Meaning, Reference, and Reification in the Definition of a Security

*Williamson B.C. Chang**

Among the most critical problems in securities regulation is determining what constitutes a "security." The Supreme Court has never positively identified the essential features of a security. If the Court ever arrives at a comprehensive definition, its decision will affect many corporations and major economic transactions. In this Article, Professor Chang develops a comprehensive, yet relatively simple model that defines security for the purposes of federal regulation and reconciles the Court's major securities decisions. The Article also provides insight into the use of language, describes the implications of "open-ended" legislative intent, and offers a framework with which to view the dialectic process of common lawmaking as a consistent evolution of standards.

INTRODUCTION

In securities regulation, the sections defining a "security" in both the 1933 Securities Act and the 1934 Securities Exchange Act[1] are impor-

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*Associate Professor of Law, University of Hawaii School of Law. A.B. 1972, Princeton University; J.D. 1975, University of California, Berkeley. The author wishes to thank the following persons for their inspiration and assistance: Mari J. Matsuda, Presley W. Pang, Alex Y. Seita, and Richard S. Miller.

[1] The definitions of a security in the Securities Act of 1933 and the Securities Exchange Act of 1934 are substantially the same. "[T]he Supreme Court has consistently held that the definition of security under the two acts is essentially the same." Daily v. Morgan, 701 F.2d 496, 500 n.4 (5th Cir. 1982) (citing Marine Bank v. Weaver, 455 U.S. 551, 555 n.3. (1982)). Section 2 of the Securities Act of 1933, 15 U.S.C. § 77b (1982), defines a security as follows:

> (1) the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee for, or warrant or right to subscribe to or purchase, any of the

tant chokepoints that allow or deny a claimant access to the panoply of important federal remedies.[2] The application of the securities acts has significant consequences for litigants who otherwise would be relegated to state law. Thus a firm and predictable definition of the term "security" would seem axiomatic to the fair and smooth operation of the securities acts. Yet, the provisions defining security have been uncertain, beset by the use of catch-all phrases and bogged down in the quagmire of contextual qualifiers that fail to define clearly the circumstances exempting certain transactions from securities regulation.[3]

Most cases interpreting these definitional sections have relied on the legislative history, policies, and purposes of the securities acts for guidance.[4] This Article suggests that other linguistic and jurisprudential

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foregoing.

[2] Explicit and implied causes of action for misrepresentation in transactions involving securities are contained in the Securities Act of 1933 §§ 11, 12 & 17, 15 U.S.C. §§ 77k, l & q (1982), and in the Securities Exchange Act of 1934 §§ 10, 14, 16 & 18, 15 U.S.C. §§ 78j, n, p & r (1982). Moreover, the 1933 Act requires registration of offers and sales of securities in § 5, 15 U.S.C. § 77e, subject to various exemptions as specified in §§ 3 & 4, 15 U.S.C. §§ 77c & d (1982).

[3] A variety of instruments, schemes, and arrangements raise the issue of whether a security is involved. As Professor Hazen has stated: "What do the following have in common: scotch whiskey, self-improvement courses, cosmetics, earthworms, beavers, muskrats, rabbits, chinchillas, fishing boats, vacuum cleaners, cemetery lots, and fruit trees? The answer is that they have all been held to be securities within the meaning of federal or state securities statutes." T. HAZEN, THE LAW OF SECURITIES REGULATION 14 (1985) (footnotes omitted). It is the manner in which the above items are packaged and sold, and not the items themselves, that invites characterization as a security. Nevertheless, the broad range of items that raise the issue evidences interpretive problems and the expansive nature of the definition. The development of the sale of business doctrine (under which a stock purchase was not deemed the purchase of a security if control of the corporation changed hands during the transaction) is the clearest example of the clash between the notion that the definition of security is modified by the qualifying prefatory phrase "unless the context otherwise requires" (signaled by the catch-all phrase, "investment contract") and the strong sense that certain instruments, such as stock, represent the paradigm of a security. Until the Supreme Court rejected the sale of business doctrine in Landreth v. Landreth Timber Co., 105 S. Ct. 2297 (1985), and Gould v. Ruefenacht, 105 S. Ct. 2308 (1985), the circuits were divided on the applicability of the sale of business doctrine. *Compare Daily*, 701 F.2d 496 *and* Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982) *with* Christy v. Cambron, 710 F.2d 669 (10th Cir. 1983) *and* Sutter v. Groen, 687 F.2d 197 (7th Cir. 1982). In *Landreth*, the Court acknowledged the ambiguity in defining a security: "It 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.' " *Landreth*, 105 S. Ct. at 2303.

[4] The Supreme Court's rationale for deciding that the sale of business doctrine was not a valid interpretation of the term "security" typically relied on statutory language and congressional purpose. "It is axiomatic that '[t]he starting point in every case in-

concerns must be addressed, such as the problem of self-referencing definitions,[5] the need to preserve the reified nature of instruments in the commercial world,[6] and the possibility that the concept of a security may be both referential and attributive.[7] This Article suggests a two-tiered model of these definitional sections.[8] The two-tiered model pro-

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volving construction of a statute is the language itself.' " *Landreth*, 105 S. Ct. at 2301 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975)). "Reading the securities laws to apply to the sale of stock at issue here comports with Congress' remedial purpose in enacting the legislation to protect investors . . . ." *Landreth*, 105 S. Ct. at 2303.

[5] *See infra* text accompanying notes 91-118. This part of the Article argues that avoiding the tendency to define the term security by reference to the policies of the Acts best preserves fairness to the parties. The notion that the concept of a security is independent of a judge's determination that the securities acts are applicable allows parties to ascertain whether their conduct must comply with the securities laws at the time of the transaction.

[6] *See infra* text accompanying notes 119-73. This part argues that stocks, bonds, notes, and even investment contracts should represent the names for classes of instruments created by state law sources. In other words, in the first level of analysis courts should determine whether an instrument is a stock or bond by reference to generalized state law conceptions that describe the inherent characteristics of such instruments.

[7] *See infra* text accompanying notes 69-90. This Article argues that the Acts' sections defining a security are both referential and attributive. One component of the definition refers to state-created instruments (stocks, bonds, notes, and the like). The attributive component of the definition operates as an open-textured term (like "due process") that excludes some of these instruments because the context of the transaction would so require.

[8] *See infra* text accompanying notes 84-90. The two-tiered approach suggests that there are two levels. For an instrument to qualify as a security it must first fit within one of the categories specifically mentioned in the definitional section, such as stock, notes, bonds, and debentures. An investment contract is considered an instrument. All of these first level categories are defined by reference to a generalized state law conception of the term. If an instrument falls within one of these categories then it may be exempted from the term "security" if contextual or policy reasons would justify exclusion. For example, if the court were considering whether or not certificates of deposit (CD's) issued by a bank were securities it would first determine whether the CD's fit the state law descriptions of notes, investment contracts, or *inter alia*, evidence of a long-term indebtedness. If the CD's met this test, the court then would determine whether the circumstances of the particular transaction or the policy and purposes of the securities acts would not merit applicability of the securities law. This Article proposes a two-tiered test in lieu of present one-tier analysis, which requires an instrument to fall within any of the categories (note, bond, stock, and the like) in order to be considered a security. The problem with the present one-tier analysis is that the context of the transaction and the policies of the act are intermingled with independent and objective descriptions of instruments, such as notes and stock, to achieve proper results. This approach has created interpretive difficulties. *See infra* text accompanying notes 37-61.

vides a means of reconciling seemingly diverse Supreme Court decisions[9] and clarifying the rules that the Court has developed.[10]

Prior to the Supreme Court's 1985 securities decisions in *Gould v.*

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[9] For example, compare *Marine Bank*, 455 U.S. 551, with *Landreth*, 105 S. Ct. 2297. In Part IV of the *Marine Bank* decision, the Court held that a profit-sharing arrangement between two families was not a security because it was a unique agreement, negotiated one-on-one by the parties and not offered to other investors. Similarly, *Landreth* involved a one-on-one negotiated agreement between parties and a nonpublic offering. Yet, since *Landreth* involved the purchase of stock and the Court considered stock to be the paradigm of a security, the Court found a security. Thus, *Marine Bank* suggests a case by case approach that considers the circumstances of the transaction. *Landreth* suggests that a generalized rule should be applied, regardless of the circumstances, to transactions involving stock. *Marine Bank* and *Landreth* can be distinguished on the grounds that *Marine Bank* involved the application of an investment contract and *Landreth*, the question of stock. This implies that "investment contract" is a term of art and "stock" a term that refers to state-created instruments. But such a distinction does not aid in analyzing a term such as "note" that must be viewed both as a term of art and the name of a class of state-created instruments. Thus, the *Marine Bank* and *Landreth* approaches are somewhat inconsistent in that they do not indicate when a case by case, transaction-oriented approach is superior to a uniform rule.

The Ninth Circuit pointed out this inconsistency between the approach to analyzing stock as opposed to notes in Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1353 (9th Cir. 1984), *rev'd*, 105 S. Ct. 2297 (1985):

> We see no principled way to justify an analysis in which we determine whether a note is a "security" within the meaning of the Acts by examining the transaction in light of the statutory purpose, but determine whether stock is a "security" by examining only the instrument and not the transaction in light of the statutory purpose.

[10] *See infra* text accompanying notes 174-230. Under the two-tiered approach an instrument could fail to be considered a security for two general reasons. An instrument might not be a security because it did not fall within one of the first tier categories such as stock, note, or the like. A court would find the appropriate description for each category through reference to generalized state law. *See infra* text accompanying notes 154-61. Secondly, an instrument that met the first test could fail to be a security if the circumstances surrounding the transaction did not justify application of the securities laws. A court would exclude an instrument for such second tier reasons if the policy and purposes of the acts did not call for the application of the substantive rules of the securities acts. This distinction helps clarify the holdings of major cases. Some of the problems interpreting the securities acts have arisen from the disagreement about the holdings of key Supreme Court decisions. For example, the controversy over the sale of business doctrine was generated by confusion over whether the decision in United Housing Found. v. Forman, 421 U.S. 837 (1975), required the three-part *Howey* test to apply to all securities or only if an instrument did not fall within the core meaning of other enumerated categories such as stock. For discussion of these contrasting approaches see *Daily*, 701 F.2d at 498-99. Under the two-tiered approach, the holding of *Forman* is clearer: The shares in the housing cooperative failed the first level because they did not meet the description for "stock" or "investment contracts." *See infra* text accompanying notes 184-92.

Ruefenacht[11] and *Landreth v. Landreth Timber Co.*,[12] the definition of a "security"[13] encountered two notable areas of interpretive difficulty: the application of the "sale of business" doctrine[14] and the determination of which kinds of promissory notes constitute a security.[15]

In *Gould* and *Landreth*, the Court held that the sale of business doctrine did not exclude from the definition of security stock transactions[16] in which the purchaser obtained significant control of a newly

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[11] 105 S. Ct. 2308 (1985).

[12] 105 S. Ct. 2297 (1985).

[13] The word "security" is used in two senses in this Article. First, the term "security" is the heading of § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1982), and § 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1982), referring to situations when the Acts apply. Second, the overall objective of this Article is to define the term "security." There are two steps to defining the term. In this Article, the phrase "definition of security" refers to the overall process of using both steps — first, the categories of instruments and second, the application of the proper "concept of a security" — to arrive at the proper test for triggering the securities acts. The term "concept of a security" refers to the second level of analysis — the process by which instruments that meet the first level are tested as to whether the acts should apply.

Section 2(1) also uses the term "security" when it refers to "interest or instrument commonly known as a security." This Article interprets this usage of "security" as referring to a class of instruments that are defined by state law, similar to stock, note, or bond. Thus, a court would determine whether an instrument belongs to that class ostensibly by looking to state law, as with stocks and bonds. This usage of "security" in the same manner as "stock" or "bond" in § 2(1) should not be confused with the above two usages. The Supreme Court has held that the meaning of "instrument commonly known as a security" is the same as "investment contract." *Forman*, 421 U.S. at 852.

[14] Under the sale of business doctrine, purchases of more than 50% of the stock of a corporation in which the purchaser acquired control of the corporation were not considered the purchase of a security for purposes of the federal securities acts. *See generally* T. HAZEN, *supra* note 3, at 18-19.

[15] Section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1982), and § 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 77c(a)(3) (1982), state that any note is a security unless the context otherwise requires. Short-term commercial notes are exempt under § 3(a)(3) of the 1933 Act, 15 U.S.C. § 77c(a)(3) (1982), and by means of the definitional § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1982). The courts have struggled with the issue of what kinds of notes should be considered a security. Until 1971 all notes generally were considered securities. Subsequently, the courts scrutinized transactions to exempt those notes that did not have the "economic realities" of a security or were considered "commercial" and not "investment" notes. *See* Note, *The Economic Realities of Defining Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 34 U. FLA. L. REV. 400, 406-16 (1982) [hereafter Note, *Economic Realities*].

[16] Under the sale of business doctrine, the circumstances surrounding the purchase of stock would be examined to determine whether the purchaser acquired substantial control over the corporation. Thus, the doctrine was inherently transaction oriented.

acquired business.[17] Courts previously applying the sale of business doctrine depended on the rationale that acquisition of a substantial percentage of a corporation's stock was in fact a purchase of assets.[18] Thus, the form of the transaction (purchase of the enterprise's stock) was not considered appropriate to trigger the federal securities law.[19] The securities acts were meant to protect investors who had given money to a promoter and had little control over future operation of an enterprise. On the other hand, courts following the sale of business doc-

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For courts willing to find a transfer of substantial control with a sale of less than 100% of the stock, the doctrine required a case by case approach. For example, the Seventh Circuit imposed a rebuttable presumption: in transactions resulting in the acquisition of more than 50% of the stock, no security was involved. Sutter v. Groen, 687 F.2d 197, 203 (7th Cir. 1982).

[17] Courts applying the sale of business doctrine took the view that the three-part test in SEC v. Howey, 328 U.S. 293 (1946), established the essential characteristics for all securities. The third part of the *Howey* test requires finding the existence of a security only when the investor is seeking profits "solely from the efforts of [others]." *Id.* at 299. Thus, when the investor acquires substantial control over the enterprise into which she has placed her investment, disclosure and the application of the securities acts are not required since she has control over her own future and is not at the mercy of a third party promoter. For discussion of *Howey*'s dual-level theory of a security, see *infra* text accompanying notes 130-34. Thus, control over the future of the enterprise is the key to the application of the sale of business doctrine. Some courts would apply a rebuttable presumption of such significant control when 50% of the stock is acquired. *See Groen*, 687 F.2d at 197. Other courts simply have held that a purchase of all the stock of a corporation is not the purchase of a security without discussing their holding's implications for percentages less than 100%. *See* Chandler v. Kew, Inc., 691 F.2d 443 (10th Cir. 1977); *see also* King v. Winkler, 673 F.2d 342, 346 (11th Cir. 1982):

> A sale of less than 100% of the stock might not be covered by the Acts. A sale of 100% of the stock can be covered by the Acts. The number of sellers and purchasers will not necessarily control the outcome. Once the literal words of the statute are abandoned for an "economic realities" test, each case must be evaluated on its own facts to determine if the transaction, though within the letter of the statute, is not within its spirit nor the intent of the lawmakers.

[18] *See Chandler*, 691 F.2d at 444: "The economic realities of the case at bar show that the plaintiff was buying a liquor store and, incidently [sic] as an indicia of ownership, was receiving 100% of the stock of the company which owned the store."

[19] *See Winkler*, 673 F.2d at 345 ("Thus, the 'economic realities' of the transaction indicate not a security transaction, but rather the sale and purchase of a business using stock merely as a method of vesting the Kings with total ownership."); Frederiksen v. Poloway, 637 F.2d 1147, 1151-52 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981) ("The plaintiffs sought to acquire NSM's business in its entirety. The 'stock' sale was a method used to vest ECC with ownership of that business. There was no offer of investment 'securities.' The stock of NSM merely was passed incidentally as an indicia of ownership of the business assets sold to ECC." (footnote omitted)).

trine reasoned that a purchaser who controlled an enterprise had economic bargaining powers to compel the kind of disclosure that federal securities laws required. As enterpreneurs, controlling purchasers were not the kind of investors the acts assertedly were designed to protect.[20] Since these investors are at the mercy of the promoter, they need full disclosure.

Gould and *Landreth* involved purchases of fifty and one hundred percent of a corporation's stock, respectively. Rejecting the sale of business doctrine, the Supreme Court held that stock was the paradigm of a security.[21] In cases in which stock has all the characteristics associated with that class of instruments,[22] the application of the securities laws will not turn on the percentage of stock purchased or on whether control passed to the purchaser. Since control depends on a number of factors,[23] whether a stock purchase falls within the definition of a se-

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[20] In *Landreth*, the Supreme Court considered but rejected this rationale for application of the sale of business doctrine:

> According to respondents, it is clear that petitioner sought not to earn profits from the efforts of others, but to buy a company that it could manage and control. Petitioner was not a passive investor of the kind Congress intended the Acts to protect, but an active entrepreneur, who sought to "use or consume" the business purchased just as the purchasers in *Forman* sought to use the apartments they acquired after purchasing shares of stock. Thus, respondents urge that the Acts do not apply.
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> We disagree with respondents' interpretation of our cases.

105 S. Ct. at 2304.

[21] "First, traditional stock 'represents to many people, both trained and untrained in business matters, the paradigm of a security.' " *Landreth*, 105 S. Ct. at 2306 (citing *Daily*, 701 F.2d at 500).

[22] We identified those characteristics usually associated with common stock as (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. . . .
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> [I]t is undisputed that the stock involved here possesses all of the characteristics we identified in Forman as traditionally associated with common stock.

Landreth, 105 S. Ct. at 2302-05 (citing *Forman*, 421 U.S. at 850).

[23] More importantly, however, if applied to this case, the sale of business doctrine would also have to be applied to cases in which less than 100% of a company's stock was sold. This inevitably would lead to difficult questions of line drawing. The Acts' coverage would in every case depend not only on the percentage of stock transferred, but also on such factors as the number of purchasers and what provisions for voting and veto rights were agreed upon by the parties.

Landreth, 105 S. Ct. at 2307. Thus, for example, if the articles of incorporation re-

curity often would be unclear at the time of purchase.[24] In the Court's view, the applicability of securities laws should be more predictable.[25]

In *Gould*, the Court implicitly rejected the idea that every transaction or instrument should satisfy the *Howey*[26] "economic realities" test[27] to be considered a security. Consequently, some instruments that do not have the economic realities of a security nevertheless will be deemed securities.[28]

Subsequent to the demise of the sale of business doctrine, the most difficult question was which kinds of promissory notes would be considered securities.[29] At one point, lower federal courts adopted a literal approach, holding that all promissory notes were securities.[30] The test

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quired a supermajority of 75% to approve extraordinary corporate changes such as an amendment of the articles, merger, or dissolution, the mere acquisition of 51% would not give full control.

[24] "As we explain more fully in [*Gould*, 105 S. Ct. 2308], decided today as a companion to this case, coverage by the Acts would in most cases be unknown and unknowable to the parties at the time the stock was sold." *Landreth*, 105 S. Ct. at 2307.

[25] "These uncertainties attending the applicability of the Acts would hardly be in the best interests of either party to a transaction." *Landreth*, 105 S. Ct. at 2307.

[26] In considering these claims we again must examine the substance — the economic realities of the transaction — rather than the names that may have been employed by the parties. We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a security." In either case, the basic test for distinguishing the transaction from other commercial dealings is "whether the scheme involves an investment in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301. This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security.

Forman, 421 U.S. at 851-52.

[27] The term "economic realities" is used to indicate the essence or fundamental structure of a security. The term originally was used in *Forman*, 421 U.S. at 849: "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." Subsequent courts considered the *Howey* test, *see supra* note 26, to be the economic reality of a security, *see Winkler*, 673 F.2d at 344, on the basis of the *Forman* Court's application of that test.

[28] In *Landreth*, we held that where an instrument bears the label "stock" and possesses all the characteristics typically associated with . . . stock a court will not be required to look beyond the character of the instrument to the economic substance of the transaction to determine whether the stock is a "security" within the meaning of the Acts.

Gould, 105 S. Ct. at 2310 (citing *Forman*, 421 U.S. at 851).

[29] *See supra* note 15.

[30] *See* Note, *Economic Realities*, *supra* note 15, at 406 n.39. *See also* Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 991-92 (5th Cir. 1969) (dicta that

shifted, however, when the courts balked at applying securities laws to commercial and consumer-oriented transactions not involving the dangers and risks of investment notes.[31] From then on, the courts turned to the "investment-commercial" dichotomy and applied the securities acts only to investment-oriented notes.[32] Since many types of investment-oriented promissory notes exist, different judicial tests have proliferated.[33] Some courts have applied a factorial analysis,[34] others a "family resemblance" or "cluster" test,[35] and still others a "risk-capital" analysis.[36]

Gould and *Landreth* may give clues on how to resolve the interpretive problems involving notes. Two alternatives remain. First, the courts could treat notes the same way the Supreme Court in *Gould* and *Landreth* treated stock. Thus, if an instrument has all the characteristics common to a note, it is a security. Under this approach the various formulations of economic reality or investment structure would not be used to exempt some notes from coverage under the acts. A second approach would be to treat notes differently from stock, only including within the concept of a security those notes with the appropriate investment or risk-capital structure.[37]

Aside from the problem of notes, *Gould* and *Landreth* leave unanswered other important interpretive questions. For example, courts

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almost all notes are securities).

[31] *See generally* Lipton & Katz, *Notes Are (Are Not?) Always Securities — A Review*, 29 BUS. LAW. 861, 866 (1974).

[32] *See* CNS Enters. v. G. & G. Enters., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert denied*, 409 U.S. 1009 (1972).

[33] *See generally* Note, *Economic Realities*, *supra* note 15.

[34] *See* Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257-58 (9th Cir. 1976) (noting as important factors: duration of the note, extent of collateralization, form of note, circumstances of issuance, relationship between amount borrowed and size of borrower's business, and contemplated use of proceeds).

[35] *See* Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976) (securities acts should apply to transaction when a note bears no "strong family resemblance" to consumer and commercial notes).

[36] *See* Union Planters Nat'l Bank of Memphis v. Commercial Credit Business Loans, Inc., 651 F.2d 1174 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981); El Khadem v. Equity Serv. Corp., 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974). *See also* Hunt, *Madame El Khadem, the Ninth Circuit, and the Risk Capital Approach*, 57 OR. L. REV. 3 (1977).

[37] This is the approach now taken by all courts that have rejected the literal approach.

often have considered the term "investment contract" a catch-all phrase.[38] Does the investment contract category act as a residual catch-all vehicle for instruments that fail to qualify for other categories? Assume, for example, the investment-commercial dichotomy is the applicable test for notes. Furthermore, suppose a note was too commercial to meet the test. May a plaintiff argue disjunctively that, although failing the note test, the instrument qualifies as an investment contract? Similarly, suppose certain forms of stock did not meet the test for stock because they lacked some essential characteristic of stock. [39] Could a plaintiff argue alternatively that it was an investment contract?[40]

Another question after *Gould* and *Landreth* is whether the Court's holding that stock is defined by reference to its usual characteristics applies to other enumerated instruments such as notes, treasury stock, bonds, and debentures. If so, how should one determine the characteristics of these instruments? Is state law the appropriate test, and if so, is it general state law[41] or specifically the law of the state of incorporation?[42] A similar issue is whether the term "investment contract" is the name of a class of instruments defined by state law or a catch-all

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[38] In *Howey* the Supreme Court asserted that the concept of an investment contract was flexible: "It embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299. While the concept may be flexible, this Article urges that it is best not to interpret an investment contract in a catch-all fashion. *See generally Groen*, 687 F.2d at 200 (viewing as a catch-all phrase the term "instrument commonly known as a security."). The Supreme Court in *Forman*, 421 U.S. at 852, stated that "instrument commonly known as a security" and "investment contract" are essentially the same. *See also infra* text accompanying notes 143-53.

[39] For example, assuming the stock was nonvoting or did not pay dividends (*see* Stroh v. Blackhawk Holding Corp., 48 Ill. 2d 471, 272 N.E.2d 1 (1971) (considering validity of stock that had no dividend rights or rights on dissolution)), it is not likely that a court would consider such stock to be stock for securities act purposes. In *Forman*, 421 U.S. at 851, the Court identified the right to receive dividends as one of the critical characteristics of the kind of stock that will be considered a security.

[40] If plaintiffs could argue that an instrument was stock, then, failing that, argue that it was nevertheless an investment contract, the legislative intent behind the use of terms such as "stock" or "note" might be undermined. If the legislature intended to exclude commercial notes from coverage by the securities acts, to allow the Acts to cover notes because they fit the test for investment contracts would subvert the proper interpretation of "note." The two terms "note" and "investment contract" should be read together, so that one term does not undermine the purpose served by the other.

[41] *See infra* text accompanying notes 154-61.

[42] *See id.*

phrase determined by federal common law.[43]

A further interpretive question focuses on the term "security." Is "security" the name of a class of instruments like "stock" or is it the name of a general category made up of subcategories such as stock? Does the term "security" have exactly the same contours as the terms by which it is exemplified? In other words, one view is that the term "security" is like the term "fruit" because it has the same coverage as the items that constitute the extension[44] of that term. This view suggests a one-tier analysis. Thus, to know the meaning of the term "fruit" one need only know what an apple, orange, and other fruits are. Similarly, to know what a security is, one need only know what a stock, bond, debenture, and other such instruments are.

On the other hand, the meaning of the term security may not be totally congruent with its paradigm instruments or most familiar examples. Take for example the following definitional section: "(1) The term life-prolonging fruit means any fresh fruit, orange, apple, cranberry, pear, plum . . . unless the context otherwise requires." Unlike the one-tiered definition of "fruit" above, the definition of "life-prolonging fruit" is two tiered. One does not know the exact definition of the term by knowing the objects listed. Certain plums, for example, may be excluded if they do not meet the criteria of being life prolonging. Perhaps, for instance, the context in which such plums are used, such as canned plums, may disqualify them from being life prolonging. Similarly, the meaning of sections defining a security may be two tiered. *Gould* and *Landreth* give no clear indication.

Finally, as a jurisprudential concern, one must question the validity of including policy considerations relating to the securities acts themselves in the definitional terms that trigger application of the acts.[45] The use of policy to interpret definitions can be unfair to parties. Normal expectations as to language may be upset. Moreover, the statute may not fairly give adequate notice that it applies to one's conduct.

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[43] *See infra* text accompanying notes 143-53.

[44] The traditional theory of meaning in philosophy of language held that "intension determines extension." The difference between intension and extension is the following: "The conjunction of properties associated with a term such as 'lemon' is often called the intension of the term 'lemon.' This intension determines what it is to be a lemon. Thus, according to traditional theories, intension determines extension." NAMING, NECESSITY, AND NATURAL KINDS 14 (S. Schwartz ed. 1977) [hereafter NAMING, NECESSITY]; *see also* A. FLEW, A DICTIONARY OF PHILOSOPHY 109 (1982): "The extension of a general term, predicate, or concept is made up of all those entities to which the term or predicate correctly applies, or which fall under the concept."

[45] *See infra* text accompanying notes 91-118.

Such self-referencing, policy-oriented definitions may allow courts to apply retroactively a substantive regulatory scheme when the parties could not have ascertained the regulation's applicability at the time of their conduct. The Court in *Gould* and *Landreth* rejected the sale of business doctrine partly for these reasons.[46] On the other hand, most of the Court's decisions defining "security" and "investment contract" have relied on the securities acts' policies.[47]

These interpretive questions demand theoretical reconciliation. The problems of interpreting these definitional sections resemble the classical problems in philosophy of language involving meaning[48] and reference.[49] Problems of reference arise because one must determine the referent[50] for terms such as "stock," "note," and "investment contract." Moreover, there is the overall question of what is meant by the term "security." Is it an open vehicle for interpretation in the sense of being an essentially contested concept?[51] Or does its meaning depend on the drafters' original intention when they created the language?[52]

The following section suggests three major concerns that the raft of

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[46] *See Gould*, 105 S. Ct. at 2311: "Therefore, under respondents' theory, the Acts' applicability to a sale of stock such as that involved here would rarely be certain at the time of the transaction." *See also Landreth*, 105 S. Ct. at 2308: "We find more daunting, however, the prospect that parties to a transaction may never know whether they are covered by the Acts until they engage in extended discovery and litigation over a concept as often elusive as the passage of control." *Accord* Golden v. Garafalo, 678 F.2d 1139, 1145-46 (2d Cir. 1982).

[47] *See, e.g.*, *Marine Bank*, 455 U.S. at 558 (reasoning that FDIC guarantee of a CD eliminates risk that acts were designed to address); International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 569-70 (1979) (since ERISA regulates pensions plans, it is unnecessary to subject pension plans to coverage of the federal securities acts).

[48] Thus, the goal of defining the term "security" is to discover what it means. For discussion of theories of meaning, see generally W. ALSTON, PHILOSOPHY OF LANGUAGE 10-49 (1964).

[49] The referential theory is a theory of meaning. Basically, it asserts that to understand the meaning of a word is to understand the concept or referent to which the word refers. *See id.* at 12. As used here, the term "reference" means that the definitional term "security" refers to specific instruments such as stock, notes, and the like. The meaning of the term "security," however, may be different from simply the whole set of stocks, notes, and the like. Certain notes may be excluded from the definition of a security, for example, because they are not of an investment nature.

[50] *See* A. FLEW, *supra* note 44, at 279 ("[R]eferent. That to which a word refers. Cows are thus the referents of the word 'cows.' ").

[51] *See* Gallie, *Essentially Contested Concepts*, ARISTOTELIAN SOCIETY PROCEEDINGS (n.s.) 167 (1955-56).

[52] As opposed to being essentially contested, the term "security" arguably should be construed in light of its legislative history. *See generally Daily*, 701 F.2d at 500 n.5.

articles[53] and cases on the subject have not addressed. First, the definition of a security should be divided into referential[54] and attributive[55] components. The referential component refers to independently existing, state-created instruments.[56] The attributive component distinguishes among these instruments by describing the proper circumstances calling for application of the acts.[57] These two functions must be systematically differentiated.

The second concern will be termed the objection against self-referencing, policy-oriented definitions.[58] The third concern is whether terms such as "stock," "note," and "investment contract" should be viewed as instruments (reified objects) or rather as a nexus-of-commercial relationships.[59]

The logical meaning of these definitional securities acts sections should follow a two-tiered approach: the terms "stock," "bond," and the like are treated as instruments whose characteristics are defined by sources outside of the federal securities acts, such as state law. Once an instrument meets the state-created criteria for inclusion, it has met the first test. The second tier is the concept of a security.[60] The purposes

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[53] The literature on the subject is vast. The amount that has been written solely on the sale of business doctrine is itself impressive. *See* Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1351 n.2 (9th Cir. 1984).

[54] The term "referential" means that the speaker had a definite idea in mind to which she was referring when using the term. *See infra* text accompanying notes 72-77.

[55] By "attributive" it is meant that the speaker may not have anything in particular in mind when using a term, but nevertheless can make meaningful statements using such a term. *See id.*

[56] The referential component of the term "security" has as its referent stock, notes, bonds, debentures, investment contracts, and other categories specifically mentioned in the definitional sections. These instruments are state created in the sense that the categories are defined by state law in much the same way that state law creates and defines the property interests that the Constitution protects. *See* Board of Regents v. Roth, 408 U.S. 564 (1972).

[57] The attributive aspect of the term "security" is an open-textured concept much like the term "due process."

[58] The basis of this objection is that threshold terms such as "security" or "property" (for the purposes of U.S. CONST. amend. XIV) should not be described in reference to the results that would be triggered by finding the existence of a security or property. *See infra* text accompanying notes 91-118.

[59] *See infra* text accompanying notes 119-73.

[60] *See supra* note 13. The concept of security should be distinguished from the definition of a security. The concept of security is the concept or test by which instruments such as stocks, notes, and the like are excluded or included as securities that trigger the application of the acts. The definition of the term "security" refers to the usage of the word security in § 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1982) — the task of

and requirements of the securities acts define this concept. It does not have a reference in state-created sources. The nature and structure of the concept of a security determine to which instruments among the stocks, notes, and investment contracts the federal securities acts should apply.[61]

Part I of this Article explains the function of the referential and attributive components, and demonstrates why a two-tiered model is necessary to separate the referential from the attributive level.[62] Part II discusses the importance of avoiding self-referencing, policy-oriented definitions that trigger application of the acts.[63] Part III stresses the necessity of maintaining the reified quality of notes, stocks, bonds, and other instruments.[64] Part IV reinterprets the major Supreme Court decisions defining a security under the suggested two-tiered model.[65] Part V discusses the concept of a security, including several important questions. One critical issue is whether the concept of a security is of conjunctive or cluster form.[66] A second question is how to derive the con-

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considering both the referential and attributive aspects of the term to reach the proper result.

[61] Thus, the second tier concept of a security acts as a transaction exemption. Stocks, notes, bonds, and the like that properly fall within these categories may be exempt depending on the circumstances surrounding the particular transaction.

[62] *See infra* text accompanying notes 69-90.

[63] *See infra* text accompanying notes 91-118.

[64] *See infra* text accompanying notes 119-73.

[65] *See infra* text accompanying notes 174-247.

[66] Traditional theories of meaning held that a term was defined by the conjunction of properties associated with that term.

> On the traditional view, the meaning of, say, "lemon," is given by specifying a conjunction of properties. For each of these properties, the statement "lemons have the property *P*" is an analytic truth; and if *P1*, *P2*, . . . *Pn* are all of the properties in the conjunction, then "anything with all of the properties *P1*, . . . , is a lemon" is likewise an analytic truth.

Putnam, *Is Semantics Possible?*, in NAMING, NECESSITY, *supra* note 44, at 103 (emphasis in original). According to others, however, some terms are not defined by a conjunction of properties but rather by a cluster of properties.

> For example, it is held that we cannot define "game" by a conjunction of properties such as having a winner and a loser, being entertaining, and involving the gaining and losing of points because some perfectly acceptable games lack some of these features. According to the cluster theory, something is a game because it has enough features from a cluster of properties like these. A cluster theorist would claim that there need not be any property in the cluster that is sufficient for the application of the term, but he nevertheless would hold that the cluster taken as a whole determines the extension of the term. Wittgenstein's position that there are only family resemblances among the individuals in the extension of many

cept. Was the concept intended to be essentially open[67] and thus a vehicle for judicial lawmaking, or should the courts strive to adhere to an original legislative concept of a security? If such an original concept exists, how do courts adhere to this original conception?

This Article concludes that while Congress may not have articulated the original concept behind the attributive aspect of a security, the courts can, by a process of "asking the right questions,"[68] focus on that original concept in a manner that follows legislative intent.

I. Referential and Attributive Aspects of the Definition of a Security

Close examination of the sections that define a security reveals that the drafters had two things in mind. The terms "stock," "bond," "note," and the like suggest a referential use and indicate that the drafters conceived of certain items when they thought of a security. In addition, their use of the qualifying language "unless the context otherwise requires"[69] demonstrates that the drafters intended the concept of a security to extend beyond these enumerated instruments.[70] They also intended the concept of a security to be attributive. In other words, while the drafters did not have in mind all possible circumstances that would show the presence of a security, they nevertheless set down the legal consequences attaching to anything later deemed a security.[71]

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ordinary terms can be construed as a version of the cluster theory.

Id. at 15. *See generally* L. Wittgenstein, Philosophical Investigations (G. Anscombe trans. 3d ed. 1976).

[67] *See generally* H. Hart, The Concept of Law 124 (1961). Like the term "due process," the term "security" may deliberately have been left open to allow future courts to apply an appropriate meaning in light of the contemporary demands of the commercial world.

[68] *See infra* text accompanying notes 231-47. By "right questions" the author refers to the process of determining which facts are outcome determinative. For example, in the problem of determining which notes should be securities, the outcome-determinative facts might include the form of a note, the degree of collateralization, the relationship between the parties, and the degree of participation by others. Whether such questions might be outcome determinative can be discerned by an inductive process in which the judge examines the outcome-determinative facts of prior holdings.

[69] *See* § 2 of the Securities Act of 1933, 15 U.S.C. § 77b (1982); § 3 of the Securities Exchange Act of 1934, 15 U.S.C. § 78c (1982).

[70] The existence of this qualifying phrase has been used to justify doctrines that may exclude some stock or notes. *See Marine Bank*, 455 U.S. at 556.

[71] The use of the qualifying phrase "unless the context otherwise requires" argues that the definition of a security in § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1982), and § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1982), is, at

Thus, the term "security" has both a referential and attributive component. "Referential" means that the speaker has a definite idea in mind to which she refers when using a term. "Attributive" means that the speaker may not have anything in particular in mind when using the term, but that she still can make meaningful statements about the term.[72] Philosopher Keith S. Donnellan gives a good example of the difference between referential and attributive use in his example of the term "Smith's murderer."[73]

> Suppose first that we came upon poor Smith foully murdered. From the brutal manner of the killing and the fact that Smith was the most lovable person in the world, we might exclaim, "Smith's murderer is insane." I will assume, to make it a simpler case, that in a quite ordinary sense we do not know who murdered Smith . . . . This, I shall say, is an attributive use of the definite description.

Now, consider a referential use of "Smith's Murderer."[74]

> [S]uppose that Jones has been charged with Smith's murder and has been placed on trial. Imagine that there is discussion of Jones's odd behavior at this trial. We might sum up our impression of his behavior by saying, "Smith's murderer is insane." If someone asks to whom we are referring, by using this description, the answer here is "Jones." This, I shall say, is a referential use of definite description.

The distinction between referential and attributive uses has other important consequences.[75] For purposes of this discussion, it proves that sensible statements can be made about a security without having in mind a definite image or conception of a security. In law, terms such as "due process" are used attributively to allow subsequent interpreters the opportunity to give appropriate content to their meaning.[76] The lack of a fixed and definite conception of due process does not, however, impede those originally coining the phrase from making meaningful legal statements about the consequences that attach to due process.

Many of the interpretive difficulties with the provisions that define a security stem from the drafters' design that the provisions be both refer-

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least in part, "open-textured" or attributive.

[72] *See generally* Donnellan, *Reference and Definite Descriptions*, in NAMING, NECESSITY, *supra* note 44, at 65.

[73] *Id.* at 46-47.

[74] *Id.*

[75] Donnellan's paper goes on to point out that attributive use can produce paradoxical results. *See generally id.*

[76] In a similar vein, Dworkin argues that "vague" terms like "cruel and unusual punishment" are meant to give the court the right to apply a concept of cruel and unusual that can be different from a possible original conception of cruel and unusual. *See* R. DWORKIN, TAKING RIGHTS SERIOUSLY 134-36 (1977).

ential and attributive. These sections are referential in that they refer to such distinct instruments as stock. Yet, they are also open and attributive because their application is uncertain in many instances.[77]

Legal scholars often speak about the "core" and "open texture" of legal terms.[78] The referential aspect of these definitional sections, which identify enumerated instruments as the paradigms of a security, is the core of these provisions.[79] The open texture lies in the ambiguity that the use of a contextual qualification creates.[80]

Most decisions and commentary on the definition of a security have not consciously viewed the term in this bifurcated sense.[81] Yet, one should recognize this distinction because a conflict between the attributive and referential aspects inevitably will develop. The emergence of

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[77] The problem in determining which notes should be deemed securities is an example of the attributive component of the term "security." The notes that should be securities under an attributive concept would be "those notes, given the goals of the legislation, which should be deemed securities." The open quality of this phrase bears out its attributive nature.

[78] *See generally* H. HART, *supra* note 67, at 124-25: "[U]ncertainty at the borderline is the price to be paid for the use of general classifying terms in any form of communication concerning matters of fact. Natural languages like English are when so used irreducibly open textured." The "core" of any term or legal rule consists of the clear, paradigm cases. *See id.* at 125:

> When we are bold enough to frame some general rule of conduct (*e.g.*, a rule that no vehicle may be taken into a park), the language used in this context fixes necessary conditions which anything must satisfy if it is to be within its scope, and certain clear examples of what is certainly within its scope may be present to our minds. They are the paradigm, clear cases (the motor-car, the bus, the motor-cycle); and our aim in legislating is so far determinate because we have made a certain choice.

See also Waismann, *Verifiability*, in ESSAYS ON LOGIC AND LANGUAGE 117-30 (A. Flew ed. 1960).

[79] The actual core of the term "security" may be different from simply the sets of all stocks, notes, bonds, and other instruments in a first tier category. If "core" refers to clear or settled paradigm cases, then the notion of a core combines the first and second tier. After *Gould* and *Landreth*, ordinary business stock would clearly be within this core. *See Landreth*, 105 S. Ct. at 2306 (stock is the paradigm of a security).

[80] The prefatory phrase "unless the context otherwise requires," appearing in the definitional sections, allows the circumstances of the transaction to justify the exclusion of certain notes, bonds, or the like from characterization as a security.

[81] The Court in *Landreth* notes the difference between paradigm cases such as stock (*see supra* note 79) and other categories that may be open textured in nature: "We here expressly leave until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.' " *Landreth*, 105 S. Ct. at 2306. However, the Court has not explicitly commented on the referential or attributive nature of the term "security."

the sale of business doctrine[82] is recent evidence of this conflict. That doctrine acknowledges the tension between the clear notion of reference in the term "stock" and the policies used to interpret the term "investment contract," which manifests an attributive use of "security." By rejecting the sale of business doctrine, *Gould* and *Landreth* indicate that the concept of a security is both referential and attributive, and not solely attributive as the sale of business doctrine implies.[83]

Most courts and commentators addressing this issue have attempted to resolve the conflict using a one-tier approach.[84] In a one-tier approach, the enumerated categories of instruments such as stocks and bonds are given the same weight as the catch-all term "investment contract." Considered on the same level, it is not clear which has dominance. Thus, interpretive problems, such as the sale of business doctrine, emerge when "investment contract" analysis assertedly renders the term "stock" surplusage.[85]

The two-tiered approach is advantageous because it separates referential and attributive aspects of the term "security" into two distinct levels of analysis. The first level is referential and refers to instruments defined and created by state law. The second level is attributive and excludes those transactions that do not justify application of the federal securities acts. This approach provides a logical and simple way of determining whether the particular analysis refers to state law or interpretation, incorporating securities acts policies.[86] Moreover, the model performs important functions: it preserves the referential nature of the

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[82] *See supra* text accompanying notes 11-28.

[83] The essence of the sale of business doctrine is that every candidate for characterization as a security had to meet the three-part *Howey* test: (1) investment of money for profit; (2) in a common enterprise; and (3) solely from the efforts of others. *Howey*, 328 U.S. at 293. As investment contract analysis was applied, the analysis was basically attributive in nature because it did not define clear referents that would constitute a security. Hence, the rejection of the economic realities approach, suggested by courts advocating the sale of business doctrine, was a rejection of the view that the definitional sections were completely attributive. The determination that stock would always be deemed a security, whether or not it met the economic realities test, indicated that the definitional sections were, indeed, partly referential.

[84] Most courts supporting the sale of business doctrine suggested a one-tier analysis. *See Chandler*, 691 F.2d at 443; *Groen*, 687 F.2d at 197; *Winkler*, 673 F.2d at 342; *Poloway*, 637 F.2d 1147 (7th Cir.), *cert. denied*, 451 U.S. 1017 (1981).

[85] If the three-part *Howey* test constitutes the necessary and sufficient definition of a security to which all first tier instruments (stocks, notes, bonds, and the like) must be subjected, then the definition may as well read, "A security is any investment contract." This would make any other words used in the definition (such as stock) surplusage.

[86] *See infra* text accompanying notes 174-219.

term "security" and avoids the danger of self-reference in definition.[87] Furthermore, the model preserves the instrument-like quality of the categories that constitute the first level so that they cannot be taken apart by characterizing the nature of the transaction.[88] Above all, the two-tiered model represents a more sophisticated approach to reconciling seemingly diverse Supreme Court decisions.[89] Without apparent awareness of this two-tiered format, the Court has demonstrated a pattern of reasoning that fits within the model. This may be because the model represents a natural way of sorting the inherent referential and attributive aspects of legal terms such as "security."[90]

II. The Objection Against Self-Referencing Policy-Oriented Threshold Definitions

Since only securities can trigger the securities acts, then, at least in part, a security must be an item or instrument defined by sources of law[91] outside the securities acts. Otherwise, if the goals of the regulatory acts defined the triggering concept of a security, then the acts would apply when a judge decided in hindsight that the act's goals would be served thereby, rather than when the parties activated the regulatory scheme by use of a security.[92] In other words, if the term

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[87] *See infra* text accompanying notes 91-118.

[88] *See infra* text accompanying notes 119-73. The sale of business doctrine is an example of cases in which instruments are deconstructed on the grounds of the nature of the transaction. The sale of business doctrine held that stock sometimes was a security and sometimes was not. Thus, the transactional nature of the use of the stock triggered the appropriate ramifications. Cases involving piercing the corporate veil also demonstrate the deconstruction of the reified corporate entity on the basis of the nature of the transaction. *See generally* Hamilton, *The Corporate Entity*, 49 Tex. L. Rev. 979, 983 (1971).

[89] *See supra* note 9; *infra* text accompanying notes 174-230.

[90] The two-tiered approach may be natural in the sense that many legal terms have the same bifurcated referential/attributive, core/open-texture nature demonstrated by the term "security." Thus, prior judicial experience with this process may lead to a reflexive, if unarticulated, application of a two-tier approach.

[91] From a logical point of view, the term "security" must include some means of referring to the world outside of the securities acts. Otherwise, it would be completely self-referencing. *See infra* text accompanying notes 112-13. Even if the set defining the concept of a security were purely the creation of the securities acts, it would have no practical effect unless it could correspond to extrinsic objects. In the same manner numbers, as parts of mathematical systems, must correspond with items outside of the set of numbers to have meaning. Thus, for example, "four" means "four birds" or "four people." Otherwise, the number "four" would have no practical meaning to us.

[92] The very nature of the concept of a security is that it triggers the application of the securities acts. In other words, we know what the securities acts are by knowing

"security" were solely attributive and defined in the sense of transactions or instruments to which the acts ought to apply, the normal sequence of legal reasoning would be inverted. Judges first would examine transactions to see if the acts should apply. Thus, if an investor needed the protection of the acts because she made an investment through a promoter and relinquished control, then the acts ought to apply. Consequently, the judge would find the existence of a security.

The problem with applying such a purely attributive approach to the concept of a security is that it employs a self-referencing use of the term "security" (it means whatever it should mean). This deprives parties of fair warning that the securities laws might apply when they enter into transactions.[93] There is a danger that judges would consider the merits of the claim before considering whether the parties have activated the Act's triggering mechanism.[94] For instance, if the claim were fraud and the judge found significant evidence of deception and injury, the question of whether a security were involved might not be given serious consideration in light of the desire to provide a remedy. On the other hand, judges might dismiss the claims of wealthy or sophisticated plaintiffs on the ground that no security was involved because judges may

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what securities are. If we do not know what securities are (either in a referential or attributive sense) then we have no real understanding of the securities acts. Hence, if the definition of a security is "whatever the judge feels would best effectuate the purposes of the Acts," we face the possibility that we will not know when the Acts are applicable. Eventually, if judges developed a pattern and practice of what to "best effectuate purposes of the Acts" means, providing concrete examples, we could develop a judgment about the meaning of "security." Until then, there would be a lack of predictability as to the application of Acts.

[93] If a security will be deemed to exist when purposes of the Acts will be effectuated, the judge will look at the nature of the fraud alleged and ask whether the plaintiff was the kind of person (an investor) whom the Acts were designed to protect. In advance of such litigation parties could not be expected to resolve such complex questions and would be uncertain about the application of the Acts. We might describe this uncertainty by stating that it is unclear whether a security exists in this particular transaction.

[94] Thus, what should be a threshold issue, namely whether the requisite security exists for the court and parties to begin thinking about the application of the Acts, instead can become a laborious, time consuming discovery process. *See, e.g.*, *Gould*, 105 S. Ct. at 2311 ("Therefore, under respondents' theory, the Acts' applicability to a sale of stock such as that involved here would rarely be certain at the time of the transaction . . . . Rather, it would depend on findings of fact made by a court — often only after extensive discovery and litigation."). *See also* Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1254 (9th Cir. 1976) (motion for dismissal ending up as motion for summary judgment on the ground that the lower court considered much evidentiary material).

feel that such parties do not need the protection of the act.[95]

Moreover, applying a policy-oriented definition of security would violate the "plain meaning" of these definitional sections and upset basic judicial norms of reliance and fairness.[96] The term security would become a term of art despite the plain meaning of words such as "stock," "note," and "bond." The use of terms in a self-referencing, policy-oriented manner undermines the authenticity of language[97] used in law, implying that there is a "private language" among lawyers who specialize in particular areas.[98]

An example of a self-referencing, policy-oriented definition is the Su-

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[95] So-called rich and smart investors have usually been exempted, in some form or other, from the application of the registration provisions. *See, e.g.*, Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971) (defendants relying on sophistication of plaintiffs as a defense); Bowers v. Columbia Gen. Corp., 336 F. Supp. 609 (D. Del. 1971) (noting that investors must have both "access" and "sophistication"). *See generally* § 4(6) of the Securities Act of 1933, 15 U.S.C. § 77d(6) (1982); former rule 146, 17 C.F.R. 230.146 (repealed); Present regulation D, codifed at 17 C.F.R. § 230.501-.506 (1985). As to the antifraud provisions, the sale of business doctrine was based on the argument that those acquiring a controlling interest in a business were entrepreneurs who were not among the intended group of investors to be protected by the Acts. *See* cases cited *supra* note 84.

[96] Under the "plain meaning" rule, when the language of a provision, statute, or text is clear, that meaning must be adopted. Applying the plain meaning in these instances is only fair because it is assumed that this was the clear intent of the legislature. Moreover, plain meaning gives great weight to the argument that parties have relied on a single interpretation. *See* Sturges v. Crowninshield, 17 U.S. (4 Wheat.) 122 (1819). *See generally* McIntosh, *Legal Hermeneutics: A Philosophical Critique*, 35 OKLA. L. REV. 1, 7 (1982).

[97] The authenticity of language is undermined when words no longer have meaning even close to their original meaning. In such a situation, as in using a term of art, we must always put quotation marks around the word. By the use of these, we signal to others that we are intending to use the word in a special, nonordinary way. But to use a word in this form is not to use that word at all but some other word. If too much of this goes on, the language basically degenerates into a private one, subverting the whole purpose of language itself. *See generally* S. KRIPKE, WITTGENSTEIN ON RULES AND PRIVATE LANGUAGE (1982).

[98] This text does not use the term "private language" in Wittgenstein's sense. Rather, "private language" refers to the specialized use of terms of art (as in "nonpublic"; *see infra* text accompanying notes 99-104), which makes the language used by lawyers a code or cipher that only they can understand. The increasing use of specialized terms of art perpetuates the notion that law is elite, mystical, and not available to the understanding of the lay person. For example, consider all of the kinds of corporations: "de facto corporation," "de jure corporation," "Subchapter S. corporation," "professional corporation," "collapsible corporation" (defined as one having "§ 341 assets"), "501(c)(3) corporation," and "controlled corporation." A lay person would have difficulty grasping the differences among these types of corporations.

preme Court's interpretation of the term "non-public offering" in *Securities & Exchange Commission v. Ralston Purina Co.*[99] At issue was the meaning of a provision exempting certain transactions from the registration requirements of the Securities Act.[100] Instead of defining "non-public" with reference to the common or plain meaning of the term "public,"[101] the Court defined the term in reference to the goals of the legislation.[102] Since the purpose of the Act is to provide information to those who could benefit by disclosure, the Court defined "non-public offering" as an offering to those who economically and intellectually could fend for themselves.[103] Thus, subsequent case law and rules have employed the term "non-public offering" in a manner having no relationship to the plain meaning of the term "non-public."[104] The term "non-public offering" has become a term of art and really means "offering to persons not in need of the protection of the Act." Only those familiar with the subsequent history of the term are on notice that it has this cipher-like character.[105] Moreover, as more courts define terms solely with reference to the Act's goals, the lawmaking role of the courts expands.[106] Substituting judicially created specialized meanings for terms that had a plain and common meaning allows the courts to usurp the legislative role.[107]

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[99] 346 U.S. 119 (1953).

[100] Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1982).

[101] "Public" is defined as: "1) of, pertaining to, or affecting a population or community as a whole; 2) open to all persons." RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1096 (College ed. 1969). Thus, "nonpublic" normally would refer to an offering not made in a public manner, or to the community at large.

[102] "Keeping in mind the broadly remedial purposes of federal securities legislation, . . . the focus of inquiry should be the need of the offerees for the protections afforded by registration." *Ralston Purina*, 346 U.S. at 126-27.

[103] *Id.* at 124-25.

[104] *See generally* SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972) (the ultimate test of whether an offering is public or private is whether the particular class of persons affected needs protection of the Act); Hill York Corp. v. American Int'l Franchises, Inc. 448 F.2d 680 (5th Cir. 1971) (the question of public offering is one of fact and must depend upon the circumstances of each case); regulation D (codified at 17 C.F.R. § 230.501-.506 (1985)) (Rules Promulgated to Effectuate the Securities Act of 1933), former rule 146, Securities Act Release No. 4552 (Nov. 6, 1962).

[105] By "cipher" is meant that the term "nonpublic offering" has become a code word, or symbol (like *X*) for a much different meaning.

[106] Allowing courts to determine whether the goals of the act are being met gives them wide discretion to fashion law and results. In this manner, the judiciary and not the legislature becomes the lawmaker. Antitrust laws illustrate this. The Sherman Act provides a very broad design that the courts must fill in.

[107] By disregarding plain meaning, courts usurp the legislative role, supplanting

Furthermore, one expects the threshold or entitlement concepts that trigger the application of substantive law to exist independently from the law itself.[108] For example, the Constitution protects property but does not define it. Hence, a court analyzing whether some interest is property must turn to sources outside of the Constitution.[109] To determine whether a professor's interest in tenure is property, a court would refer to rights created by state law.[110]

The threshold concept of a security can be viewed as an entitlement[111] much like property or liberty in the Constitution. The securities acts determine the protection given those participating in securities transactions. However, the acts must, at least in part, refer to instruments created outside of the acts themselves. By necessity, the abstractions of the securities acts must relate to the real world.[112] Since law is intended to act upon real individuals, the securities legislation must have some reference to the world of real individuals. Thus, even though

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their own intention when the legislature's intent was clear. *See* Remillard Brick Co. v. Remillard-Dandini, 109 Cal. App. 2d 405, 241 P.2d 66 (1952) (interpreting a corporation statute such that "or" means "and"). In *Sturges*, 17 U.S. (4 Wheat.) 122, 202, the Court stated:

> [I]f, in any case, the plain meaning of a provision, not contradicted by any other provision in the same instrument, is to be disregarded, because we believe the framers of that instrument could not intend what they say, it must be one in which the absurdity and injustice of applying the provision to the case, would be so monstrous, that all mankind would, without hesitation, unite in rejecting application.

[108] For example, the entitlement interest of property which accords a person due process treatment is defined by understandings and expectations generated by state law sources. As the Court stated in *Roth*, 408 U.S. at 577: "Property interests, of course, are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law — rules or understandings that secure certain benefits . . . ." Moreover, in Perry v. Sindermann, 408 U.S. 593, 601 (1972), the Court added: "A person's interest in a benefit is a 'property' interest for due process purposes if there are such rules or mutually explicit understandings that support his claim of entitlement to the benefit and that he may invoke at a hearing."

[109] Whether reasonable expectations or positive state statutory rights form the basis for a property interest has been the center of extensive judicial debate. *See generally* L. TRIBE, AMERICAN CONSTITUTIONAL LAW §§ 10-10, 10-11, at 522-32 (1978).

[110] *See Roth*, 408 U.S. at 564.

[111] Both "security" and "property" are entitlements. One must have them in order to obtain access to the protective scheme of the securities acts or the Constitution. In other words, to benefit, one must possess either a security or the requisite kind of property.

[112] *See supra* note 91.

a 501(c)(3) corporation is an abstraction of the tax code,[113] it must refer to a type of corporation. A corporation is a concept that obtains its meaning from sources of law outside the tax code. Finally, the state law sources that define a corporation declare how this abstraction relates to the rights and duties of real individuals.[114]

Thus, like constitutional provisions, the securities laws must refer at some level to entities or instruments outside of the scheme of securities laws.[115] Normally, such outside reference is accomplished by threshold or triggering concepts such as property or security.[116] More concrete usage of the term results in greater fairness to the parties. The more vague or policy referenced the term, the more difficulty parties have determining whether their conduct comes within the scope of the legislation. This concern for independent definition and objective clarity in the case of threshold concepts is more significant than the concern about vague terms in statutory interpretation generally.[117] As stated

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[113] A "501(c)(3) corporation" would be a corporation eligible to receive charitable contributions.

[114] In this manner the "fictitious" legal world of corporations interacts with real "persons." Yet the deconstruction can continue even further. "Person" is a legal concept that allows a continuity of legal consequences to affect a changing human individual. Thus, the contracts made by a man who is 20 will be enforced against him at age 40, even though every cell in his body has changed, or even though he has undergone a complete personality change. *See* Hume, *The Theory of Personal Identity, reprinted in* W. BISHIN & C. STONE, LAW, LANGUAGE AND ETHICS 234-37 (1972); *see also* Morrow, *The Burnout of Almost Everyone*, TIME, Sept. 21, 1981, at 84 (noting a concept similar to Hume's, The "Doctrine of Discontinuous Selves"). It may be simplistic, albeit necessary, to say that state law sources define how the abstraction of a corporation interfaces with real individuals. However, it may not be so simple at all.

[115] *See supra* note 91.

[116] A statutory scheme must be composed of at least two elements, substantive rules and predicate conditions that determine when the rules apply. In other words, statutes can be viewed as a number of if/then statements. The purpose of a concept like a security is to simplify the predicate conditions for knowing when the securities laws generally apply. Thus, simple possession of a security or property puts a community on notice of the possible application of the substantive rules. The simpler the triggering concept, the more easily a society is apprised of the possible consequences. The more complicated the predicate conditions, as in the case of Racketeering, Influence and Corrupt Organizations Act (RICO), 18 U.S.C. § 1961 (1982), the less advance awareness members of the community have of the possible application of the substantive rules. Thus, keeping these access concepts relatively simple is a fundamental element of fairness in the application of the law. The notion of reification, discussed *infra* text accompanying notes 119-73, is based on this drive for fairness.

[117] Open-textured terms ("due process") or laws ("no vehicles in the park"), *see* H. HART, *supra* note 67, at 125, present the well-recognized possibility of policy-oriented interpretation that may be unfair to various parties. Thus, the erection of a stationary

earlier, for threshold concepts such as property or security, using policies of the acts to determine entrance into the protective regulatory scheme often allows judges to disguise a ruling on the merits as a decision on the existence of triggering entitlements such as property or security.[118]

III. Security: Res or Nexus-of-Commercial Relationships?

A concern closely related to the objection against defining threshold terms in a self-referencing manner is whether one should view a security as a reified object (instrument) or as a nexus-of-commercial relationships.[119] The more concrete or reified the concept of a security is, the greater is the necessity of having an existence grounded in sources outside of the securities acts.[120] As a result, it is easier to conceive of a

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monument in the form of a tank in the park may be considered a "vehicle" in the park because it presents the dangers that the legislature was concerned about (safety — the possibility that ballplayers will collide with the monument). Deeming such a stationary tank a "vehicle" may be considered unfair to the parties since it would have been difficult to anticipate this decision given the plain meaning of vehicle. Thus, the fairness problems discussed in the text also occur in common law adjudication and statutory interpretation. However, threshold terms such as "security" or "property" that are designed to give notice of wholesale application of statutory or constitutional schemes should be defined as tightly and independently (from the goals of the substantive rules) as possible. This is even more important than in the case of open, substantive rules such as the one regarding vehicles in the park.

[118] The danger is that judges may look at the merits of the case, then make result-oriented decisions on whether there is an entitlement such as "property" or "security." In constitutional law, this danger is articulated as the fear that if state judges determine what constitutes property, then they control constitutional outcomes by their determination of whether property exists. Thus, a court simply may decide that something no longer is property, or that certain property always belonged to someone else. Thus, if the predicate condition is not held to an independent, objective test, then whether a party has a right to substantive rules can be manipulated by state court recharacterizations of the predicate condition. *See* Hughes v. Washington, 389 U.S. 290, 296-97 (1967) (Stewart, J., concurring): "For a State cannot be permitted to defeat the constitutional prohibition against taking property without due process of law by the simple device of asserting retroactively that the property it has taken never existed at all." *See also* Robinson v. Ariyoshi, 441 F. Supp. 559 (D. Hawaii 1977), *aff'd*, 753 F.2d 1468 (9th Cir.), *petition for cert. filed*, 54 U.S.L.W. 3279 (U.S. Sept. 10, 1985) (No. 85-406). By controlling the predicate condition (definition of a security in terms of the policies of the acts) the court can control the application of the substantive rules.

[119] The phrase "nexus-of-commercial relationships" was inspired by Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 311 (1976) (corporation described as "legal fiction which serves as a nexus for contracting relationships").

[120] Consider two examples. One is "stock," which is a fairly reified concept. The

security as having objective, definable characteristics. On the other hand, if one views a security in a nonreified sense, as a relationship between persons, then it is more difficult to define its natural characteristics.[121] Moreover, the courts are likely to proceed on a case by case basis to determine whether a relationship creates a security, a process that inevitably will lead to determinations guided by the policies of the acts.[122] Under the nexus-of-relationship or transaction approach, the determination of whether a security exists will be based on whether conduct, as opposed to the use of an instrument, justifies application of the acts.[123] Hence, a relationship or transaction approach is likely to involve the same danger of self-referencing threshold definitions dis-

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other is the term "investment contract," which is defined in terms of (1) the investment of money for profit; (2) in a common enterprise; and (3) with returns solely from the efforts of others. *Howey*, 328 U.S. at 301. The question of whether an instrument is stock is proved by comparing its characteristics with the state law description: negotiability, ability to be pledged or hypothecated, having proportionate voting rights, and ability to appreciate in value. *See Forman*, 421 U.S. at 851. The nature of the characteristics associated with stock requires one to turn to state law for a definition and determination of applicability. The definition of investment contract, on the other hand, requires courts to examine the facts of each transaction on a case by case basis. Investment contract analysis does not necessitate reference to the characteristics of an investment contract under state law. This results because investment contract analysis primarily has been viewed a matter of federal common law development. *See infra* note 125. Furthermore, the elements of an investment contract do not appear to be natural or inherent qualities of instruments but rather the reflection of policy considerations. *See infra* note 133 (discussing the dual-level theory of a security).

[121] This is evident in the definition of "investment contract." Two of its three elements focus on the relationship between investors and other investors, and the investors and those managing the investment. The second element of the *Howey* test is whether there is a common enterprise. A "common enterprise" is a group of investors all pooling their money with a promoter. The third element of the *Howey* test requires that the profit derive solely from the efforts of persons other than the investors. *See Howey*, 328 U.S. at 301. Since the number and kinds of relationships among investors and between investors and promoters can vary, the test for an investment contract cannot be as neat and succinct as that for stock.

[122] *See supra* note 121. Investment contract analysis requires a case by case evaluation of the nature of the relationship between the investor and the promoter, and among the investors. On the other hand, those possessing stock have a security if they can simply prove the document itself. *See Landreth*, 105 S. Ct. at 2304 ("There is no need here [when considering stock], as there was in the prior cases, to look beyond the characteristics of the instrument to determine whether the Acts apply.").

[123] It is always more complicated to judge whether the parties' conduct, as opposed to the characteristics of the instrument, justify a finding of a security. Moreover, judgments of conduct call for greater discovery and involve the possibility of conflicting testimony. The characteristics of stock, such as negotiability, the right to receive dividends, or right to vote are readily discernible and can be stipulated to by the parties.

cussed above.[124]

Under the two-tiered approach, the nexus versus instrument approach is an issue at both levels. First, there is the question of whether stocks, bonds, notes, investment contracts, and other first level categories are reified instruments or transactions. Second, there is the issue of whether the second tier concept of a security is the description of a certain kind of instrument or a description of a certain kind of commercial relationship.

Under the suggested two-tiered model, all of the items in level one, including notes and instruments commonly known as securities, are treated as instruments. This means that even the nexus-like concept of an investment contract is treated as a reified instrument. The reason for treating these items as instruments is that at the time of the adoption of the securities acts, they commonly were understood under state law to be instruments.[125] Moreover, it is useful within the two-tiered scheme to consider these items (including investment contracts) state-created instruments. Viewing these categories in a reified manner clarifies that this level represents the referential aspect of the sections that define a security.[126]

On the other hand, the second tier, which represents the attributive aspect of the concept of a security, need not be viewed in a reified manner. While some state-created instruments commonly are known as securities,[127] using the term in this sense is different from the use of the term "security" in the federal acts. As used in the federal acts, the term has a more specialized meaning than the ordinary usage under state

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[124] In applying the *Howey* test (also referred to as "investment contract analysis") the judge has to determine whether the efforts in the investment enterprise come solely from the efforts of others. Since this issue often may be a close one, a judge may be tempted to rule unconsciously on the basis of whether he thinks the ultimate claim is meritorious. Cases involving multi-level "pyramid" schemes often call for a close determination as to whether the managerial effort comes solely from the effort of the promoter. *See* SEC v. Glenn Turner Enters., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

[125] In *Howey*, the Supreme Court referred to investment contracts as a "crystallized" and uniformly applied concept under state law. *Howey*, 328 U.S. at 298.

[126] When stocks, notes, bonds, and the like are viewed both as state-created and reified instruments, much of the open texture is removed from the process of applying these terms to a particular case. With objective characteristics that are determined by reference to state law, the determination of whether there is a stock or note becomes rather mechanical.

[127] *See supra* note 13. The Supreme Court has held that the meaning of "instrument commonly known as a security" is the same as that of investment contract. *Forman*, 421 U.S. at 852.

law. Other terms in the securities acts also have both lay and specialized meanings. For example, the term "underwriter" has an ordinary meaning but also a more precise meaning when used in the Securities Act of 1933.[128] The specialized use of the term "security" connotes the circumstances or context justifying the application of the acts. Thus, the second level attributive concept of a security is transaction based because it involves certain relationships between parties (concerning stocks, bonds, notes, or those instruments commonly thought of as securities) that call for the imposition of the acts' substantive rules.[129]

Is there a structure or essence that describes this kind of relationship between various parties? It often was asserted that the *Howey* dual-level theory of a security described the essence of that relationship.[130] The dual-level theory of a security[131] describes a situation when an investor places money with a promoter (first level) who then invests it in another enterprise.

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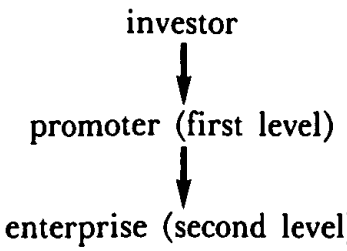
[128] The ordinary lay meaning of "underwriter" refers to investment bankers who act as middle men in the distribution of newly offered securities. *See* T. HAZEN, *supra* note 3, at 27-28. The Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11) (1982), defines underwriter more specifically, including insiders who sell large blocks of securities acquired from their corporation in a nonpublic offering. *See* § 2(11) of the Securities Act of 1933, 15 U.S.C. § 77b(11) (1982); SEC rule 144, 17 C.F.R. § 230.144 (1985); *see generally* Ira Haupt & Co., 23 SEC 589 (1946) (broker-dealer who sells under circumstances indicating dispersal of a large amount of shares among the public held to be an "underwriter").

[129] Thus, in lay or ordinary usage, the term "security" refers to an instrument commonly known as a security. Arguably, the more specialized use of "security" has two levels. The first is a presumption that all notes, stocks, bonds, and the like, which meet the characteristics for that category, are securities. The second is an exemptive concept that would exclude such instruments if the transaction did not justify application of the securities acts. Terms like "property" and "liberty" arguably have a similar two-step quality. For example, the first tier of the term "property" may include the familiar examples: fee simple ownership in land, personalty, and water rights. The second tier, reflective of the policies relevant to imposing the due process protection, may exclude certain interests in particular situations. *See* Paul v. Davis, 424 U.S. 693 (1976) ("reputation" alone does not constitute a protected liberty or property interest).

[130] 328 U.S. 293 (1946).

[131] *See* N. BUCHANAN, THE ECONOMICS OF CORPORATE ENTERPRISE 452-59 (1940), *cited in* V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 779-83 (2d ed. 1979).



The promoter may or may not control the enterprise. In any event, the investor does not control the enterprise and is dependent on others for a safe and profitable return.[132] Since the investor is not in the position as is the promotor to ascertain the risks of the enterprise, the promoter should give her full and fair disclosure prior to investment.[133] As the basis for the sale of business doctrine, parties seriously argued that the *Howey* dual-level theory was the essence of a security.[134] However, since *Gould* and *Landreth* rejected the sale of business doctrine, it is evident that the dual-level theory does not describe a security's essential structure.[135]

Nevertheless, the rejection of the sale of business doctrine does not undermine the contention that the concept of a security should be viewed in nexus-of-relationship or transaction terms.[136] The essential

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[132] If the investor had substantial control over the investment enterprises she would have access to the information necessary to evaluate the risks involved. When she is isolated from control and without sufficient bargaining power to compel disclosure, the law should require disclosure, either in the form of antifraud rules or registration requirements. Hence, the acts should apply only when the investor relies on a return solely from the efforts of others. This is the third element of the *Howey* test. Without it, no finding of an investment contract and thus a security can stand; neither the antifraud nor the registration rules are activated.

[133] The essence of the dual-level theory is that the investor needs disclosure to evaluate the risks that her promoter is taking:

> The prospective security buyer is not dealing with the probable returns from a real capital good whose form and shape he personally supervises. The problem that confronts him is as follows: How sound is my judgment of the soundness of the promoters' judgment concerning the probable yield from the real capital goods that this enterprise proposes to use? What he really has to do is to appraise the promoters' appraisal of the venture that they regard as an investment opportunity.

N. BUCHANAN, *supra* note 131, at 454.

[134] *Groen*, 687 F.2d 197; *Winkler*, 673 F.2d 342; *Poloway*, 637 F.2d 1147.

[135] *See Landreth*, 105 S. Ct. 2297; *Gould*, 105 S. Ct. 1161.

[136] Although the Supreme Court disposed of a transaction-oriented approach to stock, it deliberately left open the question whether notes, bonds, or other instruments would be evaluated on the basis of circumstances surrounding the transaction. "We here expressly leave until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only]

registration and exemptive provisions of the 1933 Securities Act treat securities in a transaction sense.[137] The Act requires registration of securities *transactions*.[138] The critical exemptions are framed as *transaction* exemptions.[139] Furthermore, the phrase preceding the definition of a security, "unless the context otherwise requires . . . ," supports a transaction concept of a security.[140] This language implies that if the transactional circumstances surrounding the use of an instrument do not warrant application of the acts, the concept of a security operates as a transaction exemption[141] to exclude the instrument from consideration as a security much like section 4 of the 1933 Act.[142]

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the document itself.' " *Landreth*, 105 S. Ct. at 2306 (citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943)).

[137] The term "security" generally connotes a reified instrument. *See* Securities Act of 1933, § 3, 15 U.S.C. § 77c (1982) (exempting securities). The registration and exemption sections are not triggered by securities but by securities transactions. In such sections, the relationship between the parties, not the incidental presence of an instrument known as a security, determines that section's application. For example, the Supreme Court in *Ralston Purina*, 346 U.S. 119, interpreted the transaction exemption for nonpublic offerings in terms of the nature of offerees.

[138] The Securities Act of 1933, § 5(a), 15 U.S.C. § 77e(d) (1982), makes it unlawful to sell a security unless a registration statement is in effect. Every sale involving a security must either be registered or exempt from registration. Thus, an initial registration does not operate as a dog tag to validate the sale of that security into the future. The application of §§ 4 and 5 of the Securities Act of 1933 requires one to find an exemption for every transaction. 15 U.S.C. §§ 77d-e (1982).

[139] Section 4, 15 U.S.C. § 77d (1982), is entitled "Exempted Transactions" and encompasses the bulk of situations in which securities transactions are exempt. Section 3, 15 U.S.C. § 77c (1982), exempts certain kinds of securities such as government securities and securities issued by savings and loan associations. Section 3(a)11, 15 U.S.C. § 77c(a)(11) (1982), although within the section on exempted securities, acts more like a transaction exemption in that it exempts "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory. . . ."

[140] *See* §§ 2 & 3 of the Securities Act of 1933, 15 U.S.C. §§ 77b & 78c (1982) (both using the language "unless the context otherwise requires . . . .").

[141] The judicial development of the concept of a security (the second tier) is similar to judicial interpretations of § 4(2), which exempts otherwise applicable instruments from the securities acts.

[142] Section 4, and particularly § 4(2) of the Securities Act of 1933, provides a means of developing a judicial common law through which the "context otherwise requires" the application of the securities acts. For a discussion of judicial "statutory law" in the interpretation of § 4(2), see generally Note, *A Position Paper of the Federal Regulation of Securities Committee, Section of Corporation, Banking and Business Law of the American Bar Association*, 31 BUS. LAW. 485 (1975).

A. The Investment Contract as an Instrument

The logical corollary to treating the second-tier concept of a security as an open, attributive provision is that one must treat the category of investment contracts as referring to a class of instruments. Indeed, the two-tiered model treats all first level items, including investment contracts, as instruments. These instruments have characteristics derived from state law understandings or expectations. While this is obvious in relation to categories of enumerated instruments such as stock,[143] the so-called catch-all phrase investment contract has always been treated in a transaction or relationship manner.[144]

Historical justification exists for treating investment contracts as instruments. The Supreme Court in *Howey* stated that the term had a "crystallized" meaning before 1933.[145] Subsequently, lower federal courts have misinterpreted *Howey* and sought to make investment contract analysis the attributive, policy-based aspect of the concept of a security. Their opinions created interpretive difficulties; they threatened to render superfluous all the enumerated categories in the definition. Furthermore, using investment contract as a catch-all term led to the development of the sale of business doctrine.[146] One might interpret the Supreme Court's rejection of that doctrine as affirming the referential, as opposed to catch-all or attributive, use of the term "investment contract."[147]

The federal common law puts such a heavy gloss on the term "investment contract" that courts may have difficulty returning investment contracts to the category of instruments created and defined by state law. Investment contract analysis has been viewed as a question of fed-

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[143] *See generally Gould*, 105 S. Ct. at 2308; *Landreth*, 105 S. Ct. at 2297.

[144] Indeed, the "flora and fauna" securities cases have been brought largely on the basis of investment contract analysis (which focuses on the relationship between the parties and manner of offering). *See generally Howey*, 328 U.S. 293 (orange groves); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) (distribution of cosmetics); Continental Marketing Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968) (beavers); SEC v. Tung Corp. of America, 32 F. Supp. 371 (N.D. Ill. 1940) (tung trees). Transactional elements, such as the manner of offering, have usually determined whether real estate interests such as rental pool arrangements, timesharing interests, or condominiums are investment contracts. *See Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development*, Securities Act Release No. 5347 (Jan. 4, 1973).

[145] 328 U.S. 293, 298 (1946).

[146] *See supra* text accompanying notes 16-28.

[147] *See supra* note 83.

eral law with little reference to its state law origins. For example, while reference to the original state law concept should answer the question of whether horizontal commonality[148] is required, the lower federal courts have used the policies of the acts for guidance.[149]

Fortunately, most interpretations of the term "investment contract" have resembled the original definition.[150] The policy concerns that have gone into investment contract analysis are more appropriately addressed in fashioning the proper concept of a security. For example, the notion of vertical commonality[151] which has been urged by some lower courts should not be forced upon the *Howey* test as an awkward modification.[152] Rather, the policies behind the adoption of vertical commonality should be employed at the second tier level of the concept of a security.[153]

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[148] "Horizontal commonality" refers to an interpretation of the common enterprises requirement of the *Howey* test. Courts applying horizontal commonality require at least two investors who pool money and invest it with a promoter. "Vertical commonality" refers to courts not requiring more than one investor "at the same level." Such courts find sufficient "common enterprise" if the promoter and investor have a common interest in seeking a profit. *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977) (requiring horizontal commonality); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972) (finding horizontal commonality absent in the case of discretionary trading accounts and thus holding that no security was involved). *But see* Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974) (holding horizontal commonality not required and vertical commonality sufficient in a case involving discretionary trading accounts).

[149] *Hirk*, 561 F.2d 96.

[150] The only areas of interpretive difficulty have been the common enterprise requirement, *see supra* note 148, and whether the requirement that the efforts be "solely from the efforts of others" can be construed as "substantially from the efforts of others." *Glenn W. Turner Enters.*, 474 F.2d 476 (relaxing the requirement that efforts come "solely" from the efforts of others).

[151] *See supra* note 148.

[152] The court in *Lamson Bros.*, 368 F. Supp. at 489, argued that the Supreme Court in *Howey* never intended to require horizontal commonality.

[153] Under the two-tier test, the state-generated description of investment contract should apply. If that definition requires horizontal commonality, then an arrangement that allegedly is an investment contract must meet that qualification. Hence, as to investment contracts, the horizontal-vertical commonality issue would be dead. No arrangement lacking horizontal commonality would survive the first level test; thus, the second tier concept could not be used to reintroduce such arrangements at the second level. However, this is a completely different question than whether notes should require horizontal commonality. The resolution of that issue (as to investment contracts) has no bearing on whether notes that demonstrate only vertical commonality could be securities.

B. Stocks, Bonds, Notes as Instruments: Which Law Governs?

Under the two-tiered model, the first level instrument categories are to be defined by state law. To determine whether a particular type of stock is truly stock, the court must decide whether to look to the specific law of the state of incorporation or to state law in general.[154] A sensible answer is that the drafters used these terms in an indexical manner.[155] By use of the term "stock," they did not mean stock as defined by the particular corporation statute of the state of incorporation. Rather, they used the term to fix a reference to a paradigm of stock.[156] For example, to "fix the reference"[157] of water one might point at a glass of clear liquid and say, "by 'water,' I mean that stuff there." If the liquid

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[154] In *Landreth*, the Supreme Court did not look to the law of the state of incorporation (Washington) to determine whether the stock would be considered stock. The Court has never intimated that the law of the state of incorporation governs. The language quoted in *Forman* refers to characteristics "typically associated with common stock." *Landreth*, 105 S. Ct. at 2302. Indeed, state statutes do not define what they mean by stock in a relevant manner. *See generally* AMERICAN BAR FOUNDATION, MODEL BUSINESS CORP. ACT ANNOT. § 1.40(21) (West 1982) (defining "share" as follows: "the unit into which the proprietary interests in a corporation are divided.").

[155] This Article uses "indexical" in the sense of "to serve to indicate." Thus, by the term "stock" the drafters of these definitional sections were using the word as if pointing to a common type of stock. They had in their minds a paradigm concept of a stock that had all the usual characteristics. *See generally* Putnam, *Meaning and Reference*, 70 J. PHIL. 699, 711 (1973) (emphasis in original):

> We have now seen that the extension of a term is not fixed by a concept that the individual speaker has in his head, and this is true both because extension is, in general, determined *socially* — there is division of linguistic labor as much as of "real" labor — and because extension is, in part, determined *indexically*. The extension of our terms depends upon the actual nature of the particular things that serve as paradigms, and this actual nature is not, in general, fully known to the speaker.

[156] At least the Supreme Court thinks so. *See Landreth*, 105 S. Ct. at 2306 (citing Daily v. Morgan, 701 F.2d 496, 500 (5th Cir. 1983) ("First, traditional stock 'represents to many people, both trained and untrained in business matters, the paradigm of security'. . . .").

[157] To "fix a reference" is to use a term in an indexical manner. Schwartz describes it as follows:

> When we introduce the term it is not necessary that we know the nature of the stuff we are naming. We hope that such knowledge will come with empirical scientific investigations. The term, once introduced, can be handed on from person to person in the referential chain, maintaining its original reference at each link. Putnam calls a term that is introduced by means of a paradigm and is meant to refer to whatever has the same underlying nature as the paradigm "an indexical term."

NAMING, NECESSITY, *supra* note 44, at 33.

turned out to be hydrochloric acid, the speaker was not intending to say that hydrochloric acid was water.[158] By pointing, the speaker was "fixing a reference." Whether or not the stuff in the glass was really water, the speaker's intent was to refer to the real thing, water.[159]

Similarly, the terms "stock," "note," and the like were meant to fix a reference to the real things, stock, bonds, notes, and the like. The real essence of stock can be garnered from general understandings and expectations. For example, if the issue were whether nonvoting stock were stock for the purpose of the securities acts,[160] the law of the state of incorporation would not solely control. Rather, general understandings and the proper usage of the word "stock" would prevail.[161]

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[158] *Id.*

[159] Real water has the scientific structure of real water. *See* Putnam, *The Meaning of Meaning*, in 2 H. PUTNAM, MIND, LANGUAGE AND REALITY PHILOSOPHICAL PAPERS 238-41 (1975).

[160] Nonvoting stock is considered stock for most other corporate purposes. More interesting questions would be raised over stock that had no proprietary rights. Would stock that had no right to receive dividends or to receive assets upon dissolution be deemed not to constitute stock for the purposes of the securities acts? Reference to the law of state of incorporation generally has been inconclusive. State law does not define stock and does not prohibit the existence of nonproprietary stock. *See* Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800 (1966) (class of stock that did not receive dividends held not violative of state law); *see also* Stroh v. Blackhawk Holding Corp., 48 Ill. 2d 471, 272 N.E.2d 1, 8 (1971) (Schaefer, J., dissenting):

> What remains, then [of stock with no right to dividends or rights on dissolution], is a disembodied right to manage the assets of a corporation, divorced from any financial interest in those assets except such as may accrue from the power to manage them. In my opinion, what is left after the economic rights are "removed and eliminated" is not a share of corporate stock under the law of Illinois.

[161] To fix a reference by use of the paradigm of stock without basing such a paradigm on any particular state statute is essentially to "know it" when one "sees it." Two factors lead to this result. First, state statutes and decisional law do not routinely define "stock" in any particular manner. The terms "stock" and "shares" are used in state statutes as if there is a common, acceptable paradigm meaning to these words. Second, it is common to use terms in this indexical or paradigmatic fashion. We use the term "atom" sensibly without having a concrete understanding of an atom's structure. Moreover, we use words such as "dreaming" and "pain" with complete confidence that everyone understands what we mean even though we do not fully understand the scientific aspects of these phenomena. The same can be said of "stock." *See generally* NAMING AND NECESSITY, *supra* note 44.

C. The Utility of Reification

One might ask what difference it makes if items such as stocks and notes are deemed reified objects or labels for types of relationships.[162] Both seem to describe the same phenomena.[163] Nevertheless, reification has a certain utility that is worth preserving in the securities acts. Reification allows complex patterns of legal relationships with attendant consequences to be simplified into mental economies.[164] Moreover, the reification of relationships into instruments facilitates a continuity of legal results across time.

As an illustration, one might examine the concept of a pawn.[165] A pawn may either be instrument-like, as the physical symbol of a concept, or it may be a mental economy that stands for a number of differ-

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[162] *See* W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 98 (1980):

> Reification is a useful device; it allows us to manage complexity . . . . In law, the idea of the separate entity serves the further, more mundane, function of symbolizing a set of important legal rules or doctrines, such as limited liability of shareholders. . . . When the entity theory leads to bad results, the courts often find ways to avoid or ignore it. Still, reification is a device for making something that is in fact complex seem simple, and that can be dangerous.

[163] It is not profitable to ask whether the real nature of a security is that of an instrument or whether it is the symbol for a set of relationships as a corporation may be. The way that we commonly talk about securities seems to indicate that it is an instrument. If one feels that to understand a word is to know how to use it correctly, it seems that "security" has a reified nature, just as a corporation does. However, the term "security" is treated as a concept as often as it is treated as a res. Since it is of a conceptual nature, similar to a "corporation," the nature of a security is whatever we deem it is. But if we are looking to find res-type characteristics we will find such characteristics. If we seek to view it as a set of relationships, then, we find it to be a set of relationships. The res versus aggregation-of-relationships nature of a security, like that of a corporation, depends on the purpose of the inquiry. This is shown by the history of the doctrines allowing disregard of the corporate entity. *See generally* Hamilton, *supra* note 88. The historical tension between the aggregate versus entity theory in partnership law also demonstrates of the dual nature of reified entities in law. *See* United States v. A & P Trucking Co., 358 U.S. 121 (1958); Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377 (1963). *See also* F. CAPRA, THE TAO OF PHYSICS 56 (1975) (the dual wave/particle nature of light).

[164] *See supra* note 162. The term "mental economy" or "economy of thought" has been attributed to the physicist Ernst Mach. *See* N. CAMPBELL, FOUNDATIONS OF SCIENCE: THE PHILOSOPHY OF THEORY AND EXPERIMENT 222 (1957) (in Mach's view, "the object of science is to attain 'economy of thought.' ").

[165] *See generally* Snare, *The Concept of Property*, 9 AM. PHIL. Q. 200 (1972). Snare makes the point that things like property or a pawn are defined by the contextual rules that create their existence.

ent rules in the game of chess.[166] The physical, reified pawn is useful because it reminds us that all pawns have the same powers and that pawns can make only specific moves at any stage of the game. Thus, reification enables the players to feel relatively certain about the consequences of moving a piece.

Stock is like a pawn. It stands for or is a mental economy for a number of different possible moves within the "corporate game." Stock can be bought, sold, pledged, hypothecated, or split. Having stock enables a player to make a variety of moves such as receiving dividends, or voting for the election of directors, for merger, for consolidation, or for the dissolution of the corporation. The utility of the reification of stock is that to have stock is an indication of all of these possible moves. Moreover, one who has stock assumes that similar consequences will attach to certain moves regardless of the point in time in the game. The purchase or sale of stock should have the same legal consequences whether it is done today or next month. In other words, the stock still should be stock a month from now.[167] Anything that detracts from this general uniformity of consequences across time detracts from the fairness of the game.[168] If players can change the rules at any time, the game is unfair; the players would become hesitant about their moves.[169] If the consequences of making a move or the powers associated with

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[166] For example, pawns are allowed to move straight ahead, one space at a time, except for the first move in which, if unobstructed, they are allowed to move two spaces. Pawns are allowed to capture other enemy pieces that are diagonally ahead of them. These rules and others, including the rules that define what other pieces can do vis-a-vis pawns, define "pawn."

[167] One of the arguments against the adoption of the sale of business doctrine was that stock would be considered a security under some circumstances (purchases of less than 50%) but not in other circumstances (purchase of a controlling interest).

[168] Problems of fairness and reliance inevitably are raised when a reified entity is deconstructed due to circumstances surrounding the transaction. For example, in "piercing the corporate veil" a corporation that would have all normal attributes of a corporation, such as limited liability, is denied its "corporateness" for policy reasons. Another example is the recharacterization of debt as equity in either the corporate or tax context. *See* Obre v. Alban Tractor Co., 228 Md. 291, 179 A.2d 861 (1962) (majority shareholder's debt characterized as equity by court below for tax purposes). Changing the rules or powers of reified instruments or entities (such as corporations) undermines the concept of having reified entities. Instead, parties become accustomed to the notion that the rules are determined on a case by case basis.

[169] For example, the development of the doctrine allowing disregard of the corporate entity, even when the shareholders have taken all the necessary steps to form a corporation, creates uncertainty as to when shareholders may rely on limited liability. The more deconstruction of the entity, the more uncertain and hesitant shareholders become to form corporations with minimal capitalization.

stock changed depending on the stage of the game or the situation one was in (even according to preexisting rules) the game would become very complex.[170] This would make the game unfair and require that only the extremely sophisticated participate.[171]

The sale of business doctrine was a rule that changed the powers of stock depending on the circumstances of the transaction. Thus, in the same sense that an imagined rule might make a queen a pawn depending upon what pieces surrounded it, stock was not always stock. Under the sale of business doctrine, stock was not stock (for the purposes of the securities acts) when a controlling block of stock was sold.[172] Consequently, players could not determine in advance when the doctrine would apply, making the doctrine too disruptive of the game, and thus unfair.[173]

Hence, the importance of maintaining the instrument-like or reified nature of stocks, bonds, and the like lies in retaining fairness in the corporate game. Those who manipulate these instruments are aware in advance whether moves made with stock or notes will trigger the application of the securities acts. Preserving the instrument quality of these items signals that the same consequences will result throughout the

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[170] The complexity of games that vary the powers of pieces depending on the point in the game and the circumstances surrounding the piece is illustrated by modern battle strategy games such as D-Day and Panzer Leader (Avalon Hill).

[171] Legal "games" (securities, corporations, or tax) with extremely complicated rules require lay persons to employ experts to assist them with the rules. This makes access to such games only available to persons with substantial financial resources. Moreover, investor suitability rules, often designed to protect the investor by allowing only those who are rich or smart to participate, *see supra* note 95, help the rich to get richer while the middle class maintains its status. Often, the complexity that justifies excluding those lacking sophistication is without basis. Such complexity is magnified by the mystical use of concepts such as "corporation" and "security."

[172] The basis of the sale of business doctrine was that the substance of the transaction, namely acquisition of assets, should not be overshadowed by the form of the transaction, the purchase of stock. *See Gould*, 105 S. Ct. at 2313 (Stevens, J., dissenting) ("I do not believe Congress intended the federal securities laws to govern the private sale of a substantial ownership interest in these operating businesses simply because the transactions were structured as sales of stock instead of assets.").

[173] *Landreth*, 105 S. Ct. at 2307:

> More importantly, however, if applied to this case, the sale of business doctrine would also have to be applied to cases in which less than 100% of a company's stock was sold. This inevitably would lead to difficult questions of line drawing . . . . [C]overage by the Acts would in most cases be unknown and unknowable to the parties at the time the stock was sold. These uncertainties attending the applicability of the Acts would hardly be in the best interests of either party to a transaction.

game. As in the case of the objection against self-referencing definitions, this advance knowledge of consequences is a critical element of fairness in the application of the securities acts.

IV. A Revisionist View From *Howey* to *Landreth*: The Two-Tiered Test

The two-tiered test is a convenient vehicle for reconciling the diverse approaches the Supreme Court has taken in recent cases.[174] One way to view this apparent fit is that the concerns about reference to state-created instruments and reification reflect forces in the application of the acts that have pushed the Court towards an intuitive, if unarticulated, resort to a two-tiered approach.

The first notable decision is *SEC v. Howey*.[175] *Howey* generally is considered the most critical Supreme Court decision defining a security. Many courts have assumed that the three-part *Howey* test sets forth the economic realities or essential structure of a security.[176] However, under the two-tiered approach, *Howey* is not a decision defining "security" but an application of "investment contract," a term originally defined by state law.

In *Howey* the Court acknowledged this state law background for investment contracts when it stated, "The term 'investment contract' is undefined by the Securities Act or by relevant legislative reports. But the term was common in many 'blue sky' laws in existence prior to the adoption of the federal statute . . . ."[177] The Court also noted that the meaning of the term "had been crystallized" even prior to state blue sky interpretation.[178] A broad catch-all phrase generally is not considered a term that has a crystallized meaning.[179] Thus, investment contract should connote more a class of instruments whose meaning derives from nonfederal understandings and expectations.[180]

Subsequent to *Howey*, many courts have viewed the investment contract test as federal in nature.[181] Instead, *Howey* should be viewed as

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[174] *See supra* note 9.

[175] 328 U.S. 293 (1946).

[176] Courts adopting the sale of business doctrine argued that the *Howey* test constitutes the economic reality of a security. *See, e.g.*, cases cited *supra* note 134.

[177] 328 U.S. at 298.

[178] *Id.*

[179] *See, e.g., id.*

[180] *See* State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920).

[181] For example, the courts that have considered the issue of modifying the third element of the *Howey* test (solely from the efforts of others) or the common enterprise

the incorporation of a state law term, to be given its state law meaning.[182] As noted previously, terms such as "stock" and "investment contract" should find consistent definition by reference to state law.[183] Within the framework of the two-tiered model, the issue in *Howey* is the proper interpretation of "investment contract," the state law term, not the interpretation of "security."

Second in importance to *Howey* is the decision in *United Housing Foundation v. Forman*.[184] *Forman* has been the source of differing interpretations of definitional section 2(1).[185] This is because *Forman* used two-step, disjunctional reasoning.[186] The issue in *Forman* was whether shares in a publicly financed housing cooperative were securities for the purpose of the federal acts. The Court first held that the "shares" did not fall within the category stock as that term is generally understood under state law. Second, the Court held that the shares did not fall within the investment contracts category.

Under the two-tiered approach both "stock" and "investment contract" are classes of instruments defined by legally created expectations and understanding. For an instrument to qualify as a security it first must fall within the class of instruments on the first level. Plaintiffs argued that the instruments were either stock or investment contracts. The Supreme Court held that neither category applied.[187] Since establishing inclusion within any category satisfies the first level require-

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requirement have noted the relevance of state cases interpreting the term "investment contract," but have not indicated an obligation to apply the original state law definition. *See* Hirk v. Agri-Research Council, 561 F.2d 96 (7th Cir. 1977) (requiring horizontal commonality but not discussing relevance of state law); SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir. 1973) ("solely from the efforts of others" modified by federal court). *But see* Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974) (indicating relevance of state law).

[182] As in the case of "stock," the term "investment contract" would be interpreted by reference to its paradigm cases. *See supra* notes 154-55. Thus, the law of the situs of the investment contract does not govern.

[183] *See supra* note 182.

[184] 421 U.S. 837 (1975).

[185] Litigants have argued that the *Forman* decision supports both the adoption and rejection of the sale of business doctrine. *See, e.g., Daily*, 701 F.2d at 498 ("Using sophisticated cut-and-paste techniques, both sides argue that we are bound by [*Forman*, 421 U.S. 837]"). The plaintiffs in *Daily* argued that if the stock meets all ordinary qualifications for stock and is used in the transaction, then the stock should be deemed a security. The defendants in *Daily* argued that the three-part *Howey* test should apply to all securities. Thus, stock that did not fit within the *Howey* test was not a security.

[186] 421 U.S. at 852.

[187] *Id.* at 848-52.

ment, the plaintiffs logically argued in the alternative. Thus, the Supreme Court had to examine inclusion in both categories.[188] Hence, one should not view the Court's two-part opinion as implying a two step catch-all approach, under which one looks first to the enumerated classes and then (failing there), examines the catch-all phrase for inclusion.[189]

If *Forman* is two step in nature, it is because the test allows the evaluation of a number of different categories of the same level. For example, *Forman* easily may have involved four steps if the plaintiffs had argued that the shares were (1) stock, (2) investment contracts, (3) instruments commonly known as securities, or (4) certificates of interest or participation in any profit-sharing agreement. Moreover, one arrangement or instrument may fit more than one class. Consider the case of hybrid stock that has a mixture of debt and equity characteristics.[190] Plaintiffs may argue that such instruments are (1) notes, (2) stock, (3) treasury stock (if held by the issuer), (4) bonds, (5) debentures, (6) evidences of indebtedness, (7) investment contracts, or (8) instruments commonly known as securities. Thus, the two-step nature of *Forman* does not indicate two different tiers or levels of analysis. It reflects the possible number of classes into which instruments may fall. Seen in this light, *Forman* merely applies two first level categories. However, since the plaintiffs failed at the first level, the Court in *Forman* did not rule on what constitutes the concept of a security.

Forman strongly reinforces the notion that investment contract is not a residual catch-all phrase.[191] While language in *Forman* implies that

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[188] *Id.* at 851.

[189] Those arguing against the application of the sale of business doctrine urged that this was the proper interpretation of *Howey*. *See Daily*, 701 F.2d at 498-500. However, under this interpretation, some notes that failed the test for notes might be included as investment contracts. The probable legislative intent, however, was that these categories should be read together and not in a manner that allows one category to undermine another.

[190] Hybrid stock is issued for the purpose of allowing shareholders to have the managerial control associated with stock but the tax advantages of debt. *See generally* Slappey Drive Indus. Park v. United States, 561 F.2d 572 (5th Cir. 1977); Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972). The Tax Reform Act of 1969 authorized the Internal Revenue Service (IRS) to prescribe regulations on whether to treat debt as stock. *See* 26 C.F.R. § 385-1 (1983).

[191] While the Supreme Court in *Howey* stated that the concept of an investment contract should be applied flexibly, 328 U.S. at 299, other courts have viewed the phrase and its equivalent "instrument commonly known as a security" as a catch-all term, implying that the judge is relatively free to find an investment contract when she sees fit. *See Groen*, 687 F.2d at 200.

investment contract applies flexibly,[192] *Forman* is more consistent with the two-tiered model's treatment of investment contracts as a stock-like category.

Tcherepnin v. Knight[193] also strongly suggests that the two-tiered structure may be inherent in sections 2(1) and 3(a)(10). The issue in *Tcherepnin* was whether withdrawable capital shares in a state savings and loan association constituted securities for the purposes of Securities Exchange Act section 3(a)(10). The shares conferred a right to vote and to receive dividends from profits at the board's discretion.

The *Tcherepnin* Court acknowledged the instrument quality of the class of items on the first level. The Court found these capital shares were most similar to investment contracts, but also fit within other categories such as certificates of interest or participation in any profit-sharing arrangement, stock, and transferable share.[194] The Court found no reason to exempt these shares from treatment as securities and held the securities acts applicable.[195] The Court discussed the House Committee testimony which indicated a possible intent to exclude such shares from coverage.[196] However, the Court refused to find this evidence dispositive. Under the two-tiered approach, such evidence would go to second level considerations — the exemptive qualities of the concept of a security. Hence, *Tcherepnin* fits within the notion that the first level encompasses instruments of equal dignity. Furthermore, like *Howey*, the holding of *Tcherepnin* does not define the exemptive concept of a security.

In *Marine Bank v. Weaver*,[197] the Supreme Court started to explore the contours of the concept of a security. In *Marine Bank*, an individual pledged a six-year certificate of deposit (CD) to guarantee a loan to a third party in connection with a profit-sharing agreement. Instead of focusing on whether the withdrawable capital shares in *Tcherepnin* were instruments, the *Marine Bank* Court analyzed whether the circumstances surrounding the transaction would justify not treating the instrument as a security.

Under the suggested two-tiered approach, one first must find an appropriate instrument such as stock or a note. Subsequently, the concept of a security can exempt an instrument for contextual reasons. In *Marine Bank*, the Supreme Court held that whether or not the CD fell

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[192] 421 U.S. at 852.
[193] 389 U.S. 332 (1967).
[194] *Id.* at 339.
[195] *Id.*
[196] *Id.* at 340-41.
[197] 455 U.S. 551 (1982).

within a first tier category, it failed because the second tier concept of a security excluded it for policy reasons. Under the two-tier test, a court need not rule on the first level if second level considerations would exclude the instrument. Because the Court skipped the first level and ruled on the second, one should view its ruling as a ruling on the concept of a security.

Addressing the first level, the lower court in *Marine Bank* held that CD's fell within several of the first level categories. The lower court held that the CD was functionally equivalent to the shares in *Tcherepnin*. Alternatively, the lower court held that the CD fell into either the class of long-term debt obligations, (presumedly meaning the class of bonds and debentures) or the class of evidence of indebtedness.

The Supreme Court in *Marine Bank* held that the lower court was wrong on both theories. First, the Court stated that the CD was not like stock because it paid a fixed rate of return while stock received dividends that varied, depending on profit.[198] Moreover, purchasers of capital shares received voting rights.[199] Second, the Court stated that CD's are different from other long-term debt obligations because the FDIC insures them.[200] CD's are also comprehensively regulated through rules governing the banking industry.[201]

This reasoning raises the issue of whether the Court was excluding CD's for first or second level reasons. The Court stated that a CD is different from other long-term debt instruments because there is no risk factor. One must ask whether the lack of risk is an objective characteristic of the kind of long-term debt that constitutes the first tier category or whether lack of risk is part of the essence of a security, thus representing a second level exclusion. To determine whether the exclusion occurred at the first or second level, the question is whether the defeating consideration (the lack of risk because of federal guarantee) is an element that defines long-term debt securities. If not, then it is a policy consideration being introduced as part of the definition of a security. Thus, whether an asserted instrument is excluded at the first or second level is not an arbitrary determination. Exclusion from the risk level is determined by reference to the state law that defines the classes of instruments at the first level. The elements that define these instruments do not express policy considerations applicable to the federal securities acts. Rather, they express the natural characteristics of the instruments

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[198] *Id.* at 557.
[199] *Id.*
[200] *Id.* at 558.
[201] *Id.*

such as the right to receive dividends and the right to vote. [202]

Hence, in *Marine Bank*, one must inquire whether the lack of risk is similar to the right to vote or the fixed rate of return. State law determines if this is an element in the description of that class. While the question is difficult,[203] lack of risk appears to be a policy concern and not an element in the description of the class. For example, long-term notes with very little risk, such as first lien mortgage bonds, nevertheless may be considered the paradigm of a security. Moreover, in this particular case, the lack of risk is not inherent in the instrument itself but is imposed by external sources in the form of a federal guarantee. This factor strongly indicates that lack of risk is not an element of the instrument. Hence, *Marine Bank* should be viewed as excluding CD's for policy reasons. As such, it constitutes a second level decision, giving content to the concept of a security.

In the second part of *Marine Bank*, the Court analyzed whether the profit-sharing agreement between the parties was a security.[204] The Court's analysis, including its discussion of the lower court's decision, could be restructured to fall within the two-tiered model as follows: 1) The profit-sharing agreement might fit within the classes of instruments either of investment contract or certificate of participation in any profit-sharing agreement (level one);[205] 2) The lower court found it was an investment contract (level two);[206] 3) The lower court found no reason to exclude the investment contract on the ground that it did not fit within the meaning of "security";[207] 4) The Supreme Court found that the negotiated agreement did not fall within the ordinary concept of a security because it was not publicly offered or traded, was unique, and was negotiated one-on-one by the parties.[208]Again, there are two versions of what the Court did:

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[202] It is difficult to determine the inherent characteristics associated with the commonly understood concept of stock. The term "stock" is not a natural kind term like "water," "gold," or "tiger." Such natural kind terms can be said to have a scientific structure. For example, the structure of water is H_2O. Some philosophers have argued that nonnatural terms such as "pencil" can have a structure like "water." *See* Putnam, *supra* note 66, at 242-45. For a judge interpreting the federal securities laws, "stock" can be viewed as a natural kind term if she simply accepts the characteristics associated with stock as if they were natural.

[203] *See supra* note 202.

[204] 455 U.S. at 559.

[205] *Id.*

[206] *Id.*

[207] *Id.*

[208] *Id.* at 560.

First Version: The Supreme Court held that the agreement was not an investment contract and thus failed to fall within a class of level one instruments because it failed the common enterprise[209] requirement of the investment contract test. The agreement was unique, not publicly offered, and negotiated one-on-one. The Court did not discuss whether the agreement fell within the level one class of certificate or participation in any profit-sharing agreement. Its judgment, however, implies that it ruled against the plaintiffs on that issue.[210]

Second Version: The Supreme Court did not address the issue of whether the agreement was an investment contract. It held that even if the instrument were an investment contract, the uniqueness of the arrangement and its one-on-one negotiation took the agreement outside the concept of a security. The Court did not discuss whether the agreement was a certificate of interest or participation in any profit-sharing agreement. However, this version implies that even if the agreement fell within this class it would be excluded at the second level because it was not within the concept of a security.[211]

Determining which version is correct is important because each has different ramifications for future interpretation.

Ramifications of Version One: The Supreme Court reinterpreted its decision in *Howey* and set forth a requirement of horizontal commonality.[212] Under this version the decision did not involve the second level concept of a security.

Ramifications of Version Two: The Court left intact the *Howey* interpretation of common enterprise but gave information about the contours of the concept of a security. The second version implies that in circumstances like these, involving a pledge to secure a profit-sharing agreement and a one-on-one negotiated agreement, the context of the transaction disqualifies the arrangement as a security.

The test of which is the correct version is whether the definition of "investment contract," under state law sources, requires horizontal

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[209] The Court held that there was no investment contract because the arrangement lacked horizontal commonality. *See supra* note 148.

[210] Since the Court ruled against the plaintiffs, their argument that the agreement was also a profit-sharing arrangement must have failed either for first level (not within the category) or second level (excluded for policy reasons) considerations.

[211] Arguably, an assertion that there was a profit-sharing arrangement would fail for the same policy reasons as did the argument for consideration as an investment contract: it was negotiated on a one-on-one basis.

[212] *See supra* note 148.

commonality. The problem is that state law rarely considers commonality. Federal courts have conducted most of the discussion of commonality. In so doing, federal courts have not sought to follow state laws, but instead have focused on policies appropriate to the federal securities acts.[213]

Further problems lie in the difference between the nature of the elements of an investment contract and those that define other classes such as stock (including the right to vote and dividends). Even under state law, the definitions of other classes probably were intended to be flexible and policy oriented. Therefore, it is much more difficult to determine whether the horizontal commonality requirement is inherent to the instrument itself (like the redness of an apple or the dividend paying aspects of stock) or is a consideration imposed upon the instrument for policy reasons.[214]

Given *Marine Bank*'s language, "does not fall within the ordinary concept of a security," and the way the Court cited cases such as *Howey*, *Joiner*, and *Great Western Bank & Trust v. Kotz*, the *Marine Bank* decision seems to fit more properly into the second version (level two exclusion).[215] This interpretation is also less disruptive. Under the first version one would have to reinterpret *Howey* as requiring horizontal commonality in investment contracts.

As can be seen, the two-tiered approach generates a more precise method for determining the holding of cases interpreting sections 2(1) and 3(a)(10). Thus, as in *Marine Bank*, a court examining an instrument might avoid a first level determination. The court then would proceed to hold that even if the arrangement fell within any of the first level classes of instruments, the instrument nevertheless would not be a security for policy reasons. The holding of the case would center on the concept of a security, immune to inference about whether the instrument would have fallen within any level one categories.

On the other hand, the court could decide that the arrangement did

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[213] *See supra* note 181.

[214] *See supra* note 202.

[215] 455 U.S. at 559-60. In citing *Howey*, the Court in *Marine Bank* emphasized that the securities in *Howey* were offered to a large number of investors (42 persons in a four month period). The Court cited the decision in *Joiner*, 320 U.S. 344 as one in which there was "common trading." In the *Great Western* decision, 532 F.2d 1252, in which there was no finding of a security, the Ninth Circuit based its decision, in part, on the fact that the note was negotiated one to one. Thus, the Court in *Marine Bank* was focusing on whether the transaction was public or private. Given that the nature of the transaction was the critical issue, the defeating consideration should be viewed as a second level policy concern.

not fall within a class of instruments because certain essential characteristics were missing; the court then would give reasons that would exclude it from the definition of a security. In this instance, the holding focuses only on the first level. The ruling on the concept of a security is dictum.[216] This latter reasoning fits the Court's decision in *International Brotherhood of Teamsters v. Daniel.*[217]

In *Daniel*, pension interests were asserted to be investment contracts. Because the Court found that the nonvoluntary, noncontributory pension interests did not meet the first part of the *Howey* test, requiring the investment of money, the Court discounted this assertion.[218]

In Part IV, the Court added that since ERISA antifraud provisions apply to these interests, the petitioner did not need securities act protection.[219] This part of the Court's discussion introduced elements relevant only to the second level concept of a security. Moreover, under the two-tiered analysis, these statements were dicta since an adequate basis for exclusion existed at the first level.

Understandably, decisions such as *Daniel* examine policy grounds for defining a security. They are reminiscent of other Supreme Court decisions that focus on standing to sue or causes of action implied under the securities acts. For example, the Court's standing decisions in *Piper v. Chris-Craft*[220] and *Blue Chip Stamps v. Manor Drug Stores*,[221] and its decision regarding implied causes of action in *Touche Ross v. Redington*[222] express a mixture of concerns for policy and fidelity to legislative intent similar to *Marine Bank*[223] and *Daniel.*[224] Decisions defining the scope of the term "security" are similar to standing and implied cause of action decisions because each case has the potential to expand securities law to protect whole new classes of interests. An affirmative decision in *Daniel*, for example, would have "implied" a new "cause of action" for antifraud suits based on noncontributory pension interests. In other words, *Daniel* potentially would have created standing for a new class of plaintiffs.[225] Thus, not surprisingly, similar policy con-

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[216] Although it is dictum, it may be equally predictive of the Court's view about the nature of the concept of security.

[217] 439 U.S. 551 (1979).

[218] *Id.* at 559.

[219] *Id.* at 569.

[220] 430 U.S. 1 (1977).

[221] 421 U.S. 723 (1975).

[222] 442 U.S. 560 (1979).

[223] 455 U.S. 551.

[224] 439 U.S. 551.

[225] Each decision that expands the concept of a security to a class of interests, such

cerns apply to all three types of cases.

Finally, fitting *Gould*[226] and *Landreth*[227] within the two-tiered framework is quite easy. In both cases the first level requirement was met because the stock in question clearly fell within a first level category.[228] In addition, neither case called for exclusion from the concept of a security on policy grounds. Moreover, the Court strongly implied that all stock transactions would involve a security.[229]

Thus, *Gould* and *Landreth* provide a holding both on level one and two. As to level one, these particular stocks fell within the category of stock. As to the second level, the Court implied that the concept of a security would not exempt stock. However, the Court was not willing to extend this conclusion to other categories such as notes. This implies that the concept of a security does not apply in the same manner to stock and notes, and that the concept is not a simple structure consisting of a conjunction of characteristics.[230]

The two-tiered model is advantageous because the different treatment of stock and notes under a one-tiered test is difficult to explain. The two-tiered model can represent a complexly structured concept in place of seemingly inconsistent treatment for similar categories. The next section explores the possibility of a complex structure and whether there is an original concept of this structure that courts should address.

V. The Concept of a Security and Process as Adherence to Original Intent

As demonstrated above, the appeal of the two-tiered approach is its ability to reconcile the Supreme Court's apparently diverse approaches to defining a security. Moreover, while the approach logically addresses a concern inherent in such threshold provisions, namely, the need to refer to instruments outside the statute, the model also allows the term to have a meaning that comports with the statute's goals.

However, while the two-tiered approach lends reliable meaning to the first level (instruments that fit within the classes such as stock and note must be included) the model leaves considerable uncertainty about the description of the concept of a security in its second level. A few

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as pension interests or limited partnerships, has an effect similar to creating a new cause of action.

[226] 105 S. Ct. 2308.

[227] 105 S. Ct. 2297.

[228] *Gould*, 105 S. Ct. at 2310; *Landreth*, 105 S. Ct. at 2304.

[229] *See Landreth*, 105 S. Ct. at 2306 (stock is the paradigm of a security).

[230] *See supra* note 66.

things can be inferred about the second level concept. For example, *Gould* and *Landreth* imply that the elements of the test for a security are not simply the three elements of the *Howey* test.[231] Moreover, dicta from *Marine Bank* and *Daniel* suggest that instruments will be excluded at the second level if substantial policy reasons exist. For example, other statutes may provide sufficient antifraud coverage.[232]

Other important questions remain concerning the concept of a security. First, are the elements of a security conjunctive in nature? Or, is there a cluster of elements from which a number can be selected to form the essence of a security?[233] Second, if the concept of a security is cluster-like, how can future judges fulfill their obligation to legislative intent when there is no clear, original conception of a security? This Article suggests the following answers. First, the structure of a security is not conjunctive, but instead is cluster-like in character. Second, the drafters of the provisions defining a security had no specific description or conception in mind. Rather, because the term is attributive in part, they had a more general concept in mind. This Article argues that when legal concepts are cluster-like, courts can fulfill their obligation to the original legislative concept by an interpretive process that produces successive conceptions.[234] When a term is designed to be essentially attributive but not completely open-ended, legislative intent is fulfilled by a process of asking the right questions. This process produces successive differing conceptions of a security that are unified by a single concept much as superimposed still pictures of successive motion indicate

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[231] Since *Gould* and *Landreth* rejected the application of the *Howey* test to stock sales in the context of the sale of a business, this implies that the universal test for a security will not be the three-part *Howey* test. *See Gould*, 105 S. Ct. 2308; *Landreth*, 105 S. Ct. 2297.

[232] *See* discussion of *Marine Bank*, 455 U.S. 551, *supra* text accompanying notes 197-201; discussion of *Daniel*, 439 U.S. 551, *supra* text accompanying notes 218-19.

[233] For a discussion explaining the terms "conjunctive" and "cluster," see *supra* note 66; *infra* text accompanying note 236.

[234] I am employing the distinction between concept and conception introduced by R. DWORKIN, *supra* note 76, at 134-36. Under this formulation, a legal "concept" generates various "conceptions." In interpreting the concept of property for purposes of the due process clause of the Constitution, various forms of this concept may be manifested, *e.g.*, a teacher's right to tenure, Board of Regents v. Roth, 408 U.S. 564 (1972), an interest in a driver's license, Bell v. Burson, 402 U.S. 535 (1971), or an interest in welfare benefits, Goldberg v. Kelly, 397 U.S. 254 (1970). The specific manifestations of a concept are the rules and tests that may be drawn from particular cases. These conceptions may be capable of delineation and articulation. On the other hand, the concepts that create these manifestations may not be capable of delineation and articulation. Moreover, the concepts that create these manifestations may not be capable of simple articulation, especially if they are of a cluster form.

movement.

In other words, the drafters of the provisions defining a security did have something in mind.[235] The courts still have an obligation to search for and adhere to this legislative intent. However, since the structure of a security reveals itself to be cluster-like, it cannot be uncovered in a single stroke. The deep structure of a cluster-like concept remains elusive because a cluster-like concept cannot wholly be articulated by its original drafter. It can be named or denoted by its paradigm or core cases. But these are only examples of a concept that the drafter is struggling to articulate.

The Supreme Court's decisions in *Gould* and *Landreth* strongly suggest that the structure of a security is cluster-like and not conjunctive. The term "conjunctive" refers to the traditional theory of meaning that terms like "water" are described by attributes such as odorless, colorless, and tasteless which *conjunctively* make up the essence of water.[236] Hence, a conjunctive description of security would be one holding that security had attributes one, two, and three that must be present in every case of a security. This would have been the case, for example, had courts held that the *Howey* three-part test constituted the three necessary and sufficient attributes of the term "security." In *Gould* and *Landreth*, however, the court rejected this notion and held that all stock, regardless of the economic circumstances of the transaction, was a security.[237] Thus, the *Howey* test was rejected as the conjunctive structure of all securities.

Since the Court probably will not hold that all notes are securities,

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[235] As argued earlier, the definition of a security was made in an indexical manner. The framers of the section could think of a few concrete examples that could "fix the reference" of the term security, *see supra* text accompanying notes 156-59, such as "stock" and "notes," but these were not meant to constitute the whole of the term. The aspect of the term that the framers could not concretely describe is the second level concept of a security. Because the framers had something in mind, this concept was not left completely open for future interpreters to fill in without regard to the framers' original intent. For instance, the framers included examples of what they meant (notes, stock, etc.) and they intended the context of the transaction to influence whether a security was found to exist. In a similar vein, imagine the problem of trying to communicate an idea for which one has no experience or reference. Suppose, for example, trying to describe a pterodactyl if one had never seen such an animal, and had no name for it. One might describe it as being "sort of like a large flying bat with very thin wings having a wingspread of 20 feet." The incompleteness or vagueness of the description is no argument that the speaker did not have a referent in mind when she chose to employ her description.

[236] *See supra* note 66.

[237] *See Gould*, 105 S. Ct. 2308; *Landreth*, 105 S. Ct. 2297.

the approach taken to stock will be fundamentally different from the approach taken to notes. The structure of the concept of a security is a cluster instead of a conjunction of attributes. The term "security" is like the term "game": it has a cluster of properties defining it.

> For example, it is held that we cannot define "game" by a conjunction of properties such as having a winner and a loser, being entertaining, involving the gaining and losing of points, because some perfectly acceptable games lack some of these features. According to the cluster theory, something is a game because it has enough features from a cluster of properties like these. A cluster theorist would claim that there need not be any property in the cluster that is sufficient for the application of the term, but he nevertheless holds that the cluster taken as a whole determines the extension of the term.[238]

Thus, because it is impossible to reconcile stocks, notes, and investment contracts in a conjunctive structure, the term "security" is of a cluster rather than a conjunctive nature.[239] If the description of a security is cluster-like and never fixed in a conjunctive sense, the courts can never meet the obligation to adhere to the original legislative concept of a security.[240] The remainder of this Article argues that for cluster structures in law, the winnowing process of adjudication based on outcome-determinative factors is itself a means of adhering to original intent.

Two things must be kept in mind. First, the problem with faithfulness to original intent for cluster concepts results because the speaker in such cases has a concept in mind but simply cannot articulate it. It is as though she constantly says "you know what I mean . . ." The frustrated listener keeps offering examples hoping to ascertain what has slipped the speaker's mind. The listener-questioner may come close, but

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[238] NAMING, NECESSITY, *supra* note 44, at 15.

[239] Thus, the cluster-like concept of a security may evolve to encompass all stock as a security. Some notes will be a security and others will not, depending on factors such as the nature of the relationship between parties and the degree of collateralization. Profit-sharing relationships may be a security depending on whether the agreements are negotiated on a one to one basis. All bonds and debentures may be considered a security. Thus, each different category of instruments may involve a different combination of the features of a security. Accordingly, the concept is cluster-like.

[240] The kind of cluster structure suggested *supra* note 239 indicates that the existence of a security may turn on a case by case approach in the instances of notes, profit-sharing arrangements, investment contracts, and similar categories. Given that a security could be found based on a wide variation of patterns, how is it that one could argue that the courts are applying any kind of an "original concept" as opposed to making one up as they go along? Part V of this Article argues that with cluster concepts, a proper process of adjudication by asking the right questions is inherent in the original concept. The original intent is one of the correct use of a process, not a particular picture of structure.

she is never exactly right. Although the speaker clearly has a concept in mind, she cannot state it, but the listener-questioner still has a duty to seek it out.

The second problem with the cluster concept in law is that the listener-questioner will keep guessing, but never will know if she's right.[241] While our forgetful speaker may concretely conceive of what she was groping for, the continuous questioner in law will never actually know whether she has found the right concept. Thus, no one can verify whether a particular cluster concept is an accurate description of the original concept. Yet, one must avoid the reasoning that the lack of verifiability removes the obligation to adhere to legislative intent.[242]

The best that one can do in the case of cluster concepts is to draw nearer to a method of rational inquiry. Consider the following model, suggested by the physicist John A. Wheeler in a different context,[243] as game-like versions of the common law process. These versions of the popular game twenty questions are offered as a way of illustrating how a process that asks the right questions generates successive conceptions based on a single concept. Thus, the rationality of a process that produces different conceptions represents fidelity to original intent.

There is a game called "Botticelli." It is similar to the game twenty questions except that instead of thinking of an animal, vegetable, or mineral, the person who answers the questions (called here the "respondent") thinks instead of a well-known person (dead or alive). Let us imagine three different versions of Botticelli:

Version I —*Basic Botticelli*: The respondent thinks of a person and the questioner has twenty questions to discern his or her identity. For

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[241] Cluster concepts like that of a security are attributive because the speaker uses them meaningfully without concretely defining the terms. No single particular conception, as a specific manifestation, is a complete and accurate description of the driving concept. By deliberately using terms attributively, the framers of such terms have acceded to the notion that no one particular conception could be correct. Thus, the listener-questioner will never know if she is correct because this is the nature of cluster concepts, and because the framers intended this result. Since this lack of ultimate certainty is the logical intent behind the use of cluster concepts, the original intent is satisfied by the properly framed search for, but failure ever to find, the original concept.

[242] Since the intent of the framers is that one will never find the correct original concept in a simple conjunctive form, the obligation to adhere to original legislative intent inheres in utilizing the correct process that will produce the desired conceptions. In other words, there is no simple answer to the question "what is a security?" However, there is a correct process by which intended results will unfold.

[243] Wheeler, *Law Without Law*, in QUANTUM THEORY AND MEASUREMENT (J. Wheeler & W. Zurek eds. 1983).

example, supposing that the respondent chooses George Washington, the questions may go as follows:

Question	*Answer*	*Thinking Of*
1. Is he or she alive?	No	(George Washington)
2. Is he or she American?	Yes	(George Washington)
3. Is he or she male?	Yes	(George Washington)
4. Was he a politician?	Yes	(George Washington)
5. Was he from the West?	No	(George Washington)
6. Was he from the South?	Yes	(George Washington)
7. Was he a President?	Yes	(George Washington)
—and so forth		

Version II — *Moving Botticelli*: The respondent initially thinks of one person, but without letting the questioner know, changes the person she is thinking of after each answer. However, each new person chosen by the respondent must be consistent with all previous answers given by the respondent. Assume our respondent starts again with George Washington.

Question	*Answer*	*Thinking Of*
1. Is he or she alive?	No	(George Washington)
After this answer our respondent chooses:		(Louis Pasteur)
2. Is he or she American?	No	
After this answer our respondent chooses:		(Madam Curie)
Who must fit the category: non-alive and non-American		
3. Is he or she male?	No	
After which our respondent chooses among the set of non-alive, non-American females		(Indira Ghandi)
4. Was she a political figure?	Yes	
After which our respondent chooses among the set of non-alive, non-American female politicians		(Queen Victoria)
5. Was she from France?	No	

After which our respondent chooses among the set of non-alive, non-American, non-French, female politicians —and so forth	(Cleopatra)

Version III — *Random Botticelli*: In this game, without letting the questioner know, the respondent will watch a large clock on a wall behind the questioner. At the end of each question asked by the questioner, if the second hand of the clock is on an even number (12:00:00) she will answer "yes," if on an odd number she will answer "no."

	Question	*Answer*	*Time*
1.	Is he or she alive? The questioner now is thinking of the set of all dead persons	No	12:46:55
2.	Is he or she American? The questioner now is thinking of the set of all dead Americans	Yes	12:47:46
3.	Is he or she male? The questioner now is thinking of the set of all male, dead, Americans	Yes	12:48:40
4.	Was he a political figure? The questioner thinks of a set of all dead Americans other than political figures	No	12:49:43
5.	Was he a scientist? The questioner thinks of a set of all dead American scientists	Yes	12:50:50
6.	Was he a physicist? Set: dead American male non-physicist scientists	No	12:51:27
7.	Was he a chemist? Set: dead male American chemists	Yes	12:52:08
8.	Did he win the Nobel Prize? —and so forth	No	12:53:00

The point is this: the questioner cannot determine whether version one or version two is being played. Moreover, unless she manipulates the questions, she cannot tell the difference between versions one, two,

or three. Each version appears rational and the questioner has the same sense of satisfaction (or lack of it) in each case. In each version, if the questioner wins by guessing the proper identity, she will believe she has found the true answer. In other words, she will feel that she guessed the identity of the personality that the respondent hid from the start. But if it was really version three being played, she did not win at all because no truth or answer existed. However, even version three appears rational to the questioner unless she suspects that this random version is being played and tests for it by repeating a question and receiving an inconsistent answer.

On the other hand, the questioner cannot in any way discern the difference between versions one and two. The questioner wins in version two the same way she wins in version one. Even as the set of possible identities becomes narrower, the respondent always must conceptualize an actual person, whom the questioner, by guessing correctly, can identify. In other words, suppose question six to our version two had been "Was she Cleopatra?" Our respondent would reply "yes" and our questioner, arriving at this question through logical deduction and process of elimination, would be quite happy. The issue for the purpose of this Article is whether a subsequent conception like Cleopatra is a right answer. Even though it is not the original answer because respondent started with George Washington, the response is yes.

The difference between versions one and two is that the original answer or preexisting target in version one is known beforehand and at all times by the respondent in a conscious way. In version two, the respondent has a pattern to which she is predisposed but not consciously aware, and thus cannot articulate. The ultimate identity (Cleopatra) is there during the initial question because the respondent has a predisposition towards certain answers and because the rules require successive consistency. Thus, Cleopatra is there initially because when the respondent starts the game she decides to include a set of personalities that would include, among others, Cleopatra and George Washington. She may not consciously be thinking of Cleopatra and George Washington, but they are there because her mind chooses to sort among all the persons in the world in a way that includes them. Then, when she chooses an answer to the first question ("dead or alive?") her mind must sort among all persons in a way that again contains Cleopatra and George Washington. Thus it is so after each question. Though she may never actually visualize Cleopatra through the first five questions, Cleopatra is like a distant figure in a crowd who is constantly asked to step away from the crowd and join a smaller and smaller group. To the

respondent, Cleopatra is a distant figure in the sense that although she does not see Cleopatra distinctly, she is thinking of her in an unconscious, unarticulated way each time she chooses to sort. In this way, we say that Cleopatra was "there" at the beginning. In this sense the process of narrowing in version two represents faithfulness to original intent.

The combination of questions and answers generates the sorting classifications that produce Cleopatra. But questioner and respondent do not act independently. Both must act rationally and consistently after each question. Both are responsible for Cleopatra. Both start by visualizing a huge, faceless crowd, and by process of question and answer, end up with the same individual. Version two is an analogy of how a cluster concept can be unmasked by the judicial process' questions and answers. The combination of the respondent's concept (to change each successive conception so that it remains consistent with previous questions) and the questioner's concept (asking questions consistent with previous answers) produces a unified concept that generates appropriate answers to each question. From the questioner's point of view, one cannot discern whether the concept is cluster-like (version two) or conjunctive (version one).

Version two demonstrates that the obligation to adhere to original intent can be met when the generating concept is attributive and cluster-like instead of conjunctive and elemental. Just because no clear history of the concept of a security exists does not mean that no process can reveal that concept. The key point is that the questioner (and even the respondents in our judicial system, the judges, are questioners) has no way to tell the difference between version one and version two.

To imitate the judicial process accurately, some corrections to versions one and two must be made. First, play the game with concepts, not persons.[244] Thus, instead of a game of "I'm thinking of a person

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[244] In law, the analogy to the questions asked and answered in Botticelli ("is this person an American?") are the issues presented and the judicial determinations in each case. In the definition of a security, the issue present in each case concerns the concept of a security. For example, one case may pose the issue, "Is a profit-sharing arrangement between two families that is negotiated on a one-on-one basis a security?" Thus, as opposed to Botticelli, in which the goal is to identify a person, the point in law is to uncover a concept that may be simple and conjunctive or complex and cluster-like. The process of uncovering the concept of a security, like that of uncovering the nature of the nucleus of an atom, is much harder than identifying personalities for which we have a preexisting agreement regarding their existence and characteristics. *See also* Dworkin, *"Natural" Law Revisited*, 34 U. FLA. L. REV. 165, 166-69 (1982) (common law process analogized to the writing of a chain novel by series of different authors).

X," the game becomes "I'm thinking of a concept that generates right answers to the definition of a security." Second, change the game so that there is no respondent. The questioner is like the judge who must frame the inquiry. The questioner must guess how the respondent, if she existed, would answer. Like the long-gone original framers of the concept of a security, the respondent becomes a necessary fiction of the game. Hence, the questioner will never know whether she has the right answer, and will be unable to discern the difference between versions one and two. There is no reason to insist that the concept of a security have a clearly definable, original structure for there to exist an obligation to adhere to legislative intent.

Each decision that has attempted to define "security" is a different question in a never ending game of version two. Each question brings the interpreter closer to the concept of a security. There is no reason to assume that the process works solely on the premise of strict originalism.[245] To the questioner and outside observers (and all of us, including judges, are questioners or outside observers), version two (the unarticulated original concept) presents a possibility equal to version one of honing in on the proper concept.

Hence, there is no need to reduce the structure of a security to simple, conjunctive elements. A cluster approach is equally viable and equally acceptable. The cluster concept can be uncovered or discovered by a process of asking the right questions. Thus, the meaning of a cluster concept such as a security is reflected in the whole line of cases, which indicates that courts have striven to be consistent with previous answers. The notion that there is a clearly delineated original concept of a security that successive judges should "see"[246] can be discarded

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[245] By "strict originalism" it is meant that the concept of a security is simple and elemental and was capable of clear articulation by the original framers. Thus, this concept has always existed prior to every judicial decision that has sought to seek it out. The premise of strict originalism is also based on the assumption that it is possible to know when a judge has correctly found this original concept.

[246] As stated *supra* note 245, one premise of strict originalism is that all legal concepts are simple and elemental and exist at the time of the creation of the term to be interpreted. Thus, the proper concept is available to be "seen" by a judge. This is similar to the Blackstonian notion that the law is outside of the observing judge, and that she merely must find the law to be applied. To the Blackstonian mind, the judge did not make law, but instead found the proper law. The appropriate law preexisted the judge's attempt to find it. *See* Levy, *Realist Jurisprudence and Prospective Overruling*, 109 U. PA. L. REV. 1, 2 (1960) (quoting 1 W. BLACKSTONE, COMMENTARIES 69T) (emphasis added): "The judge merely *finds* the preexisting law; he then merely declares what he finds. A prior judicial decision is not the law itself but only evidence of what the law is."

with the similar Blackstonian notion that judges discover an objective law that exists as a "brooding omnipresence"[247] in the sky.

The judge's problem in uncovering a cluster concept is to ask the right questions or to know how to sense the outcome-determinative factors. Put simply, the judge must be able to discern what facts are important. For example, in the case of a security, the kinds of facts that may be significant include the number of investors, the kind or nature of the investment, the sophistication and wealth of the investors, the form of the investment, and the degree of investor control. In Botticelli, the next question is generated by previous answers. Similarly, the judicial process seeks out right questions in the same inductive fashion: by hazarding a guess from previous answers and an overall understanding of the structure and purpose of the appropriate legislation.

CONCLUSION

The term "security" as set forth in the securities acts was used in an indexical manner, as if to fix a reference. The drafters of the term had an original concept in mind but that concept could not then be fully articulated. The drafters were able to fix the reference of security by pointing to some of its common examples — stocks, notes, investment contracts, and other instruments. But these instruments do not completely describe the term "security." Rather, as this Article proposes, such instruments constitute the first level of a two-tiered analysis. If an instrument is included in these categories, defined by reference to state law, it meets the first test for inclusion. However, an instrument may be excluded at the second level, the level delineated by the concept of a security, if it does not meet the conceptual requirements for being a security.

Context determines the second level concept of a security. If the transaction involving an instrument does not justify the application of the acts, then, as to this particular class of transactions, the instrument is excluded from regulation. For example, a profit arrangement between two families may be an investment contract but it may also be excluded because it was negotiated in a one-on-one fashion. Such transactions do not justify the application of the securities acts.

Recent Supreme Court decisions indicate that the structure of the second level concept of a security is not a conjunction of attributes, but rather a cluster of features. Some (but not all) of these features create

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[247] *See* Levy, *supra* note 246, at 1, 2 (the phrase "brooding omnipresence" is that of Chief Justice Holmes).

the essence of a security. Moreover, different combinations of features may give rise to a security in different contexts.

Although the structure of a security is cluster-like rather than conjunctive, treating the concept of a security as completely open and allowing courts to ignore the original, guiding legislative concept is unjustified. Rather, cluster concepts can also exist in an unarticulated form when the legislation was created. The judicial process that generates decisions from questions based on outcome-determinative facts uncovers the cluster structure. Moreover, the process of formulating outcome-determinative questions ensures fidelity to the original legislative concept when the concept is both unarticulated yet existent at the time of enaction.

The two-tiered test reconciles seemingly inconsistent approaches to the definition of a security. It preserves consistency in treating all of the categories, stocks, notes, bonds, and the like, as state-created instruments. Moreover, recognizing that the second level may have a cluster nature reconciles diverse treatment of stocks, notes, and other categories. In addition, the cluster approach adheres to a sort of modified originalism, preserving the separation of powers between the courts and legislature.

This Article has sketched broad outlines of the process of defining a security. What remains is to delineate the cluster concept in more detail. As in the case of Botticelli, the nature of the cluster concept makes a case by case approach most suitable for eventually unmasking the concept.