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Discretionary Accounts

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DISCRETIONARY ACCOUNTS

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The author examines the recent cases and rulings defining the circumstances under which discretionary commodity accounts will be considered a security. After describing the three major types of discretionary accounts the author concludes that only those accounts in which the broker and the investor have a common economic interest or dependence should be treated as securities. The author argues that in light of both the essential role in the commodities market played by discretionary accounts and the added investor protection provided by new commodities legislation, the courts should be slow to impose securities treatment upon discretionary accounts.

I. INTRODUCTION

In 1967 the United States District Court for the Southern District of New York held that a contract between a broker and an investor giving the broker discretion to trade in commodities futures contracts was itself a security.[1] Since then, at least one United States district court in each circuit except the First[2] has had to

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1. Maheu v. Reynolds & Co., 282 F. Supp. 423 (S.D.N.Y. 1967).

2. There were three more cases in the Second Circuit, Scheer v. Merrill Lynch, Pierce, Fenner & Smith Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,086 (S.D.N.Y. 1975); Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764 (S.D.N.Y. 1972); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968). The others, by circuit are: Third Circuit, Wasnowic v. Chicago Board of Trade, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd,* 491 F.2d 752 (3d Cir. 1973); Fourth Circuit, Rochkind v. Reynolds Securities, Inc., 388 F. Supp. 254 (D. Md. 1975); Fifth Circuit, SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Sixth Circuit, Curran v. Merrill Lynch, Pierce, Fenner & Smith Co., [1976-1977] FED. SEC. L. REP. (CCH) ¶ 95,862 (E.D. Mich. 1976); Seventh Circuit, Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149 (N.D. Ill. 1970), *aff'd,* 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972); Hirk v. Agri-Research Council, Inc., [Current] FED. SEC. L. REP. ¶ 96,167 (7th Cir. 1977); Eighth Circuit, Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974); Anderson v. Francis I. Dupont, 291 F. Supp. 705 (D. Minn. 1968); Ninth Circuit, Stuckey v. duPont Glore Forgan, Inc., 59 F.R.D. 129 (N.D. Cal. 1973); Tenth Circuit, Commercial Iron & Metal Co. v. Bache & Co., 478 F.2d 39 (10th Cir. 1973) (by implication only). *See also* E.F. Hutton & Co. v. Burkholder, 413 F. Supp. 852 (D.D.C. 1976), where the court discussed different treatment for discretionary accounts.

The decisions are aligned as follows:

decide whether or not the particular discretionary agreement before it was an "investment contract" and as such a "security."[3] Furthermore, the Seventh and Fifth Circuit Courts of Appeals have decided the issue and have reached apparently conflicting positions.[4]

The Seventh Circuit, in *Milnarik v. M-S Commodities*[5] held that where the success or failure of each account had no effect on other accounts being handled by the same broker, there was no investment contract. The Fifth Circuit, in *SEC v. Continental Commodities Corp.*,[6] found that since "the fortuity of the investments collectively is essentially dependent upon promoter expertise,"[7] the discretionary accounts involved in that case were investment contracts. On September 6, 1977, in *Hirk v. Agri-Research Council, Inc.*,[8] the Seventh Circuit affirmed its continuing adherence to *Milnarik* and further held, as intimated in *Milnarik*, that a pooling of funds or a pro-rata sharing in proceeds is an essential element of a common enterprise.[9]

There are two basic reasons why the courts are split. First, the courts differ in their interpretation of the "common enterprise" requirement announced by the United States Supreme Court in *SEC v. W.J. Howey Co.*[10] Secondly, the courts have failed to differentiate between different types of "discretionary accounts." For example, the scheme determined to be a security in *Continental Commodities* has little relationship to the one involved in *Milnarik*, except that both share the same name.[11]

Courts in the Second, Fourth, Fifth, Eighth and Tenth Circuits have held a discretionary account to be a security; courts in the Third, Sixth, Seventh and Ninth have said it is not a security. The D.C. Circuit indicated it might join the first group. Note that since most of these are district court decisions it is quite possible that the circuit court of appeals for that circuit may reach a different conclusion when presented with the issue.

3. The Securities Act of 1933 defines the term "security" to include investment contracts. 15 U.S.C. § 77b(1) (1970).

4. Hirk v. Agri-Research Council, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,167 (7th Cir. 1977); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

5. 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

6. 497 F.2d 516 (5th Cir. 1974).

7. *Id.* at 522.

8. [Current] FED. SEC. L. REP. (CCH) ¶ 96,167 (7th Cir. 1977).

9. *Id.* at 92,292 to 93.

10. 328 U.S. 293 (1946). In *Howey*, the Court attempted to give a useful test for an investment contract, a test that was meant to reflect the meaning that had been given to the term by the state courts and incorporated by Congress into the Federal Securities laws. The *Howey* definition, which is set out in the text accompanying note 13, *infra*, and the rationale behind it were reaffirmed in United Housing Foundation, Inc. v. Forman, 421 U.S. 850 (1975).

11. For a discussion of other schemes which have been included in the expanded definition of security, see Mofsky, *Some Comments on the Expanding Definition of "Security"*, 27 U. MIAMI L. REV. 395 (1973).

This article will suggest an analytical framework for determining whether a discretionary account is an investment contract as that term is currently defined and the three types of discretionary accounts available in the market will be distinguished. Each type of discretionary account will be examined to see whether the element of common enterprise exists. Finally, the policy reasons which indicate a need to expand the definition of security to encompass such accounts will be presented, and the necessity of undertaking an economic impact study before such expansion is made will be argued.[12]

II. DISCRETIONARY ACCOUNTS

Discretionary accounts which may be opened with a broker-dealer are generally of three types. The first type, in which a group of investors pool their money and have it invested at the broker's discretion for their common benefit, is usually an investment contract and thus a security.[13] It not only fits snugly within the *Howey* model but also has aspects which are inherent in the concept of security.[14] Like stock in a corporation, these discretionary accounts represent shares in a whole whose profits are to be distributed according to some predetermined ratio.

The second type, where the broker treats each investor's account separately and trades for each account with different objectives, but where the broker himself is risking his own money or is sharing in the profits generated by his trading skill, is arguably a security.[15] Whether these accounts are considered securities depends

12. Florida requires that the legislature, prior to the enactment of any general or special law, consider the economic impact of the proposed legislation upon the public and upon the agency which will administer it. FLA. STAT. § 11.075 (Supp. 1976). Furthermore, before adopting, repealing, or amending any rule (except rules adopted due to immediate danger to public health, safety, or welfare) all Florida agencies must give a summary of the estimated economic impact of the rule on all persons affected by it. FLA. STAT. § 120.54 (Supp. 1976).

13. Anderson v. Francis I. duPont & Co., 291 F. Supp. 705 (D. Minn. 1968). *See generally*, 1 L. LOSS, SECURITIES REGULATION 495-96 (2d ed. 1961); H. SOWARDS, *Federal Securities Acts*, 11 BUSINESS ORGANIZATIONS § 2.01 [13] (Matthew Bender 1976); Tew & Friedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407, 415 (1973).

14. In *Howey* the Court said that the definition of investment contract it had adopted would permit "the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.' H. Rep. No. 85, 73d Cong., 1st Sess., p. 11." 328 U.S. at 299.

15. SEC v. Wickham, 12 F. Supp. 245 (D. Minn. 1935) (contract whereby one person supplied funds, the other trading acumen, the profits to be shared 60-40 and the losses to be borne only by the investing party). *See, e.g.*, Maheu v. Reynolds and Co., 282 F. Supp. 423

upon whether the particular jurisdiction understands "common enterprise" to encompass both a common interest among investors (horizontal), and a common interest between investor and promoter (vertical).[16]

Finally, there is the discretionary account in which the investor deposits money with his broker to be traded at the broker's discretion in a manner which will maximize the investor's objectives.[17] The broker does not share in the profits, but instead receives a commission on each trade regardless of whether the trade realizes a profit or a loss. It is submitted that this third prototype is not an

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(S.D.N.Y. 1967) where the account was characterized as a "Joint Account." The courts have failed to make this distinction in their factual findings; instead, they have simply found that where the profits are to be generated through the efforts of the promoter, there is common enterprise. *See generally* Loss *supra* note 7, at 489; 27 U. MIAMI L. REV., *supra* note 7, at 416-17. Some of the cases in which the courts have found a discretionary account to be an investment contract may be of this type.

Brokers are prohibited from sharing in the profits or losses of their customers by NYSE Rule 369 and ASE Rule 390. NASD Rules, art. III, § 3 provide that a broker acting as an agent for his customer may charge him no more than a fair commission. NYSE GUIDE, (CCH) #2369; ASE GUIDE, (CCH) #9420; NASD MANUAL (CCH) #2154.

Furthermore, if a broker shares in the profits of his customer he may become an investment adviser under § 202(a)(11) of the Investment Advisers Act of 1940. Since brokers usually charge a flat commission, it is most likely that the reason the discretionary account broker is getting a share in the profits is because of the value of the exercise of his discretion. In short, he is receiving additional compensation for his investment advice. Therefore, he is not excluded from the definition of investment adviser by virtue of the fact that he is a broker. Investment Advisers Act of 1940, § 202(a)(11)(c). Unless he is exempted from registration by § 203(b), because he has not given investment advice to more than 15 persons in the preceeding twelve months, he is prohibited from entering into any investment advisory contract which provides for compensation on the basis of a share of the capital gains or of the capital appreciation of the investment. *Id.* § 205(1).

Although undoubtedly there are brokers who, with their customers, enter into this second type of discretionary account, the customer who wishes to challenge such an account has recourse other than claiming that the discretionary account is a security. For a discussion of why he may make such a claim anyway, see text accompanying notes 55-64 *infra*.

Note also that there are brokers who are not subject to any of these regulations. Most brokerage firms have in-house rules regarding discretionary accounts, however, and other exchanges or boards of trade may have similar rules for their members.

Furthermore, if the broker can avoid registration as an investment adviser because he has had less than fifteen discretionary account customers, he could probably also qualify the discretionary accounts as private placements under Rule 146 and section 4(2) of the Securities Exchange Act of 1934. If so, it does the customer little good to have the discretionary account declared a security, since it would be exempt from registration. As discussed in text accompanying notes 55-64 *infra*, obtaining rescission for failure to register the account is one of the primary motives for seeking to have a discretionary account found a security.

16. See notes 31-34 and accompanying text *infra*.

17. Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); Hirk v. Agri-Research Council, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,738 (N.D. Ill. 1974); A.G. Edwards & Son, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,153; E.F. Hutton & Co., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,007.

investment contract because there is no "investment of money in a common enterprise,"[18] whether that term is viewed as requiring vertical or horizontal commonality.[19]

III. COMMON ENTERPRISE

In 1946, the United States Supreme Court in *SEC v. W.J. Howey Co.*[20] 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."[21]

An investor who opens a discretionary account is investing his money in reliance upon the expertise of the brokerage firm, expecting that the firm's trading acumen will generate profits for him. Therefore, by its very nature, a discretionary account satisfies the first and third elements of the *Howey* test. These are the investment of money and the expectation of profits derived from the efforts of others. Whether or not there exists a common enterprise becomes the determinative question.

The first decision to deal with the issue of whether a discretionary account is an investment contract, *Maheu v. Reynolds & Co.*,[22] read the *Howey* test as requiring a finding of *either* a common enterprise *or* an expectation of profits solely from the efforts of others.[23] Finding that the investors had relied on the investment house to

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

19. [The] type of trading pool operation, wherein there is a common enterprise and reliance by the purchaser on the efforts of others to produce profits, should be contrasted with the ordinary investment advisory contract, wherein the investment adviser is authorized to invest for the purchaser, no part of his fee being based upon a percentage of the profits. The latter situation does not involve a security within the meaning of the Act.

SOWARDS, *supra* note 7, § 2.01[14].

20. 328 U.S. 293 (1946).

21. *Id.* at 298-99. Substantially the same language is later designated by the Court as a "test." See note 18, *supra* and accompanying text.

22. 282 F. Supp. 423 (S.D.N.Y. 1967).

23. The language in Loss quoted by the court as support for this is "the line [between what is a security and what is not] is drawn . . . where neither the element of a common enterprise nor the element of reliance on the efforts of another is present." 282 F. Supp. at 429 (*citing* Loss, *supra* note 13 at 491). Professor Loss does not say that either is sufficient to find an investment contract. He simply says that there is no security where *neither* is present.

The court also cites Loss, *supra* note 13 at 489, for the proposition that "[t]he joint account may constitute a security even if there was no pooling arrangement *or common enterprise among investors.*" 282 F. Supp. at 429 (emphasis added). But Loss only says that a "*pooling arrangement* among investors (as in the *Howey* case) helps but is not essential." (emphasis added). The *Maheu* court assumes that pooling arrangement and common enterprise are synonymous. This has been rejected by all the courts that have adopted the concept of vertical commonality.

realize a profit for them, the District Court for the Southern District of New York held that the discretionary account itself, as distinguished from the commodities futures contracts which were being traded, constituted a security.[24] The court, again failing to discuss the common enterprise element,[25] reaffirmed this reasoning in *Berman v. Orimex Trading, Inc.*[26]

In 1972, the Court of Appeals for the Seventh Circuit, in *Milnarik v. M-S Commodities,*[27] an opinion written by Mr. Justice Stevens before his appointment to the United States Supreme Court, rejected this assumption.[28] In *Milnarik,* the court noted that, "judicial analysis of the question whether particular investment contracts are 'securities' within the statutory definition have repeatedly stressed the significance of finding a common enterprise."[29] The court found "the element of commonality" absent. It reasoned that, "[a]lthough the complaint does allege that Nelson (a broker with defendant M-S Commodities) entered into similar discretionary arrangements with other customers, the success or failure of those other contracts had no direct impact on the profitability of plaintiff's contract. Nelson's various customers were represented by a common agent but they were not joint participants in the same investment enterprise."[30]

Subsequent decisions[31] have characterized *Milnarik* as defining common enterprise exclusively in terms of horizontal commonality.

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24. 282 F. Supp. at 429.

25. "[The Howey] test is satisfied here by the allegation that Orimex would make all investment decisions with respect to Berman's account, and by its alleged representation that it could make a profit for him." Berman v. Orimex Trading, Inc., 291 F. Supp. 701, 702 (S.D.N.Y. 1968).

26. *Id.*

27. 457 F.2d 274 (7th Cir.), *cert. denied,* 409 U.S. 887 (1972).

28. It was also rejected by the Southern District of Iowa in Marshall v. Lamson Bros. & Co., 368 F. Supp. 486 (S.D. Iowa 1974):

> Admittedly, the Court in Maheu . . . took the position that a discretionary account "may constitute a security even if there was no pooling arrangement or common enterprise among investors." . . . In view of the emphasis placed on "common enterprise" in *Howey* and its repeated use as a criterion of investment contract in subsequent cases, however, I cannot escape the conclusion that common enterprise is a necessary element of the *Howey* definition.

Id. at 488. The court then went on to say that to find common enterprise it need not find a pooling arrangement, and that "[t]he element of 'common enterprise' is satisfied when a single investor commits his funds to a promoter in hope of making a profit . . . ." *Id.* at 489. This superficial analysis is criticized by the court in Hirk v. Agri-Research Council, Inc., *supra* note 4, at 92,293 n.6.

29. 457 F.2d at 276.

30. *Id.* at 276-77.

31. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Rochkind v. Reynolds Securities, Inc., 388 F. Supp. 254 (D. Md. 1975); Marshall v. Lamson Bros. Co., 368 F. Supp. 486 (S.D. Iowa 1974).

That is, they interpret *Milnarik* as requiring the existence, through a pooling of monies or proceeds, of a common interest among the investors. Some of these courts have then rejected *Milnarik* and the requirement of horizontal commonality by adopting the definition of common enterprise promulgated by the Ninth Circuit Court of Appeals in *SEC v. Glenn Turner Enterprises.*[32] In that case the court defined a common enterprise as "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment of third parties."[33] This form of common interest between the investor and the promoter is known as vertical commonality.[34] In *Hirk v. Agri-Research Council, Inc.*[35] the Seventh Circuit reevaluated *Milnarik* in light of the decisions following *SEC v. Continental Commodities.* It found that *Milnarik* interpreted *Howey* as requiring a pooling of funds or a pro-rata distribution of proceeds[36] and reaffirmed its continued reliance upon *Milnarik's* rationale. In holding that the discretionary account opened by Hirk was not an investment contract, the court rejected Hirk's attempt to fit within the *Milnarik* rule by alleging in his amended complaint that his monies and those of other investors were treated as if commingled.

> "As if commingled" is not the same as commingled. Furthermore, each discretionary trading account is unitary in nature; each account has a success or failure rate without regard to the

32. 474 F.2d 476 (9th Cir. 1973).

33. *Id.* at 482 n.7.

34. *See, e.g.,* SIPC v. Associated Underwriters, Inc., 423 F. Supp. 168, 178 (D. Utah 1975).

35. [Current] FED. SEC. L. REP. (CCH) ¶ 96,167 (7th Cir. 1977).

36. In *Milnarik,* the Seventh Circuit emphasized that the broker had simply acted as an agent. Adopting the language of the district court, it mentioned the lack of pooling of funds as a factor in the determination that the relationship created was no more than that of principal and agent. 457 F.2d at 278. The district court analyzed the investment contract cases and found that they were all situations where something looking very much like stock in a corporation was sold under a different name. It found the scheme before it to be different. The Seventh Circuit quoted the district court:

> In the instant case, the "security" with which we are dealing is the "investment contract" between the plaintiffs and Nelson creating the discretionary trading account. The "security" has not been . . . issued by the defendant and sold to the plaintiff. Rather, the security . . . is an oral agency agreement in which the theoretical "seller" becomes the agent of the "buyer." It is arguable that no transaction whatsoever has occurred . . . since no interest of any kind has been "transferred" or "sold" to the "buyer" . . . . In essence, this contract creates an agency-for-hire rather than constituting the sale of a unit of a larger enterprise. . . . Each contract creating this relationship is unitary in nature and each will be a success or failure without regard to the others.

457 F.2d at 277 (quoting Milnarik v. M-S Commodities, Inc., 320 F.Supp. at 1151). *See also* discussion at note 14 *supra* and accompanying text.

> others. Hirk's effort to sidestep this fact by stressing in paragraph 6 (of the amended complaint) that substantially similar transactions were made in all accounts and that profits or losses ebbed or flowed uniformly also fails because the necessary pooling remains unshown.[37]

The court rejected the decisions following *Continental Commodities* and its rationale, emphasizing once again the conflict among the circuits.

Nevertheless, since the Hirk account was of a type three nature (that is, one in which each investor deposits money in a separate account and each investor alone reaps the consequences of trading in his particular account) and the court did not discuss whether it would be possible to satisfy the pooling requirement if the pooling occurred between investor and promoter, accounts of a type two nature (that is, those in which there is vertical commonality) may still be considered investment contracts.[38] Discretionary accounts in which the broker's profits are linked with the profits of the account traded would be investment contracts in jurisdictions adopting the *Glenn Turner* definition of common enterprise. However, even in these jurisdictions there would be no common enterprise in the third type of discretionary account.

In *SEC v. Continental Commodities Corp.*,[39] the Fifth Circuit did adopt the vertical commonality approach of *Glenn Turner* and found that an investment contract existed where the broker was simply earning commissions. It found that "the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of Continental Commodities."[40] This language must not be interpreted too broadly. The success or failure of any business depends upon the quality of its product, in this case the exercise of discretion. The trading enterprise in *Continental Commodities,* however, was involved in trading commodities options making it a very unique kind of enterprise.[41]

If an investment firm is dealing primarily in options, as appears to be the case in *Continental Commodities,* and if it is pooling the

37. [Current] FED. SEC. L. REP. (CCH) ¶ 96,167 (7th Cir. 1977) at 92,293.

38. For a discussion of the different types of discretionary accounts see notes 13-19 *supra,* and accompanying text.

39. 497 F.2d 516 (5th Cir. 1974).

40. *Id.* at 522-23.

41. If a buyer chooses to exercise his option, the firm must incur the considerable cost of supplying the futures contract. Substantial losses by the firm would make it unable to fulfill its commitment to other investors who choose to exercise their options. Therefore, where a firm is dealing in options, the success of the firm and of each investor's account are both contingent on the sagacity of the investment counselor.

money it receives from each investor in order to buy the futures contracts upon exercise of the option,[42] then these discretionary accounts arguably are comparable to type one (horizontal commonality), since there would be a common interest among the investors in how the broker handled their pooled resources and the venture would not be feasible without such pooling.[43]

The courts following *Continental Commodities* have failed to recognize the difference between that trading scheme and the scheme before them.[44] To these courts *Continental Commodities* has come to stand for the proposition that no pooling among investors is necessary where the broker has discretion to trade. Broker discretion means vertical commonality, and that is sufficient to find common enterprise.[45] Where the analysis of these courts fails is in ignoring the possibility that in the particular scheme before the court there may be no common economic interest between investor and broker.

Properly understood, *Continental Commodities* does not stand for the proposition that a discretionary account inherently involves a common enterprise. The successful operation of the scheme in *Continental Commodities* required a pooling of funds. Thus vertical commonality, in the *Glenn Turner* sense, existed because of the distinctive nature of options trading.[46] The discretionary account in

42. It would especially need to pool investors' funds to buy the commodities futures contracts if the firm were dealing primarily in "naked" options—that is, where the broker writes the option without owning the underlying contract. For a discussion of commodities options as securities, see Borton and Abrahams, *Options on Commodity Futures Contracts as Securities in California*, 29 BUS. LAW. 867 (1974); Long, *The Naked Commodity Contract As a Security*, 15 WM. & MARY L. REV. 211 (1973). *See also* SEC v. Commodity Options International, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,072 (9th Cir. 1977).

43. In Stevens v. Woodstock, Inc., 372 F. Supp. 654 (N.D. Ill. 1974), the court found that unauthorized commingling of funds was not sufficient to establish a common enterprise. Presumably this is limited to situations where the venture could be undertaken without the commingling of funds. Implicit in the finding of an investment contract in both *Howey* and SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) is the finding that the promised venture would not be feasible without a pooling of resources. In Hirk v. Agri-Research Council, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,167 at 92,293, the court noted that a common enterprise existed in *Glenn Turner* because a pooling of funds was necessary to the scheme.

44. *See, e.g.*, Marshall v. Lamson Bros., 368 F. Supp. 486 (S.D. Iowa 1974).

45. *See* cases cited at note 2 *supra*.

46. It is noteworthy that in *Glenn Turner* a common enterprise was found to exist due to the common interest of the investor and the promoter. 474 F.2d at 482. Continental Commodities Corp. was behaving much like a promoter in its option trading scheme, thus making the analogy possible. The usual broker-investor relationship is very different from that of promoter-investor, however, making the applicability of the *Glenn Turner* definition of common enterprise questionable absent a showing of some substantial economic interest between broker and investor. That interest is inherent in the promoter-investor relationship. An argument can be made that the broker is "promoting" his discretionary accounts but in reality these are often requested by the investors, rather than promoted by the brokers.

Continental Commodities, therefore, may be considered as fitting within either of types one or two. The decision does not deal with accounts of the type three nature.[47]

In *Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[48] the court refused to follow *Continental Commodities,* adopting instead the *Milnarik* rationale. It explained its reasoning thus:

> The Court, in *Continental,* seems to take the view that the element of common enterprise as such is less important than the other elements and that if the tests of "investment of money" and "led to expect profits solely from the efforts of others" are met, the common enterprise element somehow is blanketed in . . . . Our reading of *Howey* leaves us with the distinct impression that the Court there laid down a test comprising three elements. . . . When the Seventh[49] Circuit in *Continental* uses the term "resilient approach" it apparently does so in reliance on the language in *Howey* where the Court, in reference to its definition of investment contract (one that relies on the three elements hereinabove set forth), says that it "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." We view this as a characterization of the definition set down by the Court and not as a license to interpolate or relax the necessary ingredients.[50]

Involved in *Curran* were discretionary accounts from which, regardless of losses, the investor could not withdraw for eighteen months. The plaintiff argued that there was a pooling of funds and pro-rata sharing in the proceeds.[51] The Court found that since defendant's interest was limited to commissions and plaintiff had opened his account independently of other investors, there was no common enterprise.[52]

In *Curran,* it is unclear whether the contracts fit within type one or type three as the court did not decide whether in fact pooling

47. Nevertheless, *Continental Commodities* has been cited as authority for finding type three discretionary accounts in commodities futures contracts to be investment contracts. *See, e.g.,* Scheer v. Merrill Lynch, Pierce, Fenner & Smith Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,086 (S.D.N.Y. 1975); Richkind v. Reynolds Secs., Inc., 388 F. Supp. 254 (D. Md. 1975).

48. [Current] FED. SEC. L. REP. (CCH) ¶ 95,862 (E.D. Mich. 1976). This was the first court in the Sixth Circuit to deal with the issue and the first since *Continental Commodities* to follow *Milnarik.*

49. The court meant the fifth circuit.

50. Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 95,862 at 91,130-31 (E.D. Mich. 1976)(footnote added).

51. The court quotes from the plaintiff's memorandum. *Id.* at 91,128.

52. *Id.* at 91,131.

of the investors' funds was necessary to the operation of the scheme.[53] The court rejected the rationale of *Continental Commodities,*[54] but failed to adopt an analytical framework of its own.

After *Hirk* it is unclear whether *Hirk* or *Milnarik* preclude a finding of a common enterprise where there is a pooling of funds or proceeds between investor and broker. Furthermore, a discretionary account may now be found to be an investment contract even though the investor was unaware of the pooling of funds if in fact the scheme could not operate without such pooling. So, whether or not pooling is necessary to the scheme becomes a relevant inquiry.

Summarizing, common enterprise under the *Howey* test has been defined in two ways: (1) that there be a common interest among the investors in the scheme being promoted; or (2) that the investor and the promoter have a common interest in the scheme. Since a finding of common enterprise is the determinative issue in deciding whether a discretionary account is an investment contract, an analysis of the elements comprising the common enterprise factor in the discretionary account is required. Such analysis demands differentiation among the three different types of accounts currently available. This differentiation leads to the conclusion that discretionary accounts where investors pool funds or share on a pro-rata basis in proceeds with each other or with their brokers may be found to constitute investment contracts. The discretionary account of the third type, however, lacks the element of common enterprise. Lacking this element, it cannot be an investment contract and therefore it is not a security. These accounts exist where each investor expects that the account will be handled individually and that broker commissions will be standard regardless of profit or loss. Accounts of this type were involved in *Hirk* and *Milnarik.*

IV. CONCLUSION

All of the cases[55] which have decided the issue of whether a discretionary account is a security have involved discretionary com-

53. The court quotes plaintiff's allegations of pooling of funds, states that it will follow *Milnarik,* but does not make a specific finding of fact that there was no pooling arrangement. Since the investors could not withdraw from the "Specialized Guided Account Trading Program" until 18 months had passed, this is not the ordinary discretionary account. Again, as in *Continental Commodities,* the nature of the enterprise might be such that the venture would not be feasible without a pooling of funds. *See* notes 42 & 43 and accompanying text *supra.*

54. *See* language quoted in text at notes 48-50 *supra.*

55. *See* notes 1 & 2 *supra.*

modities accounts, either futures contracts or options.[56] In all of them there is a desire on the part of the plaintiff to apply the Securities Acts[57] to these transactions. The courts have consistently held that a commodities futures contract is not a security and therefore does not come under the regulation of the Securities Acts.[58] Therefore, in order to apply the protections of the Acts to transactions in commodities futures, it was necessary to find that the trading account itself was a security. This need was especially compelling when the commodity being traded was not a regulated commodity.[59] Furthermore, unlike the Securities Acts,[60] the Commodities Exchange Act does not expressly provide for civil liability.

This situation has recently changed, so that from a policy standpoint, applying the Securities Acts to commodities accounts is less justifiable. As a result of the 1974 amendments, all commodities except onions are regulated by the Commodities Exchange Act[61] and courts have implied a civil right of action for churning and margin violations.[62] Therefore, it is no longer necessary to find the

56. Only SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) involved a discretionary account in commodities options. That this makes the case unique is discussed at notes 45-46 *supra* and accompanying text.

57. The Securities Act of 1933, §§ 1-302, 15 U.S.C. §§ 77a-77bbb (1970) and the Securities Exchange Act of 1934, §§ 1-34, 15 U.S.C. §§ 78a-78hh (1970).

58. Glen-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027 (2d Cir. 1974); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972); E.F. Hutton & Co. v. Burkholder, 413 F. Supp. 852 (D.C.C. 1976); Bartley v. P.G. Commodities Assocs., Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,394 (S.D.N.Y. 1975); *In re* Weiss Sec., Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,340 (S.D.N.Y. 1975); Scheer v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,086 (S.D.N.Y. 1975); Golding v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 385 F. Supp. 1182 (S.D.N.Y. 1974); Berman v. Dean Witter & Co., 353 F. Supp. 669 (C.D. Col. 1973); McCurnin v. Kohlmeyer & Co., 340 F. Supp. 1338 (E.D. La. 1972); Schwartz v. Bache & Co., 340 F. Supp. 995 (S.D. Iowa 1972); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968).

59. Prior to the 1974 Amendments to the Commodity Exchange Act §§ 1-12, 7 U.S.C. §§ 1-17a (1970) *as amended by* 7 U.S.C. §§ 1-21 (Supp. 1975), only those commodities listed in section 2 of the Act were considered regulated. The provisions of the Act did not apply to any commodity not listed in section 2. Bartley v. P.G. Commodities Assocs., Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,394 (S.D.N.Y. 1975). Therefore, plaintiffs tried to invoke the protections of the Securities Acts. *In re* Weiss Sec., Inc., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,340 (S.D.N.Y. 1975). This approach was thoroughly unsuccessful unless a discretionary account was involved. *See* note 45 *supra*.

60. 15 U.S.C. §§ 77e, 77d, 78i, 78r (1970).

61. The 1974 amendments added to the definition of "commodity" the following "and all other goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in . . . ." Commodity Exchange Act § 2(a), 7 U.S.C. § 2 (1970 & Supp. V 1975).

62. The courts have implied a civil right of action for churning under the Commodity Exchange Act § 4(b), 7 U.S.C. § 6b (1970) (Booth v. Peavey Company Commodity Servs.,

discretionary account to be a security in order to protect an otherwise remediless public.

Despite the expanded protection of the Commodities Exchange Act and the considerable remedies available to investors under the Securities Act and the Securities Exchange Act, plaintiffs will continue to argue that all discretionary accounts are securities. Since failure to register a security is a prima facie violation of section 5 of the Securities Act of 1933, plaintiffs can rescind the transaction under section 12[63] of that Act if they succeed in establishing that these accounts are securities. This gives them a remedy even if they are unable to prove any violation based on the underlying security or commodities trading.[64]

Furthermore, the SEC has recently refused to issue no-action letters in three situations where the broker proposed to allow his customers to open discretionary accounts which would be traded individually, according to the objectives of each investor, and solely on the basis of commissions.[65] The refusal was grounded on the existing conflict among the circuit courts.

The uncertainty resulting from this conflict places brokers and dealers in a situation where they must either register their discretionary accounts and distribute account prospectuses to their customers or risk having a court grant rescission if substantial losses dampen customer enthusiasm. The costs of registering all discretionary accounts would be prohibitive, and would result in the complete elimination of discretionary accounts from the market.[66] Although an in-depth economic impact study of the function and desirability of discretionary accounts is beyond the scope of this arti-

430 F.2d 132 (8th Cir. 1970); Goodman v. H. Hentz & Co., 265 F. Supp 440 (N.D. Ill. 1967); Hirk v. Agri-Research Council, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 96,167 (7th Cir. 1977)), and for margin violations under the Securities Exchange Act of 1934, § 30(a), 15 U.S.C. § 78g(f) (Palmer v. Thompson & McKinnon Auchinclass, Inc., FED. SEC. L. REP. (CCH) ¶ 96,000 (D. Conn. 1977)).

63. 15 U.S.C. § 77(e) (1970).

64. This remedy was sought in Milnarik v. M-S Commodities, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972), and in Wiggin v. Kohlmeyer & Co., 446 F.2d 792 (5th Cir. 1971).

65. A.G. Edwards & Sons, Inc., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,153; Commodity Management Service Corp., [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,805; Robert Enright, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,671.

In E. F. Hutton & Co., Inc., [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,007, the Commission had granted a no-action letter under very similar circumstances.

66. The benefit to the broker of operating a discretionary account is not sufficient to justify the costs of registering the account. This problem could be solved by exempting discretionary accounts from registration under a rule promulgated pursuant to the authority conferred to the SEC by the Securities Act of 1933, § 3, 15 U.S.C. § 77c(b) (1970).

cle, it is suggested that such a study should be undertaken before the courts expand the definition of securities to include discretionary accounts.[67] Among the factors to be considered given the volatility of the commodities market, are whether an end to discretionary accounts would restrict commodities futures trading to those investors either constantly able to monitor the market or constantly available to their brokers so that the order to trade might be given; and whether requiring a registration prospectus would inform the investor of any risk which is not already apparent from the very nature of the transaction.[68] Balanced against these difficulties are the protections[69] which the Securities Acts seek to offer to investors in the market and which would not be available under the provisions of the Commodities Exchange Act.[70]

The current state of the law in this area allows courts to forego such a balancing of interest by a mechanical application of precedent. This will eventually allow one of the competing interests to triumph without intelligent choice by either the judiciary or the legislature.

V. RECOMMENDATIONS

Congress may decide to redefine the scope of the Securities Acts to include within their protection commodities futures. Even so, because all discretionary accounts which are securities must be registered it is essential, if discretionary accounts are to survive at all,

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67. For a discussion of the importance of a cost-benefit analysis in government regulation, see R. MILLER & J. MOFSKY, LEGAL AND ECONOMIC EVALUATION OF IMPACT STATEMENT REQUIREMENTS FOR REGULATORY AGENCIES (1976) [hereinafter cited as MILLER & MOFSKY].

68. In Milnarik v. M-S Commodities, Inc., 320 F. Supp. 1149, 1153 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972), the court questions whether there is any practical need for a registration statement: "A perusal of the information required in the registration statement . . . demonstrates the inapplicability of a typical registration statement to the instant situation." *See also* LOSS, *supra* note 13, at 468.

Furthermore, the acceptance of discretionary authority is usually conditioned on the broker obtaining written authorization from the customer. *See, e.g.*, NYSE Rule 408, NYSE GUIDE (CCH) ¶ 2408; ASE Rule 421, ASE GUIDE (CCH) ¶ 9441; NASD art. III, sec. 15, NASD MANUAL (CCH) ¶ 2165. Therefore, what little can be disclosed about the accounts may actually be disclosed under the rules of the industry or of the brokerage firm since the customer must be made aware that he is giving his broker discretionary authorization.

69. There are conflicting viewpoints on the protection which the Securities Acts have provided investors. *Compare* SEC Report, [1963-1972 Special Studies Transfer Binder] FED. SEC. L. REP. (CCH) §§ 74,001-74,431 *with* Stigler, *Public Regulation of the Securities Market*, 37 J. BUS. 117 (1964); Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) and MILLER & MOFSKY, *supra* note 67, at 13.

70. The Commodity Exchange Act does not require registration or disclosure of commodities traded.

that courts develop standards to establish which accounts are investment contracts under *Howey*.

To decide whether a given discretionary account comes within the *Howey* definition the court must determine that either a type one (investors pool funds) or type two (broker and investor share proceeds or risk capital) account is involved. This is a factual determination which depends on whether: (1) the success or failure of the individual account directly affects other accounts handled by the broker; (2) the broker's profit is to some extent dependent on success; and (3) the broker is risking money or other capital along with the investor. The court must then decide as a matter of law whether there is sufficient horizontal or vertical commonality to satisfy the *Howey* test. If it finds that a common enterprise exists, the court will find that an investment contract exists.

Even if the courts decide that these types of discretionary accounts are securities, brokers and dealers could still offer their customers a type of discretionary account (type three) geared to fulfill their investment objectives and on which the broker will make a standard commission regardless of profit or loss. From a policy standpoint, these accounts should not be held to be securities because: (1) a registration statement is of limited value since there is little that can be disclosed about a discretionary account beyond the fact that the broker is being given discretion to trade according to stated objectives; (2) discretionary accounts make commodities trading viable for investors who wish to speculate but do not have the time or experience to constantly follow a volatile market; (3) the underlying item of trade is being regulated already either by the Securities Acts or by the Commodities Exchange Act; and (4) calling the account itself a security thwarts congressional intent by allowing the application of the Securities Acts to what are essentially commodities transactions under the jurisdiction of the Commodities Trade Commission.[71]

The analytical framework proposed in this article would allow the SEC to examine investment schemes presented to it by brokers under a consistent test and to issue no-action letters accordingly. This allows for market regulation and market expansion to exist in some degree of harmony by avoiding irrational barriers to new investments and uncertain risks to brokerage firms, both of which raise the costs of trading in securities.

71. 56 U.S.C. § 5001 (1970 & Supp. 1975).