

Defining a Common Enterprise in Investment Contracts

JAMES D. GORDON III*

Under the federal securities laws, an investment contract is: (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) solely from the efforts of others. However, the federal circuit courts of appeal are fractured over the definition of a "common enterprise."

This Article argues for a "multiple investors" test for a common enterprise. Under this test, a common enterprise is an enterprise in common among the promoter and multiple parallel investors. The multiple investors test corresponds to the disclosure policy of the securities acts because it asks which contracts should have enhanced disclosure rather than the level of disclosure required by other statutes and the common law for most contracts. In addition, the multiple investors test helps determine which promissory notes are securities.

The Article also argues that the Supreme Court case of SEC v. Edwards should significantly affect the debate over the definition of a common enterprise. In addition, the Article demonstrates that the combination of several key Supreme Court cases strongly points to the multiple investors test.

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* Marion B. and Rulon A. Earl Professor of Law, J. Reuben Clark Law School, Brigham Young University; Assistant to the President for Planning and Assessment, Brigham Young University. B.A., 1977, Brigham Young University; J.D., 1980, University of California, Berkeley. Portions of this Article are based on James D. Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635, and James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383 (1990) (copyright Tex. L. Rev. Ass'n).

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I. INTRODUCTION

“Investment contracts” are securities covered by the federal securities acts, along with stocks, bonds, and certain other instruments.¹ The Supreme Court defined investment contracts in *SEC v. W.J. Howey Co.*² An investment contract is: (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) solely³ from the efforts of

¹ Section 2(a)(1) of the Securities Act of 1933 provides:

The term “security” means any note, stock, treasury stock, security future, 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, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933 § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006). Section 3(a)(10) of the Securities Exchange Act of 1934 provides a similar, although slightly different, definition. Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2006). The Supreme Court has observed that the two definitions are “virtually identical.” *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985). Similar definitions of securities appear in § 2(36) of the Investment Company Act of 1940 and § 80b-2(a)(18) of the Investment Advisors Act of 1940. Investment Company Act of 1940 § 2(a)(36), 15 U.S.C. § 80a-2(a)(36) (2006); Investment Advisors Act of 1940 § 202(a)(18), 15 U.S.C. § 80b-2(a)(18) (2006).

² 328 U.S. 293, 298–99, 301 (1946).

³ Lower courts have since held that “solely” should not be interpreted literally. *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240 n.4 (4th Cir. 1988) (citing cases from eight other circuits). It is sufficient if the profits come predominantly from the efforts of others. *SEC v. Life Partners, Inc.*, 87 F.3d 536, 545 (D.C. Cir. 1996); *SEC v. Int’l Loan Network, Inc.*, 968 F.2d 1304, 1308 (D.C. Cir. 1992). It is also sufficient if the efforts of others are “the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974) (quoting *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973)). In *United Housing Foundation, Inc. v. Forman*, the Supreme Court stated, “The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be

others.⁴ However, the federal circuit courts of appeal cannot agree on the definition of a “common enterprise.”⁵

The circuits are not only split; they are fractured. Some circuits use horizontal commonality, which is a pooling of investor contributions, and, according to some courts, a pro rata sharing of profits.⁶ Other circuits use vertical commonality, which has two versions. Broad vertical commonality requires that the investor’s fortunes depend on the promoter’s efforts.⁷ By contrast, narrow vertical commonality requires that the investor’s profits be tied to the manager’s profits—i.e., they must rise and fall together.⁸ To make matters more complex, some circuits require one approach, some circuits accept one approach but have not ruled on others, one circuit uses two approaches, and one circuit uses a completely different approach.⁹ Commentators are also divided, advocating horizontal commonality,¹⁰ broad vertical commonality,¹¹ narrow vertical commonality,¹² either horizontal or

derived from the entrepreneurial or managerial efforts of others.” 421 U.S. 837, 852 (1975). At the same time, the Court stated that it expressed no view about the holding in *SEC v. Glenn W. Turner Enterprises*. *Id.* at 852 n.16.

⁴ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99, 301 (1946).

⁵ The Supreme Court denied certiorari in *Mordaunt v. Incomco*, a case raising the common enterprise issue in connection with a discretionary trading account. 686 F.2d 815 (9th Cir. 1982) (finding no common enterprise), *cert. denied*, 469 U.S. 1115 (1985). Three justices dissented, urging the granting of review in light of the “clear and significant split” among the federal circuits on the commonality issue. 469 U.S. at 1117 (White, J., dissenting).

⁶ See *infra* notes 52–54 and accompanying text.

⁷ See *infra* note 56 and accompanying text.

⁸ See *infra* note 57 and accompanying text.

⁹ See *infra* notes 60–71 and accompanying text.

¹⁰ Christopher L. Borsani, *A “Common” Problem: Examining the Need for Common Ground in the “Common Enterprise” Element of the Howey Test*, 10 DUQ. BUS. L.J. 1, 14–17 (2008); Todd M. Tippet, *Comment, Game When They Win: Investment When They Lose*: *SEC v. SG, Ltd.*, 7 COMPUTER L. REV. & TECH. J. 313, 318–19 (2003).

¹¹ Lloyd J. Bandy, Jr., *Comment, Securities Regulation—Investment Contracts and the Common Enterprise Requirement*, 43 MO. L. REV. 779, 786–87 (1978); Stephen M. Maloney, *Comment, What is a Common Enterprise? A Question of Legislative Intent*, 11 MISS. C. L. REV. 125, 137 (1990).

¹² Shawn Hill Crook, *Comment, What Is a Common Enterprise? Horizontal and Vertical Commonality in an Investment Contract Analysis*, 19 CUMB. L. REV. 323, 350–52 (1989); William L. Doerler, *Comment, SEC v. Life Partners, Inc.: An Extended Interpretation of the Howey Test Finds that Viatical Settlements Are Investment Contracts*, 22 DEL. J. CORP. L. 253, 270 (1997); Rodney L. Moore, *Note, Defining an “Investment Contract”: The Commonality Requirement of the Howey Test*, 43 WASH. & LEE L. REV. 1057, 1082–86 (1986).

vertical commonality,¹³ and other approaches.¹⁴

I have previously proposed a multiple investors test for a common enterprise.¹⁵ Under this test, a common enterprise is an enterprise that is in common among the promoter and multiple parallel investors. I believe that the multiple investors test corresponds better to the disclosure policy of the securities acts than do the other definitions of a common enterprise. I have also argued that the *Howey* test, as modified by the multiple investors definition of a common enterprise, is a meaningful test for determining which promissory notes are securities,¹⁶ and that the Supreme Court essentially adopted this test in *Reves v. Ernst & Young*.¹⁷

The Supreme Court case of *SEC v. Edwards*¹⁸ should significantly affect the debate over the definition of a common enterprise. In *Edwards*, the Court held that a payphone sale-and-leaseback arrangement with a fixed return could be an investment contract.¹⁹ The case did not address the definition of a common enterprise. Nevertheless, this Article will argue that *Edwards* implies the death of narrow vertical commonality and casts substantial doubt on horizontal commonality. The Article will also demonstrate that the

¹³ 2 LOUIS LOSS ET AL., SECURITIES REGULATION 937-39 (4th ed. 2007) (either horizontal or narrow vertical commonality); Susan G. Flanagan, Comment, *The Common Enterprise Element of the Howey Test*, 18 PAC. L.J. 1141, 1158-60 (1987) (either horizontal, broad vertical, or narrow vertical commonality); Kyle M. Globberman, Note, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 287-88 (1999) (either horizontal or vertical commonality); Maura K. Monaghan, Note, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 FORDHAM L. REV. 2135, 2171-74 (1995) (either horizontal or narrow vertical commonality).

¹⁴ Marc G. Alcer, Comment, *The Howey Test: A Common Ground for the Common Enterprise Theory*, 29 U.C. DAVIS L. REV. 1217, 1238-41 (1996) (a common enterprise should exist when there is an investment for profit in which the success of investors correlates with either the success of other investors or the success of a promoter); Park McGinty, *What Is a Security?*, 1993 WIS. L. REV. 1033, 1089 (investment contracts should require "either a. multiple investors relying predominantly on the efforts of the promoter or a third party, or b. one or more investors relying solely on the efforts of the promoter or a third party").

¹⁵ James D. Gordon III, *Common Enterprise and Multiple Investors: A Contractual Theory for Defining Investment Contracts and Notes*, 1988 COLUM. BUS. L. REV. 635 [hereinafter Gordon, *Common Enterprise*].

¹⁶ James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383, 402 (1990) [hereinafter Gordon, *Interplanetary Intelligence*]; Gordon, *Common Enterprise*, *supra* note 15, at 679-81.

¹⁷ 494 U.S. 56 (1990); Gordon, *Interplanetary Intelligence*, *supra* note 16, at 394-404.

¹⁸ 540 U.S. 389 (2004).

¹⁹ *Id.* at 397.

combination of several key Supreme Court cases strongly points to the multiple investors test for a common enterprise.

II. THE IMPORTANCE OF THE SECURITIES ACTS

The securities markets are essential to America's economy and financial health. Securities such as stocks and bonds are a primary means through which businesses raise capital. Many people invest in securities to save money and earn a return in order to prepare for retirement or meet other financial objectives. Before the 1930s, securities were governed only by state law (the state "blue sky laws").²⁰ However, after the stock market crash of 1929, Congress passed comprehensive legislation regulating securities. The two most important acts are the Securities Act of 1933²¹ and the Securities Exchange Act of 1934.²² These acts apply to most purchases and sales of securities in the United States.

The securities acts are in large measure designed to provide enhanced disclosure to investors, either directly or through the specific and general deterrent effects of civil,²³ criminal, and administrative remedies. First, the acts require the registration of publicly offered securities with the Securities and Exchange Commission (SEC) and the use of a prospectus, unless the security or transaction is specifically exempted.²⁴ The prospectus discloses the risks and includes material information about the issuer, the securities offered, and the industry in which the issuer operates.²⁵

Second, the securities acts provide civil remedies for fraud which are more protective of victims than is common law fraud. Generally, the elements of common law fraud are a material misrepresentation (an omission qualifies if there is a duty to disclose, a half-truth, or certain other factors),²⁶ made with knowledge (or a reckless disregard) of its falsity, an intention to

²⁰ The first state securities act was enacted by Kansas in 1911. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 18 (6th ed. 2009). The state statutes are called "blue sky laws" because, it was said, they were aimed at "speculative schemes which have no more basis than so many feet of 'blue sky.'" *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917).

²¹ Securities Act of 1933 §§ 1–26, 15 U.S.C. §§ 77a–77bbbb (2006).

²² Securities Exchange Act of 1934 §§ 1–37, 15 U.S.C. §§ 78a–78nn (2006).

²³ James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 35 (1959); Harry Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 227 (1933).

²⁴ 1933 Act § 5, 15 U.S.C. § 77e (2006).

²⁵ See 1933 Act § 10, 15 U.S.C. § 77j; 1933 Act Schedule A, 15 U.S.C. § 77aa Schedule A (2006).

²⁶ W. PAGE KEETON ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* 738–39 (5th ed. 1984).

induce the victim to rely, justifiable reliance by the victim, and damages.²⁷ While some securities provisions include certain of these elements and add other elements, in general the securities acts lower the requirements for recovery. For example, issuers are strictly liable for misrepresentations and omissions in registration statements.²⁸ Other sections of the securities acts impose liability for negligence and shift the burden of proof on that issue to the defendant.²⁹ The plaintiff's burden of proof under other sections is a preponderance of the evidence, in comparison with clear and convincing evidence for common law fraud.³⁰ Some sections relax or eliminate the requirement of proving reliance,³¹ and the common law defense of *in pari delicto* is more limited.³² The class of defendants is expanded,³³ and there is

²⁷ See generally *id.* at 725–70. This statement is a generalization; some elements are modified or qualified in some jurisdictions. *Id.* at 728.

²⁸ 1933 Act § 11(a)(1), 15 U.S.C. § 77k(a)(1) (2006); see 1933 Act § 6(a), 15 U.S.C. § 77f(a) (2006) (issuer must sign registration statement).

²⁹ 1933 Act § 11, 15 U.S.C. § 77k (2006); 1933 Act § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006).

³⁰ *E.g.*, *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387–91 (1983) (citing Rule 10b-5).

³¹ Reliance is not required under § 11 of the 1933 Act (except that the plaintiff must not have known of the untruth or omission), unless the plaintiff acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least 12 months beginning after the effective date of the registration statement. 1933 Act § 11(a), 15 U.S.C. § 77k(a) (2006). However, even this reliance may be established without proof that the plaintiff read the registration statement. *Id.* Section 12(a)(2) of the 1933 Act does not require reliance, except that the purchaser must not have known of the untruth or omission. 1933 Act § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006). In omissions cases under Rule 10b-5, positive proof of reliance is not required. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153–54 (1972). In *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, the Court said that *Affiliated Ute* created a rebuttable presumption of reliance if there is an omission of a material fact by one with a duty to disclose. 552 U.S. 148, 159 (2008). Also, in a Rule 10b-5 action, when materially misleading statements have been disseminated into an impersonal, well developed market for securities, a rebuttable presumption arises that the plaintiff relied on the integrity of the market. *Basic Inc. v. Levinson*, 485 U.S. 224, 229–30, 241–42 (1988). This is called the fraud-on-the-market theory. *Id.*

³² See *Pinter v. Dahl*, 486 U.S. 622, 632–39 (1988); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 315–16 (1985).

³³ Under § 11 of the 1933 Act, signers of the registration statement, directors, experts, and underwriters are generally liable unless they sustain the burden of proof that they had, after reasonable investigation, reasonable ground to believe and did believe that the statements were true and that no material omissions existed. 1933 Act § 11, 15 U.S.C. § 77k (2006). These persons are liable for misrepresentations and omissions in statements purporting to be made on the authority of an expert other than themselves if they had no reasonable ground to believe and did not believe that the statements were untrue or that the omissions existed. *Id.* Controlling persons of violators can also be liable. 1933 Act

nationwide service of process.³⁴ Also, the acts create federal court jurisdiction, allowing invocation of the federal class action provisions.³⁵ Third, the securities acts provide public protection in the form of criminal liability,³⁶ governmental injunctions,³⁷ and administrative remedies.³⁸

III. THE *HOWEY* TEST

"Securities" are defined broadly under the federal securities laws. In the securities acts, Congress did not attempt to articulate the relevant economic criteria for identifying securities; rather, it simply set forth lists of securities. Its purpose was to define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."³⁹ These definitions include the term "investment contract," a term which originated in the state securities acts which were enacted before the federal securities acts.

The leading case regarding the definition of investment contracts is *SEC v. W.J. Howey Co.*⁴⁰ In that case the promoter offered tracts in a citrus grove coupled with a ten-year service contract under which an affiliate of the promoter would cultivate the groves and harvest and market the fruit.⁴¹ Upon full payment the land would be conveyed to a purchaser by warranty deed.⁴² The service company was paid a specified fee plus the cost of labor and

§ 15, 15 U.S.C. § 77o (2006); 1934 Act § 20(a), 15 U.S.C. § 78t(a) (2006). Furthermore, Section 12(a)(2) of the 1933 Act makes liable any person who offers or sells a security by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of any material misrepresentation or omission, unless he or she sustains the burden of proof that he or she did not know and in the exercise of reasonable care could not have known of the misrepresentation or omission. 1933 Act § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006). Liability under § 12 also extends to a person who successfully solicits the purchase, motivated at least in part by a desire to serve his or her own financial interests or those of the securities owner. *See Pinter*, 486 U.S. at 641–54 (addressing § 12(a)(1)).

³⁴ 1933 Act § 22(a), 15 U.S.C. § 77v(a) (2006); 1934 Act § 27, 15 U.S.C. § 78aa (2006).

³⁵ *See* FED. R. CIV. P. 23.

³⁶ *E.g.*, 1933 Act § 24, 15 U.S.C. § 77x (2006); 1934 Act § 32, 15 U.S.C. § 78ff (2006).

³⁷ 1933 Act § 20(b), 15 U.S.C. § 77t(b) (2006); 1934 Act § 21(d)(1), 15 U.S.C. § 78u(d)(1) (2006).

³⁸ HAZEN, *supra* note 20, at 271–72.

³⁹ H.R. REP. NO. 73-85, at 11 (1933).

⁴⁰ 328 U.S. 293, 298–99 (1946).

⁴¹ *Id.* at 295.

⁴² *Id.*

materials, and was given full discretion and authority over cultivation, harvesting, and marketing.⁴³ The company was accountable for an allocation of net profits based on a check made at harvest time.⁴⁴ Forty-two purchasers invested in the citrus groves.⁴⁵

The Court held that the arrangements were investment contracts, and thus were covered by the federal securities acts.⁴⁶ The Court defined an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”⁴⁷ It stated that this definition had been “crystallized” in the state court cases which preceded the passage of the federal acts.⁴⁸ The Court observed that the term “had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed on economic reality.”⁴⁹ The Court stated that its definition of investment contracts “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.”⁵⁰

The *Howey* test requires that the money be invested in a common enterprise.⁵¹ However, *Howey* did not explain this prong of the test, and the federal circuit courts of appeal disagree on what constitutes a common enterprise. There are three basic definitions. Horizontal commonality focuses on the horizontal relationship among investors. It requires an enterprise in which the investors’ contributions are pooled,⁵² and the fortune of each

⁴³ *Id.* at 296.

⁴⁴ *Id.*

⁴⁵ *Id.* at 295.

⁴⁶ 328 U.S. 293, 299–301 (1946).

⁴⁷ *Id.* at 298–99.

⁴⁸ *Id.* at 298.

⁴⁹ *Id.*

⁵⁰ *Id.* at 299.

⁵¹ *Id.* at 298–99.

⁵² *E.g.*, SEC v. Infinity Group Co., 212 F.3d 180, 187–88 (3d Cir. 2000); Wals v. Fox Hills Dev. Corp., 24 F.3d 1016, 1019 (7th Cir. 1994); Revak v. SEC Realty Corp., 18 F.3d 81, 87 (2d Cir. 1994); Deckebach v. La Vida Charters, Inc., 867 F.2d 278, 281–82 (6th Cir. 1989); Hart v. Pulte Homes of Michigan Corp., 735 F.2d 1001, 1004 (6th Cir. 1984); Salcer v. Merrill Lynch, Pierce, Fenner and Smith Inc., 682 F.2d 459, 460 (3d Cir. 1982); Union Planters Nat’l Bank v. Commercial Credit Bus. Loans, Inc., 651 F.2d 1174, 1183 (6th Cir. 1981); Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 622 F.2d 216, 222 (6th Cir. 1980), *aff’d on other grounds*, 456 U.S. 353 (1982); Hirk v. Agri-Research Council, Inc., 561 F.2d 96, 100–01 (7th Cir. 1977); Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 276–79 (7th Cir. 1972).

investor depends on the success of the overall venture.⁵³ Some courts also require a pro rata sharing of the profits and losses derived from the pooled funds.⁵⁴

By contrast, vertical commonality focuses on the vertical relationship between the investor and the promoter. The vertical test defines a common enterprise as one in which the investor is dependent on the promoter's efforts or expertise for the investor's returns.⁵⁵ Broad and narrow versions of vertical commonality exist. The broad version requires that the investor's fortunes be tied to the efficacy of the manager's efforts.⁵⁶ By comparison, narrow vertical commonality requires that the investor's profits be tied to the manager's profits—i.e., they must rise and fall together.⁵⁷ An arrangement in which the manager is paid a fixed fee lacks narrow vertical commonality.⁵⁸ Similarly, a discretionary stock or commodities trading account lacks narrow

⁵³ *E.g.*, *Revak*, 18 F.3d at 87; *Deckebach*, 867 F.2d at 282; *Hart*, 735 F.2d at 1004; *SEC v. Prof. Assocs.*, 731 F.2d 349, 354 (6th Cir. 1984); *Union Planters Nat'l Bank*, 651 F.2d at 1183; *Curran*, 622 F.2d at 223–24.

⁵⁴ *E.g.*, *Infinity Group Co.*, 212 F.3d at 187–88; *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144, 146 (7th Cir. 1984); *see SEC v. Banner Fund Int'l*, 211 F.3d 602, 614 (D.C. Cir. 2000); *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996); *Hocking v. Dubois*, 885 F.2d 1449, 1459 (9th Cir. 1989) (en banc); *Wals*, 24 F.3d at 1019 (requiring that the investors obtain “an undivided share in the same pool of assets and profits”).

⁵⁵ *E.g.*, *SEC v. ETS Payphones, Inc.*, 408 F.3d 727, 732 (11th Cir. 2005); *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1283–84 (11th Cir. 2002) (per curiam), *rev'd and remanded on other grounds sub nom.*, *SEC v. Edwards*, 540 U.S. 389 (2004); *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1999 (11th Cir. 1999); *Eberhardt v. Waters*, 901 F.2d 1578, 1580–81 (11th Cir. 1990); *Long v. Shultz Cattle Co.*, 881 F.2d 129, 140–41 (5th Cir. 1989); *United States v. Morse*, 785 F.2d 771, 776 (9th Cir. 1986); *Villeneuve v. Advanced Bus. Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983) (en banc); *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 521–22 (5th Cir. 1974); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 478–79 (5th Cir. 1974); *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973).

⁵⁶ *E.g.*, *Unique Fin. Concepts, Inc.*, 196 F.3d at 1199–1200; *Revak*, 18 F.3d at 87–88; *Eberhardt*, 901 F.2d at 1580–81; *Cont'l Commodities Corp.*, 497 F.2d at 522; *Koscot Interplanetary, Inc.*, 497 F.2d at 479; *Shultz Cattle Co.*, 881 F.2d at 140–41.

⁵⁷ *E.g.*, *Revak*, 18 F.3d at 88; *SEC v. Eurobond Exch., Ltd.*, 13 F.3d 1334, 1340–41 (9th Cir. 1994); *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978); *SEC v. Pinckney*, 923 F. Supp. 76, 82 (E.D.N.C. 1996); *Schofield v. First Commodity Corp.*, 638 F. Supp. 4, 7 (D. Mass. 1985), *aff'd on other grounds*, 793 F.2d 28 (1st Cir. 1986); *Shotto v. Laub*, 635 F. Supp. 835, 839 (D. Md. 1986); *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1238 (S.D.N.Y. 1981).

⁵⁸ *See Shultz Cattle Co.*, 881 F.2d at 140–41.

vertical commonality if the broker is paid commissions based on the frequency of transactions rather than on the profitability of the account.⁵⁹

The circuit courts of appeal are profoundly divided over the definition of a common enterprise. The Third,⁶⁰ Sixth,⁶¹ and Seventh⁶² Circuits require horizontal commonality.⁶³ By contrast, the Fifth⁶⁴ and Eleventh⁶⁵ Circuits use broad vertical commonality. The First,⁶⁶ Fourth,⁶⁷ and D.C.⁶⁸ Circuits accept horizontal commonality but have not ruled on vertical commonality. The Second Circuit accepts horizontal commonality, rejects broad vertical commonality, and has not ruled on narrow vertical commonality.⁶⁹ The Ninth

⁵⁹ *E.g.*, *Mordaunt v. Incomco*, 686 F.2d 815, 817 (9th Cir. 1982); *Brodt*, 595 F.2d at 461. For a discussion of discretionary trading accounts managed by securities and commodity brokers, see Harvey Bines & Steve Thel, *Investment Management Arrangements and the Federal Securities Laws*, 58 OHIO ST. L.J. 459 (1997).

⁶⁰ *Salcer v. Merrill Lynch, Pierce, Fenner and Smith Inc.*, 682 F.2d 459, 460 (3d Cir. 1982). In 2000 the Third Circuit declined to decide whether vertical commonality suffices. *SEC v. Infinity Group*, 212 F.3d 180, 187–88 n.8 (3d Cir. 2000).

⁶¹ *Newmyer v. Philatelic Leasing, Ltd.*, 888 F.2d 385, 394 (6th Cir. 1989); *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278, 281–82 (6th Cir. 1989); *Hart v. Pulte Homes of Mich. Corp.*, 735 F.2d 1001, 1004 (6th Cir. 1984); *Union Planters Nat'l Bank v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174, 1183 (6th Cir. 1981); *Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 622 F.2d 216, 222 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982).

⁶² *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016 (7th Cir. 1994); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 100–01 (7th Cir. 1977); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276–79 (7th Cir. 1972). In *SEC v. Lauer*, the Seventh Circuit upheld a preliminary injunction on the ground that an investment contract probably existed even though there was only one investor, because the promoter apparently represented that the investment would be pooled with others. 52 F.3d 667, 670–71 (7th Cir. 1995).

⁶³ *Wals*, 24 F.3d at 1018; *Deckebach*, 867 F.2d at 282; *Salcer*, 682 F.2d at 460; *Curran*, 622 F.2d at 222; *Hirk*, 561 F.2d at 100–01; *Milnarik*, 457 F.2d at 276–79.

⁶⁴ *Long v. Shultz Cattle Co.*, 881 F.2d 129, 140–41 (5th Cir. 1989); *SEC v. Cont'l Commodities Corp.*, 497 F.2d 516, 521–22 (5th Cir. 1974); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479 (5th Cir. 1974).

⁶⁵ *SEC v. ETS Payphones, Inc.* 408 F.3d 727, 732 (11th Cir. 2005); *SEC v. Unique Fin. Concepts, Inc.*, 196 F.3d 1195, 1999–2000 (11th Cir. 1999); *Eberhardt v. Waters*, 901 F.2d 1578, 1580–81 (11th Cir. 1990); *Villeneuve v. Advanced Bus. Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983) (en banc). In *SEC v. Mutual Benefits Corp.*, the Eleventh Circuit stated in a footnote that the viatical settlements at issue had both horizontal and vertical commonality. 408 F.3d 737, 743 n.4 (11th Cir. 2005).

⁶⁶ *SEC v. SG Ltd.*, 265 F.3d 42, 50 n.2 (1st Cir. 2001).

⁶⁷ *Teague v. Bakker*, 35 F.3d 978, 986 n.8 (4th Cir. 1994).

⁶⁸ *SEC v. Banner Fund Int'l*, 211 F.3d 602, 614 (D.C. Cir. 2000); *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543–44 (D.C. Cir. 1996).

⁶⁹ *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994).

Circuit recognizes both horizontal commonality and narrow vertical commonality.⁷⁰ The Tenth Circuit has rejected a requirement of horizontal commonality in favor of an “economic reality” approach.⁷¹

To illustrate the differences in the definitions of a common enterprise, let us suppose that a condominium developer sells condominium units coupled with management agreements under which the manager will rent the units to vacationers when the owners are not using them, and will pay each owner a percentage of the rental proceeds from the owner’s unit. The SEC views these arrangements as investment contracts if “[t]he condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.”⁷² Indeed, the arrangements have some similarities to the sale of citrus groves coupled with a management agreement that were addressed in *Howey*.⁷³

Under the horizontal commonality approach, these arrangements are not investment contracts.⁷⁴ Horizontal commonality is absent because each purchaser owns a separate asset, and thus the investment funds are not pooled. Nor is there a pro rata sharing of profits, since each purchaser’s return is based on the rental use of his or her particular unit. Horizontal commonality would exist if the investors’ funds were pooled to buy an entire

⁷⁰ *Hocking v. Dubois*, 885 F.2d 1449, 1459 (9th Cir.1989) (en banc). In *SEC v. R.G. Reynolds Enterprises, Inc.*, the Ninth Circuit seemed to say in dicta that broad vertical commonality would suffice. 952 F.2d 1125, 1130–31 (9th Cir. 1991).

⁷¹ *McGill v. Am. Land & Exploration Co.*, 776 F.2d 923, 924–25 (10th Cir. 1985). In *Aldrich v. McCulloch Properties, Inc.*, purchasers of lots in a real estate development alleged that “they purchased lots with investment intent, that defendants encouraged investment purchases by promising the lots would increase in value because of defendants’ activities in developing and providing amenities, and that defendants led purchasers to believe a trust would be established to construct and operate facilities for their common benefit.” 627 F.2d 1036, 1039 (10th Cir. 1980). The Tenth Circuit did not decide whether the arrangements were investment contracts, but it held that plaintiffs’ allegations were sufficient to withstand a Rule 12(b)(6) motion to dismiss. *Id.* at 1038. The buyers purchased separate lots. *Id.* at 1039. However, the court stated, “[A] common enterprise does not require the sale of undivided interests” *Id.*

⁷² 17 C.F.R. § 231.5347 (1988); see also *Hocking*, 885 F.2d at 1449 (condominiums); *Cameron v. Outdoor Resorts of Am., Inc.*, 608 F.2d 187, 192–93 (5th Cir. 1979), modified on other grounds, 611 F.2d 105 (5th Cir. 1980) (per curiam) (condominium campsites); *Wooldridge Homes, Inc. v. Bronze Tree, Inc.*, 558 F. Supp. 1085 (D. Colo. 1983) (condominiums) (denying motion to dismiss because an investment contract could be involved). But see *Revak*, 18 F.3d at 87; *Wals*, 24 F.3d at 1018.

⁷³ 328 U.S. 293 (1946).

⁷⁴ See *Wals*, 24 F.3d at 1018; *Revak*, 18 F.3d at 88; *Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278, 282–84 (6th Cir. 1989) (yacht leasebacks).

condominium project and each investor received a proportionate share of the profits of the entire enterprise.

By contrast, under either vertical commonality approach, the arrangements are investment contracts.⁷⁵ The arrangements have broad vertical commonality because the investor's fortunes are dependent on the manager's managerial and entrepreneurial effort and skill in attracting rental customers and producing income for the investor. The arrangements also have narrow vertical commonality. Because the manager pays the investor a percentage of the rental proceeds, the manager's income rises and falls with the investor's income. On the other hand, if the investor paid the manager a fixed fee, or if the manager paid the investor a fixed return, the arrangement would lack narrow vertical commonality.

IV. *MARINE BANK V. WEAVER*

Vertical commonality does not require a pooling of investment funds or a pro rata sharing of profits among investors. Therefore, vertical commonality can exist even when there is only one promoter and one investor, in a unique one-on-one contract between two parties. However, a Supreme Court case, *Marine Bank v. Weaver*,⁷⁶ held that an individually negotiated profit-sharing agreement not involving multiple investors was not a security.⁷⁷ The Weavers guaranteed a bank loan to a meat packing company owned by the Piccirillos, who in return promised to pay the Weavers fifty percent of the company's net profits and \$100 per month.⁷⁸

The contract had broad and narrow vertical commonality but lacked horizontal commonality. However, the Court did not explicitly address the concept of a common enterprise. Instead, the Court focused on the absence of multiple investors. The Court noted that the "unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case."⁷⁹ It pointed out that *Howey* involved forty-two purchasers,⁸⁰ and that in *SEC v. C.M. Joiner*

⁷⁵ See *Cameron*, 608 F.2d at 192-93 (condominium campsites); *Wooldridge Homes, Inc.*, 558 F. Supp. at 1987 (condominiums) (denying motion to dismiss because an investment contract could be involved).

⁷⁶ 455 U.S. 551 (1982). For criticism of *Weaver*, see Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 498-503 (1987).

⁷⁷ *Weaver*, 455 U.S. at 560.

⁷⁸ *Id.* at 553.

⁷⁹ *Id.* at 559.

⁸⁰ *Id.* (citing 328 U.S. at 295).

*Leasing Corp.*⁸¹ (an investment contract case involving assignments of oil leases), offers were sent to more than 1,000 prospects.⁸²

The Court also observed, "In *C.M. Joiner Leasing*, we noted that a security is an instrument in which there is 'common trading.' The instruments involved in *C.M. Joiner Leasing* and *Howey* had equivalent values to most persons and could have been traded publicly."⁸³ The Court held, "Although the agreement gave the Weavers a share of the Piccirillo's profits, if any, that provision alone is not sufficient to make that agreement a security. Accordingly, we hold that this unique agreement, negotiated one-on-one by the parties, is not a security."⁸⁴

Weaver means that broad and narrow vertical commonality between a promoter and a single investor is not sufficient; there must be multiple investors or offerees. Larry E. Ribstein has observed, "*Marine Bank v. Weaver* supports use of a multiple-investor test."⁸⁵ However, because *Weaver* did not explicitly address the definition of a common enterprise, most courts have overlooked the case in the common enterprise debate.

Also, in *Weaver* and *International Brotherhood of Teamsters v. Daniel*,⁸⁶ the Supreme Court essentially added a fifth prong to the *Howey* test—whether an alternative regulatory scheme protects investors and thereby renders application of the securities acts unnecessary.⁸⁷

V. AN EVALUATION OF THE CURRENT TESTS

The primary policy of the federal securities acts is investor protection through disclosure.⁸⁸ Therefore, for certain economic arrangements,

⁸¹ 320 U.S. 344 (1943).

⁸² *Weaver*, 455 U.S. at 559–60 (citing 320 U.S. 344, 346 (1943)).

⁸³ *Id.* at 560 (citation omitted).

⁸⁴ *Id.*

⁸⁵ Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 22 (1992) (citation omitted).

⁸⁶ 439 U.S. 551 (1979).

⁸⁷ See *Weaver*, 455 U.S. at 558–59; *Daniel*, 439 U.S. at 569–70.

⁸⁸ *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477–78 (1977); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). The preamble of the 1933 Act declares that it was designed "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, ch. 38, Preamble, 48 Stat. 74 (1933). The Senate Committee on Banking and Currency reported that the aim of the 1933 Act was "to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against competition

Congress required enhanced disclosure through registration, prospectuses, and other methods, and it provided criminal sanctions and civil remedies to deter misrepresentations and nondisclosure and to remedy injuries caused by them.

Congress did not intend the securities laws to apply to all contracts or “to provide a broad federal remedy for all fraud.”⁸⁹ Therefore, the definition of an investment contract should relate to the question about which contracts should have enhanced disclosure, rather than the level of disclosure required by other statutes and the common law for most contracts. Consequently, in defining an investment contract, we should ask which contracts need the protection of the securities acts.⁹⁰

Steven J. Choi and A.C. Pritchard have observed:

A policy question lurks in asking whether the instrument in question is a “security”: Should the securities laws apply to the transaction in question? Why do we apply securities regulations only to certain transactions? Home purchases, for example, are not covered by the securities laws, even though they are the most substantial investment that most people make. Your savings account at the local bank, another large repository of investment dollars, is not a security. How does a “security” differ from these other investments? Because securities regulation applies only to transactions in securities, the question of “what is a security” is in many ways the same as asking “should we apply securities regulation here?”⁹¹

Evaluating the current tests for a common enterprise in light of the disclosure policy of the securities acts reveals some of these tests’ fundamental weaknesses.

afforded by dishonest securities offered to the public through crooked promotion.” S. REP. NO. 73-47, at 11 (1933); *see also* H.R. REP. NO. 73-85, at 3 (1933) (“[T]here should be full disclosure of every essentially important element attending the issue of a new security.”); H.R. REP. NO. 73-1383, at 1 (1934). The 1934 Act’s prohibitions against manipulation also rest, at least partly, on the philosophy of full disclosure. *See Basic*, 485 U.S. at 230.

⁸⁹ *Weaver*, 455 U.S. at 556; *see also* *Stoneridge Inv. Partners, LLC v. ScientificAtlanta*, 552 U.S. 148, 161 (2008); *SEC v. Zandford*, 535 U.S. 813, 820 (2002); *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990) (citation omitted); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985).

⁹⁰ Ronald J. Coffey, *The Economic Realities of a “Security”: Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 373 (1967).

⁹¹ STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 89 (2d ed. 2008) (emphasis omitted).

A. Horizontal Commonality

The horizontal commonality test is flawed because the requirements of pooling and a pro rata distribution of profits are irrelevant to the question whether there is a special need for enhanced disclosure. Consider, for example, the condominium rental arrangement discussed above.⁹² The facts that the condominiums are individually owned and that each investor's return is calculated independently do not significantly reduce the special risk of fraud and the need for enhanced disclosure that these arrangements involve. The buyer lacks access to material information, and the promoter manages and controls the enterprise. The investor is dependent on the promoter's future exercise of its managerial and entrepreneurial effort and skill.⁹³

The form of ownership of the enterprise and the manner of dividing the profits are largely formal distinctions. As *Howey* explained, in the pre-1933 investment contract cases, "[f]orm was disregarded for substance and emphasis was placed on economic reality."⁹⁴ However, the horizontal commonality test elevates form over substance. *Howey* stated that its definition of investment contracts "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."⁹⁵ Horizontal commonality fails to meet this standard.

Another problem is that horizontal commonality was not present in *Howey* itself, because each investor individually owned a separate tract of land.⁹⁶ The Court noted that there was "ordinarily no right to specific fruit,"⁹⁷ and that the produce was "pooled,"⁹⁸ which probably meant that the fruit was put together for marketing. However, this is not what is usually

⁹² See *supra* notes 72–75 and accompanying text.

⁹³ See *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975).

⁹⁴ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946).

⁹⁵ *Id.* at 299.

⁹⁶ Every sale was "an out-right sale of a definitely identified tract of land." *SEC v. W.J. Howey Co.*, 151 F.2d 714, 715–16 n.5 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946); see also Jerry C. Bonnett, *How Common Is A "Common Enterprise"?*, 1974 ARIZ. ST. L.J. 339, 349–50 (*Howey* did not involve horizontal commonality); LOUIS LOSS ET AL., *supra* note 13, at 934 (there was no pooling of investors' funds in *Howey*); McGinty, *supra* note 14, at 1047 ("In *Howey*, . . . the purchasers arguably were not involved in a common enterprise. Each *Howey* purchaser's interests were separate from the others' and from the *Howey* companies'. They cost different amounts to purchase and to service." (citation omitted)).

⁹⁷ *Howey*, 328 U.S. at 296.

⁹⁸ *Id.*

meant by "pooling" in the horizontal commonality test.⁹⁹ In addition, *Howey* did not involve a pro rata sharing of profits. Instead, each investor's return was based on the citrus production from his or her own tract.¹⁰⁰ The investors' independent returns were one reason that the Fifth Circuit found that *Howey* did not involve a security,¹⁰¹ but the Supreme Court nevertheless found that that arrangements in *Howey* constituted investment contracts.¹⁰²

The horizontal commonality test is too narrow, because it excludes many arrangements in which investors purchase individual assets, but which have been found to be investment contracts, such as condominium rental arrangements, animal breeding programs,¹⁰³ cattle feeding programs,¹⁰⁴

⁹⁹ See *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1019 (7th Cir. 1994) (pooling requires "an undivided share in the same pool of assets and profits"). In *Savino v. E.F. Hutton & Co.*, the court stated:

"Pooling" has been interpreted to refer to an arrangement whereby the account constitutes a single unit of a larger investment enterprise in which units are sold to different investors and the profitability of each unit depends on the profitability of the investment enterprise as a whole Thus, an example of horizontal commonality involving brokerage accounts would be a "commodity pool," in which investors' funds are placed in a single account and transactions are executed on behalf of the entire account rather than being attributed to any particular subsidiary account. The profit or loss shown by the account as a whole is ultimately allocated to each investor according to the relative size of his or her contribution to the fund. Each investor's rate of return is thus entirely a function of the rate of return shown by the entire account.

507 F. Supp. 1225, 1236 (S.D.N.Y. 1981) (citations omitted).

¹⁰⁰ "The company is accountable only for an allocation of the net profits based upon a check made at the time of picking." *Howey*, 328 U.S. at 296. Each purchaser "looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole." *Howey*, 151 F.2d at 717. The disparity in citrus production among tracts was real, since purchasers could purchase tracts with one year-old, two year-old, or five year-old trees (or older). *SEC v. W.J. Howey Co.*, 60 F. Supp. 440, 441 (S.D. Fla. 1945), *aff'd*, 151 F.2d 714 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946). The yield among tracts could also vary because of disease, insect infestations, and soil fertility. Bonnett, *supra* note 96, at 349. These factors could impact disparately on different tracts, since the service company cared for almost 2,500 acres of citrus groves. *Howey*, 60 F. Supp. at 441; *see also* McGinty, *supra* note 14, at 1047-48 ("Each *Howey* purchaser's interests . . . promised a return based solely on the purchaser's crops, regardless of the fortunes of the other purchasers or of the service company." (citations omitted)).

¹⁰¹ *Howey*, 151 F.2d at 717-18, *rev'd*, 328 U.S. 293 (1946).

¹⁰² 328 U.S. 293, 299-301 (1946).

¹⁰³ See, e.g., *Bailey v. J.W.K. Properties, Inc.*, 904 F.2d 918, 919 (4th Cir. 1990) (cattle); *Eberhardt v. Waters*, 901 F.2d 1578, 1579 (11th Cir. 1990) (cattle); *Cont'l Mktg. Corp. v. SEC*, 387 F.2d 466, 468 (10th Cir. 1967) (beavers); *SEC v. Payne*, 35 F. Supp.

yacht leaseback programs,¹⁰⁵ railroad car programs,¹⁰⁶ and orchard tract programs¹⁰⁷ like the one in *Howey*. The *Howey* Court cautioned, "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."¹⁰⁸

B. Narrow Vertical Commonality

Like the horizontal commonality test, the narrow vertical commonality test does not relate to the disclosure policy of the acts. For example, under the narrow vertical commonality test, a discretionary brokerage account has vertical commonality if the broker receives a percentage of the account's profits, but lacks vertical commonality if the broker receives commissions based solely on the volume of transactions.¹⁰⁹ However, the method of calculating the broker's compensation is irrelevant to the question of whether a discretionary brokerage account requires the enhanced disclosure mandated by the acts.¹¹⁰ The need for enhanced disclosure depends mostly on the investor's access to information and on the degree of control exercised by the

873, 878 (S.D.N.Y. 1940) (foxes); *State v. Robbins*, 240 N.W. 456, 457 (Minn. 1932) (muskrats); *Stevens v. Liberty Packing Corp.*, 161 A. 193, 193 (N.J. 1932) (rabbits).

¹⁰⁴ *E.g.*, *Waterman v. Alta Verde Indus., Inc.*, 643 F. Supp. 797, 799-807 (E.D.N.C. 1986), *aff'd mem.*, 833 F.2d 1006 (4th Cir. 1987) (per curiam); *McLish v. Harris Farms, Inc.*, 507 F. Supp. 1075, 1076 (E.D. Cal. 1980).

¹⁰⁵ See James D. Gordon III, *Flying Into Blue Sky: Aircraft Leasebacks as Securities*, 35 UCLA L. REV. 779, 806-10 (1988).

¹⁰⁶ *E.g.*, *Richmond Tank Car Co.*, SEC No-Action Letter, 1978 WL 13618 (Sept. 14, 1978).

¹⁰⁷ *E.g.*, *SEC v. Bailey*, 41 F. Supp. 647, 648 (S.D. Fla. 1941); *SEC v. Tung Corp.*, 32 F. Supp. 371, 374 (N.D. Ill. 1940); *Kerst v. Nelson*, 213 N.W. 904, 904 (Minn. 1927) (vineyard tracts).

¹⁰⁸ *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

¹⁰⁹ *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978); *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1238-39 (S.D.N.Y. 1981).

¹¹⁰ Larry E. Ribstein has written, "With respect to vertical commonality, it is not clear why it matters whether the promoter's gains are proportionate to those of the other investors." Ribstein, *supra* note 85, at 21. Similarly, Dennis S. Karjala has written:

Champions of the vertical commonality approach should be called on to explain why there should be a federal remedy when the account manager has an interest in the account parallel to that of the investor, and therefore an incentive to work in the investor's interest, while there is no federal remedy against the manager whose only return is from a brokerage commission and who therefore has an incentive to churn the account to the detriment of the investor. What federal policy can possibly distinguish these cases?

Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U. L. REV. 1473, 1508 (1986).

broker, not on the broker's method of compensation. In part, the narrow vertical commonality test turns vertical commonality on its head, because it requires that the broker's remuneration depend on the success of the venture. The investor needs enhanced disclosure partly because the investor is dependent on the success of the enterprise. The broker's dependence on the enterprise is irrelevant, because the broker controls the enterprise.

C. Broad Vertical Commonality

Broad vertical commonality is met when the investor is dependent on the promoter's efforts or expertise for the investor's returns. Broad vertical commonality is related to the policy of disclosure. It asks whether the investor is dependent on the future exercise of the promoter's managerial and entrepreneurial effort and skill, and this question is relevant to whether enhanced disclosure is needed. However, the broad vertical commonality test merely duplicates other prongs of the *Howey* test.¹¹¹ Broad vertical commonality is present whenever the first, third, and fourth prongs of the *Howey* test are met—i.e., when there is an investment of money with an expectation of profits solely from the efforts of others. Thus, the broad vertical commonality test eliminates the common enterprise prong of the *Howey* test.

Another problem with the broad vertical commonality test is that it is overbroad. Because it requires only a commonality of interest between the two parties to a contract, many profit-sharing or income-sharing contracts between two parties would constitute securities. For example, shopping center leases often provide that a retail tenant's rent is a fixed amount plus a percentage of its gross sales. The broad vertical commonality test would incorrectly identify the profit-sharing aspect of these leases as investment contracts. The landlord invests assets (the leased space)¹¹² in a common

¹¹¹ *Revak v. SEC Realty Corp.*, 18 F.3d 81, 88 (2d Cir. 1994); *Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 622 F.2d 216, 224 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); *SEC v. Pinckney*, 923 F. Supp. 76, 82 (E.D.N.C. 1996); *Kaplan v. Shapiro*, 655 F. Supp. 336, 340 (S.D.N.Y. 1987); *Savino*, 507 F.Supp. at 1237–38 n.11; *Berman v. Bache, Halsey, Stuart, Shields, Inc.*, 467 F. Supp. 311, 319 (S.D. Ohio 1979); Mark J. Loewenstein, *The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law*, 39 IND. L. REV. 17, 35–36 (2005) [hereinafter Loewenstein, *The Supreme Court*]; Moore, *supra* note 12, at 1082–83. The Fifth Circuit, which uses broad vertical commonality, has acknowledged this issue: "We recognize that under our standard the second and third prongs of the *Howey* test may in some cases overlap to a significant degree and that our standard has been criticized for that reason." *Long v. Shultz Cattle Co.*, 881 F.2d 129, 141 (5th Cir. 1989).

¹¹² Consideration other than money can satisfy this prong of the *Howey* test. *HAZEN*, *supra* note 20, at 42; see *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 560 n.12 (1979).

enterprise (in which the landlord's return depends on the tenant's success) and expects profits solely from the tenant's efforts. A sharecropping agreement under which a tenant farmer gives a fraction of his or her crop to the landlord also satisfies the test, as does a provision of a contract in which a store owner promises the store manager a bonus of a percentage of the store's income or profits. In fact, these arrangements satisfy the narrow vertical commonality test as well.

Under both vertical commonality tests the tenant, the sharecropper, and the store manager are issuing securities. However, Congress surely did not intend to subject them to the criminal penalties or the civil remedies of the federal securities acts. Neither the landlord nor the store owner needs the protection of the securities acts, since each has sufficient bargaining power to obtain disclosure without the mandated disclosure of the acts. Theirs are really ordinary contracts, and should be subject only to the laws governing ordinary contractual relations.

In summary, the horizontal and narrow vertical commonality tests are unrelated to the policy of the acts. The broad vertical commonality test is related to the policy of the acts, but because other prongs of the *Howey* test already screen for the same elements, it eliminates the common enterprise element of the *Howey* test. In addition, the broad vertical commonality test is overbroad.

VI. THE MULTIPLE INVESTORS TEST

I have previously proposed a multiple investors test for a common enterprise.¹¹³ The multiple investors test defines a common enterprise as an enterprise in common among the promoter and multiple parallel investors. The arrangement must contemplate multiple investors; a one-on-one contract between two parties is insufficient.¹¹⁴ The parallelism requirement means that the promoter offers essentially the same instruments to multiple investors. The multiple investors test is supported by *Howey* and by the disclosure policy of the securities acts.

¹¹³ Gordon, *Common Enterprise*, *supra* note 15, at 636.

¹¹⁴ It is not necessary that multiple investors actually invest, but only that offers be made to multiple potential investors. See *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982) ("The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case." (emphasis added)). In *Howey*, the Court rejected the promoters' argument that not all the citrus grove purchasers entered into service contracts, reasoning that "[t]he Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. Hence it is enough that the respondents merely offer the essential ingredients of an investment contract." *Howey*, 328 U.S. at 301 (emphasis added).

The *Howey* Court's use of the term "common enterprise" suggests multiple investors:

[I]ndividual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.¹¹⁵

This language suggests that the Court intended a common enterprise to be an enterprise in which the promoter and multiple investors have a common interest. The commonality of interest described was apparently not between a single promoter and a single investor regarding an individual tract of land, but rather was among the promoter and multiple investors. *Howey* involved multiple investors; forty-two purchasers invested in the citrus groves.¹¹⁶

The disclosure policy of the securities acts supports the multiple investors test. In determining whether an economic arrangement constitutes a security, we should inquire whether the arrangement is one that needs or demands the protection of the securities acts.¹¹⁷ Since Congress did not intend the securities laws to apply to all contracts or "to provide a broad federal remedy for all fraud,"¹¹⁸ the definition of an investment contract should identify those contracts which have an enhanced need for disclosure. This need is present when the buyer makes an investment, lacks access to material information, and is dependent on the managerial control or entrepreneurial skill of others.¹¹⁹ The first, third, and fourth prongs of the *Howey* test ask whether the buyer is making an investment and is dependent on the managerial control or entrepreneurial skill of others by asking whether

¹¹⁵ *Howey*, 328 U.S. at 300.

¹¹⁶ *Id.* at 295.

¹¹⁷ Coffey, *supra* note 90, at 373.

¹¹⁸ *Weaver*, 455 U.S. at 556; *see also* *Stoneridge Inv. Partners, LLC v. ScientificAtlanta*, 552 U.S. 148, 161 (2008); *SEC v. Zandford*, 535 U.S. 813, 820 (2002); *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686-87 (1985).

¹¹⁹ *See, e.g., SEC v. Merchant Capital, LLC*, 483 F.3d 747, 755 (11th Cir. 2007); *Williamson v. Tucker*, 645 F.2d 404, 422-24 (5th Cir. 1981); *Hirsch v. duPont*, 396 F. Supp. 1214, 1222-24 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977). In *United Housing Foundation, Inc. v. Forman*, the Court observed, "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." 421 U.S. 837, 852 (1975).

the buyer invests money and expects profits solely from the promoter's efforts.

The multiple investors test relates, in a categorical way, to the buyer's access to information. A buyer's access to material information depends on the buyer's bargaining power to compel disclosure from the promoter. If the buyer is only one of many investors entering into standardized form contracts with the issuer (i.e., buying uniform instruments from the issuer), the buyer's bargaining power is diluted. The buyer is only one of many prospects with whom the issuer intends to deal, and the issuer's superior bargaining power is indicated by its use of its own form contracts offered on a "take it or leave it" basis. The average buyer lacks bargaining power and the ability to negotiate for additional information or protection. Therefore, the buyer needs the securities laws to mandate additional disclosure.¹²⁰

Under the multiple investors test, a unique, individually negotiated contract between two parties is not an investment contract. Parties who have the bargaining power to individually negotiate a one-on-one contract are protected by their bargaining power to obtain disclosure, as well as by the general laws governing non-securities. Those laws include civil and criminal statutes and common law and equitable doctrines regarding fraud. The parties may sue in tort for common law fraud¹²¹ or negligent misrepresentation.¹²² They may also sue for rescission or restitution, even for innocent

¹²⁰ In *Wals v. Fox Hills Development Corp.*, the Seventh Circuit rejected the multiple investors test and adhered to the horizontal commonality test. 24 F.3d 1016, 1018–19 (7th Cir. 1994). The court held that the condominium time-sharing and rental agreements at issue did not constitute investment contracts, because the investors owned separate time-shares. *Id.* The court reasoned that the 1933 Act "requires promoters and issuers to make *uniform* disclosure to all investors, and this requirement makes sense only if the investors are obtaining the same thing, namely an undivided share in the same pool of assets and profits." *Id.* at 1019. However, whether the investors' share is separate or undivided is irrelevant to the investors' need for disclosure and the issuer's ability to provide it. Because the investors are parallel—i.e., the promoter offers essentially the same instruments to multiple investors—the promoter can provide uniform disclosure. In *Howey*, the investors owned individual plots of land. See *supra* note 96 and accompanying text. Also, *SEC v. Edwards* casts substantial doubt on horizontal commonality. See generally 540 U.S. 389 (2004); see *infra* notes 214–21 and accompanying text. For an analysis of *Wals*, see Jonathan E. Shook, Note, *The Common Enterprise Test: Getting Horizontal or Going Vertical in Wals v. Fox Hills Development Corp.*, 30 TULSA L.J. 727 (1995).

¹²¹ KEETON, ET AL., *supra* note 26, at 725–70. Parties may also recover punitive damages for common law fraud. *Id.* at 9–10; 2 DAN B. DOBBS, LAW OF REMEDIES 544–46 (2d ed. 1993).

¹²² KEETON, ET AL., *supra* note 26, at 745–48; DOBBS, *supra* note 121, at 544, 554.

misrepresentations.¹²³ The parties are protected by the same legal rules that apply to the vast majority of all economic transactions.

The multiple investors test tries to distinguish paradigmatic one-on-one contracts from contracts in which one party needs the enhanced disclosure mandated by the securities acts. It asks whether a buyer's bargaining power to obtain disclosure is diminished by the presence of multiple investors.¹²⁴

In the 1930s the common law and equitable remedies were deemed inadequate for securities partly because those remedies were developed in the context of face-to-face transactions, whereas securities are sold and traded publicly.¹²⁵ However, one-on-one, individually negotiated contracts are the paradigmatic face-to-face transactions for which the common law and equitable remedies are generally deemed adequate.

Another justification for the multiplicity test is that there is a greater public interest and a greater federal interest when a larger number of investors is involved. The regulatory costs imposed on issuers, and in turn partly on investors and taxpayers, are more justified when the threat of injury is to the public and not solely to one individual negotiating a unique contract.

Dennis S. Karjala has proposed that "the common enterprise requirement is not satisfied unless a sufficient number of similar interests are sold in such form that there is a significant possibility that the interests will be traded in

¹²³ RESTATEMENT (SECOND) OF CONTRACTS § 164 (1979); DOBBS, *supra* note 121, at 554–55, 580; E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 244, 252–55 (4th ed. 2004); KEETON, ET AL., *supra* note 26, at 729–30, 748–49; JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS 293 (6th ed. 2009). The Second Restatement of Torts and a minority of courts recognize liability for damages (i.e., not just rescission or restitution) for innocent misrepresentations in sales transactions. RESTATEMENT (SECOND) OF TORTS § 552C (1976); KEETON ET AL., *supra* note 26, at 748–49. Comment (c) to Restatement of Torts § 552C states that this rule applies to the sale of securities. RESTATEMENT (SECOND) OF TORTS § 552C cmt. c (1976).

¹²⁴ The multiple investors test applies to the common enterprise element of the *Howey* test for investment contracts. It does not apply to stock, which is a separate category of securities under the securities acts. 1933 Act § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006). In *Landreth Timber Co. v. Landreth*, the Court held that the securities acts apply to the sale of 100 percent of the stock of a company, regardless of a party's need for the protection of the securities acts. 471 U.S. 681, 696 (1985). The Court reasoned in part that the acts apply to "stock" which has the usual characteristics of stock, and that persons trading in traditional stock have a high expectation that their activities are governed by the securities acts. *Id.* at 687, 693. I agree that in light of the statutory language, and for the sake of clarity and expectations, "real" stock should always be a security, whether or not the protection of the acts is needed in a particular transaction. However, an investment contract is not like stock; since the definition of "investment contract" is unclear, the policy of the acts should be consulted in forming the definition.

¹²⁵ See Shulman, *supra* note 23, at 231–32 (explaining that privity is required for rescission).

the national markets.”¹²⁶ He has argued that other cases do not present a sufficient national interest, and therefore the parties should look to state law.¹²⁷ Similarly, Judge Donald P. Lay has stated that vertical commonality, “which would include within the purview of a common enterprise even relationships between independent individual ‘investors’ and a single ‘promoter,’ is antithetical to the . . . Court’s notion [in *United Housing Foundation, Inc. v. Forman*¹²⁸] that the federal securities laws focus on the protection of broader capital markets.”¹²⁹ Scott T. FitzGibbon has argued that, to be a security, an instrument must be eligible to participate in a public market, and therefore must not be unique.¹³⁰

The Supreme Court took a similar approach in *Marine Bank v. Weaver*. It reasoned, “The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case.”¹³¹ The Court observed, “In *C.M. Joiner Leasing*, we noted that a security is an instrument in which there is ‘common trading.’ The instruments involved in *C.M. Joiner Leasing* and *Howey* had equivalent values to most persons and could have been traded publicly.”¹³² By contrast, the unique agreement in *Weaver* was “not designed to be traded publicly.”¹³³ The *Weaver* Court cited Scott T. FitzGibbon¹³⁴ for the point that the 1934 Act “was adopted to restore investors’ confidence in the financial markets.”¹³⁵ In addition, as will be discussed below,¹³⁶ in *Reves v. Ernst & Young*¹³⁷ the Court held that a factor in determining whether promissory notes are securities is whether there is common trading or, alternatively, whether the notes are offered and sold to a broad segment of the public.¹³⁸

¹²⁶ Karjala, *supra* note 110, at 1508–09.

¹²⁷ *Id.* at 1508.

¹²⁸ 421 U.S. 837, 849 (1975).

¹²⁹ SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1287 (11th Cir. 2002) (Lay, J., concurring) (advocating horizontal commonality), *rev’d and remanded*, SEC v. Edwards, 540 U.S. 389 (2004). Mark J. Loewenstein has observed that “the requirement of horizontal commonality links the definition of a security to the investor’s participation in broader capital markets—the focus of the federal securities laws.” Loewenstein, *The Supreme Court*, *supra* note 111, at 36.

¹³⁰ Scott FitzGibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 926–29 (1980).

¹³¹ 455 U.S. 551, 559 (1982).

¹³² *Id.* at 560 (citation omitted).

¹³³ *Id.*

¹³⁴ See FitzGibbon, *supra* note 130.

¹³⁵ *Weaver*, 455 U.S. at 555 n.4.

¹³⁶ See *infra* notes 162–66 and accompanying text.

¹³⁷ 494 U.S. 56 (1990).

¹³⁸ *Id.* at 66, 68.

Consistent with my view, Larry E. Ribstein has argued that the presence of multiple investors is relevant to the disclosure policy of the securities acts.¹³⁹ He has also observed, “Viewed in light of the underlying policy justifications, the thrust of the horizontal commonality element appears to be a requirement of multiple investors rather than ‘commonality,’ or the nature of sharing among these investors.”¹⁴⁰ In addition, Stephen J. Choi and A.C. Pritchard have stated that, when many investors are involved in an enterprise, collective action problems make it difficult for investors to coordinate their demands for disclosure and to hold managers accountable.¹⁴¹

Horizontal commonality is too narrow, and broad vertical commonality is too broad. The *Howey* test, as modified by the multiple investors definition of a common enterprise, occupies a middle ground between the horizontal and the broad vertical tests, and it accepts elements from both tests. Like horizontal commonality, it requires multiple investors. However, it does not require a pooling of assets or a pro rata sharing of profits, and therefore is broader than horizontal commonality. It accepts broad vertical commonality in that the first, third, and fourth prongs of *Howey* incorporate that concept. However, it is narrower than the broad vertical test because it requires multiple investors.

Howey and *Weaver* support the multiple investors test. This definition of a common enterprise directly relates to the disclosure policy of the securities acts. In addition, it corresponds to commonsense notions about which instruments Congress intended to reach under the securities acts. Under the multiple investors test, a common enterprise is an enterprise in common among the promoter and multiple parallel investors.

VII. THE MULTIPLE INVESTORS TEST AND PROMISSORY NOTES

The multiple investors test also offers a solution to the issue of determining which promissory notes are securities. The securities acts define securities as, among other things, “any note.”¹⁴² It is clear, however, that not all notes are securities. For example, a simple promissory note representing a consumer loan or a residential mortgage is not a security.

The salient feature of non-security notes is that a single lender (or a consortium represented by a lead bank) deals with the borrower and has the bargaining power to obtain detailed information from him or her.¹⁴³ An

¹³⁹ Ribstein, *supra* note 85, at 17–18, 22.

¹⁴⁰ *Id.* at 22.

¹⁴¹ CHOI & PRITCHARD, *supra* note 91, at 89–90, 151, 568–76.

¹⁴² 1933 Act § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006).

¹⁴³ Judge Eugene A. Wright of the U.S. Ninth Circuit Court of Appeals observed:

individual or a business borrowing money from a single lending institution is the paradigm of a note which is not a security. The lender's bargaining power to get information is immediately recognized by every borrower who has filled out a loan application, provided detailed financial information, had his or her credit history checked, and paid to have the collateral inspected, appraised, and insured.

Often, the lender's form of promissory note is used. The lender dictates the terms, and the terms are generally designed to protect the lender's interests. For some large commercial loans, the parties negotiate non-standardized terms, but the fact that the borrower cannot dictate the terms demonstrates the lender's significant bargaining power.

By contrast, corporate bonds are the paradigm of notes which are securities. The borrower issues standardized form notes to multiple lenders. The borrower dictates the terms of the notes. Unless a buyer of the bonds is a large investor, the buyer often lacks the bargaining power to insist on additional information. The buyer needs the additional disclosure and the enhanced antifraud remedies that the securities acts provide.

The *Howey* test, as modified by the multiple investors test for defining a common enterprise, is also a meaningful test for determining which notes are securities. Investment contracts and notes are in many ways similar; they are both subcategories of contracts. The major difference between them is that investment contracts usually pay a variable return, while notes usually pay a fixed rate of interest. However, investment contracts can pay a fixed return,¹⁴⁴ and some notes pay a variable interest rate.¹⁴⁵

I have previously argued that in *Reves v. Ernst & Young*¹⁴⁶ the Supreme Court essentially adopted the *Howey* test, with the multiple investors definition of a common enterprise, to determine which promissory notes are

While banks are subjected to risks of misinformation, their ability to verify representations and take supervisory and corrective actions places them in a significantly different posture than the investors sought to be protected through the securities acts.

In an investment situation, the issuer has superior access to and control of information material to the investment decision. Rather than relying solely on semi-anonymous and secondhand market information, as do most investors, the commercial bank deals "face-to-face" with the promisor. The bank has a superior bargaining position and can compel wide-ranging disclosures and verification of issues material to its decision on the loan application.

Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1261–62 (9th Cir. 1976) (Wright, J., concurring).

¹⁴⁴ SEC v. Edwards, 540 U.S. 389, 397 (2004).

¹⁴⁵ *Reves v. Ernst & Young*, 494 U.S. 56, 58–59 (1990).

¹⁴⁶ *Id.* at 56.

securities.¹⁴⁷ In that case, in order to raise money to support its general business operations, a farmer's cooperative sold promissory notes payable on demand.¹⁴⁸ The notes paid a variable interest rate and were uncollateralized and uninsured.¹⁴⁹ The co-op marketed the scheme as an "Investment Program" and offered the notes to its 23,000 members, as well as to non-members.¹⁵⁰ At least 1,600 people purchased the notes.¹⁵¹ The co-op ultimately went into bankruptcy.¹⁵² The Supreme Court held that the notes were securities.¹⁵³

The Court adopted the Second Circuit's "family resemblance" test.¹⁵⁴ It held that a note is presumed to be a security, but the presumption can be rebutted by showing that the note bears a strong family resemblance to certain categories of instruments that are not securities.¹⁵⁵ However, the Court stated, "More guidance . . . is needed. It is impossible to make any meaningful inquiry into whether an instrument bears a 'resemblance' to one of the instruments identified by the Second Circuit without specifying what it is about those instruments that makes them non-'securities.'"¹⁵⁶ It explained that the list of non-securities can be expanded, and therefore "some standards must be developed for determining when an item should be added to the list."¹⁵⁷

The Court announced a four-factor test.¹⁵⁸ The first factor is the motivations of a reasonable seller and buyer.¹⁵⁹ The Court explained, "If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'"¹⁶⁰ By contrast, "[i]f the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the

¹⁴⁷ Gordon, *Interplanetary Intelligence*, *supra* note 16, at 394-404.

¹⁴⁸ *Reves*, 494 U.S. at 58.

¹⁴⁹ *Id.* at 58-59.

¹⁵⁰ *Id.* at 59.

¹⁵¹ *Id.*

¹⁵² *Id.*

¹⁵³ *Id.* at 67-70.

¹⁵⁴ *Reves*, 494 U.S. at 64-65.

¹⁵⁵ *Id.* at 67.

¹⁵⁶ *Id.* at 65-66 (emphasis omitted).

¹⁵⁷ *Id.* at 66.

¹⁵⁸ *Id.* at 66-67.

¹⁵⁹ *Id.* at 66.

¹⁶⁰ *Reves*, 494 U.S. at 66.

seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, . . . the note is less sensibly described as a 'security.'"¹⁶¹

The Court stated, "Second, we examine the 'plan of distribution' of the instrument to determine whether it is an instrument in which there is 'common trading for speculation or investment.'"¹⁶² There was no common trading of the promissory notes in *Reves*, either on an exchange¹⁶³ or over the counter, because the notes could not be traded.¹⁶⁴ Nevertheless, the Court found that this factor was met.¹⁶⁵ It held that the notes were "offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite 'common trading' in an instrument."¹⁶⁶

The third factor is the public's reasonable expectations.¹⁶⁷ The Court indicated that it would consider instruments to be securities based on the reasonable perceptions of the public, even when an economic analysis of the transaction might suggest otherwise.¹⁶⁸ The Court observed, "We have consistently identified the fundamental essence of a 'security' to be its character as an 'investment.'"¹⁶⁹ The advertisements for the notes in *Reves* characterized them as "investments."¹⁷⁰

The fourth factor is "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."¹⁷¹

¹⁶¹ *Id.*

¹⁶² *Id.* (quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351, 353 (1943)).

¹⁶³ *Id.* at 68.

¹⁶⁴ See Brief for Respondent at 39, *Reves v. Ernst & Young*, 494 U.S. 56 (1990) (No. 88-1480).

¹⁶⁵ *Reves*, 494 U.S. at 68.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* at 66.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 68-69.

¹⁷⁰ *Id.* at 59, 69.

¹⁷¹ *Reves*, 494 U.S. at 67 (citing *Marine Bank v. Weaver*, 455 U.S. 551, 557, 558 & n.7, 559 (1982)).

Therefore, the *Reves* factors are:

1. Whether the parties are motivated by investment purposes or by some other commercial or consumer purpose, and whether the buyer is interested primarily in the profit the note is expected to generate;
2. Whether the notes are either a. commonly traded, or b. offered and sold to a broad segment of the public;
3. Whether the public reasonably expects the notes to be securities or investments; and
4. Whether there is an alternative regulatory scheme or other risk-reducing factors.¹⁷²

The *Reves* factors parallel the prongs of the *Howey* test, as modified by the multiple investors definition of a common enterprise. (I have previously argued that the “factors” in *Reves* are probably actually “prongs” of the test.¹⁷³) The first *Reves* factor asks whether the loan is an investment or something else. This factor is the same inquiry made by the first prong of the *Howey* test—whether there is an investment of money. The first *Reves* factor also asks whether the buyer is interested primarily in the profit the note is expected to generate. This inquiry is an elaboration of the third prong of *Howey*, which requires that the buyer have an expectation of profits.

Reves said that the second factor is to examine the plan of distribution to see whether there is common trading. The Court held that it is enough if the notes are offered and sold to a broad segment of the public.¹⁷⁴ Therefore, the second factor is similar to the common enterprise prong of *Howey* under the multiple investors test.

Reves’s third factor is the public’s reasonable expectations that the notes are securities or investments. This factor can be incorporated into the first and third prongs of the *Howey* test—whether the seller is offering an “investment” in which the buyers expect a profit. Traditional analysis under the *Howey* test already includes examining the seller’s promotional emphasis and the manner in which the instruments are marketed to see whether a security is being offered.¹⁷⁵

¹⁷² See *id.* at 66–67.

¹⁷³ Gordon, *Interplanetary Intelligence*, *supra* note 16, at 395–98.

¹⁷⁴ *Reves*, 494 U.S. at 68.

¹⁷⁵ See *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 853–54 (1975); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 346 & n.3, 347 (1943); *Teague v. Bakker*, 35 F.3d 978, 986–89 (4th Cir. 1994); *Rice v. Branigar Org.*, 922 F.2d 788, 790 (11th Cir. 1991); *Aldrich v. McCulloch Props., Inc.*, 627 F.2d 1036, 1039–40 (10th Cir. 1980); 17 C.F.R. § 231.5347 (1988).

The fourth factor—the existence of an alternative regulatory scheme or other factors that significantly reduce the risk of the instrument—is an elaboration of the fifth prong of the *Howey* test that was adopted in *Marine Bank v. Weaver*¹⁷⁶ and *International Brotherhood of Teamsters v. Daniel*.¹⁷⁷ In fact, *Reves* cited those cases.¹⁷⁸

Therefore, the *Reves* test tracks the first, second, third, and fifth prongs of the *Howey* test, as modified by the multiple investors test. That leaves only *Howey*'s fourth prong, which requires that the profits be solely from the efforts of others, unaccounted for. However, this prong will automatically be satisfied if *Reves*'s first three factors are met: the motives are investment; the notes are offered and sold to a broad segment of the public; and the public reasonably expects the notes to be securities or investments. The buyers of promissory notes issued to a broad segment of the public are passive investors, and the promoter produces the buyers' return on the notes.

Therefore, the *Reves* test parallels the *Howey* test with the multiple investors definition of a common enterprise. The Court even listed the *Reves* factors in basically the same order as the prongs of the *Howey* test:

<i>Howey</i>	<i>Reves</i>
1. An investment of money;	1. The motives are investment, not commercial or consumer.
2. in a common enterprise (under a multiple investors test);	2. The notes are commonly traded or are offered and sold to a broad segment of the public.
3. with an expectation of profits;	3. The public reasonably expects the notes to be securities or investments.
4. solely from the efforts of others.	4. (This is satisfied if the above three factors are met.)
5. The absence of an alternative regulatory scheme.	5. The absence of an alternative regulatory scheme or other risk-reducing factor.

This striking similarity is not a sheer coincidence. The *Reves* Court said that the family resemblance test applied "the same factors"¹⁷⁹ that the Court had applied in the past. The *Reves* Court cited investment contract cases to support the second and fifth factors, and five of the seven cases that the Court

¹⁷⁶ 455 U.S. 551 (1982).

¹⁷⁷ 439 U.S. 551 (1979).

¹⁷⁸ 494 U.S. at 67, 69.

¹⁷⁹ *Id.* at 66.

cited for all the factors were investment contract cases.¹⁸⁰ The Court even cited *Howey* itself to explain how the second factor could be met.¹⁸¹ Although the Court said that it rejected the *Howey* test for promissory notes,¹⁸² it relied heavily on investment contract cases in creating the factors. Ultimately, the *Reves* test resembles the *Howey* test with a multiple investors definition of a common enterprise.¹⁸³

VIII. *SEC v. EDWARDS*

The Supreme Court case of *SEC v. Edwards*¹⁸⁴ should significantly affect the common enterprise debate. In *Edwards*, the Court held that a payphone sale-and-leaseback arrangement with a fixed return could be an investment contract.¹⁸⁵ The case did not address the definition of a common enterprise. However, I believe that *Edwards* implies the death of narrow vertical commonality and casts substantial doubt on horizontal commonality.

Charles E. Edwards was chairman, chief executive officer, and sole shareholder of ETS Payphones, Inc.¹⁸⁶ The company sold payphones to the public through independent distributors.¹⁸⁷ The offers were accompanied by a five-year leaseback and management agreement.¹⁸⁸ Under the arrangement, a purchaser paid about \$7,000 for a phone.¹⁸⁹ ETS leased the phone back and paid the purchaser \$82 a month, an annual return of fourteen percent.¹⁹⁰ ETS

¹⁸⁰ *Id.* at 66–69 (citing *Marine Bank v. Weaver*, 455 U.S. 551, 557, 558 & n.7, 559 (1982); *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 569–70 (1979); *Tcherepnin v. Knight*, 389 U.S. 332, 337 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293, 295 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351, 353 (1943)). The other two cases that the *Reves* Court cited involved stock. *Id.* at 66–68 (citing *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687, 693 (1985); *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975)).

¹⁸¹ *Reves*, 494 U.S. at 68 (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 295 (1946)).

¹⁸² *Id.* at 64, 68 n.4.

¹⁸³ For another discussion of the relationship between the *Reves* factors and the *Howey* test, see Marc I. Steinberg, *Notes as Securities: Reves and Its Implications*, 51 OHIO ST. L.J. 675, 679 (1990).

¹⁸⁴ 540 U.S. 389 (2004).

¹⁸⁵ *Id.* at 397.

¹⁸⁶ *Id.* at 391.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *SEC v. Edwards*, 540 U.S. 389, 391 (2004).

selected a site for the phone, installed and maintained the phone, arranged for telephone service, and collected the revenues.¹⁹¹

The marketing materials described the payphones as “an exciting business opportunity,” and touted the opportunity for profits.¹⁹² Ten thousand people invested a total of \$300 million in the sale-and-leaseback arrangements.¹⁹³ However, the phones did not produce sufficient revenue for ETS to make the lease payments, and the company used funds from new investors to make the payments until it finally filed for bankruptcy.¹⁹⁴

The SEC filed a civil enforcement action, alleging that Edwards had violated the registration provisions and certain antifraud provisions of the securities acts.¹⁹⁵ The district court held that the arrangements were investment contracts and issued a preliminary injunction.¹⁹⁶ However, the Eleventh Circuit reversed on two grounds.¹⁹⁷ First, the court reasoned that an investment contract must offer either capital appreciation or a participation in the earnings of the enterprise, while by contrast this arrangement offered a fixed rate of return.¹⁹⁸ Second, the court held that because the purchasers had a contractual entitlement to a return, their return was not derived solely from the efforts of others, and thus the fourth prong of the *Howey* test was not met.¹⁹⁹

The Supreme Court, in an opinion by Justice O’Connor, unanimously reversed and remanded the case.²⁰⁰ The Court first emphasized the broad definition of a security: “‘Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.’ To that end, it enacted a broad definition of ‘security,’ sufficient ‘to encompass virtually any instrument that might be

¹⁹¹ *Id.* at 391–92.

¹⁹² *Id.* at 392.

¹⁹³ *Id.* at 391.

¹⁹⁴ *Id.* at 392.

¹⁹⁵ *Id.*

¹⁹⁶ *SEC v. ETS Payphones Inc.*, 123 F. Supp. 2d 1349, 1352–54, 1355 (N.D. Ga. 2000), *rev’d*, 300 F.3d 1281 (11th Cir. 2002) (per curiam), *rev’d and remanded sub nom.*, *SEC v. Edwards*, 540 U.S. 389 (2004), *aff’d*, *SEC v. ETS Payphones, Inc.* 408 F.3d 727 (11th Cir. 2005).

¹⁹⁷ *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1282 (11th Cir. 2002) (per curiam), *rev’d and remanded sub nom.*, *SEC v. Edwards*, 540 U.S. 389 (2004).

¹⁹⁸ *Id.* at 1284–85.

¹⁹⁹ *Id.* at 1285.

²⁰⁰ *Edwards*, 540 U.S. at 397. On remand, the Eleventh Circuit held that it saw “no abuse of discretion in the district court’s conclusion that the SEC met its burden of showing a reasonable probability of success on the jurisdictional question.” *ETS Payphones, Inc.*, 408 F.3d at 732–33.

sold as an investment.”²⁰¹ The Court noted that the *Howey* test “embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”²⁰²

The Court observed that when it had held that profits must come solely from the efforts of others, it had “used ‘profits’ in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.”²⁰³ The Court argued that there was “no reason to distinguish between promises of fixed returns and promises of variable returns” since in both cases “the investing public is attracted by representations of investment income.”²⁰⁴ It also expressed concern about a potential evasion of the securities laws, since “unscrupulous marketers of investments could evade the securities laws by picking a rate of return to promise.”²⁰⁵

The Eleventh Circuit relied on *Reves v. Ernst & Young*²⁰⁶ and *United Housing Foundation, Inc. v. Forman*²⁰⁷ for its conclusion that an investment contract must offer either capital appreciation or a participation in the earnings of the enterprise.²⁰⁸ However, the *Edwards* Court responded that “*Forman* supports the commonsense understanding of ‘profits’ in the *Howey* test as simply ‘financial returns on . . . investments.’”²⁰⁹ It conceded that *Reves* appeared to have mistaken *Forman*’s “illustrative description” of prior decisions about “profits” for an exclusive list, and concluded that that “passing dictum” was a misreading of *Forman*.²¹⁰

The Court also rejected the Eleventh Circuit’s holding that the fourth prong of the *Howey* test was not met because the purchasers had a contractual entitlement to a return.²¹¹ The Court noted that it was considering “investment contracts.”²¹² The Court reasoned, “The fact that investors have

²⁰¹ *Edwards*, 540 U.S. at 393 (emphasis omitted) (citation omitted) (quoting *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990)).

²⁰² *Id.* (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946)).

²⁰³ *Id.* at 394.

²⁰⁴ *Id.*

²⁰⁵ *Id.* at 394–95.

²⁰⁶ 494 U.S. 56 (1990).

²⁰⁷ 421 U.S. 837, 853 (1975).

²⁰⁸ *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1284–85 (11th Cir. 2002) (per curiam), *rev’d and remanded*, *SEC v. Edwards*, 540 U.S. 389 (2004).

²⁰⁹ *Edwards*, 540 U.S. at 396 (quoting *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 853 (1975)).

²¹⁰ *Id.* at 396.

²¹¹ *Id.* at 397.

²¹² *Id.* (emphasis in original).

bargained for a return on their investment does not mean that the return is not also expected to come solely from the efforts of others.”²¹³

Although *Edwards* addressed the third and fourth prongs of the *Howey* test (an expectation of profits solely from the efforts of others), the case has important implications for the common enterprise debate. First, in light of *Edwards*, narrow vertical commonality should be dead. Narrow vertical commonality requires that the profits of the promoter and the investor rise and fall together. However, *Edwards* held that an investment contract can have a fixed return. Therefore, *Edwards* is flatly inconsistent with narrow vertical commonality.

Second, *Edwards* casts substantial doubt on horizontal commonality. A fixed return is inconsistent with a pro rata sharing of profits, so that aspect of horizontal commonality, required by some courts, should also be dead. In addition, the Court emphasized the broad definition of a security. It stated that Congress “enacted a broad definition of ‘security,’ sufficient ‘to encompass virtually any instrument that might be sold as an investment.’”²¹⁴ However, horizontal commonality is a restrictive test that excludes many instruments sold as investments. The Court also de-emphasized the form of the arrangement: “‘Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”²¹⁵ By contrast, horizontal commonality focuses precisely on the form of the arrangement.

Under the horizontal commonality test, the arrangements in *Edwards* would not be investment contracts.²¹⁶ Horizontal commonality involves a

²¹³ *Id.*

²¹⁴ *Id.* at 393 (quoting *Reves v. Ernst & Young*, 494 U.S. 56 (1990)).

²¹⁵ *Edwards*, 540 U.S. at 393 (emphasis omitted) (citation omitted).

²¹⁶ *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1287–88 (11th Cir. 2002) (Lay, J. concurring), *rev’d and remanded sub nom.*, *SEC v. Edwards*, 540 U.S. 389 (2004). Mark J. Loewenstein observed, “The facts in *Edwards* may not satisfy the prevailing concepts of common enterprise—that there must be horizontal commonality where the investors’ money is pooled.” Mark J. Loewenstein, *Merrill Lynch v. Dabit: Federal Preemption of Holders’ Class Actions*, 34 SEC. REG. L.J. 209, 214 (2006). Ryan C. Farha wrote:

[I]f the Supreme Court eliminated vertical commonality as a practicable option, leaving horizontal commonality as the applicable standard, then the fraudulent ETS scheme . . . would not be an investment contract and thus would not be subject to the federal securities laws. In view of the fraudulent aspects of the ETS operation, such a result is unlikely. Therefore, the *Edwards* case indirectly prophesizes that the scope of the investment contract analysis will not be curbed anytime in the near future.

Ryan C. Farha, Comment, *SEC v. Edwards: An Opportunity to Knock on the Viability of the Howey Test as the Gatekeeper for the Federal Securities Laws*, 31 OKLA. CITY U. L. REV. 161, 191 (2006).

pooling of investor contributions and, according to some courts, a pro rata sharing of profits. However, in *Edwards* the investors' funds were not pooled; instead each investor separately owned a payphone.²¹⁷ Nor was there a pro rata sharing of profits. Each investor received a fixed return, regardless of whether the enterprise made profits, and profits were not shared pro rata with other investors.²¹⁸

However, if the arrangements were formally structured so that the investors did not own individual phones and so that they shared the profits pro rata, the arrangements would be investment contracts. This emphasis on form is incompatible with *Edwards*.

The Court noted that the *Howey* test “embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”²¹⁹ By contrast, horizontal commonality is a rigid test, and is not capable of adaptation to meet various schemes. Indeed, it would not meet the scheme at issue in *Edwards*.

The Court also expressed concern about a potential evasion of the securities laws, since “unscrupulous marketers of investments could evade the securities laws by picking a rate of return to promise.”²²⁰ Similarly, horizontal commonality permits an evasion of the securities laws by allowing the promoter to structure the arrangement to lack horizontal commonality, as this scheme did.

The Court also argued that there was “no reason to distinguish between promises of fixed returns and promises of variable returns,” since in both cases “the investing public is attracted by representations of investment income.”²²¹ Likewise, there is no reason to distinguish between cases in which horizontal commonality exists or not, since in both cases the investing public is attracted to the representations of investment income.

Edwards is consistent with the multiple investors test for a common enterprise. Ten thousand people invested in the payphone sale-and-leaseback arrangements, and thus the arrangements satisfied the multiple investors test. On the other hand, some language in *Edwards* could be interpreted as not supporting the multiple investors test. The Court emphasized the broad definition of securities; the multiple investors test is broader than horizontal commonality but narrower than broad vertical commonality because it requires multiple investors. In addition, the Court emphasized that the securities acts were designed to regulate “investments,” and it is true that

²¹⁷ SEC v. *Edwards*, 540 U.S. 389, 391–92 (2004).

²¹⁸ *Id.* at 391.

²¹⁹ *Id.* at 393 (quoting SEC v. W.J. *Howey* Co., 328 U.S. 293, 299 (1946)).

²²⁰ *Id.* at 394–95.

²²¹ *Id.* at 394.

one-on-one investments can exist. However, *Marine Bank v. Weaver* held that such arrangements are not investment contracts.²²²

Moreover, *Edwards* stated that Congress “enacted a broad definition of ‘security,’ sufficient ‘to encompass virtually any instrument that might be sold as an investment.’”²²³ Normally, we do not consider a unique, individually negotiated contract to be an instrument that is “sold” to one of the parties to the agreement. By contrast, we do consider a company that issues uniform instruments to multiple investors to be “selling” investment contracts. The same is true regarding promissory notes. A company that borrows money from a single lender is not considered to be “selling” a promissory note,²²⁴ but a company that issues uniform promissory notes to multiple investors is considered to be “selling” promissory notes. This understanding is reflected in *Reves*, in which the Court stated that the notes were “offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite ‘common trading’ in an instrument.”²²⁵ Individually negotiated contracts are considered to be “agreed on” by the parties, while uniform instruments issued to multiple investors are considered to be “sold” to investors.

Therefore, *Edwards* should significantly affect the common enterprise debate. *Edwards* should mean the end of narrow vertical commonality, since its holding is flatly inconsistent with that approach. In addition, *Edwards* casts substantial doubt on horizontal commonality. A fixed rate of return is inconsistent with a pro rata sharing of profits, so that aspect of horizontal commonality should be dead. In addition, the Court’s emphasis on a broad and flexible definition of investment contracts is fundamentally incompatible with horizontal commonality. By contrast, the multiple investors test is consistent with *Edwards*. The case also supports the proposition that the test for investment contracts and promissory notes should be the same. The investment contracts in *Edwards* paid a fixed rate of interest and thus were similar to promissory notes.

IX. CONCLUSION

Under the multiple investors test, a common enterprise is an enterprise that is in common among the promoter and multiple parallel investors. The

²²² 455 U.S. 551, 560 (1982).

²²³ *Edwards*, 540 U.S. at 393 (emphasis added) (quoting *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990)).

²²⁴ See McGinty, *supra* note 14, at 1101 (“Intuitively, it seems mistaken to think of a bank as purchasing a security when it takes the borrower’s note as evidence of the loan.”).

²²⁵ *Reves v. Ernst & Young*, 494 U.S. 56, 68 (1990) (emphasis added).

multiple investors test corresponds to the disclosure policy of the securities acts, because it asks which contracts should have enhanced disclosure rather than the level of disclosure required by other statutes and the common law for most contracts. The *Howey* test for investment contracts, with the multiple investors definition of a common enterprise, is also a meaningful test for determining which promissory notes are securities. In fact, *Reves* essentially adopted this test for promissory notes.

Edwards should affect the definition of a common enterprise. The Court expressly rejected the requirement of a variable return to investors, which is an essential element of narrow vertical commonality. Also, the Court held that an investment contract can have a fixed return, which is inconsistent with a pro rata sharing of profits—one aspect of horizontal commonality. In addition, the Court emphasized a broad and flexible definition for securities, which is incompatible with horizontal commonality. Analytically, *Edwards* should mean the death of narrow vertical commonality and of the requirement of a pro rata sharing of profits under horizontal commonality. Moreover, *Edwards* casts substantial doubt on the whole concept of horizontal commonality.

The combination of *Howey*, *Weaver*, *Reves*, and *Edwards* strongly points to the multiple investors test for a common enterprise. *Howey*'s use of the term "common enterprise" suggested multiple investors, and *Weaver* required multiple investors. *Reves* cited common trading or an offering to a broad segment of the public, both of which involve multiple investors. *Edwards* also involved multiple investors. By contrast, the pattern of cases is inconsistent with the major alternative tests. The investments in *Howey* and *Edwards* lacked horizontal commonality. *Weaver* demonstrated that broad vertical commonality and narrow vertical commonality are insufficient. *Edwards* rejected an essential element of narrow vertical commonality and one aspect of horizontal commonality. The multiple investors test is the path that runs through the cases.

Grounded in both policy and precedent, the multiple investors test is a promising solution to the definition of a common enterprise.