

**A “Common” Problem: Examining the Need for Common Ground in the  
“Common Enterprise” Element of the *Howey* Test**

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## **I. Introduction**

An undeniable fact in securities regulation law is that if a transaction is a security, and assuming none of the exemptions of 15 U.S.C. 77c apply, then that security must be registered with the Securities and Exchange Commission (“SEC” or “the Commission”).<sup>2</sup> Whether or not the registration requirements of the Securities Act of 1933 (“Securities Act” or “1933 Act”)<sup>3</sup> will be triggered rests with one main issue: whether a “security,” as defined by the statute, is present.

“Congress’ purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.”<sup>4</sup> In defining the term “security,” the Securities Act covers a fairly broad spectrum by listing a plethora of investment

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2. 15 U.S.C. § 77f makes it unlawful for a person to engage in any sale or offer of sale of a security prior to the filing of the registration statement. 15 U.S.C § 77f (2006). In addition, this section, commonly referred to as section 5, only applies to transactions by those not expressly exempted by 15 U.S.C. § 77d. 15 U.S.C. § 77d (2005).

3. 15 U.S.C. §§ 77a et seq. (2000).

4. SEC v. Edwards, 540 U.S. 389, 393 (2004) (citing *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990)).

transactions.<sup>5</sup> This broad definition is “sufficient to encompass virtually any instrument that might be sold as an investment.”<sup>6</sup> While some of the terms used in the definition are fairly straight forward, *i.e.*, “note,” “stock,” and “bond,” others are much less clear.<sup>7</sup>

One such transaction that has posed a considerable amount of complexity for those engaging in the buying and selling of securities is the “investment contract.” The “investment contract,” while not being a conventional security such as a “stock,” “bond” or “note,” has the

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5. See 15 U.S.C. § 77b (2000). Specifically, the 1933 Act defines “security” as:

[A]ny 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.

15 U.S.C. § 77b. See also The Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10) (2000), defining a “security” as:

[A]ny note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, 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 instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C.A. § 78c(a)(10). Due to the similarities of the definitions, courts tend to construe both definitions as meaning the same thing.

6. SEC v. Edwards, 540 U.S. 389, 393 (2004) (citing *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990)).

7. SEC v. C.M. Joiner, 320 U.S. 344, 351 (1943).

fundamental characteristic of a conventional security in that it is a passive means of gaining a financial interest in an asset.<sup>8</sup>

Deciphering the proper method for determining whether a transaction will qualify as an investment contract is something that has plagued the courts for over sixty years. In *SEC v. W.J. Howey Co.*,<sup>9</sup> the Supreme Court established a four-part test to determine whether a transaction was an “investment contract” as defined by the 1933 Act.<sup>10</sup> The second element of that test, the “common enterprise,” appeared to be clear within the context of that case, but subsequent courts have disputed its exact meaning to the point where confusion and uncertainty are understated.<sup>11</sup>

This paper will explore the investment contract, and specifically the “common enterprise” element of the *Howey* test. It will begin with a historical analysis of investment contracts prior to the Supreme Court’s *Howey* decision in 1946, followed by an in-depth look at the *Howey* four-part test. In the third section of this paper, I will give a comprehensive overview of the state of the law today, and the division among the courts. In particular, horizontal commonality and the two types of vertical commonality will be discussed. Finally, an argument will be made that there is a need for the Supreme Court to follow Justice White’s stance on the issue and have a uniform standard for the common enterprise prong of the *Howey* test.

## II. The Investment Contract

### a. *Pre-Howey*

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8. *SEC v. Lauer*, 52 F.3d 667, 670 (7th Cir. 1995).

9. 328 U.S. 293 (1946).

10. *Id.*

11. *See Mordaunt v. Incomco*, 469 U.S. 1115 (1985) *cert. denied* (White, J. dissenting) (“In light of the clear and significant split in the circuits, I would grant certiorari” to determine whether *Howey* requires vertical or horizontal commonality.) *Id.* at 1116-1117.

Prior to the enactment of the 1933 Act and the Securities Exchange Act of 1934 (“Exchange Act” or “1934 Act”),<sup>12</sup> states were left to their own devices to regulate security transactions via their Blue Sky laws.

One of the first cases to attempt to grind out a definition of the term “investment contract” as it was used by various Blue Sky Commissions was *State v. Gopher Tire & Rubber Co.*<sup>13</sup> The Minnesota Supreme Court defined the term “investment” as “[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment.”<sup>14</sup> This, they said, was how “investment” was commonly used and known,<sup>15</sup> and the definition was applied to the term “investment contract” as it was used in the “so called” Blue Sky law of Minnesota.<sup>16</sup> Ultimately, it was found that a buyer of a certificate issued by a corporation that promised a share in the profits of that corporation was an investment contract and thus subject to the regulations of the Blue Sky law.<sup>17</sup>

Initially, federal courts followed suit and looked to how states were defining and interpreting the term “investment contract” as per their Blue Sky laws.<sup>18</sup> By 1941 the lower

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12. 15 U.S.C. §§ 78a et seq. (2000).

13. 177 N.W. 937, 938 (Minn. 1920) (stating that “[n]o case has been called to our attention defining the term ‘investment contract.’”)

14. *Id.*

15. *Id.*

16. *Id.* (citing 1917 Minn. Laws ch. 429, as amended by 1919 Minn. Laws. ch 105. The Court summarized in relevant part: “All persons, firms and corporations are prohibited from engaging, within this state, in the business of selling or negotiating for the sale of any stocks, bonds, *investment contracts*, or other securities.” *Gopher Tire*, 177 N.W. at 938 (emphasis added)).

17. *Gopher Tire*, 177 N.W. at 938.

18. *See* SEC v. Wickham, 12 F. Supp. 245 (D.C. Minn. 1935) (citing almost exclusively to *Gopher Tire* and holding that a contract issued by the defendant (presumably an investment broker) was an investment contract, and thus a security under the regulatory power of the 1933 Act, making the defendant an issuer of “securities.”). *See also* SEC v. Universal Service Ass’n, 106 F.2d 232 (7th Cir. 1939).

federal courts began expanding on the principles established by states and developing their own method for defining and analyzing the investment contract issue. While the form of the transaction was given careful consideration, courts were willing to “look through the form to discover the real nature of the transaction.”<sup>19</sup> In doing so, it was determined that “an ‘investment contract’ . . . is one which contemplates the entrusting of money or other capital to another, with the expectation of deriving a profit or income therefrom, to be created through the efforts of others.”<sup>20</sup>

In its first attempt to clarify the proper method for determining whether a particular transaction is an investment contract, the Supreme Court, in *SEC v. C.M. Joiner*,<sup>21</sup> glossed over the vagary of the term.<sup>22</sup> In the Court’s opinion, Justice Jackson first acknowledged that courts cannot read out of the statute the general descriptive terms in favor of more specific ones simply because the definitions and overall understanding of some terms are clearer than others.<sup>23</sup> This is because:

[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character.<sup>24</sup>

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19. *SEC v. Bailey*, 41 F. Supp. 647, 650 (S.D. Fla. 1941). The transaction at issue in *Bailey* revolved around the sale of small tracks of land that were deemed suitable for growing tung trees. Through a massive advertising campaign, prospective investors were told that they could receive a substantial amount of income on a relatively small investment and they would not have to do anything to cultivate the land or manage the groves because that duty would be left up to experts. *Id.*

20. *Id.*

21. 320 U.S. 344 (1943).

22. *Id.* at 351-354.

23. *Id.* at 351.

24. *Id.*

The Court stressed the importance of, and the weight that must be given to, the character of the instrument and formulated a test whereby the Court looked at the terms of the offer, the method of distribution, and the economic benefits that were proffered to the prospective purchaser.<sup>25</sup> For the first time since the Securities Acts were enacted, a test was established to determine whether an instrument that was being sold, traded, etc., was one of these “novel, uncommon, or irregular devices” which included the investment contract.

**b. *SEC v. Howey*<sup>26</sup> and the 4 Part Test<sup>27</sup>**

Three years after the Supreme Court addressed the investment contract issue in *Joiner*, it decided to revisit the issue, and apparently iron out a coherent and comprehensive test for determining whether a particular security transaction is an investment contract for purposes of the Acts. This pivotal case warrants special attention because the test established by Justice Murphy, writing for the Court, is the test from which all subsequent investment contract analysis begins.

*SEC v. W.J. Howey* involved offers to sell tracks of land that were cultivated with citrus groves.<sup>28</sup> Offers were made for both a land sales contract and a service contract to prospective investors, but the offers were not dependent on one another insofar as the purchaser was free to

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25. *Id.* at 352-353.

26. 328 U.S. 293 (1946).

27. Some courts have articulated that the *Howey* test consists of only three elements. These courts group the third and fourth prong of the test together thereby announcing that the proper test is (1) an investment of money (2) in a common enterprise (3) with an expectation of profits to come solely from the efforts of others. For purposes of this paper, reference will be made to the *Howey* four part test.

28. *Id.* at 295.

either accept or reject the service contract.<sup>29</sup> Upon purchase of one of the citrus tracks it was expected that the land owners would receive a 10% return on their investment over a ten year period.<sup>30</sup>

The lower courts found that the transactions occurring between the Howey Company and its customers were nothing more than two separate contracts; one for the sale and deed of land and the other for the management of the property.<sup>31</sup> As a result of such an analysis, the lower courts found that the business dealings between the Howey Company and its customers were not securities that had to be registered pursuant to the registration requirements of the Securities Act.<sup>32</sup>

In analyzing the issue, the Supreme Court looked back to what the states were doing in interpreting their own Blue Sky laws. They noted that within the states, the form of the transaction was being discounted in favor of the economic reality of the transaction.<sup>33</sup> The Court presumed that by including the term “investment contract” within the Securities Act, Congress was using a phrase that had previously been interpreted by courts within the Blue Sky laws, and therefore it was a logical jump to apply that definition to the term on the federal side.<sup>34</sup> Based upon this logic, the definitive test for an investment contract promulgated by the Court was

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29. *Id.* Investors were specifically told that it was not “feasible to invest in a grove unless service arrangements are made.” *Id.* The benefits of having the Howey Company handle the servicing of the groves was pushed, but potential buyers were not forced to have their servicing handled by them. 15% of the individuals who purchased the citrus grove tracks from the Howey Company actually chose to go with another service Company. *Id.*

30. *Id.* at 296. While the 10% ROI was expected for ten years, in the 1943-1944 season investors actually saw a 20% ROI, and it was anticipated that would further increase during the 1944-1945 season. *Id.*

31. *Id.* at 297-298.

32. *Id.* The registration requirements of the Securities Act can be found at 15 U.S.C. § 77e. This particular section is commonly referred to as Section 5 of the Securities Act.

33. Howey, 328 U.S. at 298 (citing *State v. Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn. 1920)).

34. Howey, 328 U.S. at 298.

whether the particular scheme or transaction involves (1) the investment of money; (2) in a common enterprise; (3) with the expectation of profits; and (4) to come solely from the efforts of others.<sup>35</sup>

Nearly two decades later the Supreme Court reaffirmed its decision in *Howey* and solidified it as the predominant and sole method for determining whether a scheme is in fact an investment contract.<sup>36</sup>

This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. 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.<sup>37</sup>

The Court emphasized that it will not look to how the parties define their dealings, but rather will look to the “substance—the economic realities of the transaction.”<sup>38</sup> Since *Forman*, the Supreme Court has repeatedly and without question followed the test announced in *Howey* whenever there is an issue as to whether an investment contract exists.<sup>39</sup>

### **III. The Common Enterprise Quandary**

The Supreme Court has been virtually silent as to the true and proper definition of what constitutes a “common enterprise” for purposes of the *Howey* test. As such, lower courts, left to their own devices, have divided on this particular element of the test and three separate theories

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35. *Id.* at 301.

36. *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

37. *Id.* at 852.

38. *Id.* at 851.

39. *See Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979) (applying the *Howey* test to noncontributory, compulsory pension plans). *See also* SEC v. Edwards, 540 U.S. 389 (2004) (applying the *Howey* test to a scheme offering contractual entitlement to a fixed rate of return).

have surfaced: horizontal commonality, strict vertical commonality, and broad vertical commonality. In addition to circuits deciding the issue in favor of one method over the others,<sup>40</sup> some have either teetered on the issue<sup>41</sup> or have yet to decide on a definitive test to determine whether a “common enterprise” exists.<sup>42</sup>

**a. *Horizontal Commonality***

Horizontal Commonality is the clearest example of a common enterprise.<sup>43</sup> It looks to the relationship among investors in a transaction and “requires a pooling of investors’ contributions and distribution of profits and losses on a pro-rata basis among investors.”<sup>44</sup> With

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40. The Sixth Circuit has established that horizontal commonality is necessary for the “common enterprise” element of the *Howey* test to be satisfied. *See Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 622 F.2d 216 (6th Cir. 1980) (holding that a pooling of investors’ interests is essential to a finding of a common enterprise). In addition to the Sixth Circuit, the Third and Seventh have historically held that horizontal commonality is necessary but in recent years have considered whether vertical commonality will also suffice.

The Fifth, Eleventh and Ninth Circuits have said that vertical commonality will suffice, with the Fifth and Eleventh in favor of a broad vertical commonality approach and the Ninth in favor of strict vertical commonality. *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (holding that the critical factor for a common enterprise is the reliance on the promoter’s efforts to generate a profit); *Eberhardt v. Waters*, 901 F.2d 1578 (11th Cir. 1990) (adopting the approach of the Fifth Circuit in *Koscot*); *Brodt v. Bache & Co.*, 595 F.2d 459 (9th Cir. 1979) (finding that there was no common enterprise in a discretionary commodities trading account because the financial well-being of the investor and broker were independent of one another).

41. *See SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001) (holding that a horizontal commonality approach is sufficient to satisfy the “common enterprise” element of the *Howey* test, but also recognizing in a footnote that the facts before the court are sufficient to make such a finding as to the issue of whether either type of vertical commonality will satisfy the requirement); *Revak v. SEC Realty Corp.*, 18 F.3d 81 (2d Cir. 1994) (holding that while horizontal commonality was sufficient to meet the “common enterprise” standard, broad vertical commonality was insufficient, and they would not make a determination as to the sufficiency of strict vertical commonality); *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000) (indicated that while the court has held in the past that horizontal commonality is present, the facts before the court do not require them to determine whether some form of vertical commonality would also suffice); *Teague v. Bakker*, 35 F.3d 978 (4th Cir. 1994) (holding that horizontal commonality is sufficient but expressly not addressing whether either form of vertical commonality will satisfy the element); *SEC v. Lauer*, 52 F.3d 667 (7th Cir. 1995) (while ultimately finding that horizontal commonality was present, the court made an indication that they may not necessarily require a pooling of funds as required by horizontal commonality because it is the character of the investment that is controlling).

42. The Eighth and Tenth Circuits have not addressed the issue of which type of commonality they prefer as of the date of this writing. The Tenth Circuit appears to have gone in a completely separate direction and utilized the “economic reality” test found in *Tcherepnin v. Knight*, 389 U.S. 332 (1967). This, however, is not a test intended for the determination of whether a common enterprise exists.

43. Thomas Lee Hazen, *THE LAW OF SECURITIES REGULATIONS*, § 1.6[2][B] (Rev. 5th ed. 2006).

44. Maura K. Monaghan, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 *FORDHAM L. REV.* 2135, 2152-2153 (1995).

the horizontal approach, the fortunes of each of the investors must invariably be tied to the venture at hand.<sup>45</sup> It therefore follows that mere multiplicity of investors is not enough to satisfy horizontal commonality.<sup>46</sup>

Everything will ultimately depend upon what a court determines to be the actual investment.<sup>47</sup> For example, in *Milnarik v. M-S Commodities, Inc.*,<sup>48</sup> a discretionary trading account was not found to be an investment contract within the scope of the Securities Acts.<sup>49</sup> The central focus of the court looked beyond the multiple investors and instead looked at the investments themselves.<sup>50</sup> While all of the plaintiffs invested their money with one investment broker, that broker was free to invest that money into whatever venture he so desired. As a result, the court concluded that “the success or failure of those other contracts had no direct impact on the profitability of plaintiff’s contract . . . various customers were represented by a common agent, but they were not joint participants in the same investment enterprise.”<sup>51</sup>

Thus, for there to be horizontal commonality as required by the Third, Sixth, and Seventh Circuits, the critical issue will not be whether multiple investors pooled their risks, but whether those risks were pooled for a single investment purpose.<sup>52</sup>

**b. Vertical Commonality**

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45. Curran, 622 F.2d at 224

46. Monaghan, *supra* note 44, at 2153.

47. *Id.*

48. 457 F.2d 274 (7th Cir. 1972).

49. *Id.*

50. *Id.* at 276-277.

51. *Id.*

52. Deckebach v. La Vida Charters, Inc. of Florida, 867 F.2d 278 (6th Cir. 1989).

The concept of vertical commonality may be found in a one-on-one transaction.<sup>53</sup> This approach has been subdivided into a strict/narrow analysis<sup>54</sup> and a broad analysis by the jurisdictions that have adopted it. It necessarily eliminates the requirement of multiple investors and a pooling of the funds that is seen with a horizontal commonality approach. However, the jurisdictions that only require a vertical approach to the “common enterprise” question are willing to stipulate that horizontal commonality will also suffice.<sup>55</sup> The jurisdictional difference is that courts favoring vertical commonality refuse to put a threshold limitation of “pooling funds” for the “common enterprise” element to be met.

**i. Strict Vertical Commonality**

The idea of vertical commonality, and more specifically strict vertical commonality, began with a footnote in the case *SEC v. Glenn W. Turner Ent., Inc.*,<sup>56</sup> which stated “that a common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties.”<sup>57</sup> With this viewpoint, a common enterprise requires the fortunes of the investor to be commingled with, and dependent upon the success of the promoter.<sup>58</sup>

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53. *Mordaunt v. Incomco*, 469 U.S. 1115 (1985) *cert. denied* (White, J. dissenting). Chief Justice Burger and Justice Brennan both joined Justice White in his dissent.

54. Strict commonality and narrow commonality are interchangeable.

55. *See SEC v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125 (9th Cir. 1991) (holding that *Howey*'s second prong may be satisfied by either horizontal commonality or vertical commonality); *see also Hocking v. Dubois*, 885 F.2d 1449 (9th Cir. 1989) (stating that the involvement in a “common enterprise” may be shown via either vertical or horizontal commonality).

56. 474 F.2d 476, n.7 (9th Cir. 1973)

57. *Id.*

58. Monaghan, *supra* note 44, at 2153-2157.

While the standard from *Glenn Turner* was the starting point for many common enterprise analyses<sup>59</sup>, the Ninth Circuit acknowledged other circuits' treatment of their standard and chose to go in a slightly different direction. Specifically, the Ninth Circuit chose to additionally look to whether *both* the investor's and the promoter's financial standing would either flourish or depreciate with the ability of the promoter to secure some return on the investor's investment.<sup>60</sup> The court found it inconceivable that investing with someone who retains a commission for handling an investment would be something that the Securities Acts sought to protect.<sup>61</sup> As such, the promoter had to have some sort of financial stake in the deal, otherwise a "common enterprise" would not exist. Currently, the Ninth Circuit is the only circuit which follows this view.

## ii. Broad Vertical Commonality

The broad approach to vertical commonality, like the strict approach, is flexible and requires neither pooling of investments, nor pro rata sharing of profits.<sup>62</sup> An analysis utilizing the broad method begins with the same premise as strict vertical commonality in that the "fortunes of the investor are interwoven with and dependent on the efforts and success of those seeking the investment or of third parties."<sup>63</sup> Where it differs, however, is that the critical question is not whether the promoter also benefits, but whether the investor is dependent upon

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59. See *SEC v. Koscot Interplanetary Inc.*, 497 F.2d 473, 478 (5th Cir. 1974) (citing to the language of the *Glen Turner* footnote). Most of the cases in both the Fifth and Eleventh Circuits cite to that portion of the Koscot decision in the beginning of their analysis of whether a scheme has a common enterprise element sufficient to include it as an investment contract.

60. *Brodv. Bache & Co., Inc.*, 595 F.2d 459 (9th Cir. 1978).

61. *Id.*

62. *SEC v. Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1200 n.4 (11th Cir. 1999).

63. *Id.* at 1199.

the promoter's expertise.<sup>64</sup> Stated differently, with a broad commonality approach, an investor's expectation of profits is wholly dependent upon the expertise and knowledge of a third party to which they rely. The key difference between the two vertical commonality standards is that the broad approach is linked to the *efforts* of the promoter, whereas the strict approach is linked to the *fortunes* of the promoter.<sup>65</sup>

This approach was first developed by the Fifth Circuit in *SEC v. Koscot Interplanetary, Inc.*<sup>66</sup> *Koscot* dealt with a pyramid scheme involving the distribution and selling of a line of cosmetics.<sup>67</sup> In depositing of the first element of the *Howey* test, the court stated in reference to the "common enterprise" element that "the critical factor is not the similitude or coincidence of investor input, but rather the uniformity of impact of the promoter's efforts."<sup>68</sup> The court supported this argument by saying that "the Supreme Court emphasized not whether profits were pooled, but rather the fact that the feasibility and success of the enterprise, in attracting individuals to invest, and in cultivating, harvesting and marketing the citrus products, rested on the availability of the Howey Company's management."<sup>69</sup>

Two days after the *Koscot* decision, in *SEC v. Continental Commodities Corp.*,<sup>70</sup> the Fifth Circuit reiterated its preference for the broad vertical commonality standard. The court referred

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64. *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974).

65. *Hazen*, *supra* note 43, at § 1.6[2][B].

66. 497 F.2d 473 (5th Cir. 1974).

67. *Id.* at 475.

68. *Id.* at 478.

69. *Id.* (quoting *Howey*, 328 U.S. at 300) ("[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 investment.")

70. 497 F.2d 516 (5th Cir. 1974)

to its broad approach as a “resilient standard which would comport with the uniformly acclaimed remedial purpose of the Securities Act of 1933 and the Securities Exchange Act of 1934.”<sup>71</sup>

A recent Eleventh Circuit opinion reaffirmed its adherence to broad vertical commonality.<sup>72</sup> On remand from the Supreme Court, in *SEC v. ETS Payphones*,<sup>73</sup> in a *per curiam* opinion, the court found that broad vertical commonality was present in a scheme involving the sale and leaseback of pay phones.<sup>74</sup> Due to ninety-nine percent of the investors leasing back their phones to another company run by the same individual, the court ruled that “they had no desire ‘to perform the chores necessary for a return’ on their investment.”<sup>75</sup> As such, it indicated that the investors were relying exclusively upon the expertise and efforts of the investment promoter for their returns, i.e., that there was broad vertical commonality present.

**c. Undecided Commonality**

Most courts that have yet to definitively decide on the scope of the “common enterprise” have found that stringent requirements of the horizontal commonality approach will constitute a “common enterprise” for purposes of a *Howey* analysis.<sup>76</sup> Only one circuit has eliminated broad vertical commonality from a satisfactory means of meeting the “common enterprise” requirement,<sup>77</sup> but none of the undecided circuits have determined whether strict vertical

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71. *Id.*, at 521.

72. *SEC v. ETS Payphones, Inc.*, 408 F.3d 727 (11th Cir. 2005).

73. *Id.*

74. *Id.* at 732.

75. *Id.*

76. *See supra* note 40.

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

commonality will suffice. To illustrate the confusion and wavering that is typical in a “common enterprise” analysis, the Seventh Circuit will be examined.

Historically, the Seventh Circuit has been fairly adamant that, in order to satisfy the second prong of the *Howey* test, horizontal commonality must be met.<sup>78</sup> However, in 1995 it began to falter in its hard-nosed approach. The court stated initially that “for an interest to be classified as an investment contract there *must* be what is called ‘horizontal commonality,’”<sup>79</sup> but it proceeded to question the necessity of multiple investors and a pooling of funds.<sup>80</sup> Specifically, it was concerned about a “defrauder who was content to defraud a single investor (here to the tune of some \$14 million) . . . hav[ing] immunity from the federal security laws.”<sup>81</sup>

This waiver on the pooling of funds is only temporary. The court goes on to look to the representations made by the promoters and not the actual conduct which controls whether an investment contract was formed.<sup>82</sup> If the effect were to create the appearance of a “pooling of funds,” then it would meet the requirements of an investment contract that have long been established by the Seventh Circuit.<sup>83</sup>

However, by the end of the opinion, the court refuses to answer the question of whether an investment contract was in fact formed. Instead, it indicated that it is possible that the

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78. See *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir. 1972); *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977); *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981); *Stenger v. R.H. Love Galleries, Inc.*, 741 F.2d 144 (7th Cir. 1984); *Wals v. Fox Hills Development Corp.*, 24 F.3d 1016 (7th Cir. 1994).

79. *SEC v. Lauer*, 52 F.3d 667 (7th Cir. 1995) (quoting *Wals v. Fox Hills Development Corp.*, 24 F.3d 1016 (7th Cir. 1994)).

80. *Id.*

81. *Id.* at 670

82. *Id.* (citing *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967)).

83. *Id.* at 670-671.

transaction that took place<sup>84</sup> was not an investment contract, but that “it probably was.”<sup>85</sup> The Seventh Circuit’s indecisiveness in this realm convolutes an issue that, at least previously for it, had been steadfast.

#### IV. The Supreme Courts’ “Unworthy” Stance

As early as 1985, Justice White acknowledged the problem the lower courts were facing in determining whether a particular deal was an “investment contract” under the Securities Act and urged the Supreme Court to grant certiorari and address the issue.<sup>86</sup> He referred to the conundrum of the “common enterprise” element as both “clear and significant” and stressed the transcending nature of the issue before the Court beyond the classification of discretionary commodities futures contracts.<sup>87</sup> Justice White admonished the Court for not granting certiorari to resolve this issue.

The Supreme Court has continuously refused to address this issue when it has come before the Court.<sup>88</sup> Most recently, the Supreme Court left open the issue of the appropriate commonality to be used when performing a “common enterprise” analysis in *SEC v. Edwards*.<sup>89</sup> Granted, the issue was not briefed by either party and was thus not before the Court. But at oral argument Justice O’Connor specifically questioned the Solicitor General about not addressing the

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84. Lauer, who was the director of the Chicago Housing Authority’s employee benefits program, became entangled in a scheme with a fraudulent mutual-fund type investment program. *Id.*

85. Lauer, 52 F.3d at 671.

86. *See Mordaunt v. Incomco*, 469 U.S. 1115 (1985), *cert. denied* (White, J., dissenting). Justice White was not alone in thinking that the Supreme Court should resolve the issue among the courts; Justice Brennan and Chief Justice Burger joined in his dissent.

87. *Id.* at 1116-1117.

88. *See Brief for Appellant, Omitriton International, Inc. v. Webster*, No. 96-82, 1996 WL 33422640, at \*1 (July 19, 1996), *cert. denied*, 519 U.S. 865 (1996).

89. 540 U.S. 389 (2004).

issue.<sup>90</sup> Then, in the Court’s opinion, Justice O’Connor convoluted the “common enterprise” issue even more by stating that “an investment scheme promising a fixed rate of return *can be* an ‘investment contract’ and thus a ‘security’ subject to the federal laws.”<sup>91</sup> The scheme, involving payphone sale-and-leaseback arrangements with a fixed return rather than a variable return, would have to rely upon a vertical commonality approach to be an “investment contract.”<sup>92</sup> Through the use of the words “can be” what was being articulated to the legal community was that the payphone sale-and-leaseback arrangements could potentially be an investment contract, but there was also the possibility that the scheme was not. Justice O’Connor’s dutiful language choice left open the issue as to when the scheme is or is not an investment contract, and most importantly whether horizontal or vertical commonality should be applied.<sup>93</sup>

## V. The Better Choice?

With essentially three competing theories on the proper method for analyzing the “common enterprise” it begs the question: what is the proper method to utilize? But more importantly, it implores the Supreme Court to take a stance on the issue so that there may be some uniformity amongst the lower courts.

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90. See Transcript of Oral Argument at 12-13, SEC v. Edwards, 540 U.S. 389 (2004)(No. 02-1196), 2003 WL 22657163 (In particular Justice O’Connor stating, “[I] don’t understand either party to have addressed the- this alleged conflict over horizontal or vertical.” [agreement by Solicitor General] “So it’s entirely possible that you could win here and the case would be remanded for the court of appeals to decide.”)

91. *Id.* at 397 (emphasis added).

92. Because the rate of return was fixed and not variable, the expectation of profits was not dependent upon the efforts of others, and thus a pooling of funds was not required. This type of investment scheme would fit squarely into a vertical commonality approach, but fall short utilizing a horizontal analysis.

93. Harold S. Bloomenthal, SECURITIES LAW HANDBOOK, 1 Sec. Law Handbook §2:16 (updated December 2006).

Releases from the SEC have indisputably established that the Commission's stance on the issue is that some form of vertical commonality should apply.<sup>94</sup> In particular, the SEC has shown a preference for strict vertical commonality stating that "[a] conclusion that 'strict vertical commonality' in the absence of 'horizontal commonality' meets the common enterprise requirement of *Howey* better serves the remedial purposes of the securities laws than to require 'horizontal commonality' in all cases."<sup>95</sup> Yet, as recently as 2004, the SEC has stated that they do not believe that any sort of "common enterprise" should necessarily be a distinct requirement of an investment contract.<sup>96</sup>

The SEC's newly acquired distaste for the "common enterprise" element of the *Howey* test not only flies in the face of reason, but also expressly rebuts the Supreme Court's stance on the issue. While, as discussed *supra*, it did not address the "common enterprise" element in *Edwards*, the Supreme Court did reaffirm its stance that the benchmark for an investment contract 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."<sup>97</sup>

There is an adequate argument to be made for "common enterprise" to apply to a single investor rather than a pooling of funds from multiple investors such as the aforementioned argument by the Seventh Circuit in *SEC v. Lauer*.<sup>98</sup> However, allowing the "common enterprise"

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94. See In the Matter of Friedman, Exchange Act Release No. 7228, 1995 WL 573734 (1995); In the Matter of Union Home Loans, Exchange Act Release No. 19346, 1982 WL 522493 (1982); In the Matter of Reese, 1999 WL 278944 (Exchange Act Release No. 7690) (1999).

95. Reese, 1999 WL 278944, at \*6.

96. In the Matter of the Application of Barkate, S.E.C. Release No. 49542, 2004 WL 762434, n.13 (2004).

97. Edwards, 540 U.S. 389, 395 (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975)) (emphasis added).

98. See *supra* notes 77-78.

element to be satisfied by a single investor would effectively make it obsolete. As Judge Kinneary observed in *Berman v. Bache, Halsey, Stuart, Shields, Inc.*,<sup>99</sup> with vertical commonality as a controlling view, the *Howey* “test would simply require (1) the investment of capital (2) with the expectation of profit through the efforts of others, for nothing more is involved in a single discretionary trading account.”<sup>100</sup> This is not what was intended by the Supreme Court in *Howey*; the Court would not continuously mention “an investment in a common enterprise” if it were not essential to the investment contract analysis. Indeed, Justice Stevens has observed, albeit while a judge on the Seventh Circuit Court of Appeals, that “[j]udicial analyses of the question whether particular investment contracts are ‘securities’ within the statutory definition have repeatedly stressed the significance of finding a common enterprise.”<sup>101</sup>

Furthermore, in an era where the internet is a vital component of entrepreneurial ventures, the possibility exists for cross-jurisdictional investing. In the Fifth Circuit, a particular venture over the internet may be construed as being an investment contract, while in the neighboring Sixth Circuit, there may be no “common enterprise” and thus no security. This poses a serious problem for the broker who may have to register with the SEC in one jurisdiction, and doesn’t necessarily have to in the other.

Despite the SEC’s viewpoint and various circuits’ call for a vertical approach, the Supreme Court, prior to *Mordaunt v. Incomco*,<sup>102</sup> had already spoken on the issue of horizontal versus vertical commonality, and at the very least indicated its preference for horizontal over

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99. 467 F. Supp. 311 (S.D. Ohio 1979).

100. *Id.* at 315-316.

101. *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276 (7th Cir. 1972).

102. 469 U.S. 1115 (1985) *cert. denied* (White, J. dissenting).

vertical.<sup>103</sup> In referencing prior Supreme Court cases,<sup>104</sup> the Court noted that “[t]he unusual instruments found to constitute securities in prior cases involved offers to a *number of potential investors, not a private transaction.*”<sup>105</sup> The Court then went on to hold that the agreement at issue “*negotiated one-on-one by the parties*” was not a security.<sup>106</sup>

Clearly the Supreme Court’s comparison between a “number of potential investors” and a “one-on-one” transaction indicated its preference for horizontal commonality over vertical commonality. And yet, the lower courts have virtually ignored this language as in the *Weaver* decision, and have continued to struggle with the proper protocol for the common enterprise.

A uniform horizontal approach would allow for the courts to more easily maneuver the investment contract issue. Pooling of the funds has been agreed by all courts to satisfy the issue. With the evolution of the information era, the potential is there for promoters to seek investors from various jurisdictions and be subject to the Securities Acts in one jurisdiction and not in another. Furthermore, while the purposes of the Securities Acts are remedial in nature, when an investment is substantial enough to trigger the Acts on a one-on-one basis, there are other regulatory agencies and statutes to govern those transactions.

## **VI. Conclusion**

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103. *See* *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

104. *SEC v. Howey*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner*, 320 U.S. 344 (1943). The Court referenced *Howey* where 42 persons purchased interests in a citrus grove; and it referenced *Joiner* because offers to sell oil leases were sent to over 1,000 potential investors. Specific to *Joiner*, the Court found that “the undertaking to drill a well runs through the whole transaction as the thread on which everybody’s bead was strung.” *Howey*, 320 U.S. at 348. The sale of the leases were thus, as the Court stressed, the necessary financial means for the common drilling enterprise. *Id.*

105. *Marine Bank v. Weaver*, 455 U.S. at 559 (1982) (emphasis added).

106. *Id.* at 560 (emphasis added) (holding that a certificate of deposit is not a security).

The “common enterprise” prong of the *Howey* test “is essential if the investors are to achieve their paramount aim of a return on their investment.”<sup>107</sup> While there is an argument for all three types of common enterprise ventures, only horizontal commonality conforms to the intent, logic, and ideology of the Supreme Court’s interpretation of the investment contract in their various decisions.

In a hazy, and often complex area full of many uncertainties within the various circuits, what is clear is that the Supreme Court needs to take the initiative and, at the very least, address the confusion. It has been over sixty years since the Supreme Court first laid out the test for an investment contract in *SEC v. Howey*, and since then every court has struggled with interpreting the “common enterprise” element. It is time for the current Justices to assume the role that Justice White wanted the Court to take back in 1985 and the role that was circumvented by the Court in *SEC v. Edwards*. There needs to be commonality among the courts for what will constitute an investment of money in a common enterprise. Otherwise, courts will be faced with the coming attractions of even more complex analysis with the same answer: we don’t know.

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107. *Howey*, 328 U.S. at.300