Definition of “Security”

I. What is a “Security”? 

A. Under Section 2(a)(1) of the Securities Act of 1933, “unless the context otherwise requires,” the term “security” includes

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

B. As the Supreme Court stated in Marine Bank v. Weaver, 455 U.S. 551, (1982), construing the virtually identical definition of “security” under the Securities Exchange Act of 1934, the definition is “quite broad” and meant to include “the many types of instruments that in our commercial world fall within the ordinary concept of a security,” including “stocks and bonds, along with the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.” Weaver, 455 U.S. at 555.

C. Thus the federal securities laws define “security” in both specific (any “stock,” “bond,” “note,” “debenture,” etc.) and general (e.g., any “investment contract” or “instrument commonly known as a security”) terms.

D. The Supreme Court has suggested that “instrument commonly known as a security” and “investment contract” have the same meaning for purposes of the Securities Act and the Exchange Act. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852.
II. Interpreting the Statutory Definition of a Security

A. Investment Contracts

1. SEC v. W.J. Howey Co.
   328 U.S. 293 (1946)

The Howey Company, a Florida corporation that sold small tracts of land in a citrus grove to 42 purchasers, many of whom were patrons of a nearby resort hotel. While investing in the enterprise for profit, the purchasers, for the most part, lacked the knowledge, skill, and equipment necessary for the care and cultivation of citrus trees. And while the purchasers were free to service the tracts themselves, or contract with a number of companies to service the tracts for them, the sales contract stressed the superiority of a Howey-related service company, Howey-in-the-Hills Service, Inc. (“HITH”), which purchasers of 85 percent of the acreage chose to service their tracts. The service contracts granted HITH full and complete possession of the acreage. Individual purchasers had no right of entry to market the crop, but shared in the profits of the enterprise, which amounted to 20 percent in the 1943-44 growing season.

The Howey Company did not register the interests in the enterprise as securities. The SEC brought an action to enjoin the sale of the citrus grove interests. Because the interest at issue did not constitute any of the specific, traditional kinds of securities enumerated in Section 2(a)(1) of the Securities Act, the SEC argued that the interests were “investment contracts.” Noting that the term “investment contract” had not been defined by Congress but was widely used in state securities laws, the Supreme Court adopted the definition used by most state courts and held that an investment contract is a security under the Securities Act if investors purchase with (1) an expectation of profits arising from (2) a common enterprise that (3) depends “solely” for its success on the efforts of others. Applying this test, the Court found that the interests in the citrus grove sold by the Howey Company were “investment contracts,” and thus securities, subject to the Securities Act.

   a) expectation of profits

(1) United Housing Foundation, Inc. v. Forman
   421 U.S. 837 (1975)
The issue in *Forman* was whether shares of stock entitling a purchaser to lease an apartment in Co-op City a state-subsidized and -supervised nonprofit housing cooperative in New York City, were “securities” within the meaning of the Securities Act and the Exchange Act. The housing cooperative sold shares of stock to prospective tenants. The sole purpose of acquiring the shares was to enable the purchaser to occupy an apartment in the cooperative. No voting rights attached to the shares, nor could they be transferred, pledged, or otherwise encumbered like traditional stock. If the tenant vacated the apartment, the cooperative could repurchase the shares at cost. In effect the shares represented a recoverable deposit on the apartment.

After the housing cooperative raised rental charges, the residents sued the cooperative under Section 17(a) of the Securities Act, asserting that the cooperative falsely represented that it would bear all subsequent cost increases. The Supreme Court held that the stock issued by the cooperative was not a “security” because the shares lacked the five most common features of stock: (1) the right to receive dividends contingent on an apportionment of profits; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) voting rights in proportion to the number of shares owned; and (5) the ability to appreciate in value. Because the purchasers obtained the stock in order to acquire subsidized housing, not to invest for profit, the shares were not securities within the purview of the federal securities laws.

Thus *Forman* stands for the proposition that to determine whether a particular financial instrument is an investment contract, using the test the Court set out in *Howey*, the test is to be applied in light of “the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties.” *Forman*, 421 U.S. at 851-52.
b) common enterprise

(1) horizontal vs. vertical commonality

Courts have split over whether investment in a "common enterprise" requires horizontal commonality between investors, or vertical commonality between a promoter and an investor. Horizontal commonality requires a pooling of investor contributions and distribution of profits and losses on a pro-rata basis among investors. See, e.g., Salcer v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 682 F.2d 459 (3d Cir. 1983). Vertical commonality is less stringent, though some courts require so-called "strict" vertical commonality, insisting that there be a direct relationship between the promoters' financial success and that of the investors (see, e.g., Mordaunt v. Incomco, 686 F.2d 815 (9th Cir. 1982)), while others allow for "broad" vertical commonality, requiring only that “the fortunes of investors be tied to the fortune of the promoter” (Revak v. SEC Realty Corp., 18 F.3d 81, 88 (2d Cir. 1994); see also SEC v. Professional Associates, 731 F.2d 349, 354 (6th Cir. 1984)).

(2) horizontal commonality and the Internet

In SEC v. SG Ltd., 265 F.3d 42 (1st Cir. 2001), the First Circuit held that "virtual shares" in an Internet game were securities. The defendant operated "StockGeneration," a website where visitors could buy "virtual shares" in "virtual companies" on a "virtual stock exchange." The website indicated that the game would generate one "privileged company" whose shares would constantly increase in value by 10 percent each month. Participants had to pay real money to buy shares, and if they referred new players to the site, they would receive a percentage of the new players' payments (i.e., your typical "Ponzi" or pyramid scheme). The SEC brought an enforcement action against the defendant, claiming the virtual shares were Howey-type investment contracts, which the district court dismissed on grounds that the game was a lottery and not a common enterprise. The First Circuit reversed. It found the requisite "horizontal commonality" in the pooling of participants’ funds (the defendant had no other source of funds) to pay the