot in the sale of cosmetics.[126] Each investor could earn substantial sums of money by convincing other persons to become associated with Koscot.[127] The new participants were paid a sum of money for the right to participate in the Koscot endeavor, and the original investor who attracted the new participant received a commission.[128] Each investor was required to follow the Koscot method.[129] This entailed significant efforts by the Koscot members

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119. *Id.*

120. *E.g.*, S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-79 (5th Cir. 1974); S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 522-23 (5th Cir. 1974) (broad application of vertical commonality).

121. *Continental*, 497 F.2d at 522. "[T]he critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts." *Id.* (quoting *Koscot*, 497 F.2d at 478).

122. *Id.* The critical inquiry is confined to whether the success or failure of the investments are essentially dependent upon promoter expertise. *Id.*

123. *Id. But see* Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 224-25 (6th Cir. 1980) (the focus of fulfilling the common enterprise element is on the relationship between investors as exemplified by the pooling of funds or pro rata distribution of profits).

124. *Continental*, 497 F.2d at 522.

125. 497 F.2d 473 (5th Cir. 1974).

126. *Id.* at 475-76.

127. *Id.*

128. *Id.* (Koscot endeavor was a pyramid scheme).

129. *Id.* at 476.

to create illusions of wealth to entice new participants to sign a membership contract.[130]

Applying *Howey*, the *Koscot* court found a common enterprise between the original investor and the Koscot organization.[131] A broad interpretation of vertical commonality required the court to focus on the expertise of the promoter.[132] The requisite commonality was found because the investors' successes and losses were directly dependent on the effectiveness of the Koscot meetings.[133] The illusions of wealth and high-pressure sales techniques of the Koscot meetings resulted in more membership contracts.[134] The investors' profits were directly tied to the commissions from membership contracts.[135] The decision in *Koscot* was followed two days later by the *Securities & Exchange Commission v. Continental Commodities Corp.*[136] Applying the *Howey* test, the court held that the sale of discretionary commodity trading accounts constituted an investment contract.[137] In *Continental Commodities*, the fact that the investor relied on the expertise of the broker for the success of the investment established the requisite commonality.[138] The *Continental Commodities* court expanded the broad view of commonality to include a broker-customer relationship.[139] Since the customer relied on the investment counseling provided by the broker, the common enterprise element of the *Howey* test was satisfied.[140]

Both the *Koscot* and *Continental* decisions rejected a rigid application of the *Howey* test.[141] According to the Court of Appeals for

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130. *Id.*

131. *Id.* at 478-86. The court interpreted the "solely from efforts of others" requirement of the *Howey* test as including schemes where the investors participate in the venture to a minimal degree. *Id.* at 481.

132. *Id.* at 478.

133. *Id.* at 479. The court specifically rejected the horizontal approach which requires pooling of funds by multiple investors such that the returns of one investor are dependent on all the other instruments. *Id.*

134. *Id.* at 484-85.

135. *Id.* at 485.

136. 497 F.2d 516 (5th Cir. 1974).

137. *Id.* at 521-22.

138. *Id.* at 522.

139. *Id.* at 522-23. A broker-customer relationship is an agent-principal relationship. *Id.* *See also* BLACK'S LAW DICTIONARY 57-58 (5th ed. 1979) (agency is a relationship in which one person acts for or represents another by latter's authority, either in relationship of principal and agent, or master and servant).

140. *Continental*, 497 F.2d at 522-23. The court stated that the actual productive effect of the counseling was not important but rather that the potential for success was contingent on the counseling. *Id.*

141. *See id.* at 521; S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 478-79 (5th Cir. 1974).

the Fifth Circuit, the *Howey* test is a resilient standard that should be capable of reaching any scheme that falls within the ordinary concept of a security.[142] Thus, the emphasis on the promoter's expertise accords with the flexible standard described in *Howey* and the broad remedial purposes underlying the security statutes.[143]

C. *Vertical Commonality: Strict Interpretation*

In contrast to the broad interpretation, the strict interpretation of vertical commonality requires that the economic successes or losses of the investor and promoter be mutually dependent.[144] Thus, the strict approach requires that the financial successes of an investor directly rise or fall with that of the promoter, and vice versa.[145] Unlike the broad approach, the strict view requires a sharing of the financial risk of the venture.[146] *Brodt v. Bache & Co.*[147] exemplifies the application of the strict approach to vertical commonality.

In *Brodt*, the investor opened a discretionary commodities trading account after being solicited to do so by Bache & Co., a national brokerage firm.[148] The court in *Brodt* defined a common enterprise as a venture in which the profits of the investor and the broker are interwoven and mutually dependent.[149] The court did not look at the nature of the promoter's expertise in determining whether the necessary commonality was present.[150] Moreover, the court did not require that the investor pool interests or share profits with other investors.[151] Rather, the court focused solely on the nature of the

142. *Continental*, 497 F.2d at 521-22.

143. S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974).

144. Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 469 U.S. 1115 (1985). An agent-principal relationship would not qualify as a security using the strict approach because the economic fates of the promoter and investor are independent. The promoter will earn the usual commission despite the profits or losses of the investor. *Id.* Even if the promoter is paid on a commission based on a percentage of the profits made by the investor, this does not qualify as an investment contract under the strict approach. *See* Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc., 686 F.2d 818, 819 (9th Cir. 1982) (investment contract not found where promoter received percentage of assets because investor could withdraw funds from the account and promoter would not have shared profits), *cert. denied*, 460 U.S. 1023 (1983).

145. *See* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978); *Mordaunt*, 686 F.2d at 817. *See also* S.E.C. v. Goldfield Deep Mines Co., 758 F.2d 459, 463 (9th Cir. 1985) (requires a "direct correlation" between an investor and a promoter).

146. *See Brodt*, 595 F.2d at 461.

147. 595 F.2d 459 (9th Cir. 1978).

148. *Id.* at 459-60 (the investor authorized the representative at Bache & Co. to withdraw funds to finance commodity transactions at the broker's discretion).

149. *Id.* at 460 (reaffirming previous definition of common enterprise).

150. *Id.* at 461 (rejecting the expansive view of vertical commonality).

151. *Id.* at 460-61 (expressly rejecting horizontal commonality).

investor-promoter relationship.[152] Since the broker had no stake in the investment, the court did not find the requisite commonality.[153]

D. Contrasting the Three Commonality Theories

The horizontal test restricts commonality to transactions that have more than one investor.[154] Regardless of the nature of the fraud perpetrated by a provider, the common enterprise element will not be satisfied unless more than one investor participates in a single investment enterprise.[155] Further, the courts applying this approach require that the participation by multiple investors be evidenced by a sharing of profits or pooling of capital.[156] To justify this position, courts have relied on the fact that the *Howey* case involved multiple investors participating in a single investment enterprise.[157]

In developing the standard for determining whether a transaction is an investment contract, however, the *Howey* court emphasized the dynamic and flexible nature of the test.[158] The *Howey* court argued that by defining security to include an investment contract, Congress intended to protect the public from all deceptive schemes.[159] Therefore, to fulfill the broad remedial purposes underlying the federal securities laws, and to be consistent with the underlying rationale of *Howey*, the common enterprise element should not be limited strictly to the facts of the *Howey* case.

Because of the rigid nature of the horizontal test, other courts have applied vertical commonality to the common enterprise element of the *Howey* test.[160] Using the broad approach, the requisite commonality can be found if one investor relies on the skill, knowledge,

152. *Id.* at 461.

153. *Id.* The requisite commonality was lacking because the success or failure of the brokerage firm did not correlate with the success or failure of the investor. Since the commissions received by the brokerage firm were not dependent on the individual success of the investors' account and vice versa, the court did not find the requisite commonality. *Id.*

154. *E.g.*, Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100-01 (7th Cir. 1977).

155. *See id.*

156. *See id.* at 101 (interpreting *Howey* as requiring pooling of funds). *See also* Milnarik v. M.S. Commodities, Inc., 457 F.2d 274, 278 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

157. *See, e.g., Hirk*, 561 F.2d at 101. *See also* S.E.C. v. W.J. Howey Co., 328 U.S. 293, 294-98 (1946). This interpretation, however, deserves a closer analysis. The facts of *Howey* indicate that the payments by individual investors were for the purchase or servicing of individual tracts. The profits were based on an estimate of the yield of each individual tract and was not a pro rata distribution. *Id.* at 295-96.

158. *Howey*, 328 U.S. at 299.

159. *Id.*

160. *See, e.g.*, S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974).

and judgment of the promoter.[161] The need for multiple investors is eliminated.[162] The broad view of vertical commonality is the only approach that has found a common enterprise in a broker-customer relationship.[163] Although a broker is technically the agent of the customer, the courts have found commonality by focusing on the broker's expertise.[164]

Broad vertical commonality would be lacking, however, when the investor has knowledge about a transaction and therefore is not dependent on the expertise of the promoter.[165] For example, an expert in the field of gold mining who invests money into a gold mining scheme would be automatically excluded from the scope of the Securities Acts merely because the investor would not be entirely dependent upon the knowledge and judgment of the promoter. This exclusion contravenes the broad remedial purposes[166] behind the Securities Acts and does not comport with the flexible standard set forth in *Howey*.[167] The Securities Acts were designed to protect *all* members of the public from fraudulent schemes devised by promoters regardless of the expertise of the investor.[168] Knowledge and expertise in an area do not necessarily make an investor less vulnerable to fraud. The broad approach, therefore, unduly restricts the application of the *Howey* test.

Finally, some courts have restricted the application of the *Howey* test through the strict vertical view of commonality.[169] The strict view requires the investor and promoter to be involved in a common

161. *E.g.*, S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974).
162. *Id.*
163. *Id. See also* Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 222-23 (6th Cir. 1980). Horizontal commonality does not exist unless there also exists some relationship that ties the fortunes of each investor to the success of the overall venture. *Id.*
164. *Continental*, 497 F.2d 522.
165. *See id.*
166. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). The Court emphasized that a broad and expansive scope of the statutory definition of a security was necessary to carry out the remedial statutory purposes of the securities laws. *See also* Landreth Timber Co. v. Landreth, 471 U.S. 681, 687-88 (1985) (citing the *Howey* case as describing the definition of a security as broad so as to ensure full and fair disclosure with respect to a wide range of instruments). "[T]he reach of the Act does not stop at the obvious and commonplace." *Id.* (quoting S.E.C. v. C.M. Joiner, 320 U.S. 344 (1943)).
167. S.E.C. v. W.J. Howey, Co., 328 U.S. 293, 299 (1946). *See* S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 481 (5th Cir. 1974). "Moreover, a significant number of federal courts invoking the *Howey* test, have either given it a broader more salutary application or endorsed such an application in principle." *Id.*
168. *See* S.E.C. v. Glenn W. Turner, Inc., 474 F.2d 476, 481 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973). "The Acts were designed to protect the American public from speculative or fraudulent schemes of promoters." *Id.* (citing S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933)).
169. *See* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978).

venture without mandating that other investors also be involved in the venture.[170] Instead of focusing on the promoter's influence over the investment decision,[171] the strict approach requires the investor and the promoter to share in the risks of the scheme.[172] In addition, the strict vertical approach rejects the necessity of a pooling of investments or investor renumeration on a pro rata basis.[173]

Technically, the horizontal approach is very similar to the strict vertical approach because the promoter and investor in strict vertical commonality must pool funds or share profits.[174] The horizontal approach, however, requires a promoter and at least two investors.[175] Furthermore, the horizontal commonality test does not require that the promoter share in the financial risk of the endeavor.[176] Vertical commonality would not be found under the strict approach in any scheme in which the promoter did not participate in the risks of the venture.[177] The protections provided by the Securities Acts should encompass fraudulent schemes devised by promoters regardless of whether the promoter shares the risks of the venture.[178] As a result, the horizontal approach does not provide the intended broad scope of protection underlying the security statutes.

The court in *Howey* emphasized the need for a flexible application of the test to address the broad remedial purposes underlying the securities statutes.[179] Each approach for determining commonality frustrates these purposes by unduly restricting the reach of the *Howey* test. A better approach to the commonality element would be to broaden its definition.

PROPOSAL

The determination of whether a transaction has the requisite commonality required by the *Howey* test must comport with the intent of Congress. In addition, the approach must be consistent with the guidance provided by the United States Supreme Court in the *Howey* case. The only way to satisfy both of these criteria is to consider all

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170. *Id.*
171. *See* S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 475 (5th Cir. 1974).
172. *Brodt*, 595 F.2d at 461.
173. *Id.* at 460-61.
174. *See id.*
175. *See Koscot*, 497 F.2d at 479.
176. *Id.*
177. *See* S.E.C. v. Goldfield Deep Mines Co., 758 F.2d 459, 463 (9th Cir. 1985).
178. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).
179. S.E.C. v. W.J. Howey, Co., 328 U.S. 293, 299 (1946).

three of the commonality tests in determining whether the common enterprise element of the *Howey* test has been satisfied. A judge[180] should consider whether the underlying scheme involves horizontal, strict vertical, or broad vertical commonality. If any *one* of the commonality approaches is satisfied, then a common enterprise exists. Thus, a judge will not be limited to viewing just the relationship between the investors,[181] but will be required to examine the relationship between the investor and the promoter,[182] as well as the impact of the promoter's expertise on the transaction.[183]

Although this flexible approach will result in more transactions qualifying as investment contracts, the scope of the *Howey* test will not be unlimited. The judge still determines whether the other elements of the *Howey* test have been satisfied.[184] Thus, a transaction having the requisite commonality while not satisfying the other elements of the *Howey* test will not be considered an investment contract.

The advantages of this analysis in determining whether the commonality element of the *Howey* test has been satisfied are twofold. First, by considering all of the commonality tests, more transactions would qualify as investment contracts. Thus, courts would effectuate the legislative objective of providing a broad scope of protection to the public.[185] In addition, application of a broader, more flexible approach would effectuate the intent of the United States Supreme

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180. United States v. Carman, 577 F.2d 556, 562 (9th Cir. 1978) (although characterization of a transaction raises questions of law and fact, the ultimate issue of whether or not a particular set of facts is an investment contract is a question of law).

181. *E.g.*, Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 278 (7th Cir.) (horizontal commonality), *cert. denied*, 409 U.S. 887 (1972).

182. *E.g.*, Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982) (strict vertical commonality), *cert. denied*, 469 U.S. 1115 (1985).

183. *E.g.*, S.E.C. v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (broad vertical commonality).

184. S.E.C. v. W.J. Howey Co., 328 U.S. 293, 299 (1946).

185. *See id.* (quoting H.R. REP. No. 85, 73d Cong., 1st Sess., 11 (1933)). Congressional purpose in enacting the legislation was to protect investors by "compelling full and fair disclosure relative to the issuance of the many types of instruments that in our commercial world fall within the ordinary concept of a security." *Id. See generally* J. SELIGMAN, *supra* note 27, at 38 (quoting 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 213-14 (1938)).

> The new law [referring to the Securities Act of 1933] will also safeguard against the abuses of high-pressure salesmenship in security flotations. It will require full disclosure of all the private interests on the part of those who seek to sell securities to the public. The Act is thus intended to correct some of the evils which have been so glaringly revealed in the private exploitation of the public's money.

Id.

Court that the term investment contract should embrace newly created deceptive schemes.[186]

Second, requiring the judge to consider all the commonality approaches would produce more consistent results in the application of the *Howey* test. The courts that use horizontal commonality require the pooling of funds by investors at the cost of excluding transactions with vertical commonality and vice versa. If all the courts were to apply each of the approaches, the results would be consistent in determining whether an instrument has the characteristics of an investment contract.

CONCLUSION

The legislative intent in enacting the securities provisions was to regulate the securities industry to protect the public from fraudulent and deceptive practices. The definition of security includes investment contract. Although courts agree on the use of the *Howey* test in determining whether a transaction is an investment contract, confusion exists as to the common enterprise element of the *Howey* test. The courts have developed various solutions to the problem. Neither the horizontal test nor the broad or strict tests of vertical commonality, however, comports with the legislative intent and the remedial purposes of the Securities Acts. Only by applying each of the commonality tests to a transaction can these goals be achieved. If any one of the tests are satisfied, then the common enterprise element has been satisfied. This approach will result in more transactions qualifying as an investment contract within the definition of a security. Thus, the broad remedial purposes underlying the federal securities laws and the flexible standard admonished by the United States Supreme Court in *Howey* will be achieved.

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186. S.E.C. v. W.J. Howey, Co., 328 U.S. 293, 299 (1946). *See also* S.E.C. v. Koscot Interplanetary, Inc., 497 F.2d 473, 483-84 (5th Cir. 1974) ("adoption of a resilient standard which will allow for a practical and dynamic scrutiny of investment schemes").