University of Miami Law Review

Volume 27
Number 3 *Volume 27 Numbers 3-4 (Spring & Summer 1973)*

Article 9

7-1-1973

Securities Regulation: Investment Contract Redefined

Michel Press

since *Miranda v. Arizona*[47] has the Court been so vigorously accused of judicial legislation. However, in spite of the opinion's technical infirmities, the Supreme Court will most likely adhere to the given test.

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SECURITIES REGULATION: INVESTMENT CONTRACT REDEFINED

Defendants offered for sale to the public unique forms of self-improvement courses called "Adventures" and "Plans." In return for an investment of from one to five thousand dollars, purchasers received certain promotional materials, the opportunity to attend group seminars, and the right to enroll in a training course—all of which were geared to indoctrinating purchasers in the technique of selling "Dare To Be Great" courses to others. After completion of the training course, purchasers became "independent sales trainees," eligible to earn commissions from sales made by defendants to individuals whom the purchaser had brought to the "Adventure Meetings." The Securities and Exchange Commission sought to enjoin defendants from offering these schemes for sale, claiming violation of the registration and anti-fraud provisions of the Securities Act of 1933[1] and the Securities Exchange Act of 1934.[2] The Commission charged that these courses were part of a pyramid promotional sales plan which constituted an investment contract and, as such, a security within the meaning of the federal securities laws.[3] The Commission likened defendant to a double-level franchising operation in which the success of each individual franchisee is inextricably tied to the success of the entire franchising system.[4] Unless investors are given the opportunity to exercise practical and actual control over the managerial decisions of the entire enterprise, the Commission argued, such investors should be afforded

47. 384 U.S. 436 (1966).

1. 15 U.S.C. § 77(a)-(g), (j), (k), (q), (t), (w) (1970).
2. 15 U.S.C. § 78(a)-(c), (l), (r), (u), (z) (1970).
3. The Securities Act of 1933 defines "security" as

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

15 U.S.C. § 77(b)(1) (1970) (emphasis added). The Securities and Exchange Act of 1934 defines "security" in virtually the same language. 15 U.S.C. § 78(c)(a)(10) (1970).

4. *See Applicability of the Securities Laws to Multi-Level Distributorship and Pyramid Sales Plans*, SEC Securities Act Release, No. 5211 (Nov. 30, 1971).

the protection of the securities laws. The district court sustained this argument and granted a preliminary injunction.[5] On appeal to the United States Court of Appeals for the Ninth Circuit, *held*, affirmed: A pyramid sales plan where an investor is denied the opportunity to make those "essential managerial efforts which affect the failure or success of the enterprise"[6] is a security within the meaning of the Federal Securities laws. *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.) *cert. denied*, 94 S. Ct. 117 (1973).

Despite admonitions to the contrary,[7] the instant decision represents, at least on its face, a major departure from established federal notions of a security concept.[8] Traditionally, federal courts have defined an "investment contract" in terms of whether the investor actively participates in the operations of the enterprise. The Ninth Circuit, however, has adopted a far more expansive definition. Under the *Turner* test, the definition turns on the quality of investor participation. This expanded definition could have enormous regulatory consequences. If pursued vigorously by the SEC, the new *Turner* test could bring within the ambit of federal securities regulation heretofore unregulated industries, notably franchises, dealerships, and distributorships. For, in each of these industries, the investor, while contributing to the success of his own business, makes little input into the managerial decision-making process of the larger corporate enterprise.

The underlying purpose of the federal securities laws is full and fair disclosure relative to the issuance of securities. To carry out that purpose, Congress defined the term "security" in broad and general terms so as to include within the definition the many types of instruments that, in the commercial world, fall within the concept of a security.[9] In addition to commonly recognizable instruments such as notes, bonds, treasury stock, and debentures, Congress included several catch-all terms such as "certificates of interest or participation in any profit-sharing agreement" and "investment contracts."[10] These catch-all terms, while undefined by the Acts, were intended to identify transactions which in reality involve the same economic relationships as the more easily recognizable securities, but happen to be clothed in some unfamiliar garb.

Traditionally, federal courts have characterized an investment contract as essentially a profit-seeking venture in which a passive, relatively uninformed, and geographically distant investor relies on the promoter or a third person to manage the enterprise and to make a profit.[11] In *SEC v. W.J. Howey Co.*,[12] these elements were incorporated by the Supreme

5. SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972).
6. SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (9th Cir.) *cert. denied*, 94 S. Ct. 117 (1973) [hereinafter referred to as *Turner*].
7. *Id.* at 483.
8. See note 13 *infra* and accompanying text.
9. H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).
10. Securities Act of 1933, 15 U.S.C. § 77(b)(1) (1970).
11. *See, e.g.*, SEC v. Bailey, 41 F. Supp. 647 (S.D. Fla. 1941).
12. 328 U.S. 293 (1946) [hereinafter referred to as *Howey*].

Court into a test which became the federal standard by which to judge a security.

In *Howey*, the Court determined that a land sales contract for small parcels of an orange grove, coupled with a service contract for marketing the crop, constituted an investment contract under section 2(1) of the Securities Act of 1933. In so finding, the Court noted several factors. The defendant had represented to the purchasers, mainly non-Floridian businessmen and professional people with neither experience in nor knowledge of the citrus industry, that while substantial profits could be expected from the sale of oranges, it was unfeasible to operate the parcels individually. The service company offered to manage, cultivate, and sell the oranges, remitting to each purchaser a pro-rata share of the annual profits. Clearly, the Court reasoned, the two contracts were part of a single corporate financing scheme in which the purchasers were attracted solely by the chance to earn a good return on their investments. Thus, 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, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[13]

This definition, the Court noted, was consistent with both prior state and federal court decisions and with statutory aims.[14] It merely reduced to definitional form a legislative term, the meaning of which had been "crystallized" by prior judicial interpretation.[15]

The *Howey* test[16] received widespread judicial approval and has been cited and quoted in holding many kinds of fund-raising schemes as falling within the purview of the federal securities acts.[17] However, while *Howey* became the federal standard for interpreting the reach of the federal securities laws, some state courts held that *Howey* did not go far enough in protecting the investor. To broaden the scope of state securities regulation, state courts developed the "risk-capital" theory. The theory was first enunciated by the Supreme Court of California in *Silver Hills*

13. *Id.* at 298-99 (emphasis added).

14. *Id.* at 298.

15. *Id. But see* Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971), wherein the author contends, upon examination of the authorities relied on in *Howey*, that there had been no uniform state definition of an investment contract.

16. 328 U.S. 293 (1946). "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.* at 301.

17. *See* Annot., 3 A.L.R. FED. 592 (1970), and cases cited therein. In Tcherepnin v. Knight, 389 U.S. 332 (1967), the Supreme Court applied the *Howey* test to the definition of an investment contract under the Securities and Exchange Act of 1934. The Court held that a withdrawable capital share in a state-chartered savings and loan association was an investment contract under section 3(a)(10) of the Act, and thus a security subject to Rule 10b-5.

Country Club v. Sobieski,[18] a case involving the promotion of a country club. There, the promoters had entered into an installment contract to purchase a 22-acre ranch to be used as the site. They made a token down payment of $400 on the property, which was valued at $775,000. To raise the rest of the money necessary to finance the venture, the partners sold memberships in the newly-founded club. These memberships were held to be securities.

Justice Traynor, writing for the majority in *Silver Hills*, noted that a recurring feature in many investment schemes is the solicitation of funds for speculative, poorly-financed business ventures. In these instances, the investor, even if he can participate in or control some phase of the enterprise, is gambling "risk capital," in that there is a less than even chance of success although there is the opportunity for a large return on his investment. Because of the substantial risk of loss, to include such operations within the scope of the state securities acts would fulfill the purpose of protecting passive investors by compelling the disclosure of the disquieting aspects of the scheme.

The "risk-capital" theory thus shifted the emphasis in California from the promise of future profits to the risk of loss of the initial investment. Under this view, once the requisite risk is shown, the question of active investor participation becomes irrelevant.[19] While the "risk-capital" theory has recently been adopted, in varying forms, by several state courts,[20] and has the qualified support of at least one federal district court,[21] it is questionable whether it is applicable under the federal secu-

18. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) (membership in a country club with no legal rights thereto held to be a security) [hereinafter referred to as *Silver Hills*].

19. Some courts have expanded on the *Silver Hills* decision and have defined an investment contract by combining the "risk-capital" theory with some watered-down elements of the *Howey* test. In State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971), the Supreme Court of Hawaii in determining that a founder-membership contract constituted an investment contract, held that an investment contract is created whenever:

(1) An offeree furnishes initial value to an offeror, and
(2) a portion of this initial value is subjected to the risks of the enterprise, and
(3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
(4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

Id. at 649, 485 P.2d at 109. Although adopting the "risk-capital" theory, the *Hawaii Market Center* test seems to turn, as does the *Turner* test, on the managerial-decision making power of the investor. For a more in depth treatment of the "risk-capital" theory, see Mofsky, *The Expanding Definition of a "Security" Under the Blue Sky Laws*, 1 SEC. REG. L.J. 217 (1973).

20. State v. Hawaii Mkt. Center, Inc., 52 Hawaii 642, 485 P.2d 105 (1971); State *ex rel.* Park v. Glenn W. Turner Enterprises, Inc., 3 BLUE SKY L. REP. ¶ 71,023 (4th Jud. Dist. Idaho 1972); State *ex rel.* Healy v. Consumer Business System, Inc., 5 Ore. Ct. App. 19, 482 P.2d 549 (1971).

21. Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640 (D. Colo. 1970), *aff'd* 460 F.2d 666 (10th Cir. 1972). *Compare* Venture Investment Co., Inc. v. Schaefer, 3 BLUE SKY L. REP. ¶ 71,031 (D. Colo. 1972).

rities laws,[22] especially since the theory's underpinning has been expressly rejected by the Supreme Court.[23]

In *Turner*, the district court held "Dare To Be Great" to be a security, basing its decision, in large part, on the "risk-capital" theory.[24] On appeal, the Ninth Circuit sidestepped the thorny problem of applying the risk-capital" theory by addressing itself exclusively to the question of whether "Dare To Be Great" constituted an investment contract under a flexible interpretation of the *Howey* test.

The Ninth Circuit took the view that, despite the settled application of the *Howey* test in federal courts, adherence to such an interpretation would result "in a mechanical, unduly restrictive view of what is and what is not an investment contract,"[25] thereby frustrating the broad purpose of the securities acts. In particular, the court pointed out that insistence on the requirement that profits come *solely* from the efforts of others would create inevitable loopholes. Promoters could then evade the reach of the federal securities acts by simply requiring investors to contribute a modicum of effort. Consequently, the court admonished that the mere fact that an investor participates to some small degree should not automatically preclude a finding that the scheme is an investment contract.[26] The more realistic test, the court opined, is whether the investor makes those essential managerial efforts which significantly affect the enterprise.

Under this liberal approach, the court had little trouble determining that "Dare To Be Great" was a security. Purchasers, the court noted, although actively recruiting prospects to attend "Dare To Be Great" meetings, were really relying on Turner's professional salesmen to put the scheme over. For it was Turner's salesmen who ran the meetings and persuaded the prospects that "Dare" was a "sure route to great riches."[27]

22. The "risk-capital" theory was adopted by state courts construing state securities laws. Since these laws regulate the *merits* of publicly offered securities, it is entirely appropriate for them to be concerned with the "riskiness" of a new business promotion. Federal securities laws, on the other hand, are unconcerned with the merits of an offering. Federal securities laws merely provide for full and fair disclosure. Thus, it would be inconsistent for federal laws to adopt the "risk-capital" theory, since that theory is grounded on the policy of merit regulation.

23. "It is immaterial whether the enterprise is speculative or non-speculative . . . ." SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946), *cited in* Tcherepnin v. Knight, 389 U.S. 332, 345 (1967). *But see* Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367, 381-82 (1967), wherein the author argues that risk of loss was tacitly recognized in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

24. The district court stated that "the Supreme Court has indicated that it is appropriate to look to state law to give content to the terms used in the definition . . . ." SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766, 773 (D. Ore. 1972). This statement is taken out of context and is misleading. The 1946 Court in *Howey* looked to state court decisions pre-1933 to garner an interpretation of what Congress had meant in 1933 when it used the term "investment contract." It would be inappropriate for federal courts to look to current state decisions to give meaning to a term as used in 1933.

25. 474 F.2d at 482.

26. *See* Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953) (uncited by the Ninth Circuit *Turner* opinion).

27. 474 F.2d at 479.

In essence, the court concluded, those who bought "Adventures," and thereby the right to earn commissions, were really buying the right to share in the selling efforts of the professional salesmen, without whose efforts the scheme would have failed. To get that share, the purchasers invested three things: their money; their efforts to find prospects and bring them to the meetings; and whatever it cost them to create a sufficient appearance of instant affluence to lure others to join the venture.[28]

Submitted to close scrutiny, the court's reasoning appears flawed. From a factual standpoint, the court assumed that non-managerial efforts are insignificant to the success of a venture. However, in a scheme such as "Dare To Be Great," the role of the purchaser-salesmen appears to have been essential; for without their solicitations, sales and profits would have dried up entirely.[29] Additionally, the court intentionally played down the purchasers' active role. The court implied that purchasers contributed only a modicum of effort, when in fact, the record disclosed that purchasers put in long hours seeking out prospects and attending meetings.[30]

From a legal standpoint, the court's reasoning is equally assailable. First, even assuming a flexible interpretation of *Howey* is possible, the court's adoption of the *Turner* test, based on essential managerial efforts, appears to go far beyond what Congress intended the securities acts to reach.[31] Additionally, the court's bald assertion that its test is more "realistic" than *Howey*'s is unsupported by any federal decisions,[32] save for the district court's opinion. There, without citation, Judge Skopil asserted that "[t]he most essential consistency in the cases which have considered the meaning of 'investment contract' is the emphasis on whether or not the investor has substantial power to affect the success of the enterprise."[33] This is simply not so. As one commentator has noted, the cases have almost unanimously interpreted the *Howey* test to mean that "any effort, physical or otherwise, exerted by the investor, regardless of whether this effort has any bearing on the control of the enterprise,"[34] would disqualify a scheme as a security.

In place of rigorous analysis, the Ninth Circuit relied on imprecise and overbroad maxims of statutory construction which could stand for almost any desired proposition.[35] Moreover, the court's reliance on three

28. The idea that an investment can include labor as well as money was given support in Murphy v. Dare To Be Great, Inc., 3 BLUE SKY L. REP. ¶ 71,053 (D.C. Sup. Ct. 1972). *Accord*, Goodwin, *Franchising Law Matures*, 28 BUS. LAW. 703 (1973).

29. In SEC v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga. 1973), decided on similar facts, a district court agreed and held no security. An appeal from the *Koscot* decision is presently pending before the Fifth Circuit.

30. Brief for Appellant at 18, 474 F.2d 476.

31. See note 15 *supra* and accompanying text.

32. However, a few state court decisions are in accord with the instant case. *See, e.g.*, State v. Silberberg, 166 Ohio St. 101, 139 N.E.2d 342 (1956).

33. SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766, 775 (D. Ore. 1972).

34. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 145 (1971).

35. "We hold, however, that in light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one . . . ." 474 F.2d at 482.

"Blue Sky" decisions[36] holding "Dare To Be Great" to be a security, is unjustified,[37] especially since they were decided under the "risk-capital" theory. Interestingly, the court ignored its own very recent precedent in which the *Howey* test had been reaffirmed.[38]

While the court's conclusion—that *Howey* intended "efforts" to mean managerial, policy-making efforts—is supported by a number of commentators[39] and, to some extent, by the language in *Howey* itself,[40] the court made no attempt to develop this critical point.[41] Further, the court avoided a discussion of the fact that purchasers of the "Dare To Be Great" courses did not actually participate in the *profits* of the company. Rather, they earned *fixed* commissions from their sales, regardless of whether the sales proved profitable to the company.[42]

In the opinion of this writer, *Turner* is a short-sighted decision which was fashioned to destroy[43] "a gigantic and successful fraud."[44] In so doing, the Ninth Circuit may have worked an unwarranted extension of the federal securities laws. The *Turner* test, if permitted to stand, will

36. Hurst v. Dare To Be Great, 3 BLUE SKY L. REP. ¶ 71,012 (D. Ore. 1971), *aff'd* 474 F.2d 483 (9th Cir. 1973); Frye v. Taylor, 263 So.2d 835 (Fla. 4th Dist. 1972); State *ex rel.* Park v. Glenn W. Turner Enterprises, Inc., 3 BLUE SKY L. REP. ¶ 71,023 (4th Jud. Dist. Idaho 1972).

37. As the Supreme Court stated in Tcherepnin v. Knight: "[F]ederal law must govern whether [withdrawable capital] shares . . . constitute securities under the Securities Exchange Act." 389 U.S. 332, 337-38 (1967).

38. Chapman v. Rudd Paint & Varnish Co., 409 F.2d 635 (9th Cir. 1969), in which a "turn-key" operation into which the investor merely stepped, becoming immediately involved in a substantial and profitable undertaking with a minimum obligation on his own time, was held not to be a security. *See also* Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640 (D. Colo. 1970), *aff'd*, 460 F.2d 666 (10th Cir. 1972), where the franchisee had so little control that he could not select his own local manager; likewise held not to be a security.

39. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967); Goodwin, *Franchising Law Matures*, 28 BUS. LAW. 703 (1973); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

40. This is evidenced in the following two passages: "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." SEC v. W.J. Howey Co., 328 U.S. 293, 300 (1946) (emphasis added). Later the Court stated: "Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters *manage, control* and operate the enterprise . . . ." *Id.* (emphasis added).

41. The *Turner* decision is grounded on the assumption that an investor who is actively engaged in the management of a company is able to protect himself and does not need regulatory assistance. In theory, however, the most efficient allocation of resources would be to leave the management of a company's affairs to those best suited to the job, namely the managers. It would seem axiomatic that if untrained and unsophisticated investors were encouraged to engage in the management of a company, the company would be run less efficiently, thereby increasing the riskiness of the investment.

42. This point proved critical in a number of cases holding no security. *See* Gallion v. Alabama Mkt. Centers, Inc., 282 Ala. 679, 213 So.2d 841 (1968); Georgia Mkt. Centers, Inc. v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969); Emery v. So-Soft, Inc., 30 Ohio Op. 2d 226, 199 N.E.2d 120 (Ohio Ct. App. 1964); Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964); Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Civ. App. 1970).

43. SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972).

44. 474 F.2d at 478.

subject franchises, distributorships and similar enterprises to costly and onerous registration requirements which were previously not applicable. In discounting non-managerial efforts as insignificant, the *Turner* test may not have accurately reflected business realities. In 1970, the then General Counsel to the Securities and Exchange Commission, testifying before the Senate Select Committee on Small Businesses, expressed the view that, generally, franchises should not be considered securities because their success depends, in large measure, on the joint labor of the franchisor and franchisee.[45] It is submitted that the instant decision was colored by the defendant's fraud. Hopefully, its rule will be restricted, as here, to inherently fraudulent promotions.

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PATENTABILITY OF COMPUTER PROGRAMS

Respondents[1] filed an application in the Patent Office on a programmed conversion[2] of numerical information in general purpose digital computers for use in the transmission of telephone signals.[3] Their claim, a method for converting binary-coded-in decimal numbers into pure binary numerals, covered any use of the method in any type of digital computer.[4] Pursuant to a policy decision of the Patent Office, the claims were rejected by both the examiner and the Patent Office Board of Appeals as being "non-statutory subject matter." The Court of Customs and Patent Appeals (C.C.P.A.) reversed[5] and allowed the claims as fitting within the

45. SEC. REG. & L. REP. A-8 (April 29, 1970).

1. Amicus briefs of sixteen groups were filed. Gottschalk v. Benson, 93 S. Ct. 253, 258 n.7 (1972). The issue of patentability of computer programs has split the computer industry into two factions. On one hand, the hardware manufacturers are against extending protection to programs on the ground that it might hurt computer sales and for fear that widespread and efficient distribution of new programming techniques will be inhibited. On the other hand, software companies, whose sole product consists of computer programs, favor patent protection on the ground that lack of it discourages growth and marketability of their programs. Note, *Computer Programs and Proposed Revisions of the Patent and Copyright Laws*, 81 HARV. L. REV. 1541, 1547 (1968) [hereinafter cited as 81 HARVARD].

2. A computer program is basically a set of mathematical instructions which direct the inner workings of the computer hardware. Programs are writtten in one of several computer languages such as COBAL, FORTRAN, and ALGOL, which may be used with almost any general purpose digital computer. Programs are also written in "machine language," that is, the language peculiar to each type of computer. Different applications will warrant the use of the different languages.

3. The program was developed for and assigned to Bell Telephone Laboratories, Inc. *See Computers: Hard Ruling for Software—Victory for Hardware*, TIME, Dec. 4, 1972, at 46.

4. See notes 45 & 46 *infra*.

5. *In re* Benson, 441 F.2d 682, 169 U.S.P.Q. 548 (C.C.P.A. 1971).