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The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications

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I. INTRODUCTION

In two recent decisions[1] construing the scope of the federal securities acts, the Supreme Court apparently has undertaken to alleviate some of the confusion and uncertainty surrounding the most fundamental question in securities law: the definition of "security" itself. Much of the existing confusion can be traced to earlier decisions of the Court that first implied,[2] and later held,[3] that the regulatory or offering context in which a particular transaction occurs could function to exclude the transaction from coverage of the securities laws' antifraud provisions. This result could follow even though the transaction in question otherwise might satisfy the traditional *Howey*[4] or "economic reality" test for determining the presence of a "security."

Because the Court has offered few clear guidelines for excluding a transaction in this manner, however, these earlier decisions, *International Brotherhood of Teamsters v. Daniel*[5] and *Marine Bank v. Weaver*,[6] have obscured, rather than clarified, the threshold question that must be addressed whenever the federal securities laws are invoked. In particular, the Court's analysis in *Weaver* has resulted in a great deal of uncertainty about the circumstances under which instruments clearly fitting within the statutory definition should be denied coverage and when other, more unusual, transactions similarly ought to be excluded.

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1. Gould v. Ruefenacht, 471 U.S. 701 (1985) (rejecting the "sale of business" doctrine); Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (same).
2. *See* International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979).
3. *See* Marine Bank v. Weaver, 455 U.S. 551 (1982).
4. SEC v. W.J. Howey Co., 328 U.S. 293 (1946). *See infra* notes 10-16 and accompanying text.
5. 439 U.S. 551 (1979).
6. 455 U.S. 551 (1982).

At first glance, the Court's more recent decisions rejecting the "sale of business" doctrine, *Landreth Timber Co. v. Landreth*[7] and *Gould v. Ruefenacht*,[8] indicate the Court's desire to render more predictable the applicability of the federal securities laws. In *Landreth* the Court observed, "[i]t is fair to say that our cases have not been entirely clear on the proper method of analysis for determining when an instrument is a 'security.'"[9] Consistent with this observation, the Court refrained from raising "difficult questions of line-drawing,"[10] in order to avoid the even "more daunting . . . prospect that parties to a transaction may never know whether they are covered by the Acts until they engage in extended discovery and litigation."[11] Thus, although the thrust of the sale of business doctrine is that a transfer of control through the sale of traditional stock is precisely the sort of context in which the antifraud provisions' protection is unnecessary, the Court looked instead to the statutory definition's "plain meaning" in holding that such a transaction necessarily involves a "security."[12]

Perhaps in recognition that "context" analysis had assumed a key role in its prior decisions construing the definition of "security," however, the Court in *Landreth* also observed that "the context of the transaction involved here—the sale of stock in a corporation—is typical of the kind of context to which the Acts normally apply."[13] Nevertheless, while explicitly referring to the role of "context" in determining the presence of a "security,"[14] *Landreth* fails to offer much insight into the nagging questions raised by *Weaver*. The Court's sale of business decisions merely resolve one isolated issue that gained prominence in the wake of *Weaver* and its persistent ambiguities. In effect, despite its allusion to the need for clarity in this area, the Court forfeited an opportunity to elaborate the precise role of "context" analysis. Thus, in search of a working definition of "security," one must return to grapple with *Weaver*—a formidable task because, although *Weaver* may well be the Court's most significant opinion in the definition of "security" area, it has received relatively little critical

7. 471 U.S. 681 (1985).
8. 471 U.S. 701 (1985).
9. *Landreth*, 471 U.S. at 688.
10. *Id.* at 696.
11. *Id.* at 696-97.
12. *Id.* at 687.
13. *Id.*
14. *Id.*; *cf. Gould*, 471 U.S. at 704.

attention,[15] in contrast to the extensive commentary devoted to the sale of business doctrine.[16] Moreover, not only is *Weaver* riddled with ambiguity, the decision is also simplistic, and its understanding of securities law is weak.

Weaver, when viewed in isolation, is indeed an unfortunate decision containing ill-conceived analysis and having potentially massive ramifications, as the following discussion will elaborate in detail. The main point of this Article, however, is that when considered with a number of other recent Supreme Court decisions involving federal securities law, *Weaver* serves as a compelling focus for an even more serious problem: The Supreme Court's apparent inability to comprehend thoroughly and to address analytically, consistently with the language, legislative history, and underlying policies of the securities acts, the important issues of federal securities regulation.

Part II of this Article offers an overview of Supreme Court decisions construing the definition of "security" and concludes with an examination of the Court's analysis in *Weaver*. Part III explores the Court's use of the "context" clause preceding the statutory definition as a vehicle for expanding or contracting the securities acts' scope and analysis and the potential ramifications of that approach and focuses particular attention on the problems that arise from the Court's treatment of certificates of deposit. Part IV addresses the present state of "investment contract" analysis and assesses the continued validity of the *Howey* test for determining the presence of a security. Part V seeks to expose the Court's misunderstanding of congressional intent in its application of the securities laws. Finally, Part VI offers further evidence of the Court's deficiencies in this area by examining recent decisions involving two additional issues of increasing concern: tender offers and insider trading.

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15. A few commentators, at least to a degree, have addressed *Weaver*. *See, e.g.*, Arnold, *"When is a Car a Bicycle?" and Other Riddles: The Definition of a Security Under the Federal Securities Laws*, 33 CLEV. ST. L. REV. 449 (1984-85); Bunch, Marine Bank v. Weaver: *What is a Security*?, 34 MERCER L. REV. 1017 (1983); Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311 (1984); Chang, *Meaning, Reference, and Reification in the Definition of a Security*, 19 U.C. DAVIS L. REV. 403 (1986); Dillport, *Restoring Balance to the Definition of Security*, 10 SEC. REG. L.J. 99 (1982); Note, *The Definition of Security:* Marine Bank v. Weaver, 24 B.C.L. REV. 1053 (1983); *see also* M. STEINBERG, SECURITIES REGULATION 81-86 (1986).

16. *See infra* note 50.

II. The Meaning of "Security"

A. The Court's Analytical Framework

The definition of "security" in the Securities Act of 1933 and the Securities Exchange Act of 1934[17] ("the Acts") covers a broad range of transactions. Although the term includes familiar instruments such as stock, notes, bonds, and "in general, any instrument commonly known as a 'security,' "[18] the statutory definition also encompasses a wide variety of irregular devices. In part because of the remedial purposes[19] underlying the federal securities laws, the

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17. *See* Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1982); Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1982). Section 3(a)(10), for example, provides:

> (a) When used in this chapter, unless the context otherwise requires —
>
> . . . .
>
> (10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

15 U.S.C. § 78c(a)(10). The definition of "security" in the Securities Act of 1933 § 2(1), *Id.* § 77(b)(1), is virtually identical and has been treated as such in the Court's decisions construing the scope of that term. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985).

18. 15 U.S.C. § 78c(a)(10).

19. The Senate Report on the Securities Act of 1933 states:

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

S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 1 Securities Law Comm., Federal Bar Ass'n, Federal Securities Laws: Legislative History 1933-1982, Item 6, at 89 (1983) [hereinafter Federal Securities Laws].

term "investment contract"[20] has emerged as a catch-all for transactions that do not fit neatly into the conventional categories.[21]

The Supreme Court has construed the definition of "security" on several occasions.[22] In the first such case, *SEC v. C.M. Joiner Leasing Corp.*,[23] the Court recognized that although the statutory definition makes specific reference to a number of "standardized" investment devices, "the reach of the Act does not stop with the obvious and commonplace."[24] Therefore, as the Court suggested, other "[n]ovel, uncommon, or irregular devices" may fall within one of the definition's more descriptive categories, such as "investment contract," if the facts so warrant.[25]

In *SEC v. W.J. Howey Co.*[26] the Court subsequently explained that the term "investment contract" had been employed in previously enacted state "blue sky" laws and had come to signify "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.' "[27] The *Howey* Court emphasized that "investment contract" embodies a "flexible rather than a static principle"[28] and that the term had been broadly construed as a means of protecting the investing public.[29] "Form was disregarded for substance and emphasis was placed upon economic reality."[30] Reasoning that Congress was aware of prior judicial interpretation of "investment

20. *See* 15 U.S.C. § 77b(1), 15 U.S.C. § 78c(a)(10); *see also supra* note 17.

21. *See generally* 1 L. Loss, SECURITIES REGULATION 483-511 (2d ed. 1961).

22. *See* Gould v. Ruefenacht, 471 U.S. 701 (1985); Landreth Timer Co. v. Landreth, 471 U.S. 681 (1985); Marine Bank v. Weaver, 455 U.S. 551 (1982); International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975); Tcherepnin v. Knight, 389 U.S. 332 (1967); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959); SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

23. 320 U.S. 344 (1943) (holding that the sale of assignments of oil leasehold subdivisions constituted a sale of securities).

24. *Id.* at 351.

25. *Id.* The court looked to such factors as "what character the instrument is given in commerce by the terms of the offer, the plan of distribution and the economic inducements held out to the prospect." *Id.* at 352-53.

26. 328 U.S. 293 (1946) (holding that the sale of units in a citrus grove development together with service contracts for cultivating and marketing the produce constituted a sale of securities).

27. *Id.* at 298 (quoting State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920)).

28. 328 U.S. at 299.

29. *Id.* at 298.

30. *Id.*

contract" when it employed the term in defining "security"[31] and noting that a broad construction was consistent with the federal securities laws' remedial intent,[32] the *Howey* Court devised a standard to comport with this background.

Under what has become known as the "*Howey* test," an investment contract is a transaction or scheme that involves "an investment of money in a common enterprise with profits to come solely from the efforts of others."[33] In *Tcherepnin v. Knight*[34] the Court reiterated that "remedial legislation should be construed broadly to effectuate its purposes"[35] and that "[e]ven a casual reading of [section] 3(a)(10) of the 1934 Act reveals that Congress did not intend to adopt a narrow or restrictive concept of security in defining that term."[36] Therefore, in its early post-*Howey* decisions construing the Acts,[37] the Court adopted a flexible, expansive interpretation of the three-part *Howey* test.[38] The lower courts, expanding on the *Howey* test, followed suit.[39] By the mid-1970s, however, the Court retreated from this remedial approach.

The decision that signaled the Court's retreat was *United Housing Foundation, Inc. v. Forman.*[40] In *Forman* the Court held that shares of stock in a cooperative housing project purchased by individuals who were residents of the apartment complex were not

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31. *Id.*

32. *Id.* at 299 (defining the term "investment contract" to encompass "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").

33. *Id.* at 301.

34. 389 U.S. 332 (1967).

35. *Id.* at 336 (also stating that "form should be disregarded for substance and the emphasis should be on economic reality").

36. *Id.* at 338 (footnote omitted).

37. *See* SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959) (holding that variable annuity contracts are securities); Tcherepnin v. Knight, 389 U.S. 332 (1967) (holding that withdrawable capital shares in a savings and loan association are securities); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (holding that "flexible fund" annuity contracts are securities).

38. In brief, the *Howey* test requires (1) an investment, (2) in a common enterprise, (3) with the expectation of profits to be derived solely or essentially from the efforts of others. *See* 328 U.S. at 301.

39. *See, e.g.,* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) (holding that a franchise-like "pyramid" promotion scheme involved securities even though the investors exerted some effort, provided that the promoters' efforts were the undeniably significant ones); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir.) (looking to "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise"), *cert. denied,* 414 U.S. 821 (1973).

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

securities. The Court assessed the economic realities of the transaction: the shares purchased did not confer the attendant rights that ordinarily accompany stock, were not transferable to a nontenant, could not be pledged or encumbered, carried no voting rights, and had to be offered back to the cooperative housing corporation at the initial selling price. In determining whether the shares of stock constituted securities, the Court rejected a literal approach and refused to require that the transaction, evidenced by the sale of "stock," be considered a security transaction merely because the statutory definition of a security contains the words "any . . . stock."[41] Instead, the Court stressed that economic reality, not form, should control: "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."[42]

After finding that the shares of stock in *Forman* lacked the attributes of ordinary stock, the Court also declined to view the instruments as investment contracts. The Court reasoned that the securities laws are inapplicable when the purchaser is "motivated by a desire to use or consume the item purchased," rather than by the anticipation of receiving a return on his investment.[43]

Similarly, in *International Brotherhood of Teamsters v. Daniel*[44] the Supreme Court applied the "economic reality" concept to constrict, rather than broaden, the definition of "investment contract." Specifically, the Court held that a noncontributory, compulsory pension plan is not an investment contract and, hence, not a security. In a noncontributory, compulsory pension plan, the employer contributes the necessary payments, not the

41. *Id.* at 848 (construing Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1982)).

42. *Forman*, 421 U.S. at 849. The Court, however, did not reject the name given to an instrument as irrelevant:

> There may he occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Id. at 850-51. Applying this rationale, the Court in Gould v. Reufenacht, 471 U.S. 701 (1985), and Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985), held that shares of "stock" having the characteristics normally identified with such instruments constitute securities. For further discussion, see *infra* notes 50-55 and accompanying text.

43. *Forman*, 421 U.S. at 852-53. *See id.* at 852 (defining "profits" to mean "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds"). *See generally* Deacon & Prendergast, *Defining a "Security" After the* Forman *Decision*, 11 PAC. L.J. 213 (1980).

44. 439 U.S. 551 (1979).

employee who ultimately benefits from the plan. The Court applied the three-pronged *Howey* test for an investment contract. Concentrating on the economic reality of the plan, the Court observed that "an employee is selling his labor primarily to obtain a livelihood, not making an investment" and, therefore, concluded that the *Howey* test's "investment of money" element was not satisfied.[45] Moreover, the employer's contributions to the fund were not the equivalent of an "investment" by the employee because no fixed relationship existed between the employer's contributions and the employee's potential benefits. The Court also found that the pension fund's maintenance did not depend on profits yielded by the efforts of others. To the contrary, the vast majority of the income generated derived from the employer's contributions and thus was independent from the efforts of the fund's managers. In addition, actual receipt of benefits from the fund depended on whether employees met certain individual eligibility requirements, not on the financial success of the fund itself.[46]

The Court further supported its holding in *Daniel* by concluding that the enactment of ERISA, which expressly regulates pension plans,[47] eliminated the need for coverage under the securities laws:

> The existence of this comprehensive legislation governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans. Congress believed that it was fulfilling a regulatory void when it enacted ERISA, a belief which the SEC actively encouraged. Not only is the extension of the Securities Act . . . not supported by the language and history of those Acts, but in light of ERISA it serves no general purpose . . . . Whatever benefits employees might derive from the effect of the Securities Acts are now provided in more definite form through ERISA.[48]

Thus, in both *Forman* and *Daniel* the Supreme Court employed the language, if not quite the spirit, of the *Howey* "economic reality" test to exclude transactions that otherwise might fall within the definition of "investment contract."[49] More recently,

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45. *Id.* at 560-61.

46. *Id.* at 561-62.

47. *See* Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001-1461 (1982 & Supp. 1985).

48. 439 U.S. at 569-70 (citations omitted). *See generally* Stansbury & Bedol, *Interests in Employee Benefit Plans as Securities:* Daniel *and Beyond*, 8 SEC. REG. L.J. 226 (1980); Comment, *The Impact of the* Daniel *Litigation: Growing Interest in Pension Vesting and Investment Control*, 1979 WIS. L. REV. 1228.

49. We do not suggest that the Court's conclusions in *Forman* and *Daniel* were unwarranted on the basis of the facts. Clearly, however, the Court approached those cases with a

however, in rejecting the sale of business doctrine,[50] the Court indicated that scrutiny of a transaction's economic substance is necessary only when the instruments involved are "unusual . . . not easily characterized as 'securities.' "[51] Hence, the Court distinguished *Forman* in *Landreth Timber Co. v. Landreth*[52] and *Gould v. Ruefenacht*[53] by reasoning that the stock involved in the latter cases bore all the characteristics traditionally associated with common stock, which the Court described as follows: "(i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value."[54] Looking to the "plain meaning" of the statutory definition of a "security," the Court held that traditional stock necessarily falls within the Acts' coverage.[55] In light of its failure to address the important questions raised by *Weaver*, however, the Court's rejection of the sale of business doctrine should not be regarded as the commencement of a more expansionist era.

B. Marine Bank v. Weaver

The dispute in *Weaver* had its origins in the troubled financial condition of the Columbus Packing Company, an unincorporated, family-owned business that operated a wholesale slaughterhouse and retail meat market. Although Columbus was not a party to the suit, the company's financial plight was central to the fraudulent misconduct claims that later arose. Between 1976 and 1978,

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much narrower view of the term "security" than it had displayed in previous decisions.

50. The "sale of business" doctrine was the subject of extensive commentary. *See, e.g.*, Hazen, *Taking Stock of Stock and the Sale of Closely Held Corporations: When Is Stock Not a Security?*, 61 N.C.L. REV. 393 (1983); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Security Transaction*, 57 N.Y.U. L. REV. 225 (1982); Note, *Function Over Form: The Sale of Business Doctrine and the Definition of "Security"*, 63 B.U.L. REV. 1129 (1983).

51. Landreth Timber Co. v. Landreth, 471 U.S. 681, 690 (1985).

52. *Id.* at 689-92.

53. 471 U.S. 701, 704 (1985).

54. *Landreth*, 471 U.S. at 686 (footnote omitted). *See Gould*, 471 U.S. at 704-06.

55. *Landreth*, 471 U.S. at 687; *see Gould*, 471 U.S. at 704. Hence, in both cases the Court rejected the argument that the instrument at issue was not a security simply because the *Howey* test had not been satisfied. The *Landreth* Court noted that in contrast to previous decisions in which it had employed the *Howey* test, the instrument involved in the case at bar was "traditional stock, plainly within the statutory definition." 471 U.S. at 690. Hence, the Court found "no need here, as there was in [our] prior cases, to look beyond the characteristics of the instrument to determine whether the Acts apply." *Id.*

Columbus obtained three secured loans from Marine Bank.[56] By early 1978, it became apparent to officers of Marine Bank that Columbus did not have adequate cash flow to meet its debts. In addition to the outstanding loans, for which there was no set repayment schedule, Columbus was substantially overdrawn on its checking account with the bank and had failed to meet both past due federal taxes and past due obligations to trade creditors.[57] In view of Columbus' precarious financial condition, Marine Bank's local manager designated the loans "concerned" and informed the owners, Raymond and Barbara Piccirillo, that the bank would take possession of its collateral unless they repaid the bank by (1) selling the business, (2) closing the business and selling its assets, or (3) securing additional capital.[58]

Subsequently, Marine Bank and Columbus executed a new agreement. The bank agreed to lend Columbus an additional $65,000 in exchange for a secured demand note signed by the Piccirillos and an agreement signed by Mr. and Mrs. Weaver guaranteeing payment of the debt to a maximum of $50,000.[59] The latter guaranty was secured by the pledge of a $50,000 certificate of deposit, which Marine Bank previously had issued to the Weavers.[60] In consideration for their guaranty, the Piccirillos agreed to pay the Weavers fifty percent of the packing company's adjusted net profits and one hundred dollars per month for as long as the Weavers remained co-obligors on the new loan. The agreement between the Weavers and the Piccirillos also entitled the Weavers to use the Columbus barn and pasture, at the Piccirillos' discretion, and further provided that the Piccirillos would not borrow additional funds without first consulting with the Weavers and obtaining their approval.[61]

Of the additional $65,000 lent by Marine Bank, the bank

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56. *See* Weaver v. Marine Bank, 637 F.2d 157, 159 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982). The loans were secured by perfected security interests in Columbus' assets, including "equipment, inventory and accounts receivable, liens on several motor vehicles, and second mortgages on two pieces of real estate."

57. *Weaver*, 637 F.2d at 159. As of March 1978, $33,000 in loans from Marine Bank remained unpaid. *Weaver*, 455 U.S. at 553. In addition, Columbus had overdrawn its checking account by approximately $9,800 and owed approximately $18,400 in back taxes and to other creditors. *See Weaver*, 637 F.2d at 159.

58. *Weaver*, 637 F.2d at 159.

59. *Id.* The note was secured identically to the previous loans. *See supra* note 56.

60. *Weaver*, 637 F.2d at 159. The certificate of deposit had a six-year maturity, paid 7.5% interest, and was insurable by the FDIC to a maximum of $40,000. *Weaver*, 455 U.S. at 552-53 & n.1.

61. *Weaver*, 455 U.S. at 553. *See supra* note 57.

retained $42,800 to repay the previous loans and to cover the overdrafts on Columbus' checking account. Another $18,400 was immediately disbursed to satisfy the company's other financial obligations. Only $3,800 of the $65,000 loan remained for working capital. Moreover, the bank no longer permitted Columbus to overdraw its account. When Columbus filed for bankruptcy four months later, Marine Bank indicated that because the security for the new loan was inadequate, it would resort to the Weavers' certificate of deposit for the deficiency.[62]

The Weavers filed suit in federal court, asserting violations of the federal securities laws and also pleading pendent state law claims for violations of the Pennsylvania Securities Act and for common-law fraud.[63] Specifically, the Weavers alleged that officers of Marine Bank violated section 10(b),[64] the general antifraud provision of the Securities Exchange Act of 1934 (the "Exchange Act"), by soliciting their investment in Columbus for the asserted purpose of providing working capital, while the bank officers had full knowledge of and failed to disclose the company's desperate financial condition.[65] Hence, the Weavers contended that although they had no knowledge of or interest in investing in a slaughterhouse business[66] and initially declined to make the investment,

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62. *See Weaver*, 455 U.S. at 553-54; *Weaver*, 637 F.2d at 159.

63. *See Weaver*, 637 F.2d at 159.

64. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1982), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986), adopted by the Securities and Exchange Commission pursuant to its rulemaking authority under § 10(b), provides:

It shall be unlawful for any person . . .

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

65. *Weaver*, 637 F.2d at 160.

66. *Id.* Mr. and Mrs. Weaver, aged 79 and 71, were engaged in the business of auctioning livestock. Neither possessed formal education beyond the eighth grade, and they both had spent their entire lives as cattle farmers. *Id.* at 159.

Marine Bank persuaded them to pledge their certificate of deposit and enter into the agreement with the Piccirillos. According to the Weavers, Marine Bank represented that substantially all the loan's proceeds would be available for working capital and, moreover, that the Weavers' investment would be adequately protected by existing collateral.[67]

The pivotal question in the suit was whether the transaction involved a "security," as defined by section 3(a)(10) of the Exchange Act.[68] In a brief opinion authored by former Chief Justice Burger, the Court unanimously held that neither the agreement between the Weavers and the Piccirillos nor the certificate of deposit issued by Marine Bank was a "security" for purposes of the 1934 Act.[69] At the outset of its analysis the Court paraphrased the

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67. *Id.* at 160. Marine Bank responded that (1) it had disclosed to the Weavers all relevant information regarding Columbus' finances of which it had knowledge; (2) at the time, it believed the loans were fully collateralized; and (3) it had no knowledge of the agreement between the Weavers and the Piccirillos. *Id.* at 159-60.

68. 15 U.S.C. § 78c(a)(10). *See supra* note 17. Without deciding whether the bank's conduct might otberwise constitute a violation of § 10(b), the district court concluded, as a matter of law, that if any wrong occurred it did not take place "in connection with the purchase or sale of any security." *Weaver*, 637 F.2d at 160 (quoting 15 U.S.C. § 78j(b)). The district court, tberefore, entered summary judgment for Marine Bank on the federal claim and declined to exercise pendent jurisdiction over the state law claims. 637 F.2d at 159.

The Third Circuit reversed, 637 F.2d 157 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982), on the grounds that a trier of fact could have found that the bank officers had engaged in "manipulative and deceptive conduct" in soliciting the Weavers' participation; that such conduct, if it took place, was in connection with the agreement between the Weavers and the Piccirillos; and that the Weaver-Piccirillo agreement itself was a "security" within the meaning of § 3(a)(10). 637 F.2d at 160-64. More specifically, the court of appeals held that the interest "sold" by the Piccirillos in exchange for the Weavers' guaranty could be considered eitber a "certificate of interest or participation in a profit-sharing agreement" or an "investment contract," or both. *Id.* at 161.

Tbe court of appeals' holding with respect to the Weaver-Piccirillo transaction was a sufficient basis for finding that the district court had erred in granting summary judgment. Before remanding for retrial, however, the Third Circuit also addressed the issue of whether the certificate of deposit issued by Marine Bank was a security. The court initially noted that the Securities Acts do not exempt bank securities from their antifraud provisions and that the Weavers' six-year certificate did not fall within the § 3(a)(10) exception for short-term instruments. *Id.* at 164. The thrust of the court's analysis thereafter focused on the premise that the certificate of deposit, which obligated Marine Bank to pay a sum certain at a fixed rate of return, was the "functional equivalent" of a long-term bond or note. In view of the Exchange Act's inclusion of such instruments within its definition of a "security," the court tbought it ill-advised to dismiss the question without further factual development. *Id.*

69. *Weaver*, 455 U.S. at 560. As discussed in note 68 *supra*, the Third Circuit's line of reasoning stands in marked contrast to the Supreme Court's restrictive approach in *Weaver*. Not only did the Court arguably disregard the Act's legislative history and make unwarranted presumptions about congressional intent, see *infra* notes 190-206 and accompanying text, in holding that a certificate of deposit is not a security; the Court also failed to recognize the dual nature of the problem when it concluded that federal banking regulations

prefatory language to section 3(a)(10),[70] stating that the terms included in the Act's definitional section are not to be considered securities if "the context otherwise requires."[71] The Court then concluded that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."[72]

In addressing the certificate of deposit issue, the Court elevated the presence of other comprehensive regulation, a factor of inferential importance in *Daniel*,[73] to paramount significance in *Weaver*.[74] The Court commenced its analysis by distinguishing the withdrawable capital shares in *Tcherepnin v. Knight*[75] on the ground that the *Tcherepnin* purchasers received dividends based on the savings and loan associations' profits, rather than at a fixed rate of interest, and also received voting rights.[76] The Court observed that the withdrawable capital shares "were much more like ordinary shares of stock and 'the ordinary concept of a security,' . . . than a certificate of deposit."[77] Then, looking to the context of the transaction, the Court turned to the differences it perceived between a certificate of deposit and other long-term debt obligations. The Court focused not on the particular attributes of these instruments, but rather on the existence of comprehensive federal regulation governing the banking industry. Unlike the holder of a long-term debt obligation, who assumes the risk of the borrower's insolvency, the purchaser of a certificate of deposit is almost assured of repayment.[78] Accordingly, the Court concluded that "[i]t is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws."[79]

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adequately protect the *depositor* and therefore obviate any need for *investor* protection under the securities laws.

70. *See* 15 U.S.C. § 78c(a)(10); *supra* note 17.

71. *Weaver*, 455 U.S. at 556.

72. *Id.*

73. International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979). *See supra* notes 47-48 and accompanying text.

74. 455 U.S. at 559.

75. 389 U.S. 332 (1967) (holding that withdrawable capital shares in a savings and loan association are securities).

76. *Weaver*, 455 U.S. at 557.

77. *Id.* (quoting H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933)) (citation omitted).

78. *Id.* at 558.

79. *Id.* at 559. The Acting Solicitor General of the United States submitted a brief to the Supreme Court as amicus curiae expressing the combined position of the SEC, the Comptroller of the Currency, the FDIC, and the Federal Reserve Board that certificates of deposit, if issued by federally regulated banks whose deposits are insured by the FDIC, are

Likewise, the Court observed that the profit-sharing agreement between the Piccirillos and the Weavers was not the type of transaction that "comes to mind when the term 'security' is used"[80] and concluded that the agreement differed in several respects from other unusual arrangements found to involve securities.[81] Specifically, the Court noted that the agreement was a private transaction, negotiated one-on-one, with no prospectus distributed to potential investors; that the agreement was unique (as evidenced by the provision allowing the Weavers to use the barn and pasture), lacked "equivalent value" to other investors, and was not designed to be traded publicly; and that the Weavers' "veto" power over future loans gave them a measure of control over the business.[82] Therefore, although the Court did not apply the *Howey* test expressly, it held that the agreement was not a security despite the profit-sharing provision.[83]

Weaver is troubling for several reasons. First, by relying on the "context" clause to hold that application of the antifraud provisions is unnecessary if the transaction is governed by another comprehensive federal regulatory scheme, the Court arguably disregarded the legislative history of the Acts as well as its own previous interpretation of that clause. Second, the Court's failure to apply the *Howey* test in a meaningful way casts doubt on whether that test remains a viable mechanism for determining the presence of a "security." The Court's ambiguous analysis in *Weaver* certainly raises several issues that merit careful consideration. Moreover, the Court's insupportable presumptions about congressional intent threaten to undermine the objectives underlying the federal securities laws.[84]

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not "securities" for purposes of § 10(b) of the Exchange Act. Brief for the United States as Amicus Curiae, Marine Bank v. Weaver, 455 U.S. 551 (1982) [hereinafter Brief for United States]. *See* Kronstein, *The CD Muddle*, 9 SEC. REG. L.J. 395, 396 (1982).

80. *Weaver*, 455 U.S. at 559.

81. *Id.* at 559-60. The Court contrasted this arrangement with that in SEC v. W. J. Howey Co., 328 U.S. 293 (1946), which involved 42 purchasers, and SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943), in which offers were sent to more than 1000 potential investors.

82. *Weaver*, 455 U.S. at 559-60.

83. *Id.* In a footnote, however, the Court limited its holding: "It does not follow that a certificate of deposit for a business agreement between transacting parties invariably falls outside the definition of a 'security' as defined by federal statutes." *Id.* at 560, n.11.

84. *See generally* M. STEINBERG, CORPORATE INTERNAL AFFAIRS: A CORPORATE AND SECURITIES LAW PERSPECTIVE (1983).

III. "CONTEXT" ANALYSIS AND ITS RAMIFICATIONS

A. *The "Context" Clause*

In holding that it is "unnecessary" to subject federally regulated issuers of certificates of deposit to the Acts' antifraud provisions, the *Weaver* Court appears to have *assumed* that the "context" clause authorizes judicial exclusions on the basis of *factual* circumstances, even if an instrument otherwise falls within the statutory definition of "security."[85] This assumption continues to have the Court's support, as evidenced by its more recent decisions rejecting the sale of business doctrine.[86] As an appellate court has pointed out, however, the "context" clause provides no such authority.[87] Contrary to the Court's implication,[88] the phrase "unless the context otherwise requires" does not modify the term "security" in particular, but precedes a long list of general definitions in both the 1933[89] and 1934[90] Acts. Moreover, nothing in the Acts' legislative history suggests that this language refers to the context of the underlying factual transaction. Rather, early drafts of the proposed legislation show that the prefatory language refers to the context in which the defined terms appear in the statute itself, and the reports accompanying the final version contain no indication to the contrary.[91]

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85. The Court offered no authority, legislative or judicial, for this proposition. Moreover, although the Court attempted to distinguish between certificates of deposit and other forms of debt obligations that fall literally within the statutory definition of "security," the only differences the Court was able to discern related to the existence of banking regulations and the relative security of a purchaser's investment, not to the nature of the instruments themselves. *See Weaver*, 455 U.S. at 557-58.

86. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 687 (1985) ("[T]he context of the transaction involved here—the sale of stock in a corporation—is typical of the kind of context to which the Acts normally apply."); *see also* Gould v. Ruefenacht, 471 U.S. 701, 704 (1985).

87. *See* Ruefenacht v. O'Halloran, 737 F.2d 320, 331 (3d Cir. 1984), *aff'd on other grounds*, 471 U.S. 701 (1985).

88. *See Weaver*, 455 U.S. at 556 ("The broad statutory definition is preceded . . . by the statement that the terms mentioned are not to be considered securities if 'the context otherwise requires . . . .' "); *id.* at 558-59 ("The definition of 'security' in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires."); *accord Landreth*, 471 U.S. at 686-89.

89. *See* 15 U.S.C. § 77b(1)-(15) (1982).

90. *See id.* § 78c(a)(1)-(40).

91. *See O'Halloran*, 737 F.2d at 330-32. Section 2 of the Senate-enacted version of the 1933 Act employed the phrase "unless the text otherwise indicates." S. 875, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 1 FEDERAL SECURITIES LAWS, *supra*, note 19, Item 5, at 27. An early House version contained the identical phrase. H.R. 4314, 73d Cong., 1st Sess. 1 (1933).

Thus, the statutory definitions properly control, regardless of the factual circumstances surrounding a claim, except when the language, structure, or legislative history of the Acts (or other federal legislation) warrants a different meaning.[92] The *Weaver* Court's conclusion to the contrary is inconsistent with the Court's understanding of the "context" clause adopted over a decade earlier in *SEC v. National Securities, Inc.*[93] In *National Securities* the Court observed: "Congress itself has cautioned that the same words may take on a different coloration *in different sections* of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires.' "[94]

Although Chief Justice Burger cited *International Brotherhood of Teamsters v. Daniel* in *Weaver* to support the Court's "factual" application of the "context" clause,[95] *Daniel* rested on several independent grounds.[96] Furthermore, the *Daniel* Court did

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This phrase was later replaced by the words "unless the context otherwise requires." H.R. 5480, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 1 FEDERAL SECURITIES LAWS, *supra*, Item 9, at 99. Although the later House version ultimately was adopted, the House Conference Committee Report on the bill that was to become the Securities Act of 1933 does not suggest any difference in meaning between the two versions. *See* H. CONF. REP. NO. 152, 73d Cong., 1st Sess. 24 (1933), *reprinted in* 1 FEDERAL SECURITIES LAWS, *supra*, Item 17, at 275. Were a different meaning intended in the final version, it is unlikely that the intended difference would have gone unmentioned in the Conference Committee Report, as the Report addresses a number of significant differences between the House and the Senate bills. *See generally* 2 L. LOSS, *supra* note 21, at 1698, 1705; 4 L. LOSS, *supra* note 21, at 2485 (Supp. 1969); Hammett, *Any Promissiory Note: The Obscene Security—A Search for the Non-Commercial Investment*, 7 TEX. TECH. L. REV. 25, 38-40 (1975); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219, 277-79 (1974); Seldin, *When Stock is Not a Security: The "Sale of the Business" Doctrine under the Federal Securities Laws*, 37 BUS. LAW. 637, 669-70 (1982); Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1577-78 & n.44 (1980); Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities and Exchange Act of 1934*, 36 MD. L. REV. 233 (1976).

92. *See O'Holloran*, 737 F.2d at 331. The Third Circuit viewed *Weaver* as consistent with its approach: "Although the [*Weaver*] Court relied in part on the context clause, its holding was independently supported by the legislative history and structure of the banking laws and securities acts." *Id.* at 332 n.29. This contention may be plausible, but little question exists that the Court assumes that the "context" clause refers at least in part to the context of the underlying factual transaction. The latter view is further evidenced by the Court's decisions rejecting the "sale of business" doctrine. *See supra* notes 85-91 and accompanying text; *infra* notes 100-02 and accompanying text.

93. 393 U.S. 453 (1969).

94. *Id.* at 466 (emphasis added).

95. *See Weaver*, 455 U.S. at 558 n.7.

96. In *Daniel* Justice Powell applied the *Howey* standard and found that the pension fund failed both the "investment" and the "expectation of profits" aspects of that test. *See supra* notes 44-46 and accompanying text. By contrast, in *Weaver* the Court neither applied

not invoke the "context" clause, but merely offered the existence of alternative regulatory devices and Congress' belief that it was filling a "regulatory void" when it enacted ERISA[97] as additional support for the Court's conclusion that the transaction in question was not a security. Indeed, although it garners heightened significance in retrospect,[98] Justice Powell's dicta in *Daniel* appears to have been little more than an afterthought in response to any lingering doubts that the added protection of the antifraud provisions was necessary.[99]

By contrast, the Court based its reasoning in *Weaver* largely, if not solely, on the availability of the "context" clause as a means to exclude certain instruments from the definition of "security."[100] The language in *Weaver*, particularly when considered with the subsequent decision in *Landreth*, indicates that the Court apparently adheres now to the view that the "context" clause refers (at least in part) to the underlying transaction's factual context.[101] Nevertheless, with respect to the Court's certificate of deposit analysis, an argument can be made that although the Court looked at the transaction's factual surroundings, its rationale was premised principally on the structure and legislative history of the federal banking and securities laws.[102]

If the foregoing construction represents the Court's view in

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the *Howey* test nor offered any other rationale for excluding the transaction. The *Weaver* Court instead relied on its observations that the existence of comprehensive banking regulation, together with the availability of insurance by the FDIC, made application of the securities laws unnecessary. *See* 455 U.S. at 558-59. Although the latter observation might suggest that the Court applied a sort of risk capital analysis in addition to its "context" clause analysis, the Court's disposition of the accompanying profit-sharing agreement is at best inconsistent with a risk capital approach. *See infra* notes 179-80 and accompanying text. In short, while the Court may have hinted at the application of a risk capital analysis in its treatment of the Weavers' certificate of deposit, little in *Weaver* suggests that the Court has overcome the reluctance it displayed in *Forman, see Forman*, 421 U.S. at 857 n.24, to embrace the validity of that approach.

97. 439 U.S. at 570.

98. *See, e.g., Landreth*, 471 U.S. at 691-92 (1985); *see also supra* note 96.

99. Writing for the Court, Justice Powell stated: "If any further evidence *were* needed . . . the enactment of ERISA in 1974 would put the matter to rest." 439 U.S. at 569 (citation omitted) (emphasis added). The *Daniel* Court did not suggest that the existence of ERISA, by itself, was sufficient grounds to exclude the compulsory noncontributory pension fund from the definition of "security." Rather, the Court merely noted that the enactment of ERISA "severely undercut" arguments that extension of the securities laws would serve a useful purpose. *Id.* at 569-70.

100. *See supra* note 96.

101. *See* 455 U.S. at 556, 560 n.11; *see also Landreth*, 471 U.S. at 686-87; *supra* note 86.

102. *See supra* note 92. *But see Landreth*, 471 U.S. at 686-89; *supra* note 86.

Weaver, then the approach espoused in *National Securities*[103] has not been altered markedly. Although the *National Securities* Court evidently construed the "context" clause to authorize an examination confined to the language, structure, and legislative history of the federal securities statutes, "context" clause analysis in this setting should not be limited to the Acts. Rather, given the interrelationship between the securities laws and other federal statutes, such as those involving antitrust and banking, a court properly may consider Congress' intended impact on the scope of the federal securities laws when it enacted the related legislation.[104] In this regard, however, courts should be wary of sweeping too broadly when applying the "context" clause to exclude instruments from the Acts' coverage. As will be elaborated below,[105] even assuming that *Weaver* focused on the proper meaning of the "context" language, the Court's application of this concept appears to have been erroneous.[106]

The Court's implicit application of the "context" clause to preclude the *Weaver* profit-sharing agreement from constituting a security also is problematic.[107] Although *Weaver* may be viewed as holding simply that the *Howey* test was not satisfied because of, for example, the failure to establish the existence of a common enterprise,[108] the Court's seeming reliance on the "context" clause

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103. *See supra* notes 93-94 and accompanying text.

104. Such congressional intent may be evidenced, for example, by the legislative history of the related legislation. In this regard, however, Congress did not intend the securities laws' application to be conditioned on the absence of other regulation. See Securities Exchange Act of 1934 § 28, 15 U.S.C. § 78bb(a) (1982) ("The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or equity . . . . ").

105. *See infra* notes 126-49 and accompanying text.

106. Moreover, the Court's analysis raises semantic as well as logical problems. Merely because the Court perceived application of the securities laws to be "unnecessary" in this particular context, the conclusion does not follow that the surrounding factual circumstances "required" exclusion of this transaction. At most, under the Court's rationale, application of the securities laws would have been superfluous.

107. *See Weaver*, 455 U.S. at 560 n.11, where the Court stated:

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

Id. (emphasis added). Relying upon this language, the SEC has taken the position that the marketing of money market fund shares, the assets of which are comprised of certificates of deposit, is within the scope of the securities laws. *See* Brief for United States, *supra* note 79, at 20-24.

108. This view assumes that the Court impliedly held that horizontal and not vertical

apparently forecloses this assertion.

Arguably, however, the *Weaver* Court's "context" analysis in the investment contract setting[109] supplements or modifies, rather than substitutes for, the *Howey* test. Although this view appears correct,[110] offering its "context" analysis as a modification of the investment contract test seemingly would have required the Court, for purposes of analytical consistency, to recognize the "risk capital" approach[111] as a viable means for defining the term "security." This path was expressly rejected by the Court in *United Housing Foundation, Inc. v. Forman*[112] and, if followed in *Weaver*, should have mandated a contrary disposition of the profit-sharing agreement, for the concept of "risk" is at the heart of the Court's "context" analysis.[113]

If the *Weaver* Court indeed construed the "context" clause as a preliminary supplement to the *Howey* test, the unsettling conclusion must follow that an instrument or transaction can qualify as an "investment contract" yet not be treated as a security, even though the instrument or transaction does not fall within an express statutory exception. This result would not only require a

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commonality is necessary to satisfy the common enterprise element of the *Howey* test. *See infra* notes 160-71 and accompanying text.

109. The same analysis applies if the Weavers' agreement is viewed as a "certificate of interest or participation in any profit-sharing agreement." *See* 455 U.S. at 559-60.

110. *See infra* notes 179-89 and accompanying text.

111. The risk capital test remains a viable alternative to the *Howey* test for ascertaining the presence of an investment contract. Although the federal courts do not generally use the risk capital analysis, a number of states follow it pursuant to statute or case law. *See, e.g.*, Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); GA. CODE ANN. § 10-5-2 (a)(16) (1982); MICH. COMP. LAWS ANN. § 451.801(l) (West Supp. 1986); OKLA. STAT. ANN. tit. 71, § 2(20)(West Supp. 1987). For example, in Commissioner of Sec. v. Hawaii Mkt. Center, Inc., 52 Haw. 642, 485 P.2d 105 (1971), the Hawaii Supreme Court held that, under the risk capital test, an investment contract exists whenever:

> (1) An offeree furnishes initial value to an offeror, and
> (2) a portion of this initial value is subjected to the risks of the enterprise, and
> (3) the furnishing of the initial value is induced by the offeror's promises or representations which gave rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
> (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

Id. at 649, 485 P.2d at 109, *relying on* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 377 (1967); *see also* M. STEINBERG, *supra* note 15, at 53-55; Carney & Fraser, *Defining a* "Security": *Georgia's Struggle with the "Risk Capital" Test*, 30 EMORY L.J. 73 (1981).

112. 421 U.S. at 857 n.24.

113. *See infra* notes 159-69 and accompanying text.

court to ignore forty years of judicial gloss, including the Supreme Court's own observation that the *Howey* test embodies the "essential attributes" of an investment contract,[114] but also would permit the indefinite language of the prefatory clause to govern the express terms of the statutory definition.[115]

Another set of problems arising from the Court's analysis in *Weaver* concerns the specific application of the "context" clause. Assuming that use of the "context" clause to exclude certain transactions from the definition of "security" is a valid exercise of judicial discretion, what guidelines should courts follow? How comprehensive must an alternative regulatory scheme be to serve as the basis for an exclusion?[116] The *Weaver* Court concluded that the combined banking regulation and FDIC insurance backdrop was sufficient in that case, even though the alternative regulatory schemes did not provide depositors with a right of action in the federal courts.[117] By relying on the *Daniel* dicta, however, the Court may have implied that a regulatory scheme entitling the *government* to take action against an issuer would be adequate, without regard to whether individual investors are afforded any protection.[118] This conclusion is tenable only if one focuses solely on the Acts' regulatory aspects and disregards their remedial scope.

Furthermore, by injecting the indefinite "context" analysis into the definition of "security," the Court has created potentially serious notice problems. Although certain presumptions about notice are necessary whenever broad statutory definitions are involved,[119] the severe consequences associated with violation of the securities laws can be rationalized only on the basis of forewarning,

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114. *Forman*, 421 U.S. at 852. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 691 (1985).

115. *See infra* notes 190-206 and accompanying text.

116. *See* Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281 (D. Mass. 1983). In holding that a Penn Square CD purchased by the plaintiff through a money market broker was not a security, the court examined the effect of federal insurance on the security determination. The plaintiff argued that *Weaver* excludes certificates of deposit from federal securities regulation only to the extent that the certificates actually are federally insured. The *Brockton* court rejected this argument and stated that the language in *Weaver* regarding the protection given to depositors by federal insurance referred only to the fact that depositors in FDIC banks always have heen paid in full and was not meant to expand the definition of "security." *Id.* at 1285.

117. *See* 455 U.S. at 558; *see also* Arnold, *supra* note 15, at 461; Bunch, *supra* note 15, at 1030-31.

118. *Weaver*, 455 U.S. at 558-59.

119. *See, e.g.*, United States v. Naftalin, 441 U.S. 768, 776 (1979).

especially in view of the Acts' strict liability and criminal penalty provisions.[120] Therefore, issuers who reasonably rely on the existence of other regulatory schemes should not be held accountable for failure to comply with the Acts' requirements in the absence of sufficiently clear guidelines on what conditions preempt application of the securities laws. Conversely, fraud victims should not be put in the position of possibly forgoing other remedies or engaging in costly and ultimately fruitless litigation because the Court has clouded the issue of what constitutes a security.[121]

A related question concerns the role of state and foreign law in "context" analysis. What, if any, impact should the existence of parallel state or foreign regulation have in determining the scope of the federal securities laws? If parallel regulation exists in only some states, the *Weaver* analysis raises the possibility that the definition of "security" under federal law may vary from state to state.[122] Moreover, if the definition can vary by state, it likewise is possible that conflicting applications of federal law could result within a single federal appellate jurisdiction. This situation would lead to inconsistency, uncertainty, and nonuniformity, a consequence at variance with the Acts' objectives.[123] This result is possi-

120. The seller's failure to perfect an exemption may result in a violation of the registration provisions of § 5 of the Securities Act, thereby entitling the purchaser to rescind the transaction against the seller pursuant to § 12(1) of that Act, irrespective of the seller's culpability. Moreover, "willful" violation of the 1933 and 1934 Acts or the rules and regulations promulgated under the Acts subjects the violator to criminal liability. *See* Securities Act of 1933 § 24, 15 U.S.C. § 77x (1982); Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) (1982). *See generally* M. STEINBERG & R. FERRARA, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT §§ 6:02-6:13 (1985).

121. Under certain circumstances, the state securities statutes and common law can be invoked successfully by aggrieved parties. *See generally* Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 NOTRE DAME LAW. 201 (1977); Dent, *The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care*, 61 B.U.L. REV. 623 (1981); Shaneyfelt, *The Personal Liability Maze of Corporate Directors and Officers*, 58 NEB. L. REV. 692 (1979); Comment, *Maryland Statutory and Common Law Remedies for Misrepresentation in Securities Transactions*, 13 U. BALT. L. REV. 574 (1984).

122. Pursuant to the federal courts' application of *different* standards in defining a "security," an instrument may be a "security" under federal law in some circuits but not in others. The current split in the circuits as to whether vertical as well as horizontal commonality satisfies the common enterprise element of the *Howey* test serves as one example. *See* Mordaunt v. Incomco, 469 U.S. 1115 (1985) (White, J., dissenting from the denial of the petition for a writ of certiorari); *infra* notes 158-71 and accompanying text. Of course, in the states' construction of their respective blue sky laws, the definition of "security" may vary from state to state. *See generally* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

123. Moreover, as Exchange Act § 28 provides: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at

ble, however, because although both *Weaver* and *Daniel* specifically refer to the existence of other federal regulatory schemes and contain no mention of overlapping state (or foreign) regulation, the Court's "context" analysis is essentially a *functional* approach.

Yet another troublesome ramification of the Court's "context" analysis in *Weaver* is the possibility that the definitional scope of "security" periodically may assume different proportions, depending upon the regulatory context at the moment it is invoked. For example, if banking regulation had been nonexistent when the *Weaver* case arose, the Court by its own analysis would have concluded that a security was present. If an identical claim arose shortly after the institution of extensive banking regulation, however, the result necessarily would be different. Conversely, the repeal of regulation could give rise to situations in which transactions formerly not constituting securities would be deemed to fall within the Acts' scope. Thus, the Court's "context" analysis could engender divergent modes of treatment within the identical species of transaction, albeit at different times. Perhaps the *Daniel* Court obliquely anticipated this ground for objection by noting, "Congress believed that it was filling a regulatory void when it enacted ERISA."[124] The *Weaver* analysis, however, suggests that in the absence of clear legislative intent, the definition of "security" could expand and contract with the ebb and flow of future legislation, regardless of what Congress may believe when it acts.[125]

Although a skeptic might assert that the foregoing objections are too speculative, these considerations, when examined both individually and in their totality, reinforce the conclusion that the Court's current "context" analysis is an inappropriate method of defining a security. Moreover, it is difficult to fathom that Congress intended the "context" clause to operate in this manner. If developments subsequent to the securities laws' enactment have made their application onerous or unnecessary in certain situations, the reasonable remedy is the one reflected in the Acts themselves: specific legislative exclusion, not judicial activism, is the

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law or equity . . . ." 15 U.S.C. § 78bb(a) (1982).

This potential problem also is present under the *Goldberg* line of cases, Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978), when a federal court looks in part to the applicable state law for ascertaining the existence of federal rights and liabilities under the securities laws. For further discussion on this subject, see Ferrara & Steinberg, *A Reappraisal of* Santa Fe: *Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980).

124. 439 U.S. at 570.

125. *See* 455 U.S. at 558.

appropriate solution.

B. The CD Morass and its Ramifications

On the surface, the *Weaver* Court's decision regarding the certificate of deposit, supported by an amicus curiae brief of the Acting Solicitor General of the United States expressing the combined view of four government agencies,[126] is correct. Unfortunately, the Court and the government applied a superficial regulatory function analysis without scrutinizing the significant policy issues at stake. Succinctly stated, the existence of banking regulations—no matter how extensive—will not eliminate fraud in the industry (including fraud in the purchase or sale of securities), though the regulations do serve as a deterrent. The Weavers' disheartening predicament alone is sufficient evidence to support this conclusion. Similarly, although the availability of depositor insurance goes a long way toward providing peace of mind in ordinary banking transactions, it does not necessarily guarantee against fraud. Moreover, because the banking regulations themselves do not create a private right of action,[127] they are an ineffective substitute for the antifraud protections of the federal securities laws.[128]

The Supreme Court's holding to the contrary confuses the problem of overregnlation with the nature of the remedy Congress sought to provide. The Acts have at least a dual function: to provide an adequate and accurate informational flow to the investing public and to ensure a measure of integrity and protection against abuse in the marketplace.[129] These functions are performed largely through the Acts' registration, reporting, and "antifraud" requirements and through the creation of governmental as well as private rights of action against misleading and deceptive conduct.[130] Although these requirements and rights of action serve to reduce

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126. *See* Brief for United States, *supra* note 79.

127. *See* Arnold, *supra* note 15, at 461; Bunch, *supra* note 15, at 1030-31, 1034-35.

128. It is clear that § 10(b), the general antifraud provision of the Exchange Act, provides an implied right of action for damages. *See* Herman & MacLean v. Huddleston, 459 U.S. 375 (1983); M. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 9.04 (1986).

129. *See* United States v. Naftalin, 441 U.S. 768 (1979) (asserting that the goals of the Securities Acts are to promote investor protection, integrity of the marketplace, and high ethical standards in the securities industry); Steinberg, *Section 17(a) of the Securities Act of 1933 After* Naftalin *and* Redington, 68 GEO. L.J. 163 (1979); *supra* note 19.

130. *See, e.g.,* Securities Act § 5 (requiring registration of offerings); Exchange Act §§ 12-13 (requiring registration of and periodic reporting by certain puhlicly held companies); Exchange Act § 10(b) (containing a broad antifraud provision and impliedly providing for a private right of action for damages).

the risk of fraud, Congress recognized that certain instruments or transactions, because of the contexts in which they take place or the nature of the "security" itself, are less likely to be vehicles for abuse. Therefore, Congress exempted these less "risky" instruments or transactions from the Securities Act's registration requirements and subjected them only to modified informational guidelines.[131] On the other hand, because some possibility of abuse exists irrespective of the instrument's or transaction's nature, Congress did not exempt any security from the antifraud provisions.[132]

Thus, the likelihood of abuse is relevant *only* to the issues of registration and reporting, *not* to whether the antifraud provisions should apply. Fraudulent misconduct in the context of *any* securities transaction will give rise to civil or criminal liability, or both.[133] Furthermore—and most important for purposes of this discussion—the likelihood of abuse should play no part in determining what is, and what is not, a security. Although the context in which a particular transaction occurs may exempt it from certain of the Acts' requirements, that context does not alter the nature of the instrument itself. Phrased differently, if an instrument or transaction meets the Acts' definition of "security," it always will remain a security, regardless of whether the registration or reporting requirements apply.

The *Weaver* Court thus appears to have confused Congress' rationale for exempting certain instruments or transactions from registration and reporting requirements with the securities laws' antifraud thrust. If the Court declines to recognize this incongruity, its present construction of the "context" clause may lead to situations in which an instrument or transaction, although falling within the definition of "security," nevertheless will not be treated as a security. This consequence would lead, in turn, to the very result the Court has sought to avoid: commercial confusion and un-

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131. *See, e.g.*, Securities Act § 3(a)(2) (exempting securities issued or guaranteed by tbe United States from the registration requirement of § 5); *Id.* § 4(2) (providing a transactional exemption from § 5 for private offerings). For the type of information that must be disclosed pursuant to a § 4(2) private placement, see Rule 506 of SEC Regulation D, 17 C.F.R. §§ 230.501-.503, 230.506 (1986).

132. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985) ("[A]lthough § 4(2) of the 1933 Act . . . exempts transactions not involving any public offering from the Act's registration provisions, there is no comparable exemption from the antifraud provisions.").

133. This assertion assumes, of course, that the complainant establishes the requirements for a private right of action, for example, by being a purchaser or seller with the resulting standing to sue under Exchange Act § 10(b). *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

certainty both in business planning and in investment transactions.[134]

Upon scrutiny, the *Weaver* Court's analysis appears to have developed as follows:

(1) The Court observed that federally regulated banks are governed by extensive reserve, reporting, inspection, and advertising requirements—devices that serve a purpose analogous to the Securities Act's registration and information requirements. Therefore, the Court employed a line of reasoning similar to the one that led Congress to exempt certain instruments or transactions from the registration (and, in some cases, the reporting) requirements of the securities laws: because the transaction's context indicated little risk of abuse, the Court looked to the *risk of loss* to determine whether the Acts' antifraud provisions should apply to the certificate of deposit.

(2) Upon examining the risk of loss, the Court concluded that because the FDIC insures certificates of deposit issued by federally regulated banks, there was no *need* to invoke the antifraud provisions.

(3) The Court apparently combined the two lines of analysis: even though the certificate of deposit in *Weaver* fit the definition of a security, because, first, the banking regulations substantially duplicated the securities laws' registration and reporting functions and, second, the FDIC protected depositors, both functions of the securities laws were served, a result that obviated the *need* to place a certificate of deposit within the Acts' scope.

(4) Accordingly, the Court found no *need* to consider the certificate of deposit a "security."

There are several flaws in this logic. First, when a security is involved, need and context are irrelevant to the application of the antifraud provisions. The Acts' remedies address actual instances of abuse in the investment markets, whether private or public, not merely abuses that occur in those contexts in which fraud is most likely. Therefore, although the registration and reporting requirements may not apply to certain instruments and transactions, to limit the antifraud remedy is contrary to a fundamental premise underlying the Acts.[135] Moreover, FDIC protection is not analogous

134. For examples of the Court's decisions rejecting the "sale of business" doctrine, see *Gould*, 471 U.S. at 704-06 (1985); *Landreth*, 471 U.S. at 696 ("[U]ncertainties attending the applicability of the Acts would hardly be in the best interests of either party to a transaction.").

135. Although the Court has limited the antifraud remedy of § 10(b) of the Exchange

to the availability of a private right of action under the securities laws: the former insures against loss, but the latter serves as both a deterrent and a remedy in proper circumstances.[136]

The *Weaver* Court mistakenly assumed that the only "risk" confronting depositors is the possibility of bank failures[137]—a context in which FDIC insurance indeed has fulfilled its purpose. *Weaver's* facts, however, demonstrate that the possibility of fraud on certificate of deposit holders is not so sharply circumscribed. Undoubtedly, although other types of instruments or transactions may be involved, endless variations on the *Weaver* scenario are possible. By focusing on the context of one particular transaction, rather than on the nature of the transaction itself, the Court erroneously equated the question of what constitutes a security with the frequency with which a specific pattern of fraudulent conduct can be expected to occur. That the Court inverted the proper inquiry is evident from its conclusion, which it phrased in terms of the propriety of subjecting certain issuers to liability, rather than of the need to provide actual securities fraud victims with a remedy.[138]

The shortcomings of this approach—in which the presence of government regulation serves to displace private rights of action under the federal securities laws—have become evident in other contexts. For example, in the wake of *Daniel* and *Weaver*, a number of courts have held that interests in voluntary, contributory pension plans are not securities.[139] To support their holdings, these

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Act by requiring scienter, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), this limitation does not undermine the purpose of the Acts. Requiring scienter clarifies the definition of "manipulative or deceptive" conduct that falls within the scope of the antifraud provisions, but does not limit the availability of the remedy in the presence of prohibited conduct.

136. By focusing on the availability of FDIC protection and the existence of extensive banking regulation, the *Weaver* Court also disregarded the need for protection at both ends of a securities transaction, as the Third Circuit observed. *See* Weaver v. Marine Bank, 637 F.2d 157, 163 (3d Cir. 1980). Merely because one party to a particular type of transaction is in an *unlikely* position to be the victim of fraud should not influence the scope of the antifraud provisions if the transaction otherwise involves a "security."

137. *See* 455 U.S. at 558.

138. *Id.* at 559 ("It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under the federal banking laws.").

139. *See, e.g.,* Conrad v. Colgate-Polmolive Co., 686 F.2d 1230 (7th Cir. 1982), *cert. denied,* 460 U.S. 1070 (1983); Polack v. Payne, 591 F.2d 83 (9th Cir.), *cert. denied,* 444 U.S. 867 (1979); Cunha v. Ward Foods, Inc., 545 F. Supp. 94 (D. Haw. 1982); Newkirk v. General Elec. Co., [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,216 (N.D. Cal. 1979); Tanuggi v. Grolier, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,880, at 95,609

courts cite the thorough regulation of such plans under ERISA and the source of their appeal to participants, which derives from their "insurance-like stability . . . and not the prospect of growth."[140] On the other hand, the SEC, in a position taken prior to *Weaver*, has asserted that these plans are securities. The Commission's rationale is that (1) a voluntary contributory plan constitutes an employee's investment of identifiable consideration in return for a separable financial interest; (2) some of these plans maintain for each participant a separate account that defines the participant's contributions; and (3) "[b]y deciding to participate in the plan voluntarily, the employee implicitly has made an investment decision to the effect that his contribution will achieve investment results that will be equal to or superior to those he could obtain from investing his funds elsewhere."[141] In the current deregulatory climate the SEC, perhaps not surprisingly, has not invoked this position actively post-*Weaver*. Unlike holders of certificates of deposit issued by federally regulated banks that are insured by the FDIC, however, the participant in a voluntary, contributory pension plan incurs both the risk of the plan's insolvency and the lack of business acumen on the part of the plan's investment advisers.[142]

The problems devolving from *Weaver*'s "functional" approach are also evident in the Ninth Circuit Court of Appeals' post-*Weaver* decision *Wolf v. Banco Nacional de Mexico*.[143] In *Wolf* the court faced the issue whether time deposits in Mexican pesos issued by a Mexican bank to a United States citizen were securities within the meaning of the Acts. Relying on *Weaver*'s rationale, the Ninth Circuit examined the components of the Mexican banking system and found that Mexican bank regulation was comparable to regulation in the United States. Hence, the court held that "when

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(S.D.N.Y. 1979); *supra* note 48.

140. Tanuggi v. Grolier, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,880, at 95,609 (S.D.N.Y. 1979).

141. Employee Benefit Plans, Securities Act Release No. 6281, 1 Fed. Sec. L. Rep. (CCH) ¶ 1052 (Jan. 15, 1981); Employee Benefit Plans, Interpretations of Statute, Securities Act Release No. 6188, 1 Fed. Sec. L. Rep. (CCH) ¶ 1051 (Feb. 1, 1980).

142. ERISA §§ 404-410, 29 U.S.C. §§ 1104-1110 (1982). Although ERISA proscribes certain classes of transactions for plan fiduciaries, sets forth "prudence" requirements for such fiduciaries, and provides for personal liability upon breach of "any of the responsibilities, obligations or duties imposed upon fiduciaries by [ERISA (29 U.S.C. § 1109(a))]," nevertheless, "[a] 'prudent' fiduciary has wide discretion under ERISA in how he invests the plan assets." Raymond, *ERISA Trusts and Tender Offers*, 13 SEC. REG. L.J. 253, 262 (1985), *citing* Taylor v. Bakery & Confectionary Union & Indus. Int'l Welfare Fund, 455 F. Supp. 816, 819 (E.D.N.C. 1978).

143. 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985).

a [domestic or foreign] bank is sufficiently well regulated that there is virtually no risk that insolvency will prevent it from repaying the holder of one of its certificates of deposit in full, the certificate is not a security for purposes of the federal securities laws."[144]

Under *Wolf*'s application of *Weaver*, it appears that whenever a foreign country has extensive banking regulations virtually guaranteeing depositors repayment, certificates of deposit issued by banks chartered in that country are not securities under United States law. This extension of *Weaver*, although evidently consistent with the Supreme Court's functional analysis, appears unwarranted, particularly with respect to the absence of antifraud protection. Under the Ninth Circuit's interpretation, foreign banks, which are not subject to banking regulation under United States law, can publicly market their certificates of deposit in this country, yet evade coverage of the Acts.

Congress could not have intended this result, and, irrespective of *Wolf*, foreign banks that engage in public marketing of their deposits likely do so at their peril.[145] Although not eliminating the drawbacks of *Weaver* and its progeny, the SEC's approach would be to ascertain the commercial or investment nature of the foreign certificates of deposit.[146] Factors to examine under this approach would include the manner of issuance (particularly the presence of underwriting or promotional activity), the certificates' length of maturity, the extent and nature of the issuance (including the number of certificates issued, the number of depositors who purchased the certificates, and the "sophistication" of the purchasers), and the manner in which the issuer or its promoters characterized

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144. *Id.* at 1463. The lower court in *Wolf* came to a different conclusion, reasoning:

> In this case it is not contested that Mexico thoroughly regulates its banks and that no Mexican bank has become insolvent in fifty years. That is not enough, however, to make Wolf's investment virtually free of risk. Indeed, governmental regulation has no effect on the essential risk to which an investor in foreign time deposits is exposed—the risk of devaluation. Because the rationale of *Weaver* is inapplicable here, the Court holds that plaintiff's time deposits were securities.

Wolf v. Banco Nacional de Mexico, 549 F. Supp. 841, 853 (N.D. Cal. 1982) (footnote omitted), *rev'd,* 739 F.2d 1458 (9th Cir. 1984), *cert. denied,* 469 U.S. 1108 (1985). *See also* Meason v. Bank of Miami, 652 F.2d 542 (5th Cir. 1982) (CD issued by bank chartered in the Grand Cayman Islands may be a security).

145. *See* Farrar, *Foreign CD Deemed Outside Securities Law,* Legal Times, Oct. 29, 1984, at 15.

146. For decisions applying the "commercial/investment" test to ascertain whether a note transaction is a "security," see, e.g., Bauerer v. Planning Group, Inc., 669 F.2d 770 (D.C. Cir. 1981); American Fletcher Mortgage Co. v. United States Steel Credit Corp., 635 F.2d 1247 (7th Cir.), *cert. denied,* 451 U.S. 911 (1980); Unitcd Am. Bank v. Gunter, 620 F.2d 1108 (5th Cir. 1980).

the certificates.[147] The SEC's approach implicitly recognizes the deficiency of *Weaver* without coming to terms with it: many of the above factors look to the "risk" of loss to the purchaser, even though pursuant to regulation in those foreign countries, depositors are "virtually guaranteed" repayment in full.[148] Under a number of circumstances, as in *Weaver*, a depositor's risk of loss may not be limited to a foreign bank's insolvency. The SEC alludes to this "risk," yet abandons its concern for investor protection if the certificates are deemed, under the foregoing factors, to be "commercial" in nature.[149]

IV. Investment Contract Analysis

A. *The Meaning of "Investment Contract"*

Prior to *Weaver*, courts generally were consistent in applying the *Howey* test to determine the presence of an investment contract. Although the basic test has been refined in response to previously unaddressed factual situations, the fundamental considerations remained unchanged: was there (1) an investment, (2) in a common enterprise, (3) with the expectation of profits derived essentially from the efforts of others?[150] *Weaver*, however, is so riddled with ambiguities that its analysis—or lack thereof—does not make clear how courts should apply the test in the future. Although post-*Weaver* decisions have continued to apply the *Howey* test,[151] *Weaver* casts doubt on whether the *Howey* test is applicable in all cases of investment contract analysis. Indeed, the distinct possibility exists that *Weaver* retains the *Howey* test as the basic standard, but in substantially revised form.

The Third Circuit's decision in *Weaver* concerning the profit-

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147. Brief for SEC as Amicus Curiae at 17, Wolf v. Banco Nacional de Mexico, 739 F.2d 1458 (9th Cir. 1984) [hereinafter Brief for SEC].

148. *See Wolf*, 739 F.2d at 1463-64. The SEC's approach, impliedly focusing on the degree of "risk," resembles somewhat the Ninth Circuit's "risk capital" test for determining whether a note transaction is a "security." *See, e.g.*, Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).

149. *See* Brief for SEC, *supra* note 147, at 17-18. Applying the above factors, the SEC opined, after receiving advice from federal banking regulators, that most certificates of deposit issued by foreign banks are "commercial [representing] short term cash management or the placement of funds awaiting use for payment or similar transactions." *Id.*

150. *See supra* notes 26-55 and accompanying text.

151. *See, e.g.*, McGill v. American Land & Exploration Co., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,368 (10th Cir. 1985); Goodwin v. Elkins & Co., 730 F.2d 99 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); Odom v. Slavik, 703 F.2d 212 (6th Cir. 1983).

sharing agreement between the Weavers and the Piccirillos rested squarely on the Court's construction of "investment contract" or, alternatively, "certificate of interest or participation in a profit-sharing agreement."[152] Although the Supreme Court's framing of the issue on appeal suggested an analysis of the transaction in the same terms, in reality the Court seems to have avoided applying the *Howey* test as it had evolved through prior judicial interpretation. Instead, the Court noted initially that the profit-sharing agreement was not among "those instruments ordinarily and commonly considered to be securities."[153] This observation, however, appears to exclude the arrangement from only one of the Acts' definitional categories—"any instrument commonly known as a 'security.'"[154] As the Court indicated in *Tcherepnin v. Knight*, a more sweeping conclusion would be the product of "misplaced emphasis"[155] because the "commonly known" language does not act as "a limitation on the other descriptive terms used in the statutory definition."[156] Furthermore, when the *Weaver* Court sought to distinguish the profit-sharing agreement from other "unusual" instruments found to constitute securities, it merely listed a series of factors—in rather haphazard fashion—without explaining how they relate to *Howey*-type analysis.[157]

The distinguishing features listed by the *Weaver* Court fall into a number of categories.[158] First, the Court observed that the profit-sharing agreement was private and negotiated "one-on-one."[159] In this regard, the Court, at first blush, seems to have held implicitly that "horizontal" commonality, and not "vertical" commonality, is required to satisfy the *Howey* test's common enterprise element.[160] Generally, all courts hold that horizontal commonality (which looks to the relationship between an individual investor and the pool of other investors) meets this element of the *Howey* test.[161] Courts widely disagree, however, on whether vertical

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152. *See Weaver*, 637 F.2d at 161-62; *supra* note 68.
153. *Weaver*, 455 U.S. at 559.
154. *See supra* note 17; *see also* 15 U.S.C. § 77b(1) (1982).
155. Tcherepnin v. Knight, 389 U.S. 332, 343 (1967).
156. *Id.*, *citing* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 350 (1943).
157. *See Weaver*, 455 U.S. at 559-60.
158. *See supra* notes 80-83 and accompanying text.
159. *Weaver*, 455 U.S. at 559-60.
160. *See id.* at 560 n.10, *citing* Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1260-62 (9th Cir. 1976) (Wright, J., concurring) ("[an] unsecured note, the terms of which were negotiated face to face, given to a bank in return for a business loan, is not a security").
161. *See, e.g.*, Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459 (3d Cir. 1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Milnarik v. M-S

commonality is sufficient.[162] Vertical commonality generally requires only that the investor(s) and promoter (or third party) be involved in some common venture.[163] Based on *Weaver*, some lower courts have asserted that the vertical commonality approach no longer survives.[164] This view, although plausible, is premature. Indeed, a number of other courts have ruled otherwise, refusing to read *Weaver* in an unduly restrictive manner.[165] This latter interpretation of *Weaver*'s implications finds strong support in the Court's post-*Weaver* denial of the petition for a writ of certiorari in *Mordaunt v. Incomco*.[166] In *Mordaunt* Justice White, dissenting from the denial of the petition, surveyed the divergent views among the lower courts concerning the requisite commonality and opined that "[i]n light of the clear and significant split in the Circuits, I would grant certiorari."[167]

Hence, the requisite commonality to satisfy *Howey*'s common

Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Wasnowic v. Chicago Bd. of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd*, 491 F.2d 752 (3d Cir. 1973). As the Sixth Circuit stated in Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 224 (6th Cir.), *aff'd on other grounds*, 456 U.S. 353 (1982): "no horizontal common enterprise can exist unless there . . . exists between [the investors] themselves some relationship which ties the fortunes of each investor to the success of the overall venture."

162. For decisions holding that vertical commonality is sufficient, see, e.g., McGill v. American Land & Exploration Co., [1985-1986 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 92,368 (10th Cir. 1985); Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc., 686 F.2d 818 (9th Cir. 1982), *cert. denied*, 460 U.S. 1023 (1983); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974). *Cf.* Booth v. Peavey Co., Commodities Servs., 430 F.2d 132 (8th Cir. 1970). For courts ruling that vertical commonality is not sufficient for *Howey's* common enterprise element, see cases cited *supra* note 161.

163. This issue often arises in the context of individual discretionary trading accounts. These accounts clearly are not securities if horizontal commonality is required. *See, e.g.*, cases cited *supra* note 161. In addition, for a number of courts adopting the vertical commonality approach, these accounts are not securities because they create no "direct relation between the success or failure of the promoter and that of his investors." Mordaunt v. Incomco, 686 F.2d 815, 817 (9th Cir. 1982), *cert. denied*, 469 U.S. 1115 (1985). Hence, as the Ninth Circuit stated in Meyer v. Thompson & McKinnon Auchincloss Kohlmeyer, Inc., 686 F.2d 818 (9th Cir. 1982): "Plainly, just as in *Mordaunt* and *Brodt*, the promoter continued to profit through commissions even as the account lost money. On the other hand, had the account been successful, the promoter would not necessarily have shared the benefits because [the investor] could elect to withdraw profits as they accrued." *Id.* at 819 (citations omitted). *See generally* Raisler, Adams, & Donley-Hoopes, *Discretionary Commodity Accounts: Why They Are Not Governed by the Federal Securities Laws*, 42 WASH. & LEE L. REV. 743 (1985).

164. *See, e.g.*, First Nat'l Bank & Trust Co. v. Thoele, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,854 (W.D. Okla. 1982).

165. *See, e.g.*, McGill v. American Land & Exploration Co., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,368 (10th Cir. 1985).

166. 469 U.S. 1115 (1985).

167. *Id.* at 1117 (White, J., dissenting).

enterprise element appears to remain an open question. A court applying the Court's "economic reality" approach should hold the requisite commonality to exist when the profits derived by the investor are interwoven substantially with the efforts exerted by and benefits received by the promoter. Phrased somewhat differently, there must be "some direct relation between the success or failure of the promoter and that of [the] investor[s]."[168] The offering's size and the number of investors should be relevant only to whether the offering is exempt from registration.[169] The exclusion of an instrument otherwise deemed an "investment contract" from the Acts' antifraud provisions merely because the transaction involved a single investor would constitute an assault on the underlying purposes of the Acts. Moreover, the result should not turn on whether a "prospectus" is distributed. The *Weaver* Court's implication in this regard[170] is the product of hopelessly circular logic: if a prospectus is required only upon first determining that a security is involved, how can "security" be defined in terms of whether a prospectus is distributed?[171]

In short, as the Court concluded in *Tcherepnin*, whether a particular instrument is publicly traded is immaterial if it otherwise fits the definition of "security."[172] An instrument's susceptibility to public trading may be evidence of its character in commerce, but the Court made clear in its very first decision construing the definition of "security" that the Acts' scope does not end with the "obvious or commonplace."[173]

Moreover, by dwelling on the "unique" nature of the transaction, as evidenced by both the provision granting the Weavers use of company property for private purposes and the instrument's lack of "equivalent value" to other potential investors, the *Weaver* Court took an unduly narrow view of the notion of "profits." Not only could the former provision be viewed as an incidental benefit

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168. *Mordaunt*, 686 F.2d at 817. *See supra* note 163.

169. *See* Marine Bank v. Weaver, 637 F.2d 157, 161 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982); *see also* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC Regulation D, 17 C.F.R. §§ 230.501-230.506 (1986).

170. *See* 455 U.S. at 560.

171. Under a literal interpretation of *Weaver*'s language, an issuer arguably could escape liability by operating solely through word of mouth. Of course, the Court could not have intended to suggest this possibility, but thinking it through demonstrates the inadequacy of the Court's analysis.

172. 389 U.S. at 343, 345.

173. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

of the overall transaction,[174] but also these aspects of the agreement merely indicate that the investment partners in *Weaver* were especially well matched—a significant characteristic of potentially successful ventures. As long as a true capital investment occurs and the investing party does not meaningfully participate in management of the enterprise,[175] neither "uniqueness" of the arrangement's terms nor the subjective value of profits yielded should have any bearing on whether a transaction involves a security.

Finally, to preclude a transaction from constituting a security because the investor obtains a measure of "control" over the enterprise is contrary to established authority. As long as "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise,"[176] the "profits to be derived from the efforts of others" standard is deemed met. Examined in a somewhat different light, a "veto" power over further borrowing until existing obligations are satisfied (as in the Weaver-Piccirillo agreement) is a bargaining point that may be negotiated with respect to conventional debt securities. Investors and borrowers agree upon such restrictive covenants in certain situations, particularly those of high risk, because in such circumstances investors, not surprisingly, are loath to part with their money without some assurance that it will be handled responsibly.[177] In light of the Piccirillos' financial record, a potential investor would have been foolish to enter into the arrangement without insisting on this condition. Furthermore, nothing indicated that the Weavers intended to undertake any managerial responsibility for the enterprise. Hence, in the absence of fraud the veto provision, at most, would have provided the Weavers some measure of protection for their investment; any revenues (and consequent profits) generated from the agreement, however, would have resulted solely from the Piccirillos' managerial skills.

As the foregoing discussion demonstrates, none of the distinguishing factors relied on by the *Weaver* Court would have

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174. *See Weaver*, 637 F.2d at 162. The procedural posture of *Weaver* is relevant to this observation. Because the case was decided on summary judgment in the absence of additional factfinding on this point, the determination of whether this benefit was primary or incidental to the transaction apparently would have been a futile exercise.

175. *See supra* notes 22-55 and accompanying text.

176. SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 82 (1973). *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

177. *See* W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 160 (1980).

excluded the transaction under conventional *Howey* analysis. As Chief Justice Warren once explained in a similar context, such factors "serve only to distinguish among different types of securities. They do not, standing alone, govern whether a particular instrument is a security under the federal securities laws."[178] Moreover, without further enlightenment from the Court, these distinctions, taken together, failed to provide useful guidelines for applying the *Howey* test. As a result, significant uncertainties emerge from *Weaver* concerning the future definition of "security."

B. Howey's *Continued Vitality*

As *Landreth Timber Co. v. Landreth* makes clear, the Court has not abandoned the *Howey* test in the investment contract setting.[179] Moreover, in light of *Weaver*'s facts, any suggestion that the Court has adopted an alternative "risk capital" approach[180] is meritless: it is difficult to conceive of a riskier investment proposition than guaranteeing the debts of a business on the verge of bankruptcy.

In view of the various extraneous factors that the *Weaver* Court found to be pertinent, however, it is unlikely that the conventional *Howey* test endures as the sole standard for defining an "investment contract." The Court simply injected too many additional considerations for the *Howey* guidelines alone to remain dispositive. Unfortunately, the *Weaver* Court never adequately explained—or even attempted to explain—how its observations interacted with the *Howey* test's various components.[181]

If *Weaver* represents a modification of or supplement to the *Howey* test, which is the only reasonable conclusion under the circumstances, the Court's analysis has several unsettling implications. For example, as discussed above,[182] the Court's observations about the "uniqueness" of the Weavers' arrangement with the Pic-

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178. Tcherepnin v. Knight, 389 U.S. 332, 344 (1967).

179. See *Landreth*, 471 U.S. 681, 691 (1985), where the Court stated that "the *Howey* economic reality test was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples listed in the statutory definition of 'security.' " (emphasis in original).

180. That the *Weaver* Court cited Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976), a leading example of the risk capital test in the "note" context, in support of the Court's conclusion that Congress "did not intend to provide a broad federal remedy for all fraud," creates some confusion about what the Court was suggesting. *See* 455 U.S. at 556.

181. *See supra* notes 107-15 and accompanying text.

182. *See supra* notes 159-71 and accompanying text.

cirillos arguably suggest that the second component of the *Howey* test (the "common enterprise" requirement) is satisfied only when a transaction involves a pool of similar investors. Whether "vertical" commonality (an arrangement involving one investor and at least one "manager" of a profit-seeking enterprise) is sufficient, or whether "horizontal" commonality (an arrangement involving more than one investor, in addition to management) is required, has been a controversy among the lower courts.[183] Although the issue calls for expeditious resolution, it would be unfortunate were the several unilluminating references in *Weaver* to "private transactions" and "one-on-one" negotiations to signal the end of this debate, without further elaboration of the opposing viewpoint's merits.[184]

Similarly, the *Weaver* Court's comments about public trading and negotiability could foster the conclusion that arrangements such as limited partnerships are beyond the Acts' scope if their terms are privately negotiated and include restrictions on transfer—as is often the case. Arrangements with these characteristics generally have been held to involve securities,[185] and for *Weaver* to prompt courts to hold otherwise on these grounds would defy reason. Likewise, an instrument's mere novelty or uniqueness should bear little relevance to whether a security is involved.[186] Indeed, as the *Howey* Court perceived, the definition of "investment contract" is designed to encompass "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."[187]

Unfortunately, *Weaver* sheds too little light on these issues and generates several concerns that otherwise might not matter, obscuring both the role and the content of investment contract analysis. By abstaining from meaningful application of the *Howey*

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183. *See supra* notes 161-67 and accompanying text.

184. In this regard, however, Justice White's dissent from the Court's denial of the petition for a writ of certiorari in Mordaunt v. Incomco, 469 U.S. 1115 (1985) (White, J., dissenting), signals that this issue still is very much alive. *See supra* notes 166-67 and accompanying text.

185. *See, e.g.*, Mayer v. Oil Field Sys. Corp., 721 F.2d 59 (2d Cir. 1983); SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980); Goodman v. Epstein, 582 F.2d 388 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); Felkay v. ZB Ltd. Partnership No. 1, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,241 (S.D.N.Y. 1983).

186. *See, e.g.*, Glen-Arden Commodities, Inc., v. Constantino, 493 F.2d 1027 (2d Cir. 1974) (Scotch Whiskey receipts); Continental Mktg. Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968) (beaver breeding).

187. 328 U.S. at 299.

test without sufficient explanation, the Court leaves one with the uneasy conviction that it has contorted the relevant inquiry in order to find support for a preconceived conclusion.

Nevertheless, *Weaver* signifies that an investment contract may not exist even if the *Howey* test is satisfied. Although far from certain, an instrument apparently will not be deemed an investment contract, irrespective of the *Howey* test, if (1) the transaction involves a novel or unique instrument, (2) that is not capable of mass distribution or public trading, (3) when no prospectus has been distributed, *and* (4) the transaction is negotiated privately and involves few individuals.[188] This interpretation of *Weaver*, while consistent with the thrust of the Court's holding, does not undermine investment contract analysis. In addressing *Weaver*'s impact in this manner, the proffered interpretation comports with the Court's view that the securities laws were not designed to provide a remedy for all fraud.[189] At the same time, the *Howey* test remains, as it has since its adoption, the principal focus for determining the existence of an investment contract.

V. The Court's Misguided View of Congressional Intent

After acknowledging the broad definition of "security" in the Securities Exchange Act,[190] reviewing the expansive interpretation that definition had undergone in prior case law,[191] and noting the remedial purpose of the federal securities laws,[192] the Court began its analysis in *Weaver* by asserting that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."[193] The spirit of this conviction pervades every aspect of the *Weaver* opinion: it is the force behind the Court's conclusion

188. *See* Marine Bank v. Weaver, 455 U.S. 551, 559-60 (1982). Under this interpretation, *Weaver* should not be limited to one-on-one transactions. The Court, as seen from Justice White's dissent from the denial of the petition for a writ of certiorari in *Mordaunt*, 469 U.S. 1115-17, did not intend to address the requisite commonality issue. Moreover, it appears likely, based on the Court's language, that the Court would have reached the same result if the transaction had been, for example, a three-on-one transaction, provided that all the other *Weaver* circumstances were present.

Importantly, under the profferred interpretation *all* the conditions must exist for *Weaver* to place the transaction outside the federal securities laws' scope. If *any* condition is not present, then the proper analysis for determining the existence of an investment contract is solely the *Howey* test (presuming the inapplicability of the risk capital test).

189. *See* 455 U.S. at 556.

190. *Id.* at 555.

191. *Id.* at 556.

192. *Id.* at 555-56.

193. *Id.* at 556.

that the "context" clause authorizes judicial exclusion of certain instruments from the Acts' scope, and it apparently stimulated the Court's efforts to distinguish the *Weaver* profit-sharing arrangement from other unconventional transactions that constitute securities. Because the way the Court sought to implement its observation about congressional intent conflicts with the federal securities laws' underlying purposes, however, the wisdom of the Court's analysis is questionable.

Undoubtedly, the Court's assertion is correct at its most literal level: Congress clearly did not intend to remedy all instances of fraud with a single (or double) legislative wave of the hand, no matter how sweeping the scope of the 1933 and 1934 Acts. To pursue the contrary position would be to mistake the obvious: despite the Acts' undeniable breadth, Congress intended to address only those transactions involving "securities." Moreover, in ascertaining the coverage of the securities laws, judicious application of traditional canons of statutory construction may lead one to conclude that an instrument "may be within the letter of the statute and not yet within the statute, because not within its spirit, nor within the intention of its makers."[194]

The misguidance of the *Weaver* Court is more subtle and, unfortunately, more significant. Viewed in isolation, the Court's assertion that federal securities legislation is not directed against all fraud may be interpreted as alluding to the securities laws' remedial scope. In fact, however, the Court invoked its observation about congressional intent to confine even further the antifraud provisions' coverage, by employing the observation in defining the term "security" itself. In essence, by concluding that Congress did not intend the Acts to remedy "all fraud," the Court decided *Weaver* under the erroneous assumption that it had discovered a vehicle for narrowing the federal securities laws' reach.

This assumption ignores the reality that the type of conduct that the Acts prohibit and the definition of "security" are unrelated, except to the extent that a security must be present for the

194. Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892), *cited in* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975). Hence, a long-term note executed by a bank customer in exchange for the financing of a consumer good (for example, a personal automobile) would be excluded from the securities laws' coverage under this principle. For discussion of notes and the applicability of the securities acts, see generally Sonnenschein, *supra* note 91. Of course, if the principle is applied too broadly, the same problems as those seen in the Court's "context" clause analysis will arise. *See* Thompson, *supra* note 50, at 250-52.

antifraud provisions to apply. Observations about one have no bearing on conclusions about the other. A finding that fraud has occurred in a particular factual situation does not in itself qualify the transaction involved as a security; likewise, the mere presence of a security will not expose a party to a transaction to liability under the antifraud provisions absent evidence of prohibited conduct.

The *Weaver* Court appears to have presumed that because the Acts do not extend to all types of fraud, neither must they encompass all types of transactions, even those that otherwise fit the definition of "security." The flaw in this reasoning is its failure to recognize that although the securities laws do not broadly prohibit all fraud, the antifraud provisions do prohibit all instances of manipulative or deceptive conduct "in connection with the purchase or sale of *any* security."[195] Thus, not only do the limits on the antifraud remedy place no corresponding restrictions on the definition of "security," the antifraud provisions make clear that prohibited conduct in the context of *any* transaction meeting the definition of "security" falls within the Acts' scope.

Of course, the *Weaver* Court was not speaking literally when it indulged in its reading of congressional intent. On the surface, the Court's point apparently was merely that the securities laws are not a panacea for claims of fraud in all types of business transactions. The Court, however, seems to have misdirected this principle by focusing on the nature of the fraud and the existence of alternative remedies as being determinative of whether a security is present. In particular, the Court's comments about the profit-sharing agreement's uniqueness and private nature, together with its observations about FDIC protection and banking regulation, suggest a de minimus approach to determining the scope of federal securities regulation.[196]

Nor should it escape notice that *Weaver* is devoid of any persuasive support for how the Court interpreted congressional "intent" in construing and then constraining the definition of "security."[197] That any sort of de minimus approach is foreigu to the

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195. Exchange Act § 10(b), 15 U.S.C. § 78f (1982) (emphasis added); *cf.* Securities Act § 17(a), 15 U.S.C. § 77q (1982) (the corresponding antifraud provision of the 1933 Act).

196. *See Weaver*, 455 U.S. at 557-60. The final paragraph of the *Weaver* decision fosters this impression by implying that the appropriate remedy resided in the pendent state claims. *See id.* at 560-61.

197. The Court offered no support from the legislative history for its interpretation and cited only two lower court cases, neither of which addresses the congressional intent

Acts' operation underscores this deficiency. For example, the strict liability consequences for noncompliance with the Securities Act's precise and extensive registration requirements make clear that Congress was adopting a stern approach when it designed this legislation.[198] Even those transactions purportedly falling within the limited offering and private offering exemptions are scrutinized to determine whether they meet the exacting guidelines, and all these transactions are subject to the antifraud provisions.[199] One of the few aspects (perhaps the only aspect) of the securities laws even faintly suggesting a de minimus approach is the materiality requirement of the Acts' remedial provisions,[200] but even that concept has nothing to do with whether the transaction itself constitutes a security. Rather, "materiality" measures the importance of misinformation (or omission of information) to investors and the marketplace, and although the standard is not subjective,[201] its emphasis is on the misconduct's significance to the parties allegedly aggrieved—not to the overall scheme of regulation.

The *Weaver* Court's understanding and application of congressional "intent" threaten to restrict the scope of the federal securities laws to large-scale, multi-investor transactions and to those transactions occurring in the ordinary investment markets. While recognizing that instruments having the attributes of traditional stock are necessarily "securities," the Court's decisions rejecting the sale of business doctrine[202] do not diminish the possi-

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issue in any significant way. *See* 455 U.S. at 556 (citing Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1253 (9th Cir. 1976), and Bellah v. First Nat'l Bank, 495 F.2d 1109, 1114 (5th Cir. 1974)). In *Kotz* the Ninth Circuit applied a "risk capital" approach in analyzing a promissory note given to a bank in the course of a commercial financing transaction. In *Bellah* the Fifth Circuit analyzed a note issued in a loan transaction and commented simply that it had "grave doubts" that registration of commercial paper under the securities laws was a result sought by Congress.

198. See Securities Act § 12(1), 15 U.S.C. § 77 (1982), which grants the purchaser the right to rescind the transaction against the seller of a security when the security was offered or sold in violation of § 5 of that Act. *Id.* § 77e.

199. *See, e.g.,* Securities Act §§ 3(b), 4(2), 15 U.S.C. §§ 77c(b), 77d(2); SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980); Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978); Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977). For further discussion of the applicability of the antifraud provisions, see *supra* notes 129-36 and accompanying text.

200. *See, e.g.,* Securities Act §§ 11, 12(2), 15 U.S.C. §§ 77k, 77l; Exchange Act §§ 14(e), 18(a), 15 U.S.C. §§ 78n(e), 78r(a).

201. *See, e.g.,* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("An omitted fact is material [under Rule 14a-9] if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

202. *See* Gould v. Ruefenacht, 471 U.S. 701, 703-04 (1985); Landreth Timber Co. v. Landreth, 471 U.S. 681, 694 (1985); *supra* notes 50-55 and accompanying text.

bility of a narrowing scope in other contexts. When the instrument involved is more irregular, and the inquiry therefore focuses on whether an investment contract exists, *Weaver*'s implications may signify that individual investors in small-scale or family-run enterprises will be denied protection under federal law.[203] This is possible because the thrust of the Court's logic in its recent decisions,[204] other than those involving the sale of business doctrine, generally is to reserve application of the securities laws to protect the "business" of investment.

Hence, by asserting that the Acts were not intended to remedy "all fraud," the Court implied that the antifraud provisions normally apply only to those transactions that fit a common, familiar mold, or—as the *Weaver* Court revealingly put it—"those instruments ordinarily and commonly considered to be securities in the commercial world."[205] This reasoning not only confuses the "economic reality" approach to defining "security" with the frequency and visibility with which certain types of transactions occur, but it also neglects the underlying purposes of the Acts, which make no such distinctions in their design "to protect the investing public and honest business."[206]

VI. Further Evidence of Supreme Court Inadequacy in Securities Law Construction

Marine Bank v. Weaver is an example of judicial activism at its worst. Little doubt exists that the type of fraudulent misconduct alleged in *Weaver* would have satisfied the antifraud provisions' "manipulative or deceptive" standard, were either of the

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203. In this regard, the *Landreth* Court asserted that scrutiny of the transaction's economic substance need be conducted only when the instruments involved were "unusual . . . not easily characterized as 'securities.'" 471 U.S. at 690.

204. *See, e.g.*, Marine Bank v. Weaver, 455 U.S. 551 (1982); International Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).

205. 455 U.S. at 559. An argument supporting the Court's rationale may be set forth as follows:

> [I]f it be recognized that the danger of fraud is quantitatively and qualitatively reduced where a transaction is both isolated and private, there is persuasive force in the argument that the application of the special fraud procedures, protections and remedies of the securities laws should be cut off short of the thousands of transactions which involve only a handful of knowledgeable or sophisticated buyers.

Coffey, *supra* note 111, at 411. Upon analysis, however, it appears that "factors in mitigation of the probability of fraud are relevant to the issue of exemption [from registration]—not to the issue of security status." *Id.* at 408.

206. *See supra* note 19.

transactions in question found to involve a "security." Therefore, to find a basis for excluding each of those transactions from the Acts' scope, the *Weaver* Court strained to narrow the definition of "security." In doing so, the Court either ignored or displaced fairly well-established guidelines by drawing distinctions where few significant differences existed and devised ill-conceived theories for limiting the Acts' reach.

To subordinate individual claims to the demands of a defined regulatory scheme is one thing; indeed, effective statutory construction requires the segregation of pertinent claims from those that are equally distressing but that arise in extraneous contexts. To employ questionable methods to recast legislative directives so that the latter coincide with one's private conception of how legal affairs should be ordered is quite another matter. Whatever the Court's rationale for departing from its earlier philosophy of broadly applying the securities laws to prevent abuse in the private or public capital-raising markets—whether a fear of the antifraud provisions' expansion into a blanket remedy for all commercial misconduct, a desire to curtail the federal courts' burgeoning caseload, or simply a recognition of the regulatory environment's increased complexity since the securities laws' enactment—*Weaver*'s effect is to superimpose a layer of uncertainty on the meaning of "security" and to raise troubling questions about the Acts' scope.

In all fairness, although *Weaver* represents a personal catastrophe for the plaintiffs, it is reasonable to assume that the subtler implications of *Weaver* were overlooked in the deluge of seemingly more pressing issues the Court faces each term. Moreover, in view of the Acting Solicitor General's amicus curiae brief urging reversal,[207] the relatively simple fact pattern, the evident availability of state law remedies,[208] and, at least superficially, the opinion's apparently limited scope, it is understandable (although indeed unfortunate) that a unanimous Court joined Chief Justice Burger's opinion. Nevertheless, the Court's analysis contains severe deficiencies: *Weaver* is wrought with misreading of statutory commands, distortion of relevant definitions, and misleading suggestions about congressional intent.

Were *Weaver* an isolated, self-contained instance of shortsightedness in the press of more urgent matters, the shortcomings

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207. *See* Brief for United States, *supra* note 79.

208. *See Weaver*, 455 U.S. at 554, 561; *Weaver*, 637 F.2d at 159, 165.

inherent in the Court's analysis might be explained. As detailed above, however, *Weaver*'s ramifications are especially far reaching. Moreover, in deciding other important issues in recent terms, the Court has demonstrated a similar lack of sophistication in its approach to federal securities regulation. Two major subjects of national concern further illustrate this deficiency: tender offers[209] and insider trading.[210]

A. Tender Offer Regulation

During the past decade, the proliferation of hostile multimillion and billion dollar takeover bids for corporate control has generated much debate over the propriety of defensive and offensive maneuvers by corporate management.[211] The implementation of these maneuvers, including "golden parachutes," "shark repellant" provisions, "lock-ups," "poison pills," "scorched earth" tactics, "white knights," and the "Pac-Man" defense,[212] has prompted aggrieved parties to seek judicial redress. Under state law, for the most part, the business judgment rule has shielded management from liability.[213] As a result, plaintiffs have focused their attention

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209. Generally, a "tender offer" is an offer to shareholders of a company (often made without the approval of that company's management) to exchange their stock for securities and/or cash at a specified price or for other specified consideration.

210. Generally, "insider trading" refers to the act of trading or tipping on the basis of material, nonpublic information. Hence, the term encompasses "outsiders" as well as "insiders."

211. *See, e.g.,* K. DAVIDSON, MEGAMERGERS: CORPORATE AMERICA'S BILLION-DOLLAR TAKEOVERS (1985); TENDER OFFERS: DEVELOPMENTS AND COMMENTARIES (M. Steinherg ed. 1985); Bebchuk, *The Case for Facilitating Competing Tender Offers,* 95 HARV. L. REV. 1028 (1982); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 HARV. L. REV. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers,* 33 STAN. L. REV. 819 (1981); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation,* 83 COLUM. L. REV. 249 (1983).

212. Definitions of these maneuvers are provided in M. STEINBERG, *supra* note 15, at 743-45; Goldherg, *Regulation of Hostile Tender Offers: A Dissenting View and Recommended Reforms,* 43 MD. L. REV. 225, 237 app. (1984).

213. The business judgment rule allows corporate fiduciaries who engineer the various tactics to escape liahility for the ensuing consequences. Generally, the rule creates, in the absence of self-dealing or other confiict of interest, "a [rebuttable] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the hest interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). *See, e.g.,* Treadway Cos., Inc., v. Care Corp., 638 F.2d 357 (2d Cir. 1980) (applying New Jersey law); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980) (applying New York law); Moran v. Household Int'l, Inc., 550 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Pogostin v. Rice, 480 A.2d 619 (Del. 1984). *But see* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (business judgment rule may not be in-

on the scope of section 14(e) of the Exchange Act,[214] the basic federal antifraud provision regulating tender offers. The fundamental issue is whether section 14(e) is directed solely at ensuring adequate disclosure or whether the statute also is intended to reach the legitimacy of bidders' maneuvers to procure corporate control and target managements' maneuvers to fend off hostile bidders.

The Supreme Court resolved this issue in *Schreiber v. Burlington Northern, Inc.*[215] Prior to *Schreiber*, although a clear majority of lower courts held that section 14(e) was directed to disclosure only,[216] a minority of courts[217] and numerous commentators[218] argued that tactics which artificially inhibited the operation of a fair market for the corporation's stock and thus precluded shareholders from tendering to their favored bidder were "manipulative" within the meaning of section 14(e), even if those tactics were fully disclosed.[219] In asserting this position, many authorities relied not only on policy reasons, but also on the framework, statutory language, and legislative history underlying section 14(e) to conclude that the statute has a dual purpose: "first, to provide shareholders the required information; and second, to [prevent] any conduct that unduly impedes the shareholders' exercise of the decision-making prerogative guaranteed to them by Congress."[220]

In *Schreiber* a unanimous Court held that section 14(e) is concerned only with the sufficiency of disclosure,[221] which signifies

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voked to justify grant of lock-up in an active bidding situation).

214. 15 U.S.C. § 78n(e) (1982) (prohibiting any material misrepresentation or nondisclosure or "any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or . . . any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation").

215. 472 U.S. 1 (1985).

216. *See, e.g.*, Feldman v. Avon Prods., Inc., 741 F2d 234 (8th Cir. 1984); Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984); Panter v. Marshall Field & Co., 646 F.2d (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

217. *See, e.g.*, Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981).

218. *See, e.g.*, Junewicz, *The Appropriate Limits of Section 14(e) of the Securities Exchange Act of 1934*, 62 TEX. L. REV. 1171 (1984); Loewenstein, *Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons*, 71 GEO. L. J. 1311 (1983); Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901 (1979); Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982).

219. *See* authorities cited *supra* notes 217-18.

220. Data Probe Acquisition Corp. v. Datatab, Inc., 568 F. Supp. 1538, 1545 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984). *See supra* authorities cited notes 217-18.

221. 472 U.S. at 8. The Court concluded that "all three species of misconduct [listed in Section 14(e)], i.e., 'fraudulent, deceptive, or manipulative' . . . are directed at failures to

that the legitimacy of takeover tactics is a matter solely within the purview of state law. Although the Court's conclusion is supportable, its reasoning is inadequate. The Court failed to acknowledge the existence of a contrary view based upon a different reading of the statute's language and legislative history. Pointing to its decision in *Santa Fe Industries, Inc. v. Green*[222] that section 10(b) of the Exchange Act does not reach breaches of fiduciary duty absent misrepresentation or nondisclosure,[223] the *Schreiber* Court opined that Congress intended section 14(e), like section 10(b), to be solely a disclosure statute. The purpose of section 14(e), the Court asserted, is to provide shareholders with information adequate to enable them to make informed decisions on whether to tender their stock.[224] Unfortunately, the Court failed to address, even minutely, how shareholders can make informed choices if "show-stopper" and similar takeover tactics,[225] which *Schreiber* now permits under federal law, are undertaken by the respective bidding and target managements for the very purpose of precluding shareholders from tendering to their favored bidder. Phrased differently, nowhere did the Court confront the inconsistency in its logic: Disclosure matters little to informed shareholder decision-making when takeover tactics effectively prevent any meaningful

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disclose." *Id.*

222. 430 U.S. 462 (1977).

223. *Id.* at 474. For further discussion, see Ferrara & Steinberg, *supra* note 123.

224. The Court reasoned:

> Congress' consistent emphasis on disclosure persuades us that it intended takeover contests to be addressed to shareholders. In pursuit of this goal, Congress, consistent with the core mechanism of the Securities Exchange Act, created sweeping disclosure requirements and narrow substantive safeguards. The same Congress that placed such emphasis on shareholder choice would not at the same time have required judges to oversee tender offers for suhstantive fairness.

Schreiber, 472 U.S. at 12. The Court, however, declined to address the assertion aptly put forth by former District Court Judge Sofaer:

> A review of the Act's legislative history with the legitimacy of defensive tactics in mind reveals that Congress indeed meant for the federal courts to prevent tender offer participants from interfering with the informed investor choice that the Act sought to assure. One can safely say that the Act underwent from its original introduction in 1965 to its ultimate passage in 1968 a steady transformation from legislation designed to prevent corporate takeovers hy cash tenders, to a bill that studiously maintained neutrality between offerors and targets, but consciously protected the rights of shareholders to transfer managerial power by tendering their shares, with proper information and without undue interference.

Data Probe, 568 F. Supp. at 1545.

225. Generally, a "show-stopper" maneuver is any action taken by target management, such as the sale of the company's "crown jewel" (the most prized asset), that has the effect of materially impeding or precluding shareholders from tendering their stock to the "hostile" bidder.

shareholder decision in the first place.

Thus, the *Schreiber* Court applied a wooden analysis, refusing to acknowledge contrary legislative history and to examine the difficult issues. Unfortunately (or fortunately, depending on one's point of view), the Court's decision signifies that the legitimacy of takeover maneuvers in multibillion dollar tender offers, which have both national and international ramifications,[226] will be examined solely under state law. To proponents of corporate accountability and shareholder democracy, the states' continual "race for the bottom" in matters of corporate law signals that these interests will be neglected.[227] *Schreiber* also means that Delaware, the predominant state of incorporation for publicly held companies,[228] will have the principal voice in determining the validity of takeover tactics.[229]

B. Insider Trading

Like tender offer regulation, insider trading has aroused national[230] and worldwide[231] concern.[232] The deluge of SEC en-

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226. *See generally* K. DAVIDSON, *supra* note 211; *Mergers and Takeovers*, J. of Comm., Apr. 4, 1986, at 15A, col. 1 (reporting that in 1985 the value of mergers totalled $180 billion, that there were 268 acquisitions valued at $100 million or more, and that there were 36 billion dollar transactions).

227. *See generally* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Ferrara & Steinberg, *supra* note 123, at 267-72; Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969). Delaware's recent passage of legislation resulting in greater protection for corporate fiduciaries in duty of care situations provides yet another example of that state's willingness to accommodate the interests of management. *See* DEL. CODE ANN. tit. 8, §§ 102(b)(7) & 145(b), (e), (f), (j) (Supp. 1986); 18 Sec. Reg. & L. Rep. (BNA) No. 36, at 1309 (1986). *See generally* Special Project, *Director and Officer Liability*, 40 VAND. L. REV. 599 (1987). *But see* Fischel, *The "Race for the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982).

228. *See, e.g.*, Friend, *Chancery Court—High Stakes in Delaware*, Nat'l L.J., Feb. 13, 1984, at 1 ("[A]bout half of the nation's 500 largest corporations are incorporated in [Delaware] because of its liberal corporation law . . . . ").

229. Recent Delaware Supreme Court decisions support this statement. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (invalidating "lock-up" and "no shop" clauses given to competing bidder when company was to be broken up); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding board of directors' adoption of a "poison pill"); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (upholding use of issuer tender offer and excluding the hostile potential bidder under business judgment rule); Pogostin v. Rice, 480 A.2d 619 (Del. 1984) (applying business judgment rule in the tender offer setting). On this point, see Fiflis, *Of Lollipops and Law—A Proposal for a National Policy Concerning Tender Offer Defenses*, 19 U.C. DAVIS L. REV. 303 (1986). Professor Fiflis opines: "One may properly ask whether it is appropriate for Delaware, which conceivably may not be the abode of a single Unocal shareholder, to fix national policy in an international securities market, while Congress and the federal courts, Nero-like, abdicate a policymaking role." *Id.* at 306.

230. *See, e.g.*, Dentzer, *Greed on Wall Street*, NEWSWEEK, May 26, 1986, at 44-46;

forcement actions,[233] as well as the widespread public perception that insider trading is common in the securities markets,[234] is evidence of this concern. When Congress enacted the 1933 and 1934 Acts, one way it sought to remedy this problem was by including the "short-swing" trading prohibition of section 16(b) of the Exchange Act[235] and the antifraud provisions of section 17(a) of the Securities Act and section 10(b) of the Exchange Act.[236] To effec-

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authorities cited *infra* note 234.

231. *See, e.g.*, SEC v. Boesky, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986); SEC v. Banca Della Svizzera Italiana, 92 F.R.D. 111 (S.D.N.Y. 1981); SEC v. Certain Unknown Purchasers of the Common Stock, and Call Options for the Common Stock of Santa Fe Int'l Corp., [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,323 (S.D.N.Y. 1981); STOCK EXCHANGE LAW AND CORPORATION LAW: REPORT FROM A SYMPOSIUM IN SWEDEN (C. Roos ed. 1984); Carvalhosa & Eizirik, *Disclosure and Insider Trading Regulation: Recent Developments in Brazilian Law*, 4 J. COMP. CORP. L. & SEC. REG. 395 (1982).

232. Some authorities assert, however, that permitting insider trading has social value. *See, e.g.*, H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983). These commentators argue: "The unique advantage of insider trading is that it allows a manager to alter his compensation package in light of new knowledge, thereby . . . increas[ing] the manager's incentive to acquire and develop valuable information in the first place (as well as to invest in firm-specific human capital)." *Id.* at 870-71.

233. For a description of many of these actions, see M. STEINBERG & R. FERRARA, *supra* note 120, §§ 2:06-2:15. *See also* Steinberg, *SEC and Other Permanent Injunctions—Standards for Their Imposition, Modification, and Dissolution*, 66 CORNELL L. REV. 27 (1980); authorities cited *supra* notes 230-31.

234. *See Poll Finds Majority Thinks Insider Trading is Common*, Wall St. J., June 6, 1986, at 3, col. 4 (reporting that two out of every three American adults in a Wall Street Journal/NBC News poll perceive that insider trading is common).

235. 15 U.S.C. § 78p(b) (1982). Generally:

> Section 16 of the Securities Exchange Act relates to officers, directors, and principal stockholders of publicly held corporations. It requires them (in paragraph (a)) to file reports of their ownership of their corporation's equity securities, provides (in paragraph (b)) for their liability to their corporation for profits made in trading in these securities within any six-month period, and generally prohibits them (in paragraph (c)) from selling short or delaying delivery of such securities after sale.

Ferher, *Short-Swing Transactions Under the Securities Exchange Act*, 16 REV. SEC. REG. 801 (1983). *See* M. STEINBERG, *supra* note 128, §§ 4.01-4.09.

236. Securities Act § 17(a), 15 U.S.C. § 77q(a) (1982); Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1982). *See also* Exchange Act § 9, 15 U.S.C. § 78i (proscribing manipulative acts or practices). For example, the House Report explained the provision that was to become § 16 of the Exchange Act as follows:

> A renewal of investors' confidence in the exchange markets can be effected only by a clearer recoguition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations. Men charged with the administration of other people's money must not use inside information for their own advantage. Because it is difficult to draw a clear line as a matter of law between truly inside information and information generally known by the better-informed investors, the most potent weapon against the abuse of inside information is full and prompt publicity. For that reason, this bill requires the disclosure of the corpo-

tuate Congress' intent in the insider trading setting, lower federal courts adopted the "equal access" theory in construing section 10(b). Succinctly put, the equal access theory commands that those persons who regularly receive or are "tipped" material nonpublic information by such "access" persons and who have reason to know that the information is derived from a corporate source must either disclose the information to the marketplace as a whole or refrain from trading (and tipping).[237] Hence, under this approach tippees "stand in the shoes" of their tippers. If the tipper could not trade on the information, generally neither could the tippee.[238]

The equal access theory enjoyed widespread, if not universal, judicial acceptance until the Supreme Court's decision in *Chiarella v. United States*.[239] In *Chiarella*, over stinging dissents,[240] the Court rejected the equal access theory, opting instead for a rationale based upon state law notions of fiduciary duty.[241] The duty to disclose, the Court asserted, rested upon a fiduciary or similar relationship between the parties to the transaction.[242] In the context of tippee trading, as the Court subsequently held in *Dirks v. SEC*,[243] tippees are precluded from trading only if the tipper breached a fiduciary duty *and* the tippee knew or should have known of the breach. Moreover, by conditioning this breach of duty upon the tipper's intent to benefit financially from selective disclosure, the *Dirks* Court engrafted a motivational requirement onto the law of

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> rate holdings of officers and directors and stockholders owning more that 5 [enacted as 10] percent of any class of stock, and prompt disclosure of any changes that occur in their corporate holdings. Short selling and selling against the box by insiders are prohibited . . . .

Committee on Interstate and Foreign Commerce, H. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934). For further discussion, see Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 CORNELL L. REV. 557 (1982).

237. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

238. *See, e.g.*, Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); SEC v. Geon Indus., Inc., 531 F.2d 39 (2d Cir. 1976); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). This principle's well-established foundation prompted the authors of one textbook to state that the "prohibition [against trading on material, nonpublic information] almost certainly extends to the immediate 'tippees' of the insiders who, by trading on such information, participate in the wrong committed in the giving of the tip." L. SOLOMON, R. STEVENSON, & D. SCHWARTZ, CORPORATIONS: LAW AND POLICY 908 (1982).

239. 445 U.S. 222 (1980).

240. *See id.* at 245-52 (Blackmun, J., dissenting); *id.* at 239-45 (Burger, C.J., dissenting).

241. *Id.* at 232-35.

242. *Id.*

243. 463 U.S. 646 (1983).

tipper-tippee trading.[244]

Both *Chiarella* and *Dirks* left open the possibility that one who misappropriates confidential information may be liable under section 10(b).[245] Under the misappropriation theory, certain persons, such as investment bankers, attorneys, and financial printers, who trade on or tip information given to them in confidence have breached a duty owed to their employer and to their employer's clients.[246] Although a number of decisions have applied this theory,[247] little question remains that *Chiarella* and *Dirks* have confused insider trading law to the detriment of the investing public and marketplace integrity.

Today, as a result of *Chiarella* and *Dirks*, the government, self-regulatory organizations, private parties, and the courts all must look to concepts of fiduciary duty, financial benefit, and misappropriation to determine the legality of transactions undertaken or contemplated.[248] The equal access theory, in the context of section 10(b), is dead.[249] Not surprisingly, in neither *Chiarella* nor

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244. *Id.* at 660. The Court also stated that a "gift" conveyance would satisfy its "intent to henefit" test. In that situation "[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." *Id.* at 664. In addition, the Court, in a footnote, developed the quasi-insider theory: "Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may hecome fiduciaries of the shareholders." *Id.* at 655 n.14. For discussion of *Chiarella, Dirks,* and their implications, see, e.g., A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD §§ 7.4-7.5 (1985); Branson, *Discourse on the Supreme Court Aproach to SEC Rule 10b-5 and Insider Trading,* 30 EMORY L.J. 263 (1981); Hiler, Dirks v. SEC—*A Study in Cause and Effect,* 43 MD. L. REV. 292 (1984); Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets,* 1982 DUKE L.J. 627; Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement,* 70 CALIF. L. REV. 1 (1982); Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?,* 54 S. CAL. L. REV. 1217 (1981).

245. *See Dirks,* 463 U.S. at 665; *Chiarella,* 445 U.S. at 235-37. More recently, the Court made an apparently favorable reference to the misappropriation theory in Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 313 n.22 (1985), *quoting Dirks,* 463 U.S. at 665 (stating that "a tippee may be liable if he . . . 'misappropriate[s] or illegally obtain[s] the information' ").

246. *See, e.g.,* SEC v. Materia, 745 F.2d 197 (2d Cir. 1984); United States v. Newman, 664 F.2d 12 (2d Cir. 1981); *see also* United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted,* 107 S. Ct. 666 (1986). In many situations involving insider trading by accountants, attorneys, investment bankers, and others retained by the corporation, the quasi-insider theory also may be employed to impose liability. *See Dirks,* 463 U.S. at 655 n.14; *supra* note 244.

247. *See* cases cited *supra* note 246; authorites cited *supra* note 244.

248. Other concepts receiving Supreme Court approval in the insider trading context include the "gift" and "quasi-insider" theories. *See Dirks,* 463 U.S. at 655 n.14, 664; *supra* notes 244 & 246.

249. *See Dirks,* 463 U.S. at 656-59; *Chiarella,* 445 U.S. at 232-35. Reacting to

Dirks did the Court offer any specific legislative history to support its reasoning. Moreover, reliance on state law based principles of fiduciary duty is misplaced. Congress clearly intended the federal securities laws to offer greater protection than state law provides.[250]

In *Santa Fe Industries, Inc. v. Green*[251] the Court ruled that section 10(b), absent misrepresentation or nondisclosure, does not encompass misconduct involving breach of fiduciary duty.[252] Yet, illogically, the Court in *Chiarella* and *Dirks* looked to state law concepts of fiduciary duty to determine the existence of federal disclosure obligations under that very same statute. In sum, *Chiarella* and *Dirks* exhibit a lack of both understanding and sophistication regarding the federal framework underlying insider trading law.[253] Unfortunately, these decisions, while difficult to

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Chiarella, the SEC promulgated Rule 14e-3, 17 C.F.R. § 240.14e-3 (1986), pursuant to its rulemaking authority under § 14(e) of the Exchange Act. The rule's significance is that it revitalizes the equal access theory in the tender offer context. In short, Rule 14e-3, with certain exemptions, invokes the disclose-or-abstain provision when an individual possesses material information relating to a tender offer and has reason to know that the information is nonpublic and was procured (directly or indirectly) from a corporate source. For commentary on Rule 14e-3, see, e.g., Gruenbaum, *The New Disclose or Abstain from Trading Rule: Has the SEC Gone Too Far?,* 5 CORP. L. REV. 350 (1981); Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" Versus Economic Theory,* 37 BUS. LAW. 517 (1982); Koprucki, *Market Insiders' Duty Under Section 10(b), Rule 10b-5, and Rule 14e-3 to Disclose Material, Nonpublic Market Information,* 50 U. CIN. L. REV. 558 (1981); Loewenstein, *supra* note 218; Note, *Trading on Material, Nonpublic Information Under Rule 14e-3,* 49 GEO. WASH. L. REV. 539 (1981).

250. In his dissent in *Chiarella,* Justice Blackmun noted:

> By its narrow construction of § 10(b) and Rule 10b-5, the Court places the federal securities laws in the rearguard of this movement, a position opposite to the expectations of Congress at the time the securities laws were enacted. I cannot agree that the statute and Rule are so limited. The Court has observed tbat the securities laws were not intended to replicate the law of fiduciary relations. Rather, their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate. As Congress itself has recognized, it is integral to this purpose "to assure that dealing in securities is fair and without undue preferences or advantages among investors."

Chiarella, 445 U.S. at 248 (Blackmun, J., dissenting) (citations omitted).

251. 430 U.S. 462 (1977).

252. *See* 430 U.S. at 474; *see also supra* note 123 and accompanying text.

253. With respect to *Chiarella,* Professor Anderson is far more critical. She asserts: "This is not a Supreme Court construing a complicated federal statutory scheme with wisdom, craft, and candor; this is a first-year Torts class on a bad day." Anderson, *Fraud, Fiduciaries, and Insider Trading,* 10 HOFSTRA L. REV. 341, 376-77 (1982). Referring to *Weaver,* another respected authority has opined: "The Court's rationale for its holding, if an answer to a law examination including the identical question, would probably have been graded F by 95% of the securities regulation professors in the United States." H. BLOOMENTHAL, 1982 SECURITIES LAW HANDBOOK xlvii (1982).

fathom from a purely analytical standpoint, also have an adverse impact at a very practical level. During a period when public perception of insider trading abuse is at a highpoint,[254] the Court's position has increased the difficulties that both aggrieved parties and the government face in initiating successful litigation against this practice.[255]

VII. Conclusion

The foregoing analysis of the Supreme Court's approaches to tender offer regulation and insider trading seeks to illustrate that *Marine Bank v. Weaver,* while very significant by itself, is also part of a disturbing trend. Whether or not the results reached in these particular cases are correct, the Court's reasoning, analysis, and methodology have been disconcerting. One hopes that the Court will recognize and correct these deficiencies. In this regard, the *Landreth* Court's observation concerning the weakness of its own case law[256] is a positive sign. Until the Supreme Court takes corrective steps, however, its decisions affecting securities regulation may continue to misconstrue congressional intent, look away from compelling arguments developed among the lower federal courts, and confuse, rather than clarify, the law.

254. *See* Poll, *supra* note 234 (observing, moreover, that "[t]he recent spate of insider trading cases has increased concern on Wall Street that the stock market's reputation might suffer").

255. *See, e.g.,* Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983); SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984).

256. *See supra* note 9 and accompanying text.