COMMENTS

The *Howey* Test: A Common Ground for the Common Enterprise Theory

INTRODUCTION

Inez, a novice investor, wants to buy common stock.[1] Because Inez knows nothing about the stock market, she enters into an investment[2] agreement with a broker, Brook.[3] Brook assumes discretion[4] over the trading activities in Inez's account.[5] Conse-

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[1] The term "common stock" indicates a class of stock representing an ownership interest in a corporation. BLACK'S LAW DICTIONARY 278 (6th ed. 1990). Holders of common stock normally have voting privileges and may receive profits of the corporation through dividends. *Id.* Holders of common stock are the last to share in the corporation's property upon dissolution. *Id.*

[2] The term "investment" means an expenditure of money to purchase securities, or the placing of money or property in business ventures or real estate, in the hope that it will produce revenue or gain in the future. *Id.* at 825.

[3] A "broker" is an agent employed to make bargains and contracts for compensation. *Id.* at 193. This agent works, usually on a commission basis, for a buyer or a seller who buys or sells stocks, bonds, commodities, or services. *Id.* With respect to the securities market, a broker is one who deals in securities issued by others. *Id.*

[4] A "discretionary account" is an account in which an investor gives a broker the power to purchase or sell securities on the investor's behalf without prior approval. *Id.* at 417. A discretionary account allows the broker to make decisions involving the selection, timing, and price paid or received for securities. *Id.*

[5] *See* Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980) (noting that discretionary commodity account authorizes broker to buy and sell without prior consultation with investor), *aff'd*, 456 U.S. 553 (1982); *see also* Brodt v. Bache & Co., 595 F.2d 459, 459-60 (9th Cir. 1978) (noting power of broker to withdraw funds to finance transactions without investor approval in discretionary commodity account).

quently, Brook has the authority to execute trades in Inez's account without her prior approval.

In exchange for Inez's initial funds, Brook represents that he can provide a high rate of return on those funds by investing her money in the stock market. Inez contracts to pay Brook a percentage commission[6] based on profits[7] from each trade Brook conducts for Inez.[8] Over the next six months, Brook negligently mishandles Inez's account, losing all of Inez's money. Inez wants to sue Brook for a return of her initial funds, alleging that Brook has violated the Securities Acts.[9]

Inez's ability to recover may depend on which circuit hears her case.[10] All courts agree that if a discretionary trading agreement is an investment contract, it is a type of security.[11] To

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[6] The term "commission" means a fee paid to a broker for transacting a piece of business or performing a service. BLACK'S LAW DICTIONARY, *supra* note 1, at 272. This is normally a percentage based on the amount of a transaction or on the profit to the principal. *Id.*

[7] A "profit" is the excess of gains or revenues minus expenditures in an investment. *Id.* at 1211.

[8] Courts analyzing discretionary trading accounts as securities generally focus on the method of a broker's commission. 1 THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 38-39 (2d ed. 1990 & Supp. 1994). Additionally, courts finding a security point out that the broker's commission usually ties into the profits or the asset value of the account. 1 *id.* By compensating a broker on a percentage basis, the broker shares the risk with the investor. 1 *id.* This shared risk satisfies the common enterprise requirement of an investment contract in several circuits. 1 *id.*

[9] Inez might pursue a fraud action against Brook for any false representations regarding expected risks and returns on her account that induced her into investing. *See* 1 *id.* at 37 (noting that most securities cases involving discretionary accounts arise with regard to anti-fraud provisions); *see also* Lowenbraun v. Rothschild, 685 F. Supp. 336, 342 (S.D.N.Y. 1988) (discussing fraud in inducement claim in securities action). The Securities Acts also offer protection to all investors in securities. *See infra* notes 32-33 and accompanying text (noting that Congressional definition of security includes investment contract).

[10] *See infra* notes 63-128 and accompanying text (explaining split among circuits regarding ability to recover under Securities Acts). *Compare* Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc., 686 F.2d 818, 819 (9th Cir. 1982) (holding that discretionary commodity accounts are not securities due to lack of strict vertical commonality), *cert. denied*, 460 U.S. 1023 (1983), *Lowenbraun*, 685 F. Supp. at 341 (holding investment portfolios are not securities because no strict vertical commonality exists), *and* Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 315-16 (S.D. Ohio 1979) (holding that discretionary commodity futures accounts are not securities because no horizontal commonality exists) *with* United States v. Faulhaber, 929 F.2d 16, 19 (1st Cir. 1991) (finding that mutual fund shares are securities) *and* Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983) (holding that discretionary commodity futures account is security because broad vertical commonality satisfied).

[11] *See infra* notes 31-33 and accompanying text (noting that Congressional definition of security includes investment contract).

determine whether Inez's agreement is indeed an investment contract, a court will apply the test the United States Supreme Court devised in *SEC v. W.J. Howey Co.*[12] Under the *Howey* test, circuit courts differ on whether a discretionary trading agreement constitutes an investment contract.[13] This split of authority results from inherent ambiguities in the *Howey* test. In *Howey*, the Supreme Court held that an "investment contract"[14] is a contract, transaction, or scheme whereby (1) a person invests her money,[15] (2) in a common enterprise,[16] (3) and is led to expect profits[17] (4) solely from the efforts of others.[18] The Court has addressed certain aspects of the *Howey* test to clarify the requirements for an investment contract.[19] Despite the Court's efforts, however, the circuit courts remain divided concerning the definition of common enterprise.[20]

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[12] 328 U.S. 293 (1946).

[13] *Compare Taylor*, 572 F. Supp. at 671 (holding that discretionary account constitutes security) *with Meyer*, 686 F.2d at 819 (holding that discretionary accounts are not securities).

[14] An "investment contract" is a contract, transaction, or scheme whereby an investor lays out money in a way intended to secure income or profit from its employment. BLACK'S LAW DICTIONARY, *supra* note 1, at 826.

[15] *See* International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 n.12 (1979) (noting that goods and services satisfy investment of money requirement as well as cash); *see also* Hector v. Wiens, 533 F.2d 429, 432-33 (9th Cir. 1976) (finding that promissory note satisfies money requirement); Sandusky Land, Ltd. v. Uniplan Groups, Inc., 400 F. Supp. 440, 445 (N.D. Ohio 1975) (noting that services satisfy money requirement).

[16] *See infra* notes 63-128 and accompanying text (recognizing three distinct approaches to defining common enterprise).

[17] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975) (noting that profit includes either capital appreciation or participation in earnings on invested funds); *see also* SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 464 (9th Cir. 1985) (noting that prospect of tax benefits based on initial losses satisfies expectation of profit element); SEC v. Aqua Sonic Prod. Corp., 687 F.2d 577, 583 (2d Cir.) (finding expectation of profit element satisfied though investment primarily for tax benefits), *cert. denied*, 459 U.S. 1086 (1982).

[18] *See* SEC v. Glenn W. Turner Enters., 474 F.2d 476, 482 (9th Cir.) (holding "solely" to mean significant or essential managerial efforts), *cert. denied*, 414 U.S. 821 (1973); *see also Goldfield Deep Mines*, 758 F.2d at 464 (finding "solely" to mean undeniably significant efforts necessary for success of an investment). *But see* Hirsch v. Dupont, 396 F. Supp. 1214, 1218-20 (S.D.N.Y. 1975) (indicating that "solely" should have literal application), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

[19] *See International Bhd. of Teamsters*, 439 U.S. at 560 (noting that investment of money may take forms other than cash); *United Hous. Found.*, 421 U.S. at 855 (noting that profit may come in form of either capital appreciation or earnings).

[20] *See* Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980) (noting that current debate in defining investment contract focuses on horizon-

The circuit courts have developed three distinct methods for defining the *Howey* test's common enterprise element. The first method, the horizontal approach, focuses on the relationship among the investors in an enterprise.[21] The second method, the narrow vertical approach, focuses on the correlation between an investor's and a promoter's profits.[22] The third method, the broad vertical approach, examines the dependency of an investor on a promoter's expertise.[23]

None of these three current approaches adequately serves the objectives of the Securities Acts. Therefore, this Comment proposes a uniform definition of common enterprise. Part I of this Comment introduces the *Howey* test for an investment contract. Part II describes the circuit courts' three-way split in defining common enterprise. Part III discusses the strengths and weaknesses of each approach and the need for a new definition of common enterprise. Finally, Part IV proposes that the courts adopt a uniform definition of common enterprise to enforce the Securities Acts consistently.

I. SECURITIES REGULATION — THE CONCEPT OF AN INVESTMENT CONTRACT

Federal securities regulation began with the Securities Act of 1933[24] and the Securities Exchange Act of 1934 (the Acts).[25] The primary goal of the Acts is to protect potential and actual investors from fraud.[26] To achieve this goal, the Acts require

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tal or vertical common enterprise), *aff'd*, 456 U.S. 353 (1982).

[21] *See id.* (stating that horizontal approach focuses on relationship between individual investor and pool of other investors).

[22] *See* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978) (holding that failure to show correlation between investor's and promoter's success indicates lack of narrow vertical common enterprise).

[23] *See* Long v. Shultz Cattle Co., Inc., 881 F.2d 129, 141-42 (5th Cir. 1989) (finding that cattle feeding consulting agreements constituted broad vertical common enterprise because investors relied on promoter's expertise for success of their investments).

[24] 15 U.S.C. §§ 77a-77aa (1994).

[25] *Id.* §§ 78a-78dd.

[26] *See* United Hous. Found. v. Forman, 421 U.S. 837, 849 (1975) (noting that purpose of Securities Acts is to prevent fraud); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (noting that central purpose of 1934 Act is to protect investors from fraud through full disclosure); *see also* Marine Bank v. Weaver, 455 U.S. 551, 556 (1982) (noting that anti-fraud provisions of securities laws extend to uncommon and irregular instruments).

full disclosure of all material facts relevant to an investor's decision to purchase or sell a security.[27] The Acts' disclosure provisions help reduce fraud because informed investors are more likely to discern fraudulent investments.[28]

The Securities Acts only regulate securities and those who deal in them.[29] Accordingly, to obtain protection under the Acts, a transaction must fall within the definition of a security. Congress defined security to cover a broad spectrum of transactions.[30] The Acts provide courts with discretion to expand coverage to include almost any transaction.[31]

This discretion stems from the Acts' inclusion of the term "investment" contract within the definition of a security.[32]

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[27] *See* 15 U.S.C. §§ 77e-j (describing 1933 Act's purpose to regulate initial offerings through disclosure); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 727-28 (1975) (describing 1934 Act's purpose to regulate exchanges and over-the-counter markets through disclosure).

[28] *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-74 (1984) (noting that mandatory disclosure leads to optimal choices by investors because informed investors can verify most of disclosed information and ascertain accurate risks). In addition to ensuring informed investors, the Securities Acts discourage fraudulent practices by imposing civil penalties on those who fail to disclose material information to investors. *See* 15 U.S.C. § 77k(a) (noting availability of civil penalties); *id.* § 77l(2) (noting civil penalties); *see also* Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 227 (1933) (discussing civil liability for violating Securities Act of 1933). A violation of the Acts can also result in administrative penalties. *See* 15 U.S.C. § 78o(b)(4) (noting availability of administrative sanctions); *id.* § 78u(d) (noting availability of administrative fines). Lastly, failure to comply with the Acts' disclosure requirements may result in criminal penalties. *See id.* § 77x (noting criminal penalties for violation of Acts); *id.* § 78ff (noting criminal penalties).

[29] 15 U.S.C. §§ 77b(1), 78c(a).

[30] *See* Reves v. Ernst & Young, 494 U.S. 56, 60-61 (1990) (noting that Congress recognized limitless human ingenuity in creating profit schemes and responded with broad and general definition of security to include those schemes within ambit of Securities Acts).

[31] The Acts state that the instruments they list as "securities" are securities unless the context otherwise requires. *See* 15 U.S.C. §§ 77b, 78c(a). Additionally, the Acts mention that anything commonly known as a security is a security within the meaning of the Acts. *Id.* §§ 77b(1), 78c(a). *See also* Thomas R. Frazer II, Comment, *Catch-All Investment Contracts: The Economic Realities Otherwise Require*, 14 CUMB. L. REV. 135 (1984) (discussing development of investment contract concept providing broad coverage to Acts).

[32] *See* Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 316 n.4 (S.D. Ohio 1979) (noting that both 1933 and 1934 Acts include term "investment contract" in definition of security); *see also* Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982) (noting that definition of security in 1934 Act is essentially same as in Securities Act of 1933); United Hous. Found. v. Forman, 421 U.S. 837, 847 n.12 (1975) (noting that definitions of security in 1933 and 1934 Acts are virtually identical); Tcherepnin v. Knight, 389 U.S. 332, 335-36 (1967) (noting Acts' identical definitions of security).

Courts have treated investment contract as a "catchall phrase"[33] that can define unusual investment schemes as securities.[34] Neither Congress nor the United States Supreme Court has outlined a precise test defining an investment contract,[35] and this has caused considerable confusion regarding its meaning.[36]

The United States Supreme Court has had several opportunities to establish the standards for an investment contract under the 1933 and 1934 Acts.[37] The Court first attempted to define an investment contract in 1946, in *SEC v. W.J. Howey Co.*[38] In *Howey*, a promoter[39] owned and cultivated large tracts of Florida citrus groves.[40] To fund development, the promoter offered and sold part of those tracts to investors.[41] The offers of sale contained both a land sale contract and an optional service contract.[42] The land sale contract simply conveyed ownership to a

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[33] *See* SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946) (noting that investment contract is flexible principle capable of adaptation to reach countless and variable schemes); Golden v. Garafalo, 678 F.2d 1139, 1144 (2d Cir. 1982) (noting that catchall phrase "investment contract" is used to classify unique instruments not fitting into other categories); *see also* Frazer, *supra* note 31, at 135-36 (noting that broad construction of investment contract definition leads to catchall status); Bradley D. Johnson, Note, *Discretionary Commodity Accounts as Securities: An Application of the* Howey *Test*, 53 FORDHAM L. REV. 639, 643 (1984) (noting that Congress intended "investment contract" to be catchall phrase).

[34] *See* HAROLD S. BLOOMENTHAL ET AL., SECURITIES LAW HANDBOOK 31-32 (1995 ed.) (noting that courts liberalize use of investment contract approach to cover wide variety of investments).

[35] *See Howey*, 328 U.S. at 298 (noting that Securities Act and legislative reports do not define term "investment contract"); *see also* SEC v. Aqua-Sonic Prods. Corp., 687 F.2d 577, 581 (2d Cir. 1982) (citing *Howey* for proposition that there is no precise definition of investment contract), *cert. denied*, 459 U.S. 1086 (1982).

[36] *See infra* notes 63-128 and accompanying text (noting three interpretations of requirements for common enterprise element of *Howey* test).

[37] *See* Marine Bank v. Weaver, 455 U.S. 551, 560 (1982) (noting that individual profit-sharing agreement is not investment contract); United Hous. Found. v. Forman, 421 U.S. 837, 858 (1975) (holding that shares in state-subsidized cooperative apartment corporation are not investment contracts); Tcherepnin v. Knight, 389 U.S. 332, 344-46 (1967) (holding that withdrawable shares in savings and loan association are investment contracts); SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 211-12 (1967) (holding that flexible annuity program involved investment contracts); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 71 (1959) (holding that variable annuity life insurance contracts are investment contracts).

[38] *Howey*, 328 U.S. at 298-99.

[39] The term "promoter" refers to an individual who encourages or fosters a plan by which it is hoped to insure the success of a business or venture. BLACK'S LAW DICTIONARY, *supra* note 1, at 1214.

[40] *Howey*, 328 U.S. at 295.

[41] *Id.*

[42] *Id.*

particular tract of land in the citrus groves.[43] The service contract provided that the promoter would cultivate the citrus fruit, market the harvest, and remit the net proceeds to the investor.[44] Forty-two of the fifty-one investors purchased both the land sale contract and the service contract.[45]

Although they purchased these lots, the investors did not obtain any rights to specific fruit or even to enter their own land.[46] Additionally, the promoter pooled the fruit from all the parcels and allocated the profits from sales pro rata[47] to each investor.[48] Moreover, the investors lacked the expertise and equipment to cultivate the tracts themselves.[49]

The Securities and Exchange Commission (SEC) brought suit to enjoin the land and service contract sales.[50] The SEC alleged that the promoter was selling investment contracts, which are securities under the Acts.[51] The SEC therefore demanded that the promoter register[52] the securities in compliance with the 1933 Act. Conversely, the promoter argued that each sale was a separate contract for land, not a security.[53] Both parties' arguments hinged on the definition of investment contract.[54]

The Supreme Court defined an investment contract as a contract, transaction, or scheme whereby (1) a person invests her money, (2) in a common enterprise, and (3) is led to expect profits (4) derived solely from the efforts of a promoter or third party.[55] In *Howey*, the investors invested money in a fruit enter-

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[43] *Id.*

[44] *Id.* at 296.

[45] *Id.* at 302 (Frankfurter, J., dissenting).

[46] *Id.* at 296.

[47] The term "pro rata" means a proportionate allocation according to a certain rate, percentage, or rule of proportion. BLACK'S LAW DICTIONARY, *supra* note 1, at 1220.

[48] *Howey*, 328 U.S. at 296.

[49] *Id.*

[50] *Id.* at 294.

[51] *Id.*

[52] Registration of securities is a statutory procedure which requires the filing of various documents with the SEC including a prospectus in order to publicly offer securities. BLACK'S LAW DICTIONARY, *supra* note 1, at 1284. Registration effectuates disclosure because the SEC must grant clearance before selling the securities. *Id.* One of the documents filed, the registration statement, discloses financial data, the purpose of the securities offering, and other items of interest to potential investors. *Id.*

[53] *Howey*, 328 U.S. at 297-98.

[54] *Id.* at 297.

[55] *Id.* at 298-99. The *Howey* Court noted that courts should broadly construe the term

prise anticipating that the promoter's efforts would reap profits.[56] The Court, therefore, held that the offering was an investment contract.[57] Consequently, the Securities Acts governed the enterprise,[58] and the Court enjoined the promoter from further sales of the unregistered securities.[59]

The *Howey* test remains the standard for defining an investment contract under both the 1933 and 1934 Acts.[60] Despite its unanimous acceptance as the standard, however, courts have not uniformly applied the *Howey* test.[61] In particular, courts have not applied the common enterprise element uniformly. The circuits have developed a three-way split over the common enterprise element of the investment contract definition.[62]

"investment contract" and that economic substance should predominate over strict form. *Id.* at 298. The Court continues to emphasize this flexible approach. *See* United Hous. Found. v. Forman, 421 U.S. 837, 851-52 (1975) (noting that investment contract analysis focuses on substance rather than names given to transaction by parties); *see also* Reves v. Ernst & Young, 494 U.S. 56, 61-62 (1990) (noting commitment to examination of economic realities of transaction over legal formalism); Tcherepnin v. Knight, 389 U.S. 332, 338 (1967) (noting Congressional intent to adopt expansive concept of security).

[56] *Howey*, 328 U.S. at 299-300.

[57] *Id.* at 300.

[58] *Id.* Because the Securities Acts regulated the investment scheme, and the promoter failed to register the offering, the investors could rescind the transaction or recover damages. BLOOMENTHAL ET AL., *supra* note 34, at 518.

[59] *Howey*, 328 U.S. at 301.

[60] *See* SEC v. Eurobond Exch., Ltd., 13 F.3d 1334, 1338 (9th Cir. 1994) (noting that *Howey* test still defines term "investment contract"); SEC v. International Loan Network, Inc., 968 F.2d 1304, 1307 (D.C. Cir. 1992) (finding *Howey* test still applicable for identifying investment contracts); *see also* James D. Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635, 635 (noting that in past 40 years courts have applied and refined *Howey* test); John F. Wagner Jr., Annotation, *"Common Enterprise" Element of* Howey *Test to Determine Existence of Investment Contract Regulable as "Security" Within Meaning of Federal Securities Act of 1933 and Securities Exchange Act of 1934*, 90 A.L.R. FED. 825, 831 (1988) (noting that *Howey* test has become standard for determining investment contract).

[61] *See infra* notes 63-128 and accompanying text (noting three different approaches to application of *Howey* test).

[62] *See* Mordaunt v. Incomco, 469 U.S. 1115, 1115-16 (1985) (White, J., dissenting) (noting clear and significant split in circuits regarding common enterprise element of investment contract), *denying cert. to* 686 F.2d 815 (9th Cir. 1982); *see also* Meyer v. Thomas & McKinnon Auchincloss Kohlmeyer, Inc., 686 F.2d 818, 819 (9th Cir. 1982) (requiring narrow vertical commonality for investment contract), *cert. denied*, 460 U.S. 1023 (1983); J.J. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 224 (6th Cir. 1980) (requiring horizontal commonality for investment contract), *aff'd*, 456 U.S. 353 (1982); SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (requiring broad vertical commonality for investment contract).

II. THE THREE-WAY SPLIT — DEFINING COMMON ENTERPRISE

Although the Court has often espoused a liberal interpretation of the *Howey* test, the Supreme Court has never explicitly defined common enterprise.[63] Rather, the Court has expressly declined to resolve the dispute.[64] Consequently, the circuit courts remain divided[65] into three distinct approaches — the horizontal,[66] the narrow vertical,[67] and the broad vertical approaches.[68]

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[63] *See* BLOOMENTHAL ET AL., *supra* note 34, at 31-32 (noting Supreme Court's liberal use of investment contract approach); *see also* Landreth Timber Co. v. Landreth, 471 U.S. 681, 687 (1985) (noting broad coverage of *Howey* test).

[64] *Mordaunt*, 469 U.S. at 1117 (White, J., dissenting) (noting Court's refusal to hear issue of what constitutes common enterprise).

[65] In addition to the division among the circuits, the Ninth Circuit remains internally divided over the proper approach to defining a common enterprise. *Compare* Hocking v. Dubois, 839 F.2d 560, 567 (9th Cir. 1988) (finding that Ninth Circuit accepts both horizontal and vertical approaches to common enterprise), *cert. denied*, 494 U.S. 1078 (1990) *with* Shaw v. Hiawatha, Inc., No. 88-6001, 1989 WL 102013, at *3 (9th Cir. Aug. 25, 1989) (noting that Ninth Circuit rejects horizontal approach in favor of vertical approach). Similarly, courts in the Second Circuit fail to uniformly follow one approach to common enterprise. *Compare* SEC v. Brigadoon Scotch Distrib., Ltd., 388 F. Supp. 1288, 1291 (S.D.N.Y. 1975) (noting validity of all three approaches to common enterprise) *with* Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1237 n.11 (S.D.N.Y. 1981) (noting that broad vertical approach is invalid because it is inconsistent with *Howey* test).

Courts in the Fourth Circuit also seem to diverge in their approaches to common enterprise. *Compare* SEC v. National Executive Planners, Ltd., 503 F. Supp. 1066, 1071 (M.D.N.C. 1980) (noting that broad vertical approach is proper test) *with* Shotto v. Laub, 635 F. Supp. 835, 839 (D. Md. 1986) (finding that single investor relying on expertise of promoter is not enough for common enterprise). Further, courts in the Eighth Circuit has not adopted a uniform approach. *Compare* Marshall v. Lamson Bros. & Co., 368 F. Supp. 486, 489 (S.D. Iowa 1974) (finding that broad vertical approach satisfies common enterprise requirement) *with* Fargo Partners v. Dain Corp., 405 F. Supp. 739, 742-43 (D.N.D. 1975) (finding that narrow vertical approach satisfies common enterprise requirement), *aff'd*, 540 F.2d 912 (8th Cir. 1976). Finally, the Tenth Circuit remains undecided on which approach to follow. *Compare* Rother v. La Renovista Estates, Inc., 603 F. Supp. 533, 538 (W.D. Okla. 1984) (noting that common enterprise exists only with horizontal commonality) *with* Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D.C. Utah 1981) (finding narrow vertical approach satisfies common enterprise requirement).

[66] *See infra* notes 69-88 and accompanying text (discussing horizontal approach to defining common enterprise element).

[67] *See infra* notes 89-110 and accompanying text (discussing narrow vertical approach to defining common enterprise element).

[68] *See infra* notes 111-28 and accompanying text (discussing broad vertical approach to defining common enterprise element).

A. The Horizontal Approach

The horizontal approach to common enterprise focuses on the relationship among investors in an economic venture.[69] The horizontal test finds a common enterprise if multiple investors[70] pool their funds[71] in an investment,[72] and the profits[73] of each investor correlate[74] with those of the other investors.[75] The Third, Sixth, and Seventh Circuits follow this approach.[76]

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[69] *See* Kaplan v. Shapiro, 655 F. Supp. 336, 339-40 (S.D.N.Y. 1987) (noting that horizontal approach requires pooling of investors' interests in venture for common enterprise); *see also* Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 221 (6th Cir. 1980) (stating that horizontal approach focuses on relationship between individual investor and pool of other investors), *aff'd*, 456 U.S. 353 (1982).

[70] *See Curran*, 622 F.2d at 221 (noting that horizontal approach requires relationship between individual investor and pool of other investors); Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 277 (7th Cir.) (finding that horizontal approach requires joint participants in same investment enterprise), *cert. denied*, 409 U.S. 887 (1972).

[71] "Pooling funds" is a method by which a combination of persons involved in a particular venture contribute to a common fund which is then invested as a whole. BLACK'S LAW DICTIONARY, *supra* note 1, at 1160.

[72] *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 101 (7th Cir. 1977) (finding that horizontal commonality requires sharing or pooling of funds); Meredith v. Conticommodity Servs., Inc., No. 79-1282, 1980 WL 1465, at *6 (D.D.C. Nov. 24, 1980) (finding pooling of funds necessary to satisfy common enterprise element of investment contract). Some courts additionally require that a promoter distribute the profits from an enterprise on a pro rata basis. *See, e.g.*, Stenger v. R.H. Love Galleries, Inc., 741 F.2d 144, 146 (7th Cir. 1984) (noting requirement of pro rata sharing of profits for horizontal approach). *But see* Adams v. Cavanagh Communities Corp., 847 F. Supp. 1390, 1399 (N.D. Ill. 1994) (finding pro rata sharing of profits not required for satisfying horizontal common enterprise).

[73] *See supra* note 7 and accompanying text (defining "profit").

[74] The term "correlation" as used here means a reciprocal or mutual relation between the fluctuations of each investor's profits and the fluctuations of other investors' profits within the same venture. BLACK'S LAW DICTIONARY, *supra* note 1, at 344.

[75] *See* Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1183 (6th Cir. 1981) (stating that horizontal commonality requires all investors share common fortune), *cert. denied*, 454 U.S. 1124 (1981); *see also* Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 224 (6th Cir. 1980) (noting that horizontal approach requires relationship between investors tying fortunes of each investor with success of overall venture), *aff'd*, 456 U.S. 353 (1982).

[76] *See* Deckebach v. La Vida Charters, Inc., 867 F.2d 278, 283 (6th Cir. 1989) (holding that yacht investments are not investment contracts because of no pooling of venture capital); Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982) (holding commodity account not investment contract because no pooling of funds); *Hirk*, 561 F.2d at 101 (holding that discretionary future trading accounts are not investment contracts because of no sharing of profits or pooling of funds).

In addition, the Ninth Circuit occasionally follows the horizontal approach. *See* Hocking v. Dubois, 839 F.2d 560, 566 (9th Cir. 1988) (finding that Ninth Circuit accepts

In *Wals v. Fox Hills Development Corp.*,[77] the Seventh Circuit applied the horizontal approach to decide whether a time-share agreement[78] was an investment contract.[79] In *Wals*, an investor purchased a condominium time-share and concurrently signed an agreement allowing the developer to rent out his share.[80] In return, the developer promised to remit rental fees to the investor.[81] Because of the unprofitable outcome of the investment, the investor brought suit to rescind the sale.[82] The investor contended that the time-share scheme was an investment contract and that the developer failed to register it as required under the Securities Acts.[83]

The *Wals* court held that no common enterprise existed because the promoter did not pool profits.[84] The investor simply received rent from his individual unit, rather than from a share of pooled rental profits.[85] The agreement made it possible that the rental agent might not rent out the investor's unit.[86] Consequently, even though one investor would receive no profit, other investors in the same scheme could receive profits from rental

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both horizontal and vertical approaches to common enterprise), *cert. denied*, 494 U.S. 1078 (1990). *But see* SEC v. Eurobond Exch., Ltd., 13 F.3d 1334, 1339 (9th Cir. 1994) (noting that strict vertical approach is required to establish requisite common enterprise even if horizontal approach is satisfied); Shaw v. Hiawatha, Inc., No. 88-6001, 1989 WL 102013, at *3 (9th Cir. Aug. 25, 1989) (noting that Ninth Circuit has rejected horizontal approach in favor of vertical approach); Svets v. Osborne Precious Metals Co., No. C-92-0357-BAC, 1992 WL 281413, at *1 (N.D. Cal. June 8, 1992) (noting that Ninth Circuit defines common enterprise with narrow vertical approach).

[77] 24 F.3d 1016 (7th Cir. 1994).

[78] A "time-share agreement" is a form of shared property ownership, commonly in vacation or recreation condominium property. BLACK'S LAW DICTIONARY, *supra* note 1, at 1483. In these agreements, rights vest in several owners to use property for specified periods each year. *Id.*

[79] *Wals*, 24 F.3d at 1017. In dicta, the court rejected the vertical commonality approach taken by other circuits despite finding that the facts in this particular case satisfied that test. *Id.* at 1017-18.

[80] *Id.* at 1017.

[81] *Id.*

[82] *Id.*

[83] *Id.*

[84] *Id.* at 1019.

[85] *Id.*

[86] *Id.* at 1017.

of their respective units.[87] There was no sharing of profits among investors.[88]

B. The Narrow Vertical Approach

Unlike the horizontal approach, the narrow vertical approach may allow a single investor to satisfy common enterprise.[89] The narrow vertical approach finds a common enterprise if there is a correlation[90] between the fortunes of an investor and a promoter.[91] If a promoter profits or loses, then so must the investor.[92] Additionally, if an investor profits or loses then so must the promoter.[93] The First, Ninth,[94] and Eleventh Circuits follow this approach.[95]

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[87] *Id.* at 1019.

[88] *Id.*

[89] The narrow vertical approach does not require that a transaction involve multiple investors. *See* Hector v. Wiens, 533 F.2d 429, 433 (9th Cir. 1976) (noting that commonality is required among investor and promoter rather than between multiple investors); *see also* Walsh v. International Precious Metals Corp., 510 F. Supp. 867, 871 (D. Utah 1981) (noting that it makes no sense to penalize individual merely because she is sole investor in misfortune).

[90] *See supra* note 74 and accompanying text (defining "correlation").

[91] *See* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978) (holding that failure to show correlation between investor and promoter as to either failure or success indicates lack of common enterprise); *see also* Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121, 1124 (11th Cir. 1983) (noting that common enterprise element requires that promoter tie fortunes of investor with efforts and success of those seeking investment); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1238 (S.D.N.Y. 1981) (finding that common enterprise requires interdependent relationship between profits and losses of investor and investment manager).

[92] *See* SEC v. Eurobond Exch., Ltd., 13 F.3d 1334, 1340 (9th Cir. 1994) (finding that investment satisfied common enterprise element because investor and promoter shared risk of gains and losses in venture).

[93] *Id.*

[94] An earlier Ninth Circuit decision recognized a common enterprise with fulfillment of either the horizontal or narrow vertical approach. *See* Hocking v. Dubois, 839 F.2d 560, 566 (9th Cir. 1988), *cert. denied*, 494 U.S. 1078 (1990). However, a subsequent case seems to reject the horizontal approach. *See* Shaw v. Hiawatha, Inc., No. 88-6001, 1989 WL 102013, at *3 (9th Cir. Aug. 25, 1989) (noting that Ninth Circuit rejects horizontal approach in favor of vertical approach).

[95] *See Villeneuve*, 698 F.2d at 1124 (noting that distributorships for sale of self-watering planters satisfy common enterprise element because failure of promoter determines failure of scheme); *Brodt*, 595 F.2d at 462 (holding that discretionary brokerage account is not investment contract because success of promoter does not correlate with investor profit or loss); Copeland v. Hill, 680 F. Supp. 466, 468 (D. Mass. 1988) (holding that contract for sale of rare coins was not investment contract because only promoter risked loss).

In 1994, the Ninth Circuit applied the narrow vertical approach in *SEC v. Eurobond Exchange Ltd.*[96] In *Eurobond*, investors provided a promoter with money.[97] The promoter invested the money in high-yield treasury bonds issued by foreign governments.[98] The promoter then used the newly purchased bonds as security for low interest loans to buy additional bonds for the investors.[99] The investors expected profit from the spread[100] between the interest rate received on the bonds and the interest paid on the loans.[101] The SEC brought suit contending that the promoter was selling investment contracts in violation of the Securities Acts.[102]

The promoter argued that because he received a flat fee up front, he profited independently from the fortunes of the investors.[103] Indeed, even if the foreign governments defaulted on their bonds, the promoter would suffer no loss.[104] Nevertheless, the court found narrow vertical commonality.[105]

The court found that the agreement imposed profit limitations on the investors[106] by requiring that any rate of return exceeding a calculated rate went to the promoter.[107] This limitation tied the promoter's fortunes to those of the investors.[108] This correlation between the investors' and promoter's profits satisfied the narrow vertical approach for common enterprise.[109] Consequently, the court held that the Acts governed the scheme because it involved an investment contract.[110]

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[96] *Eurobond*, 13 F.3d at 1334.

[97] *Id.* at 1338.

[98] *Id.* at 1339.

[99] *Id.*

[100] The term "spread" as used here means the difference between the interest rate received from the foreign treasury bonds and the interest rate paid on the loans used to purchase those bonds. BLACK'S LAW DICTIONARY, *supra* note 1, at 1402.

[101] *Eurobond*, 13 F.3d at 1339.

[102] The SEC sought a permanent injunction and disgorgement of the promoter's profits. *Id.* at 1334-36.

[103] *Id.* at 1339.

[104] *Id.* at 1340.

[105] *Id.* at 1340-41.

[106] *Id.* at 1340.

[107] *Id.*

[108] *Id.*

[109] *Id.* at 1341.

[110] In addition to the common enterprise element, the court found that the scheme satisfied the other *Howey* elements as well. *Id.* at 1338-41.

C. The Broad Vertical Approach

Unlike the narrow vertical approach, the broad vertical approach does not focus on a correlation between an investor's and a promoter's profits.[111] Furthermore, unlike the horizontal approach, this view does not require multiple investors[112] or a pooling of funds.[113] Instead, the broad vertical approach finds a common enterprise if the success of an investor depends[114] on a promoter's expertise.[115] Only the Fifth Circuit adheres to this view.[116]

The Fifth Circuit applied the broad vertical approach in *SEC v. Continental Commodities Corp.*[117] In *Continental*, a promoter sold to investors options[118] on commodities futures[119] contracts.[120] The promoter recommended certain futures contracts and then sold options on those contracts.[121] Additionally, the promoter recommended when to sell the options and when to sell the underlying futures contracts.[122] The SEC brought suit to enjoin the promoter from soliciting further investments in

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[111] *See supra* note 91 and accompanying text (noting that narrow vertical approach to common enterprise requires correlation of profits between investor and promoter).

[112] *See supra* note 75 and accompanying text (noting that multiple investors are required to satisfy horizontal definition of common enterprise).

[113] *See supra* note 76 and accompanying text (noting that pooling of funds is required to satisfy horizontal definition of common enterprise).

[114] The term "depend," as used here, means that an investor's success is contingent upon a promoter's efforts. THE NEW LEXICON WEBSTER'S DICTIONARY 96 (School ed. 1988).

[115] The term "expertise" refers to the promoter's knowledge and skills acquired as a result of much practical experience. *Id.* at 128.

[116] *See* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974) (holding that pyramid selling scheme satisfied common enterprise because fortunes of investor tied to efficacy of promoter's efforts); *see also* Long v. Shultz Cattle Co., 881 F.2d 129, 141-42 (5th Cir. 1989) (finding that cattle-feeding consulting agreements constituted common enterprise because investors relied on promoter's expertise for success of their investments).

[117] 497 F.2d 516 (5th Cir. 1974).

[118] The term "option" is a privilege existing in one person, for which she has paid money. BLACK'S LAW DICTIONARY, *supra* note 1, at 755. An option gives the owner a right to buy certain commodities or securities from another person, if she chooses, at any time within an agreed period. *Id.* Additionally, some options give owners the right to sell commodities or securities to such other person at an agreed price and time. *Id.*

[119] A "commodity future" is a speculative transaction involving the sale for future delivery of a staple such as wool or cotton at a predetermined price. *Id.* at 274.

[120] *Continental*, 497 F.2d at 518.

[121] *Id.* at 519.

[122] *Id.*

the trading scheme.[123] The SEC contended that the scheme constituted an investment contract.[124] Therefore, the SEC contended, the promoter needed to register the trading scheme in compliance with the Acts.[125]

The Fifth Circuit focused on the extensive efforts and expertise of the promoter in buying and selling the options and futures contracts.[126] The court found that the investors' dependence on the promoter's expertise to realize a profit constituted a common enterprise.[127] Consequently, the court held that the scheme was an investment contract and was governed by the Acts.[128]

III. EVALUATING THE THREE DIFFERENT APPROACHES

None of the three existing approaches to defining a common enterprise is sufficient. Each of the tests suffers from inadequacies that preclude effectuating the intent of the Acts.[129] Further, as the introductory hypothetical illustrates, applying each of the three approaches to the same facts can yield different results.[130] Each approach has defects that exclude investment schemes that would be common enterprises under another approach. This can lead to inconsistent determinations of what constitutes an investment contract, and consequently to unequal enforcement of the Acts.

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[123] *Id.* at 517.

[124] *Id.*

[125] *Id.* at 517-20.

[126] *Id.*

[127] *Id.* at 522-23.

[128] *Id.*

[129] *See infra* notes 139-74 and accompanying text (discussing defects in three current approaches to defining common enterprise).

[130] A court adopting the broad vertical approach would likely find a common enterprise in the hypothetical. *See infra* notes 136-38 and accompanying text (applying broad vertical definition of common enterprise to hypothetical). In contrast, a court advocating the horizontal approach would probably not find a common enterprise because of a lack of multiple investors. *See infra* notes 131-33 and accompanying text (applying horizontal definition of common enterprise to hypothetical). Additionally, a court following the narrow vertical approach might find a common enterprise if Brook's profits correlated with Inez's profits. *See infra* notes 134-35 and accompanying text (applying narrow vertical definition of common enterprise to hypothetical).

For example, a court following the horizontal approach would not find a common enterprise based on the introductory hypothetical agreement between Brook and Inez. Under that approach, the agreement is not a common enterprise because there is no link[131] among multiple investors.[132] The horizontal approach does not grant protection of the Acts to single investors like Inez.[133]

On the other hand, a court following the narrow vertical approach would likely find a common enterprise because Brook's profits rise and fall with Inez's profits.[134] Brook's commission is based on a percentage of Inez's returns rather than on a flat rate for each transaction.[135] When Inez profits, Brook receives a commission. When Inez loses, Brook receives nothing. Because the percentage fee ties Brook's success to that of Inez, the scheme would satisfy narrow vertical commonality.

Like a court applying the narrow vertical approach, a court following the broad vertical approach would likely find a common enterprise. To prevail in a court, however, Inez must demonstrate that she relied on Brook's expertise. Given Inez's complete lack of stock market experience,[136] she would likely satisfy

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[131] *See* Deckebach v. La Vida Charters, Inc., 867 F.2d 278, 282-83 (6th Cir. 1989) (finding no horizontal common enterprise due to no pooling of profits or prorating of losses among investors); *see also* Stenger v. R.H. Love Galleries, Inc., 741 F.2d 144, 146 (7th Cir. 1984) (noting horizontal common enterprise requires pro rata sharing of profits from pooled funds).

[132] *See* Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 319 (S.D. Ohio 1979) (finding that entrustment by single investor of money to promoter does not satisfy horizontal approach for common enterprise); *see also* Salcer v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 682 F.2d 459, 460 (3d Cir. 1982) (finding that commodity account is not common enterprise because investment not pooled with other investments); Adams v. Cavanagh Communities Corp., 847 F. Supp. 1390, 1398 (N.D. Ill. 1994) (noting that horizontal common enterprise requires pooling of funds from multiple investors).

[133] *See supra* note 75 and accompanying text (discussing requirement of multiple investors for horizontal approach to common enterprise).

[134] *See* Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1239 (S.D.N.Y. 1981) (noting that individual securities trading accounts do not satisfy horizontal approach but may fulfill narrow vertical approach if commission is based on percentage of investor's profits).

[135] *See* SEC v. Eurobond Exch., Ltd., 13 F.3d 1334, 1340-41 (9th Cir. 1994) (noting that ordinary broker transaction with flat-rate commission is not valid common enterprise, but percentage commission based on profits and losses is common enterprise); *see also Savino*, 507 F. Supp. at 1239 (holding that discretionary stock account satisfies narrow vertical common enterprise because of commissions based on percentage of profits).

[136] There is no defined limits qualifying the level of investor expertise which would preclude a finding of common enterprise. However, a lack of any investor expertise sup-

broad vertical commonality.[137] If Inez were an experienced stock trader, however, her success would probably be independent of Brook's expertise. Under those circumstances, the scheme would probably not satisfy broad vertical commonality.[138]

A. Defect of the Horizontal Approach

The horizontal approach will find a common enterprise when multiple investors pool their funds and share the risks and profits of a venture.[139] Therefore, multiple investors are necessary to satisfy horizontal commonality.[140] The number of investors in an enterprise, however, is an arbitrary distinction and does not necessarily correlate with the need for disclosure.[141] One investor's need for disclosure may be identical to that of multiple investors.[142]

Moreover, a single investor may face an even greater risk of loss if her sole asset performs badly than if she pools the failing asset with others that succeed.[143] This increased risk creates a

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ports a finding of reliance on a promoter and satisfaction of broad vertical common enterprise. *See infra* note 168 and accompanying text (noting that lack of investor expertise supports finding of reliance on promoter).

[137] *See* Long v. Shultz Cattle Co., Inc., 881 F.2d 129, 142 (5th Cir. 1989) (finding common enterprise based on investors' dependence on promoter's expertise to manage their investments); *see also* Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 671 (N.D. Ga. 1983) (finding that investor's reliance on promoter for guidance and success of investment provides common enterprise element).

[138] *See* SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (noting that broad vertical common enterprise was satisfied because investor's complete lack of business experience led to reliance on promoter's expertise).

[139] *See* Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100 (7th Cir. 1977) (finding that horizontal commonality requires joint participants in same investment enterprise); *see also supra* notes 69-88 and accompanying text (discussing horizontal approach to defining common enterprise).

[140] *See supra* note 70 and accompanying text (noting that horizontal approach requires multiple investors to satisfy common enterprise).

[141] *See infra* notes 143-46 and accompanying text (noting that single investor may require as much or more protection from Acts).

[142] *See* Gordon, *supra* note 60, at 669 (noting that drawing numerical lines suggests arbitrariness).

[143] Combining investments in multiple assets to reduce risk is known as diversification. *See* RICHARD A. BREALEY & STEWART C. MEYERS, PRINCIPLES OF CORPORATE FINANCE 131-32 (3d ed. 1988). For example, every stock has a range of possible returns called variability. *Id.* Investing in a single stock subjects the investor to a large risk because the overall return is based on the performance of one stock. *Id.* On many occasions, however, the decline in

greater need for disclosure and protection for single investors.[144] A single asset creates more risk than multiple assets because the overall return on an investment derives from the performance of one asset.[145] Conversely, investing in multiple assets lowers the risk because in many instances a decrease in the value of one asset is offset by a corresponding increase in the value of another asset.[146] Therefore, an investor who invests in a single asset rather than a pool of assets has a greater need for disclosure because of the additional risks.

Another problem with the horizontal approach is that by focusing exclusively on the number of investors in an enterprise, courts inevitably overlook many deceptive schemes.[147] For example, a promoter could avoid regulation under the horizontal approach simply by not involving multiple investors. Under the horizontal approach, single investors have no protection under the Acts.[148] This discrepancy undermines the Acts' purpose of preventing fraudulent schemes through the disclosure of all material facts regarding those schemes.[149]

B. Defect of the Narrow Vertical Approach

Unlike the horizontal approach, the narrow vertical approach does not require multiple investors to find a common enterprise.[150] Under this approach, the test for common enterprise is whether an investor's profits rise and fall with the success of a promoter.[151] So long as a promoter and an investor share the

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the value of one stock is offset by an increase in the price of another. *Id.* Therefore, an investor can lessen the risk of loss by investing in multiple stocks with different amounts of individual risk. *Id.* Although stock price changes do not always cancel out one another, economic theory shows that diversification decreases the overall risk associated with an investment. *Id.*

[144] *Id.*

[145] *Id.*

[146] *Id.*

[147] *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (noting that emphasis on economic substance rather than form in investment contract context is response to countless schemes devised by those seeking investors' money).

[148] *See supra* note 70 and accompanying text (noting that horizontal definition of common enterprise requires multiple investors).

[149] *See supra* note 28 and accompanying text (noting effects of Act's disclosure provisions on prevention of fraudulent schemes).

[150] *See* Brodt v. Bache & Co., 595 F.2d 459, 461 (9th Cir. 1978) (noting that common enterprise can exist without involvement of other investors).

[151] *Id.* at 461-62. *See also supra* notes 89-93 and accompanying text (discussing

risks of a scheme, whether there is a pooling of funds is irrelevant.[152]

This view does not comport with the purposes of the Securities Acts because it emphasizes form over substance.[153] The narrow vertical approach focuses on the terms of an agreement rather than the undisclosed risks that an investor faces.[154] A circuit following narrow vertical commonality would not find an investment contract if a promoter did not share the risk.[155] The same circuit faced with an identical transaction, however, would find an investment contract if a promoter did share the risk.[156] Consequently, an investor who compensates a promoter, irrespective of the investment's success, assumes all of the risks without receiving any protection under the Acts.

In circuits following the narrow vertical approach, promoters could avoid regulation simply by choosing a flat-rate commission rather than a share of the profits.[157] This strict emphasis on the terms of a promoter's compensation does not further the Acts' intent to provide a broad scope of coverage over a variety of transactions.[158] Additionally, the narrow vertical approach's emphasis on form contravenes the Supreme Court's flexible interpretation of an investment contract.[159]

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requirements for narrow vertical definition of common enterprise).

[152] Similarly, the narrow vertical approach does not require a pro rata sharing of profits. *See supra* note 71 and accompanying text (noting that some courts following horizontal approach require pro rata sharing of profits).

[153] *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (finding that form is disregarded for substance, with emphasis primarily on economic reality of transaction); *see also infra* note 199 and accompanying text (describing remedial purpose of Securities Acts).

[154] *See supra* notes 90-93 and accompanying text (noting that narrow vertical approach defines common enterprise solely on relationship between investor and promoter).

[155] *See* SEC v. Goldfield Deep Mines Co., 758 F.2d 459, 463 (9th Cir. 1985) (noting that common enterprise only exists if there is direct correlation between success or failure of promoter and success or failure of investment).

[156] *Id. See also* SEC v. Eurobond Exch., Ltd., 13 F.3d 1334, 1340 (9th Cir. 1994) (noting that sharing of risk of loss between investor and promoter in venture satisfies narrow vertical requirement for common enterprise).

[157] *See Eurobond*, 13 F.3d at 1340-41 (noting that prepaid commission in ordinary broker arrangement does not satisfy narrow vertical approach to common enterprise); *see also* 1 HAZEN, *supra* note 8, at 36-37 (noting distinction between service fees for specified stock trades and commissions for managing investment accounts).

[158] *See supra* note 31 and accompanying text (discussing Congressional intent to provide broad coverage under Acts).

[159] *See supra* note 33 and accompanying text (discussing catchall status of investment contract element).

C. Defect of the Broad Vertical Approach

The broad vertical approach also fails to provide an adequate test for common enterprise.[160] Broad vertical commonality does not require multiple investors[161] or correlated profits.[162] Rather, this approach merely requires that an investor depend on a promoter's expertise.[163]

The broad vertical approach has two problems.[164] First, this approach may discriminate against investors that possess expertise in a scheme.[165] For example, suppose in the introductory hypothetical that Inez is an experienced investor in the stock market. A court following the broad vertical approach might not find a common enterprise merely because of Inez's knowledge of stock trading.[166]

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[160] *See infra* notes 161-74 and accompanying text (discussing defects in broad vertical approach to defining common enterprise).

[161] *See supra* note 70 and accompanying text (noting that horizontal definition of common enterprise requires multiple investors).

[162] *See* Long v. Shultz Cattle Co., 881 F.2d 129, 140 (5th Cir. 1989) (noting that no direct correlation between promoter's success or failure and investor's profits or losses is required to constitute common enterprise). *But see supra* notes 73-75 and accompanying text (noting that horizontal definition of common enterprise requires correlation of profits between investors).

[163] *See* SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974) (finding that broad vertical commonality requires success of investment to be dependent on promoter skill); *see also supra* note 116 and accompanying text (listing other cases that applied broad vertical approach to defining common enterprise).

[164] One commentator additionally has proposed that the broad vertical approach is too inclusive. *See* Gordon, *supra* note 60, at 665-66 (noting that broad vertical approach is too broad and can extend to cover simple lease agreements and employee bonus plans). This can be a problem because the cost of registration is very expensive and may prevent legitimate promoters from offering affordable investments. *See* BREALEY & MEYERS, *supra* note 143, at 331-32 (noting that high cost is due to fees for management, legal counsel, accountants, underwriters, their advisors, and SEC filing fees). It is important to note, however, that there are several exemptions from securities registration including: (1) the private offering exemption, (2) the intrastate exemption, (3) offerings made to specified classes of investors, and (4) other conditional exemptions adopted by the SEC. *See* BLOOMENTHAL ET AL., supra note 34, at 360-61.

[165] *See supra* notes 137-38 and accompanying text (discussing cases finding that broad vertical definition of common enterprise was satisfied because of investor's complete lack of expertise in venture).

[166] *See* Long v. Shultz Cattle Co., 881 F.2d 129, 141 (5th Cir. 1989) (noting that investor's lack of necessary expertise in cattle-feeding led to sufficient reliance on promoter to satisfy broad vertical common enterprise); *Continental*, 497 F.2d at 522 (finding common enterprise in commodities investment scheme because investors lacked business knowledge and completely relied on guidance of promoter for success of investment).

Thus, if an experienced investor and a novice investor invest in an identical scheme, courts following broad vertical commonality may not grant protection to the experienced investor.[167] This discrepancy occurs despite the similar risks faced by both investors. Courts following the broad vertical approach find that a novice investor generally depends on a promoter's expertise.[168] Conversely, a knowledgeable investor is not as dependent on a promoter's expertise and therefore does not satisfy broad vertical commonality.[169] This distinction contravenes the intent of the Securities Acts to protect all investors, not just novice investors, from fraudulent schemes.[170]

The second problem is that the broad vertical approach essentially duplicates the fourth element of the *Howey* test.[171] The fourth element requires that an investor's success come from the efforts of others.[172] Dependence on a promoter for the success of an enterprise satisfies the fourth element.[173] Similarly, the broad vertical approach finds a common enterprise when an investor depends on a promoter's expertise.[174]

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[167] *See Long*, 881 F.2d at 141 (finding broad vertical common enterprise based on investor's lack of expertise in cattle-feeding business).

[168] *See Continental*, 497 F.2d at 522-23 (noting that critical fact for broad vertical approach is investor's lack of knowledge and experience); *see also Long*, 881 F.2d at 135-36 (finding common enterprise based on investors' general lack of knowledge and sophistication in area concerning investment).

[169] *See supra* notes 167-68 and accompanying text (discussing knowledgeable investors in context of broad vertical approach).

[170] *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 687 (1985) (citing *Howey* regarding remedial purpose of statutes to cover wide range of instruments in defining security); *see also* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (noting that courts should construe remedial legislation broadly to serve purpose); SEC v. Glenn W. Turner Enters., 474 F.2d 476, 481 (9th Cir.) (noting that Securities Acts are designed to protect public from fraudulent schemes by promoters), *cert. denied*, 414 U.S. 821 (1973).

[171] *See* Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1237 n.11 (S.D.N.Y. 1981) (noting that broad vertical approach essentially gives no content to common enterprise element of *Howey* test); *see also* Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994) (noting that, under broad vertical approach, two elements of *Howey* test are essentially duplicative of one another); Berman v. Bache, Halsey, Stuart, Shields, Inc., 467 F. Supp. 311, 319 (S.D. Ohio 1979) (holding that finding common enterprise based solely on entrustment of funds by single principal to agent deletes common enterprise element of *Howey*).

[172] *See supra* note 18 and accompanying text (discussing requirement of fourth *Howey* element in defining investment contract).

[173] *See Glenn W. Turner Enters.*, 474 F.2d at 482 (noting that reliance on promoter's essential efforts and expertise satisfies fourth element of *Howey* test).

[174] *See supra* notes 111-15 and accompanying text (discussing requirements for broad

Therefore, an investor's dependence on a promoter fulfills two different elements of the test. This essentially reduces the *Howey* test to three elements. Accordingly, the broad vertical approach gives no individual significance to the common enterprise element of the test.

IV. PROPOSAL FOR A UNIFORM TEST DEFINING COMMON ENTERPRISE

To realize the intent of the Acts and achieve consistency among the circuits, the courts should apply a uniform definition of common enterprise.[175] None of the three current approaches defines common enterprise adequately.[176] This Comment proposes a uniform test that would avoid the defects of these approaches. Under the proposed test, a common enterprise would be an investment[177] for profit[178] in which the success[179] of investors correlates[180] with either the success of other investors or the success of a promoter.

This test cures three major defects that exist in the current approaches. First, this definition does not require multiple inves-

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vertical approach to defining common enterprise).

[175] *See* Jeffrey A. Tew & David Freedman, *In Support of* SEC v. W.J. Howey Co.: *A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407, 408 (1973) (noting that uncertainty in definition of security inhibits any proper business planning). *See generally* Gordon, *supra* note 60, at 667-82 (proposing uniform definition for common enterprise). In contrast, one commentator proposes that the test should be a combination of all three current views, allowing the courts to choose an approach depending on the situation. *See* Susan G. Flanagan, Comment, *The Common Enterprise Element of the* Howey *Test*, 18 PAC. L.J. 1141, 1158-60 (1987).

[176] To determine whether an investment comprises a common enterprise the court must look beyond the form to the substance of a transaction. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (noting that Congress adopted state courts' broad construction of term "investment contract" that disregarded form for substance); *see also supra* notes 139-74 and accompanying text (discussing defects of current approaches to defining common enterprise).

[177] *See supra* note 2 and accompanying text (defining "investment").

[178] *See supra* note 7 and accompanying text (defining "profit").

[179] The term "success" in the proposed test means attainment of wealth or prosperity from a profitable investment. *See* THE NEW LEXICON WEBSTER'S DICTIONARY, *supra* note 114, at 428.

[180] *See supra* note 74 and accompanying text (defining "correlation").

tors,[181] unlike the horizontal approach. This avoids the arbitrary lack of protection for single investors.

Second, unlike the broad vertical approach,[182] this test provides knowledgeable investors with protection under the Acts.[183] The degree of an investor's expertise is irrelevant under the proposed test.[184] This avoids discrimination against knowledgeable investors who frequently face the same risks as novice investors.[185]

Third, unlike the narrow vertical approach,[186] the proposed test does not base a finding of common enterprise solely on the correlation between an investor's and promoter's profits.[187] Rather, this test finds a common enterprise based on either of two relational aspects within the enterprise.[188] This dual analysis creates greater flexibility that, in turn, reduces a promoter's ability to circumvent the Acts by simply changing the structure of a scheme.[189]

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[181] *But see supra* note 70 and accompanying text (noting that current horizontal approach requires multiple investors to satisfy common enterprise).

[182] *See supra* notes 111-28 and accompanying text (discussing broad vertical approach to defining common enterprise).

[183] *See supra* notes 165-69 and accompanying text (discussing lack of common enterprise for knowledgeable investors under broad vertical approach).

[184] *See supra* notes 177-80 and accompanying text (discussing requirements of proposed test for defining common enterprise).

[185] *See supra* notes 167-69 and accompanying text (discussing discrimination against knowledgeable investors under broad vertical approach to common enterprise).

[186] *See supra* notes 89-110 and accompanying text (discussing narrow vertical approach to defining common enterprise).

[187] *See supra* notes 90-93 and accompanying text (discussing relationship between profits of investor and promoter required under narrow vertical approach).

[188] The court has more flexibility under the proposed approach because it is not limited to analysis of a single relationship in an investment. *See supra* notes 175-80 and accompanying text (explaining proposed definition of common enterprise). The narrow vertical approach places too much emphasis on form by requiring a relationship between the profits of an investor and a promoter. *See supra* notes 150-59 and accompanying text (discussing defect of narrow vertical approach to common enterprise). The proposed approach diminishes the emphasis on form by finding a common enterprise based on either of two relationships. *See supra* notes 177-80 and accompanying text (discussing requirements of proposed test for finding common enterprise). The court may find a common enterprise when there is a correlation among multiple investors in the same enterprise or between a single investor and a promoter. This furthers the *Howey* Court's emphasis on a broad, flexible test. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (noting broad and remedial nature of Securities Acts and investment contract test).

[189] *See supra* note 157 and accompanying text (discussing ease of circumvention of Acts under narrow vertical approach to common enterprise).

Some might object to the proposed test on the ground that it gives courts too much discretion. This approach, however, would not provide the courts with unbridled discretion to find a security.[190] The courts remain limited by the other three elements of the *Howey* test.

Others might object to the proposed test because of the lack of a multiple-investors requirement.[191] One commentator suggests that individually negotiated contracts should not be securities because the law presumes that individuals can protect their own interests.[192] In contrast, investments with multiple investors usually involve standard form contracts in which the promoter dictates the terms.[193] Therefore, the investors are unable to bargain for favorable terms or to compel disclosure.[194] Although this justification for protecting multiple investor transactions is compelling, it does not warrant excluding individual investor transactions in which the investor lacks bargaining power or negotiation skills. In both cases, the investor's need for protection may be high. Further, requiring multiple investors ignores the flexible nature of the *Howey* test by focusing on the form of a transaction rather than the substance.[195]

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[190] The other three *Howey* elements combine with common enterprise to limit the courts' discretion. *See Howey*, 328 U.S. at 299 (noting four separate elements required for finding existence of investment contract).

[191] *See, e.g.*, Gordon, *supra* note 60, at 667-70 (proposing multiplicity requirement for defining common enterprise).

[192] *See id.* at 667 (suggesting exclusion of individually negotiated arrangements).

[193] *See id.* at 668 (discussing use of standardized form contracts among multiple investors).

[194] *Id.*

[195] The Supreme Court does not require multiple investors for a common enterprise to exist. Most of the early Supreme Court cases that found investment contracts involved more than one investor. *See Howey*, 328 U.S. at 295 (noting presence of multiple investors in scheme subsequently determined to be investment contract); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 346 (1943) (noting that at least 50 investors were involved in transaction deemed to be investment contract); *see also* Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (noting that prior U.S. Supreme Court determinations of common enterprise involved multiple potential investors, not private transactions). In 1985, however, the Court noted that privately negotiated transactions may also be investment contracts subject to regulation under the Securities Acts. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985) (finding that privately negotiated transaction involving bilateral agreement constituted investment contract). This indicates the Supreme Court's position that a transaction with a single investor can constitute a common enterprise. *See also* 2 LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 928-29, n.130 (3d ed. 1989) (discussing Court's retrenchment from earlier position that private transaction is not secu-

Courts should not penalize an investor merely because a scheme does not involve multiple investors. Rather, the focus should be on the substance of an investment itself.[196] A single investor has no less need for protection than an individual who is part of a group of investors.[197]

In sum, the proposed test will resolve the three-way split defining common enterprise. Although the proposed test remains flexible, it will provide the courts with a single definition which would lead to more uniform results. Additionally, the proposed test cures the major defects found in the three current tests for common enterprise.[198] Lastly, the proposed test furthers the broad remedial purpose of the Acts.[199]

CONCLUSION

The Securities Acts of 1933 and 1934 provide the courts with tools to protect investors from securities fraud. To maximize compliance, courts must enforce the Acts consistently.[200] The current split of authority in defining common enterprise, however, has resulted in inconsistent enforcement which can leave many defrauded investors without adequate recourse.

The courts need a flexible, yet predictable, test to further the intent of Congress to provide broad remedial coverage over

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rity).

[196] *See infra* note 199 and accompanying text (discussing *Howey* Court's emphasis on economic substance rather than form).

[197] *See supra* notes 143-46 and accompanying text (noting that single investor may face greater risks and therefore demand greater protection than multiple investors).

[198] *See supra* notes 139-74 and accompanying text (discussing defects of current approaches to defining common enterprise).

[199] *See Howey*, 328 U.S. at 298 (noting that form is to be disregarded for substance to give investing public full measure of protection); *see also* Landreth Timber Co. v. Landreth, 471 U.S. 681, 688 (1985) (noting Supreme Court's emphasis on economic substance over form in determining application of Acts). The Fifth Circuit has noted that the *Howey* test requires a flexible standard capable of covering any scheme that falls within the ordinary concept of a security. *See* Long v. Shultz Cattle Co., 881 F.2d 129, 141 (5th Cir. 1989) (noting flexibility of *Howey* test for investment contracts); *see also* SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974) (noting purposes of Acts mandate a functional approach to *Howey* test).

[200] Inconsistent application of the Acts reduces the deterrent effect of the Acts' criminal sanctions. *See* Gordon, *supra* note 60, at 671 (noting that Securities Acts impose criminal sanctions to deter fraud). *See generally* 15 U.S.C. § 77x (noting criminal penalties for violation of Acts); *id.* § 78ff (noting criminal penalties).

unusual financial transactions. The proposed test defines common enterprise as an investment for profit in which the success of investors correlates with either the success of other investors or the success of a promoter. By using this test, courts have the flexibility to find a common enterprise based on either of two relationships in a venture. Therefore, this approach will foster the broad protection intended for investors. Additionally, by providing a single definition for a common enterprise, the proposed test helps to insure consistent decisions among the courts.

Marc G. Alcser