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Remarks to

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"REGULATION D OFFERINGS OF LIMITED PARTNERSHIPS AND CORPORATE CAPITAL RAISING: AT THE COMMISSION AND IN PRACTICE"

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CURRENT DEVELOPMENTS IN THE DEFINITION OF A SECURITY

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Since all of you will be spending the balance of the day concentrating on how to keep your clients who are selling securities from running afoul of the registration requirements of the Securities Act, I thought I would step back and discuss an even more basic question: the definition of a security. Despite the fact that the Securities Act is 50 years old, the most basic definition remains a persistent question.

About 10 years ago many of us securities practitioners thought that once we worked out the problem of multi-level distributions, we had resolved all the open definitional issues. A few years later after, we similarly were convinced that once we resolved a few problems with recreational real estate, we had finally resolved all the issues. A few years later, the problem was thoroughbred breeding deals. And so it goes on; I suppose that is why, year after year, panels and seminars continue to deal with this basic issue. But, on top of that, it's also fun about once a year to see how creative the minds of a number of people -- ranging from lawyers to honest promoters and dishonest con-men -- have been. Invariably, there's a new twist.

First, I would like to review some of the recent developments and then briefly discuss some situations where policy reasons may lead a court to depart from traditional analysis and to find no security. I caution you, however, that this review of recent developments will not be an exhaustive discussion of the subject because of time constraints. For a more thorough review, I would refer you, for example, to an article by Carl W. Schneider in the January 5, 1983 issue of The Review of Securities Regulation entitled "Developments in Defining a Security."

Franchises and Distributorships

Franchises and licenses have historically been troublesome and continue to be so. In the late 60's and the 70's, the use of franchises extended far beyond its previous dimensions and spread to such diverse businesses as the fast food business, travel agencies, and nursing homes.

As you know, franchise arrangements are generally analyzed under the investment contract test set forth by the Supreme Court in SEC v. W. J. Howey Co. in 1946. The three-part Howey test for an investment contract requires an investment of money in a common enterprise with the expectation of profit soley from the efforts of others. Whether a particular franchise agreement constitutes an investment contract generally depends on the extent of the franchisee's participation. A franchise arrangement may involve into one of three catagories:

1. The franchisee participates only nominally in the franchised business in exchange for a share of the profits as a passive investor.

2. The franchisee participates actively in the franchised business and the franchisor retains only nominal control.

3. Both the franchisee and the franchisor participate in the franchised business.

In the first case, where the franchisee only participates nominally, the courts have generally found a security. In the second situation, where the franchisor retains only nominal control, the courts have generally not found a security. The difficult cases have arisen under the third category where both the franchisee and the franchisor participate actively in the franchised business.

The leading test for these cases was set forth by the Ninth Circuit in SEC v. Glenn W. Turner Enterprises, Inc., in 1973. The court said that whether an investor has an expectation of profits to be derived soley from the efforts of others will be determined by

> "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."

In response to this "undeniably significant" test, practitioners have employed some creative drafting of franchise and licensing agreements. This is often done by including an option in the agreement that would permit the investor to retain control over the essential elements of the business that affect the failure or success of the enterprise. One case that I will mention reflects such an attempt.

That case is SEC v. Aqua-Sonic Products Corp., a Second Circuit decision. In Aqua-Sonic, the court found that a license agreement to distribute an ultra-sonic dental device in an exclusive territory was a security. The package of offering materials given to potential investors included the license agreement, a sales agency agreement, and a tax opinion. Under the sales agency agreement, the company was authorized to perform all significant marketing functions on behalf of the licensees, including as finding customers, taking orders, collecting proceeds, paying expenses and taxes, and setting prices. Additionally, prospective licensees were informed that "by entering into the proposed Sales Agency Agreement . . . you will derive substantial tax advantages in connection with your acquisition of a license." In most cases, the territory of the license was not close to the licensee's residence. The promotional materials did not offer or advise of the existence of any sales agent other than the company.

The court concluded, citing Glenn W. Turner, that the "solely from the efforts of others" language of Howey was not to be taken literally. Although the licensee retained the right to distribute the products himself, the court found that the offering was aimed primarily at investors who could not reasonably be expected to be desirous or capable of undertaking the distribution on their own. In fact, none of the fifty licensees had any such experience, and each of the fifty was a passive investor who accepted the Sales Agency Agreement.

<u>Animal Breeding and Feeding Programs</u>.

For the purpose of determining whether a security is present, these tax shelter programs present similar questions and are analyzed under the <u>Howey</u> investment contract test. In <u>McLish</u> v. <u>Harris Farms, Inc.</u>, the defendant argued that under the cattle feeding arrangement the plaintiff retained certain significant rights which prevented the transaction from meeting the third requirement of the <u>Howey</u> test. However, the court found that

> "[m]easured against the panoply of powers granted to the defendant in this contract, the rights which the plaintiff had to control the transaction pale by comparsion. The whole scheme of the contract as developed by the defendant, is to secure absolutely repayment to the defendant of all the charges regardless of what fate befell the plaintiff due to the variations to the cattle feeding market."

The court said further:

> "So it would appear that the plaintiff's right to sell the cattle before they were finished greatly diminishes in significance to the fact that to exercise this right, the plaintiff must come forward with a substantial sum of money to satisfy his account with Harris . . .".

The court had no difficulty finding that the efforts of the defendants were "the undeniably significant ones . . . ."

Two other recent decisions of interest are presented by staff no action letters, both of which deal with the syndication of interests in horses. Secret Passage Syndicate Agreement, available February 2, 1982, dealt with the sale of ten undivided fractional interests in a throughbred yearling named Secret Passage. Counsel claimed that, under the Howey investment contract test, the "solely from the efforts of others" element was not satisfied in this arrangement, because all decisions regarding the management of the horse's racing career would be subject to the approval of a majority of the interests. This authority included the ability to remove any trainer, jockey, or other management personnel. Additionally, any decision regarding the sale of the horse was to be made by a vote of a majority of the interests outstanding. Although Counsel characterized the transaction as a joint venture agreement that required the active participation of all parties, the staff declined to take a no-action position, citing Williamson v. Tucker, in which the court said that a genuine dependence on others, such as where the investors are forced to rely on particular non-replaceable expertise on the part of the promoter or manager, might distribute power as would a limited partnership.

In the second letter, Gin & Peppy Horse Syndication, available June 25, 1982, the staff took a no-action position. The syndicate proposed to offer fractional interests in a stallion whereby the purchaser would have the right to breed his own mare to the stallion. Purchasers would have complete dominion and title to offspring of their mares. Each purchaser was required to represent to the seller that he was acquiring an interest in the stallion for the primary purpose of breeding and was not acquiring his interest with any expectation of earning a profit through the entrepreneurial or managerial efforts of the syndicate manager. Counsel requested a no-action position, citing Forman, which held that "when a purchaser is motivated by a desire to use or consume the item purchased . . . securities laws do not apply." The staff agreed.

Guarantees.

Practitioners should also be sensitive to the existence of a security when one entity guarantees the obligations of another. In Union Planters Corporation, available November 29, 1982, the staff declined to take a no-action position on whether the guarantee should be deemed a security required to be registered under the 1933 Act. Union Planters, a Tennessee bank holding company, proposed to acquire Tennessee Commerce Corporation, another Tennessee bank holding company, as a wholly-owned subsidiary. Under the plan of merger, each share of common stock of Tennessee Commerce would be exchanged for cash and a promisory note of TCC, which would be guaranteed by Union Planters. Although the TCC promisory notes were exempt from registration pursuant to the exchange exemption in Section 3(a)(9), the staff deemed the guarantee by Union Planters to be a separate security requiring registration under the 1933 Act.

Memberships in Recreational Facilities.

Whether a security is created by the sale of a membership in a social club or other recreational facility is often determined by the Supreme Court's decision in Forman. The Court in Forman stated that "when a purchaser is motivated by his desire to use or consume the item" and not by "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others" the transaction is not within the scope of the Federal securities laws.

A recent staff no-action letter, Boca Lago Country Club, Inc., available October 14, 1981, illustrates the case. The club was a not-for-profit membership corporation to be formed for the purpose of purchasing a private country club in Boca Raton, Florida, and operating the facility. The facility was part of a large residential development which included approximately 1700 condominium units. Memberships were to be sold only to owners of condominium units and, through their memberships, members would only obtain the right to use the club's facilities. The club was to be organized for the use and pleasure of its members, not for pecuniary gain or with the expectation of profits. Counsel requested a no-action position on registration, citing Forman. The staff concurred.

Miscellaneous

There are two remaining miscellaneous areas of interest that I would like to cover today. The first is brokerage account free credit balances. In a release dated November 17, 1981, the Commission stated that "there may be a regulatory distinction . . . between the conventional type of interest bearing free credit balance that arises as an incidence of maintaining a securities account for a customer, and an interest bearing account that is, in economic reality, a separate security." (Rel. No. 34-18262 note 2.) The release generally dealt with the protection of free credit balances under the Securities Investor Protection Act of 1970 and so it did not elucidate on the question of how a security might be created for the purposes of the 1933 Act. The SIPA analysis focused on whether the cash balance in an account arose from an intent to purchase securitites or as a result of the sale of securities. Arguably, the same analysis would apply to a determination of whether a security existed for the purposes of the 1933 Act.

The second area of miscellaneous interest is novelty items. Frequently, interests in real or personal property may look like a security, but if the investment feature is of such inconsequential value when compared to the novelty aspect of the interest, no security will be found. A case in point is a staff no-action letter issued to Terlingua Cattle Company, available July 13, 1981. The company proposed to sell one million interests in a Texas Longhorn Steer. Each purchaser would receive a bill of sale certificate and an illustrated certificate stating that the holder was a genuine one-millionth owner of a Texas Longhorn Steer. Counsel stated that no representation would be made to prospective purchasers that they would receive anything more for their purchase price than the bill of sale and the certificate. He stated further that no purchasers would expect to receive any monetary return from the purchase. In short, no purchasers would be making an investment with an expectation of profit. The Staff issued a no-action letter, stating that the proposed certificates appeared to be novelty items which could be sold without compliance with the registration provisions of the Securities Act of 1933.

Sale of Stock Incidental to Transfer of Control of a Business.

There have been a number of cases involving business acquisition transactions in which purchasers purchased all or most of the stock of an acquired company from a seller. A number of courts have held that the stock being purchased in this context does not constitute a "security."

If the Howey test were applied, the third requirement that "the profits are to come from the entrepreneurial or managerial efforts of others" is not met. In purchasing the entire business, the buyers assume managerial control over it.

For several reasons, the Commission is not persuaded by the argument that the sale of business doctrine will prevent application of the securities laws. First, by choosing to deal in stock, the parties may have created an expectation, deserving of some consideration, that the securities laws would apply.

Second, adoption of the sale of business doctrine would create some arbitrary results of its own. The Seventh Circuit has recently held that, under the doctrine, when a purchaser acquires more than 50% of a business, his purpose in purchasing the stock will be presumed to have been entrepreneurship rather than investment, and he will not be covered by the securities laws unless the presumption can be overcome by a showing that the main purpose was investment. Sutter v. Groen, 687 F.2d 197, 203 (7th Cir. 1982). A rule that tells a defrauded purchaser that he has no federal remedy since he bought 50.1% of the stock in a business, while leaving a remedy for his partner who bought 49.9% of the stock, seems no less arbitrary than the alternative rule. Furthermore, if ten equal shareholders in a business sold their stock to a single purchaser, the sale of business rule could lead to the anomalous result that the sellers would have protection under the securities laws but the purchaser would not.

Recent Supreme Court Activity: Weaver v. Marine Bank

Turning to recent Supreme Court activity, most of you may have heard of the story of Sam and Alice Weaver. They purchased a $50,000 certificate of deposit from Marine Bank. The certificate of deposit had a 6 year maturity and was insured by the FDIC to the extent of $40,000. The Weavers claimed that Bank officers actively solicited them to pledge the certificate of deposit to the Bank to guarantee a $65,000 loan to be made by the Bank to Columbus Packing Company, a wholesale slaughterhouse and retail meat market which owed the Bank $33,000 for prior loans and which was heavily overdrawn at the Bank. In consideration for guaranteeing the Bank's new loan, Columbus' owners, Raymond and Barbara Piccirillo entered into an agreement with the Weavers, which entitled the Weavers to receive 50% of Columbus' net profits and $100 per month as long as they guaranteed the loan, to use Columbus' barn and pasture at the discretion of the Piccirillos, and to veto future borrowing by Columbus.

The Weavers further claimed that Bank officers told them that Columbus would use the $65,000 loan as working capital. Instead, the proceeds of the new loan were immediately applied against overdue obligations to the Bank. All but $3,800 was used to pay old obligations, and the Bank then refused to permit Columbus to overdraw its checking account. Columbus became bankrupt 4 months later. The Bank acknowledged to the Weavers that it intended to claim the pledged certificate of deposit. Further, the Weavers alleged that the Bank had not disclosed the company's financial plight or the Bank's plans to apply the proceeds of the new loan against outstanding debt. Had they known these facts, they claimed that would not have pledged the certificate of deposit. The Weavers brought suit alleging that the bank had violated the anti-fraud provision of §10(b) and Rule 10b-5 of the Exchange Act.

The Supreme Court ultimately held that neither the certificate of deposit or the agreement was a security. The Court pointed out that the statutory definition is preceded by the statement that the instruments mentioned are not to be securities if the "context otherwise requires." Congress, the Court emphasized, did not intend for securities laws to provide a broad federal remedy for all fraud -- even if an instrument fell within the literal language of the definition.

The Court reasoned that the controlling difference between "a bank certificate of deposit and other long-term debt obligations" is the fact that the certificate of deposit was issued by a "federally regulated bank ... subject to the comprehensive set of regulations governing the banking industry." In addition, the Court noted that "deposits" are insured by the FDIC.

Weaver apparently is the first time the Court had held that an instrument literally falling within the broad sweep of the definition of a security in the 1933 and 1934 Acts and having its traditional characteristics was not to be considered so because "the context otherwise requires." The Court was careful to point out, however, that "it does not follow that a certificate of deposit ... between transacting parties invariably falls outside the definition of a security as defined by federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole."

This instruction no doubt will cause tears and travail for you, for us at the Commission and on the lower Courts, especially as we wonder whether it was the federal banking regulation and federal insurance which were the boundaries of the "context," or the fact that after the "factual setting" was considered as a "whole," the circumstances were that the holders of the instrument were not assuming the "risk of the borrower's insolvency."

Weaver demonstrates that the Howey test has never been particularly helpful in debt instrument cases, including C.D's, anyway. The 5th, 7th and 10th Circuits have developed the "commercial-investment test" for debt instruments, which is premised on the belief that the securities laws were intended to protect investors but were not meant to impose burdensome obligations on those engaged in ordinary or commercial transactions. By one version of this test, an investment transaction must be either (i) offered to some class of investors, (ii) acquired for speculation or investment; or (iii) exchanged to obtain investment assets, directly or indirectly. McClure v. 1st National Bank of Lubbock, 352 F. Supp. 454 (N.D. Tex. 1973).

The Court in Weaver, however, did not mention either the "risk capital" or "investment/commercial" test.

An analysis of Weaver was not long in coming. The catalyst was a California attorney who sued a Mexican commercial bank, Banco Nacional de Mexico ("Banamex"), to recover damages allegedly resulting from his investment in three time deposits, denominated in pesos, and very similar in substance to the C.D. in Weaver. Although Banamex met its obligation to repay his principal, in pesos, with a high rate of interest, in pesos, Wolf suffered a net loss because of the devaluation of the peso prior to the maturity of his deposits.

The district court granted summary judgment for Wolf on the registration claims under Section 12(1) of the Securities Act without reaching the fraud claims and awarded him damages resulting from the currency devaluation. In analyzing *Weaver*, the district court noted that Mexican bank deposits were not, at the time of Wolf's investment, insured by the Government of Mexico. (Mexico has since implemented a system of FDIC-type insurance). The district court acknowledged that Mexican reserve, reporting, and inspection requirements are very thorough and, in fact, that in 50 years, no Mexican bank has become insolvent. The district court further noted that while Congress had exempted bank securities from the registration provisions of the 1933 Act, it did not extend the exemption to foreign banks.

The case is now on appeal before the Ninth Circuit. The appeals court will have several alternatives. Among those options are:

(1) reversal of the district court's opinion with a holding that extensive Mexican banking regulation satisfied the "context" requirement of *Weaver*.

(2) apply either the "risk capital" or "investment/commercial" test, the result of which could be either reversal or affirmance, depending on the Court's view of the facts; or

(3) a holding that Wolf's damages do not include losses from devaluation, unless he can prove his fraud claim - that the bank mislead him with respect to devaluation risks.

A few words of advice:

1. For the average practitioner, particularly in the private placement area, the chances are very high that a deal structured to attract passive investors, including nominally "active" investors, will be a "security." Cases such as Forman and Weaver are rare and I doubt that the phase "unless the context otherwise requires" will be seen with any frequency in judicial opinions or Commission no-action letters. The Supreme Court has invoked that phase only once in 50 years, and only in a situation involving federal banking regulation.

2. Make it your business to know what kind of deals constitute an offering of securities -- you may be surprised to learn how many types of instruments or contracts fall under the term "investment contract". In 50 years, many have tried -- and failed -- to sneak something past the securities acts by changing or inventing labels. Their failures can be valuable guideposts. Look to "economic reality."

3. Keep your objectivity, as a lawyer, in constructing a deal. Don't let your client convince you that investors have been given entrepreneurial or managerial responsibilities

when in fact no investor will exercise them. Keep your client advised that full compliance with the securities laws today may be the best insurance he'll have against a lawsuit down the line if the economics of the deal don't meet everyone's best hopes.

The securities acts were not designed, it is true, to create a federal remedy for all fraud. But in 50 years they have been given very broad application, based on a broad definition of the term "security." Your clients will be much better served, I assure you, when that is kept in mind.