Notes as Securities: Reves and Its Implications

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I. INTRODUCTION

Prior to the Supreme Court's decision in Reves v. Ernst & Young,1 the lower federal courts were sharply divided on the applicable criteria to be employed in determining the security law status of notes. The tests utilized included the "family resemblance" approach,2 the "commercial/investment" standard,3 the "risk capital" test,4 and the Howey criteria.5 Given the divergent approaches, the Supreme Court's decision in Reves, although far from being a model of clarity, helps to resolve ambiguities in this area.

II. THE SUPREME COURT'S DECISION

The instruments in Reves were demand notes, such notes being uncollateralized and uninsured, paying a variable rate of interest adjusted monthly to be higher than that paid by local financial institutions but not being linked to the earnings of the business.6 Reversing a jury verdict of $6.1 million against the defendant accounting firm, the Eighth Circuit held that the notes were not securities.7 Its rationale principally was premised on the application of the Howey

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3. See, e.g., Bauer 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); United American Bank v. Gunter, 620 F.2d 1108 (5th Cir. 1980). As stated by this author: Several courts have adopted the commercial/investment test where the focus is on the underlying character of the transaction. Applying the "unless the context otherwise requires" language of Sections 2(1) and 3(a)(10) as well as the economic reality concept, courts adhering to this view hold that a note is not a security where it arises from a commercial transaction even when its terms are literally within the Acts’ coverage. In making this determination, the courts have focused on such factors as the use of the funds (to fund current expenses rather than long-term projects), whether the note is collateralized (and, hence, less "risky"), the number of purchasers (limited to few or marketed to many), the level of sophistication of the purchasers (is the purchaser a bank or an uninitiated investor), and whether the note has a short maturity. See generally Sonnenschein, Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions, 35 Bus. Law. 1567 (1980).
4. See, e.g., Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) (looking at such factors as the length of the note's maturity, whether the note is collateralized, the relative size of the debt in relation to the size of the borrower's business, and the use of the proceeds). See generally Sonnenschein, Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions, 35 BUS. LAW. 1567 (1980).
5. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); discussion infra notes 8-15 and accompanying text.
7. Reves, 110 S. Ct. at 946. The pertinent facts in Reves follow. Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-op), a conventional farmer's cooperative, operated in the northern portions of Arkansas and Oklahoma. The Co-op raised a substantial amount of its operating capital through the sale of promissory notes. These uncollateralized, unsecured notes were payable on demand by the noteholder, and paid a rate of interest which was adjusted monthly to exceed the rate of interest available at neighboring financial institutions. The notes were marketed as an "Investment Program" and were sold to both members and nonmembers through advertise-
investment contract test, defined as "(1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the entrepreneurial or managerial efforts of others." Applying the Howey test, the court found that the demand notes failed to satisfy the requisite elements. First, since the notes were short-term, carried fixed interest rates and were to be used to fund operations, the notes were more in the nature of commercial loans than investment in capital. Second, the "reasonable expectation of profit" element was construed as either a participation in earnings or capital appreciation. Because the noteholders received a fixed-sum repayment, this element was lacking as such repayment was not dependent upon either a participation in earnings or capital appreciation. As such, the Eighth Circuit found that the demand notes neither met the Howey test nor did they possess the traditional characteristics of a security. Accordingly, they were held not to be securities within the meaning of the Exchange Act.

ments touting their safety and security. Purchasers of the notes were provided with an abbreviated statement of the Co-op's total assets; however, no other financial information was given to purchasers at the point of sale. Reves, 856 F.2d at 53.

Co-op retained Arthur Young to audit and report on the Co-op's 1981 and 1982 financial statements. From these reports Co-op management created abbreviated financial statements which were distributed at annual meetings to the relatively few Co-op members who were in attendance. During the 1982 and 1983 annual meetings, Arthur Young representatives made brief presentations of the Co-op's general financial status, and informed the members in attendance that Co-op's audited financial statements and Arthur Young's reports were available at the Co-op's office. Approximately one year later, with more than 1,600 people holding notes worth $10 million, the Co-op filed for bankruptcy. Id.

Following the Co-op's bankruptcy filing, a class of plaintiff noteholders brought suit against Arthur Young in the United States District Court for the Western District of Arkansas, alleging securities fraud in violation of section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), and section 67-1256 of the Arkansas Securities Act (Arkansas Act). Plaintiffs argued that Arthur Young, in an effort to artificially inflate the Co-op's assets and net worth, intentionally failed to follow generally accepted accounting principles (GAAP) with respect to its valuation of a gasohol plant, one of the Co-op's significant assets. Plaintiffs claimed that they had relied upon the financial statements in making their decisions to purchase Co-op notes and that had Arthur Young properly employed GAAP in its gasohol plant valuation, Co-op's insolvency would have been readily revealed. Id. at 53-54.

At trial, judgment was rendered following a jury verdict that Arthur Young engaged in fraudulent activities in connection with the sale of securities in violation of the Exchange Act and the Arkansas Act. Plaintiffs were awarded $6.1 million in damages. Arthur Young appealed, principally on the ground that the Co-op notes were not "securities." The Eighth Circuit agreed with Arthur Young and reversed. Id. at 53-55.

8. Id. at 54 (citing SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)).
9. Id. at 54.
10. Id. at 55.
11. Id.
12. Id. at 54 ("Even if the Supreme Court should determine it inappropriate to apply the Howey test to an instrument which bears both the name 'note' and the usual characteristics of a security, . . . it is no bar in this case because the instrument at issue, while possessing the name, lacks the characteristics.").
13. Id. at 54-55. The court also held that since the Arkansas case law definition of a security is "essentially identical to the definition under the federal securities laws," the notes were likewise not securities for purposes of the Arkansas Act. Id. at 55.

On the petition for rehearing en banc, four members of the Eighth Circuit dissented from the court's denial of the petition. Writing for the dissenters, Judge Arnold stated:

It seems to me that the notes involved in this case meet all the traditional tests of a security. The statute, of course, expressly includes "notes" in its definition, so one begins at least with a presumption that notes are covered. It remains true that some notes are not "notes" as the statute uses the term - for example, a note I sign to evidence a loan from a friend or a bank. But the notes at issue here are poles apart from such a case of personal or commercial credit. They were sold to large numbers of relatively unsophisticated investors; their purpose is to raise capital which will be put at risk in the insurer's business; and those
The Supreme Court reversed. In determining the proper test to be applied, the Court rejected application of the Howey test to notes, reasoning:

Howey provides a mechanism for determining whether an instrument is an "investment contract." The demand notes here may well not be "investment contracts," but that does not mean they are not "notes." To hold that a "note" is not a "security" unless it meets a test designed for an entirely different variety of instrument "would make the Acts' enumeration of many types of instruments superfluous," and would be inconsistent with Congress' intent to regulate the entire body of instruments sold as investments.

On the other hand, the Court rejected the Landreth Timber formula in the note context. Unlike "stock" which by its nature (if it has the attributes typically associated with such an instrument) is within the class of instruments Congress intended to regulate under the securities laws, the same cannot be said of "notes" which are used in a variety of settings, some of which are commercial and others of which involve investments. Hence, since "notes" are not necessarily securities, the Court, after searching for a proper standard to be applied, opted for the "family resemblance" test. This test, as formulated by the Court, consists of the following:

First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment." Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. . . . Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

who buy them expect to reap a benefit in the form of interest payments. So even if these notes have to meet the traditional test for "investment contracts," they clearly qualify. Our panel's conclusion to the contrary appears to commit the Eighth Circuit to a definition of security unique among the federal courts.

Id. at 56 (Arnold, J., dissenting from the denial of the petition for rehearing en banc).

15. Id. at 951 (citations omitted). But see infra notes 31-38 and accompanying text.
16. Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985); see infra notes 17-18 and accompanying text.
17. These characteristics of stock include "(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." Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).
20. Hence, the Court rejected application of the "risk capital," "investment versus commercial," and Howey tests in this context. Id. at 950-51 (citing cases). The Court deemed the risk capital approach "virtually identical to the Howey test." Id. at 951.
We conclude, then, that in determining whether an instrument denominated a "note" is a "security," courts are to apply the version of the "family resemblance" test that we have articulated here: a note is presumed to be a "security," and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of the enumerated categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors.21

Prior application by the Second Circuit of a version of this test revealed that the following notes are not securities:

the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)22 and "notes evidencing loans by commercial banks for current operations."23

Applying the "family resemblance" test to the case at bar, the Supreme Court held that the notes came within the purview of the securities laws. The notes were sold in an effort to raise capital for general business operations and were purchased by investors in order to earn a profit, the plan of distribution was widespread, the public's reasonable expectations were that the notes were securities as they were advertised as investments, and there was no risk-reducing factor, such as the presence of other comprehensive regulation, that minimized the risk of loss.24 Moreover, the "demand" nature of the notes did not take them outside the reach of the federal securities laws in that their liquidity did not nullify the investment's risk. Indeed, according to the Court, "demand only eliminates risk when and if payment is made."25 Accordingly, the Court held that such promissory notes are securities.26

III. ISSUES RAISED BY REVES

The Court's decision in Reves resolves a number of issues yet others are left unsettled. In this regard, the following points may be made.

A. Rejection of the Howey Test

The Court's rejection of the Howey test27 in the "note" context seemingly is significant. With the exception of "stock," some lower courts had advocated that the Howey test be applied, irrespective of the nature of the instrument.28 The Supreme Court's rejection of this interpretation may signal that Howey's

21. Id. at 951-52.
25. Id. at 953.
26. Id.
27. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); see supra notes 8-15 and accompanying text.
relevance is confined to investment contract analysis. Indeed, if any applicable standard has widespread application in the definition of "security" setting, it is the "family resemblance" test. Referring to this test, the Reves Court stated that the factors comprising that test are the ones that the Court has looked to "in deciding whether a transaction involves a 'security.'"  

On the other hand, an argument can certainly be made that the Howey and "family resemblance" tests are quite similar. Many of the same factors apply. For example, under either test in order for a security to exist, (1) there must be investment, as compared to commercial, motives underlying the transaction; (2) the investing public must reasonably believe that such instrument is being offered as a security, hence with investors having a reasonable expectation of profit; (3) the instrument must be capable of mass distribution or widespread trading; and (4) there is present no alternative regulatory framework that significantly reduces the investment's risk of loss.

Thus, in many cases, a note will be a security only if it in fact meets the Howey test, even if the "family resemblance" test is the applicable standard. Key differences between the two standards, however, may exist. The most significant is that "profit" is defined expansively under the "family resemblance" test, thereby having the effect of bringing certain notes within securities law coverage that would otherwise be excluded under Howey. Another is that a security may be present even if all the factors of the "family resemblance" test are not met. By contrast, all factors of the Howey investment contract test must be satisfied in order for an instrument to come within the purview of the federal securities laws. Although this issue awaits judicial clarification, application of a flexible "family resemblance" approach utilizing a four-prong "weighing" analysis would expand securities law coverage of notes beyond that otherwise permitted by Howey.

29. Reves, 110 S. Ct. at 951. ("Howey provides a mechanism for determining whether an investment is an 'investment contract.'").

30. Id. at 951.

31. This factor goes to the first prong of the "family resemblance" test and the first and third parts of Howey. See supra notes 8-15, 27 and accompanying text.

32. This factor goes to the third prong of the "family resemblance" test and the third part of Howey. See sources cited supra note 31. Note also that Howey has been modified to require that profits be derived essentially, rather than solely, from the efforts of others. See, e.g., SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974).

33. This factor goes to the second prong of the "family resemblance" test and the "common enterprise" requirement of Howey, as arguably modified by Weaver. See generally Comment, Defining an "Investment Contract": The Commonality Requirement of the Howey Test, 43 WASH. & LEE L. REV. 1057 (1986).

34. This factor goes to the fourth prong of the "family resemblance" test and Weaver's modification of Howey. See Marine Bank v. Weaver, 455 U.S. 551, 559-60 (1982), discussed in M. Steinberg, Securities Regulation: Liabilities and Remedies § 4A.02[2] (1990).


36. Reves, 110 S. Ct. at 952 n.4, discussed infra notes 47-50 and accompanying text.

37. Id. at 953; Marine Bank, 455 U.S. at 559-60; Howey, 328 U.S. at 301; see also M. Steinberg, supra note 34, at § 4A.02[1].

38. See infra notes 40-44 and accompanying text. One such example is whether certain loan participations are securities. See generally Scholl & Weaver, Loan Participations: Are They 'Securities'? 10 FLA. ST. U.L. REV. 215 (1982).
B. Application of Four-Prong Standard

As alluded to above, in adopting the four-prong "family resemblance" test, the Court declined to state whether all factors must be met or whether the standard calls for balancing the various factors. The Court's language here is somewhat ambiguous. However, it may be argued that, if the following elements are met, the instrument should be deemed a "security." First, the motives of the buyer and seller, both subjectively and as reasonable persons, are unclear. In other words, unless it is clear that, as reasonable persons, the seller's motive is to raise funds for "solely" commercial (rather than investment) purposes and the buyer's principal motive is not based upon expectation of profit, the notes should be deemed "securities," provided that the next three factors also are met. Second, the notes should be "capable" of being mass distributed, even if there were in fact few offerees and purchasers and no common trading of the instrument. This is consistent with the Court's prior interpretations of this issue. Third, in the manner that the instrument was advertised or otherwise marketed, a reasonable person would conclude that an investment security was being offered. This standard is an objective one and complements the partly subjective analysis of prong (1) above. Fourth, the instrument is not subject to comprehensive oversight by another regulatory framework which significantly lessens (or insures against) the risk of loss. This functional regulation element is subject to criticism but is consistent with the Weaver analysis. If the foregoing factors are met, then the note should be held to be a "security."

39. Unfortunately, such ambiguity raises additional concerns for counsel and client. See infra notes 76-77 and accompanying text.

40. This approach is compatible with the subjective approach utilized in part by the "family resemblance" approach. See Reves, 110 S. Ct. at 951-52.

41. Id. at 953 (even though "the notes were not traded on an exchange, [t]hey were . . . offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite 'common trading' in an instrument.").

42. Id., relying on, Landreth Timber, 471 U.S. at 687, 693 (1985) (stock of closely held corporation not traded on any exchange held to be a "security"); Tcherepnin v. Knight, 389 U.S. 332, 337 (1967) (nonnegotiable but transferable "withdrawable capital shares" in savings and loan association held to be a "security"); Howey, 328 U.S. 293, 295 (1946) (units of citrus grove and maintenance contract held to be "securities" although not traded on exchange). Hence, although the Court did not refer to the "capability" of mass distribution, the cases relied on by the Court support this proposition.


44. See Reves, 110 S. Ct. at 953.

45. Criticizing the functional regulation analysis, this author has opined: "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. 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."


46. See Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) ("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."); International Bhd. of
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C. Definition of "Profit"

As stated above, the Court's definition of "profit" in *Reves* is vitally important. Under *Howey*, profits generally have been defined to include capital appreciation or a participation in the earnings of the business. If this definition were to be applied in the "note" context, many such instruments, such as the one in the case at bar, would not have the requisite "profit" attributes to be defined as an investment coming within the purview of the securities laws. For example, the "demand" notes in *Reves* paid a fixed rate of interest, not being keyed to profits. Importantly, the Court held that the *Howey* definition of "profit" did not apply in this context and may well be confined to solely investment contract analysis. Rather, in the "note" setting, profit means an investment having a valuable return, "which undoubtedly includes interest." As a result, it may be asserted that in order for a note to have a "valuable" return, it must pay interest to the holder above the generally prevailing rate offered by instruments that are deemed "safe." Such "safe" instruments would include notes that are adequately insured and other instruments where the rate of default (both from a prospective and historical view) is practically nil. Generally, an investor purchases a note not having these more secure characteristics for the purpose of receiving a return that may be deemed "substantial," and hence, "valuable." At the same time, when an investor seeks a more valuable return, the risk of loss is magnified. As a consequence, such factors as the presence of an investment, the prospect of a valuable return, and the lack of other comparable regulation, call for the instrument to come within the coverage of the securities laws.

D. Notes Exceeding Nine Months

The Court's holding articulates that a "note" is presumed to be a "security" unless the note bears a strong resemblance (by looking to the four-factor "family resemblance" test) to an instrument that has been excluded from the securities laws' reach or unless application of the "family resemblance" test indicates that the note ought to be excluded. The Court, however, declined to address whether this presumption applies to securities with a maturity not exceeding nine months. Chief Justice Rehnquist, writing for a four member dissent, would exclude notes of nine months or less duration from the scope of the securities laws as a matter of law. While a literal interpretation of the nine-month exemption contained in Section 3(a)(10) of the Exchange Act would

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49. *Id.* at 952.
50. Such an interpretation is consistent with *Reves* and *Weaver*. See *Reves*, 110 S. Ct. at 953; *Weaver*, 455 U.S. at 558-59.
52. *Id.* at 951.
53. *Id.* at 958-59 (Rehnquist, C.J., concurring in part and dissenting in part).
exclude such instruments from that Act's reach altogether, the exclusion in Section 3(a)(3) of the Securities Act would exclude such instruments from the registration provisions. The antifraud provisions of the 1933 Act would still apply to such instruments. Irrespective of the difference in this statutory language, the Court has consistently held, reaffirmed in Reves, that the coverage of the two Acts is the same. Moreover, each definition is prefaced by the term "unless the context otherwise requires." Employing this language, courts have applied an approach rooted in economic reality to determine whether a particular instrument is a security.

There can be little question that, from a general perspective, the shorter time period one's money is in another's hands, the less the risk of loss. It also can be stated with confidence, however, that such a time period is far from a guarantee of repayment. Other factors are equally, if not more, important, such as the solvency of the seller of the note, the intended use of the proceeds, general market conditions, and the rate of interest required to be paid to service the debt. Indeed, recent financings extended in leveraged buyouts evidence that fairly short-term debt can often be at risk of default. Hence, a note's duration, although relevant, is not determinative.

In light of the above, perhaps the better approach is to require the plaintiff to prove by a preponderance of the evidence that a note of less than a nine-month duration is a security. As this standard of proof is applied in federal securities litigation at this time, its extension to this particular issue is the least problematic alternative. Hence, if a federal securities claim is brought in this context, one of the elements to establish a successful claim is that the short term promissory note at issue is a "security." With the plaintiff bearing the burden of proof by a preponderance of the evidence, the four-factor "family

56. See Sections 12(2) and 17(a) of the Securities Act, 15 U.S.C.S. § 77l(2), q (Law. Co-op. 1989); Reves, 110 S. Ct. at 959 (Rehnquist, C.J., concurring in part and dissenting in part).
57. Id. at 949 n.1 (quoting, United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975)).
58. Forman, 421 U.S. at 847 n.12 (citations omitted) ("The definition of a security in § 3(a)(10) of the 1934 Act, is virtually identical [to the Securities Act definition] and, for present purposes, the coverage of the two Acts may be considered the same.").
59. See, e.g., id. at 849 (holding under economic reality approach that instruments called stock were not securities because they did not have characteristics traditionally identified with such an instrument). For a discussion of the prefatory "context" clause, see M. STEINBERG, supra note 34, at § 4A.03[1].
62. See Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) (preponderance of the evidence standard applied in private actions for damages under the 1934 Act § 10(b) and Rule 10b-5); Steadman v. SEC, 450 U.S. 91 (1981) (preponderance of the evidence standard appropriate standard in SEC administrative proceedings premised on fraud); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) (preponderance of the evidence standard applied in SEC injunctive actions for violations of 1933 Act § 17(a)); discussion in M. STEINBERG, supra note 34, at § 7.04.
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ressemblance” test should be utilized. Upon application of this standard, a note is a security only if the plaintiff meets the burden of proof.  

E. Status of Commercial Paper

Another important issue is whether the Reves decision signifies that commercial paper is not a security. It is clear that the four-member dissent would hold that commercial paper, being less than nine months duration, is not entitled to securities law coverage. The majority, although not reaching the issue, arguably would exempt from securities law coverage only that short-term commercial paper that is of “blue chip” quality, namely, “short-term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors.” Justice Stevens, who joined the five-member majority, also wrote a concurrence, opining that the nine-month exclusion applies to “commercial paper, not investment securities.” For authority, he relied on the Seventh Circuit’s decision in Sanders v. John Nuveen & Co. and on an SEC release. In other words, while Justice Stevens favors a commercial paper exemption, this exemption should be limited by the quality and other characteristics associated with the instrument.

The above observation is supported by Sanders and the SEC release. In Sanders, the Seventh Circuit held that commercial paper of inferior quality purchased by forty-two investors for purposes unrelated to current transactions was a security. Hence, certain types of commercial paper are investment securities. To determine when short-term commercial paper is not a security, the Seventh Circuit approvingly quoted an SEC release on this issue. Hence, commercial paper is excluded from securities law coverage if it is “(1) prime quality negotiable commercial paper (2) of a type not ordinarily purchased by the general public, that is, (3) paper issued to facilitate well recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve banks.”

63. See supra notes 61-62 and accompanying text.
64. Reves, 110 S. Ct. at 958-59 (Rehnquist, C.J., concurring in part and dissenting in part).
65. Id. at 951.
67. Reves, 110 S. Ct. at 955 (Stevens, J., concurring).
68. Id. at 956.
69. 463 F.2d 1075, 1080 (7th Cir.), cert. denied, 409 U.S. 1009 (1972).
71. Sanders, 463 F.2d at 1079-80 (relying on A. Bromberg, Securities Law, Fraud, SEC Rule 10b-5 § 4.6 (321) (1971)).
72. Sanders, 463 F.2d at 1079 (quoting, Securities Act Release No. 4412 (1961)). In an accompanying footnote, the Seventh Circuit stated:

The [SEC] release emphasized the prime quality of the paper intended to be exempted and stated that the exempted items are “composed of assets easily convertible into cash and are comparable to liquid inventories of an industrial or mercantile company.” During the hearings on the 1933 Act, commercial paper discountable by Federal Reserve banks were described as having “a record of safety only second to Government bonds” and as being the basis of our currency. It is significant that section 3(a)(10) of the 1934 Act excepts “currency” from the definition of security.

Id. at 1079 n.12 (citations omitted).
From the above, the law is as it should be: short-term high quality commercial paper marketed to sophisticated purchasers for facilitating current operations is exempt from securities law coverage. This standard comports with the “family resemblance” test: application of the four factors in this setting connotes exclusion from the reach of the securities laws. On the other hand, where an instrument is called commercial paper but is in reality an investment security, the “family resemblance” test mandates that the instrument be deemed a “security.” Otherwise, issuers could seek to evade the securities laws by structuring an instrument, otherwise having characteristics of a security, and label it as commercial paper. Such an approach, fortunately, is not permitted as it neglects the investor protection principles underlying the securities laws and contravenes the economic reality underlying the instrument.

F. Uncertainty for the Corporate Planner

Although the “family resemblance” test adopted by the Reves Court looks to the underlying economic reality of the transaction to determine whether a security is present, the decision offers little solace to the corporate planner. Unless a particular instrument comes within a category that has been excluded from securities law coverage by previous court decisions, corporate lawyers and their clients are left with little guidance. For planning purposes, the four-factor “family resemblance” test simply may be too indefinite to provide necessary guidance for commercial certainty. It is possible, however, as judicial precedent is established construing the test over time, there will be a sufficient number of court decisions impacting upon defined categories of instruments to provide a basis for advance planning. Until sufficient precedent is developed, however, unless an instrument comes within an excluded category or is nearly identical to such an instrument in all material respects, counsel planning a transaction would be prudent to assume that the federal securities laws apply.

IV. Conclusion

The Court’s decision in Reves, although certainly having its shortcomings, offers a superior analysis to that provided in a number of previous Supreme Court decisions defining the term “security.” Reves is a decision that flexibly permits securities law application. From a planning perspective, however, the

73. Reves, 110 S. Ct. at 951-52.
74. Id. at 954 (“If petitioners are correct that the exclusion is intended to cover only commercial paper, these notes [at issue in Reves], which were sold in a large scale offering to unsophisticated members of the public, plainly should not fall within the exclusion.”). See supra note 24 and accompanying text for application of relevant criteria.
75. Id. at 949 (“In discharging our duty, we are not bound by legal formalisms, but instead take account of the economics of the transaction under investigation.”), citing, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (In construing the term “security,” “form should be disregarded for substance and the emphasis should be placed on economic reality.”).
76. Reves, 110 S. Ct. at 951-52; supra notes 22-23 and accompanying text.
77. See Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485 (10th Cir.), vacated and remanded, 110 S. Ct. 1314 (1990). In this regard, see generally M. Steinberg, Corporate Malpractice (PLI) (forthcoming).
78. See discussion in Steinberg & Kaulback, supra note 45, at 504-29.
decision provides client and counsel little comfort. Unless a note is clearly transacted in a commercial context, application of the "family resemblance" test leaves open the possibility that a court will construe a given "note" as coming within the purview of the federal securities laws.