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CHAPTER 2

DEFINITION OF A SECURITY

§ 2.1 Introduction

As discussed in Chapter 1, in order for an entity to be an investment company under Section 3(a) of the 1940 Act,¹ it must be an issuer. Section 2(a)(22) of the 1940 Act² defines the term “issuer” as every person who issues or proposes to issue any “security” or has outstanding any “security” that he or she has issued.

In addition, in order for an issuer to be deemed to be an investment company under Sections 3(a)(1)(A)³ or 3(a)(1)(C)⁴ of the 1940 Act, the issuer must invest in, reinvest in, own, hold, or trade in securities. Section 3(a)(1)(A) defines as an investment company any issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. Section 3(a)(1)(C) defines as an investment company any issuer that engages or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities and that owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of certain of the issuer’s assets. Section 3(a)(2) defines the term “investment securities,” as used in Section 3(a)(1)(C), as including all securities except for certain types of specified securities.

¹ 15 U.S.C. § 80a-3(a).

² *Id.* § 80a-2(a)(22).

³ *Id.* § 80a-3(a)(1)(A).

⁴ *Id.* § 80a-3(a)(1)(C).

The term “security” is defined in Section 2(a)(36) of the 1940⁵ Act to mean, “unless the context otherwise requires:”

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 (including a certificate of deposit) or on any 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.⁶

The definitions of the term “security” in the 1933 and 1934 Acts are virtually identical to each other and also are nearly identical to the definition in Section 2(a)(36) of the 1940 Act.⁷ The courts and the Commission typically have taken the position that the definitions of the term “security” in the 1933 and 1934 Acts cover the same instruments.⁸

The Commission and the Staff take the position, however, that “the context otherwise requires” the term “security” as defined in Section 2(a)(36) of the 1940 Act to be broader than the definition of the term “security” in the 1933 and 1934 Acts.⁹ For example, as discussed

⁵ *Id.* § 80a-2(a)(36).

⁶ This definition is identical to the definition of the term “security” in Section 202(a)(18) of the Advisers Act, *Id.* § 80b-2(a)(18).

⁷ *See* Section 2(a)(1) of the 1933 Act, 15 U.S.C. § 77b(1), and Section 3(a)(10) of the 1934 Act, *Id.* § 78c(a)(10).

⁸ *See, e.g.,* *Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985); *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982); *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975). *See also* *Tcherepnin v. Knight*, 389 U.S. 332, 335–36 (1967) (the 1933 Act contains a definition of security virtually identical to that contained in the 1934 Act) (footnote omitted).

⁹ *See, e.g.,* Harrell Int’l Inc., SEC No-Action Letter (May 24, 1989) (a commercial note was a security for purposes of the 1940 Act even if it was not a security for purposes of the 1933 and 1934 Acts); Bank of America Canada, SEC No-Action Letter (July 25, 1983) (“[A] determination that a note evidencing a commercial transaction is not a security under the 1933 Act and 1934 Act is, in our view, not applicable in determining whether a person engaged in the business of investing in such notes is investing in ‘securities’ in the context of a determination of whether the person is an investment company under the 1940 Act.”). *See also* Joseph A. Franco, *The Investment Company Act’s Definition of “Security” and the Myth of Equivalence*, 7 STAN. J. L. BUS. & FIN. 1 (Autumn 2001) (arguing the definition of “security” in the 1940 Act is broader than the 1933 and 1934 Act definitions); C. Steven Bradford, *Expanding the Investment Company Act: The SEC’s Manipulation of the Definition of Security*, 60 OHIO ST. L.J. 995 (1999) (arguing the definitions should be the same in each Act).

Whatever the merits of this position with respect to determining whether a particular instrument held by an investment pool is a security, it would seem that the context should otherwise require the definition of the term “security” in the 1940 Act to be co-extensive with the term “security” as used in the 1933 and 1934 Acts for purposes of determining whether an instrument issued by that investment pool is a security. An investment pool typically issues securities for capital raising and similar purposes, just as an industrial company does, and the pool’s issuance of securities is subject to the registration and other requirements imposed by the 1933 Act to substantially

below, the Commission and the Staff take the position that certificates of deposit are or may be securities for purposes of the 1940 Act, even though the Supreme Court held, in *Marine Bank v. Weaver*,¹⁰ that certificates of deposit generally are not securities for purposes of the 1933 and 1934 Acts.¹¹ In its amicus brief to the Supreme Court in *Weaver*, the Commission explained that “[w]hile the language in the Investment Company Act’s definition of the term ‘security’ is identical to that in the Securities Act, the regulatory context under the Investment Company Act differs fundamentally from that under the Securities Act and the Securities Exchange Act. . . .”¹² For example, with respect to the treatment of certificates of deposit under the 1940 Act, the Commission noted that “the bank regulatory statutes generally do not apply to the operation of [money market] funds [which often invest in certificates of deposit], and . . . the exclusion of certificates of deposit from the definition of security in the Investment Company Act would seriously undermine the protections contemplated by Congress. . . .” Accordingly, the Commission argued that “the relevant context requires that the term ‘security’ take on a ‘different coloration’ under the Investment Company Act.”¹³ The Staff has suggested that the *Weaver* Court effectively agreed with this position because the Court stated that, despite its holding that the certificate of deposit at issue in that case was a security under the 1933 and 1934 Acts,

[i]t does not follow that a certificate of deposit . . . between transacting parties invariably falls outside the definition of a “security” as defined by the 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.¹⁴

Nonetheless, the court cases and other precedent interpreting the term “security” for purposes of the 1933 and 1934 Acts are relevant to the determination of whether an instrument is a security for purposes of the 1940 Act, because presumably any instrument that is a security for 1933 and 1934 Act purposes also is a security for 1940 Act purposes. Therefore, some of the principal Supreme Court cases on the definition of a security under the 1933 and 1934 Acts are

the same extent as is an issuance of securities of an industrial company. Accordingly, it appears that the determination under Section 3(a) of the 1940 Act of whether an instrument issued by an issuer is a security, and thus whether that issuer may be subject to the 1940 Act, should involve substantially the same considerations as does the determination of whether an instrument is a security for purposes of the 1933 and 1934 Acts.

¹⁰ 455 U.S. 551 (1982).

¹¹ See also Harrell Int’l Inc., SEC No-Action Letter (May 29, 1989) (taking the position that a note evidencing a commercial transaction is a security for purposes of the 1940 Act even if it is not a security under the 1933 or 1934 Acts).

¹² See Joel H. Goldberg, SEC No-Action Letter (May 6, 1982) (quoting Amicus Brief for the United States in *Weaver* at 22–23); Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter (Oct. 28, 1982) (same).

¹³ See Joel H. Goldberg, SEC No-Action Letter (May 6, 1982) (quoting Amicus Brief for the United States in *Weaver* at 22–23); Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC No-Action Letter (Oct. 28, 1982) (same).

¹⁴ See *Weaver*, 455 U.S. at 560 n.11.

discussed briefly below.¹⁵ Even if an instrument is not a security for purposes of the 1933 and 1934 Acts, however, it still may be regarded (at least by the Commission and the Staff) as a security for purposes of the 1940 Act.¹⁶ Accordingly, a survey of some of the significant Commission and Staff positions regarding whether particular instruments are or are not securities for purposes of the 1940 Act also is included below.

§ 2.2 Overview of Supreme Court Decisions

The Supreme Court has considered the definition of the term “security” for purposes of the 1933 and 1934 Acts on a number of occasions,¹⁷ although it has not to date considered the definition of the term “security” for purposes of the 1940 Act. In considering the definition of the term “security” for purposes of the 1934 Act, the Court has stated that the definition is “quite broad” and that the definition:

was meant to include “the many types of instruments that in our commercial world fall within the ordinary concept of a security. . . . It includes ordinary 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. . . .” Thus, the [definition of the term “security”] is not limited to instruments traded at securities exchanges and over-the-counter markets, but extends to uncommon and irregular instruments. We have repeatedly held that the test “is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.”

The broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if “the context otherwise requires. . . .”

¹⁵ A discussion of lower federal court cases, as well as state court cases, would be equally relevant but is beyond the scope of this book.

¹⁶ Moreover, the Commission and the Staff appear to take the position that the context might require that a particular instrument is a security for one purpose under the 1940 Act but not for another purpose. For example, as discussed in Chapter 33, most futures and options on futures are not treated as securities for purposes of determining whether an investment pool is engaged in investing or trading in securities and thus for purposes of determining whether that investment pool is an investment company under Section 3(a)(1)(A) or Section 3(a)(1)(C). However, the Staff may take the position that contracts for futures and options on futures entered into by a mutual fund for speculative purposes are “senior securities” within the meaning of Section 18(f) of the 1940 Act, which restricts the issuance of senior securities by mutual funds. In this regard, in *Steinroe Bond Fund, Inc.*, SEC No-Action Letter (Jan. 17, 1984), the Staff took the position that futures and options on futures used for hedging purposes are not senior securities. There, the Staff stated:

In our opinion, because the Fund will be utilizing futures contracts only for hedging purposes and only within [certain limits], the Fund’s use of futures contracts will not “increase unduly the speculative character” of the common stock of the Fund . . . [and thus the Fund’s] use of the futures contracts should not be objectionable to the staff by reason of section 18(f).

Based on this reasoning, it is conceivable that the Staff might take the position that futures contracts used for speculative purposes would “increase unduly the speculative character” of the common stock of a mutual fund and thus would constitute a “senior security” for purposes of Section 18(f).

¹⁷ In addition, lower courts have issued a large number of opinions dealing with the definition of the term “security” for purposes of the 1933 and 1934 Acts.

Moreover, we are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.¹⁸

While the Court's opinions have not always been entirely consistent,¹⁹ the Court has established a framework for considering whether an instrument is an investment contract, a note, stock, transferable share, certificate of interest or participation in any profit-sharing agreement, or other instrument specifically listed in the definition of the term "security." On several occasions, the Court also has addressed when the "context otherwise requires" an instrument to be deemed not to be a security.

2. Investment Contracts and Instruments Commonly Known as Securities

The Supreme Court's decision in *SEC v. W.J. Howey Co.*²⁰ is perhaps the best known and most frequently cited case on the definition of the term "security."²¹ In *Howey*, the Court held that units of a citrus grove, coupled with a contract for servicing the grove, was an investment contract. The Court specifically defined the term "investment contract" to mean "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. . . ." ²² The Supreme Court

¹⁸ *Marine Bank v. Weaver*, 455 U.S. 551, 555–56 (1982) (citations omitted and not indicated).

¹⁹ *See, e.g., Landreth Timber Co. v. Landreth*, 471 U.S. 681, 688 (1985) ("It is fair to say that our cases have not been entirely clear on the proper method of analysis for determining when an instrument is a 'security.'").

²⁰ 328 U.S. 293 (1946).

²¹ Indeed, the Court has referred to the test established by *Howey* for determining whether an instrument is a security as, "in shorthand form, [embodying] the essential attributes that run through all of the Court's decisions defining a security." *See United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975). However, the Court subsequently emphasized that this statement was meant to apply only in the context of determining whether an instrument is an investment contract. *See Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 n.5 (1985).

²² 328 U.S. at 298-99. In *Howey*, the Court stated that "[s]uch a definition necessarily underlies" the Court's earlier decision in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). In *Joiner*, the Court held that the offer of oil and gas leaseholds, which would be drilled by the offeror for the buyer, was the offer of a security. In rejecting the claim that these rights were strictly leasehold interests, the Court foreshadowed its later opinion in *Howey* by stating:

Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well, it would have been a quite different proposition. Purchasers would then have been left to their own devices for realizing upon their rights. . . . It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that defendants were selling and gave to the instruments most of their value and all of their lure. The trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end.

320 U.S. at 348, 349. The Court also has relied on the *Howey* definition of the term "investment contract" in subsequent decisions, such as when it held that a variable annuity contract is a security (*see SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65, 72 n.13 (1959)) and when it held that withdrawable capital shares in a state-chartered savings and loan association were securities rather than certificates of deposit (*see Tcherepnin v. Knight*, 389 U.S. 332, 338 (1967)). *See also SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) (holding that the accumulation portion of a flexible fund variable annuity contract was an investment contract for purposes of the

has recognized that lower courts subsequently have required only an expectation of profits from the efforts of others, rather than solely from the efforts of others, although the Supreme Court has not expressly stated whether it agrees with this construction.²³

If an instrument does not satisfy the requirements of the *Howey* test, it is not an investment contract. For example, in *International Brotherhood of Teamsters v. Daniel*,²⁴ the Court held that interests in a noncontributory, compulsory pension plan were not investment contracts because there was no investment of money and no expectation of profit from a common enterprise.²⁵

The Court also has held that an investment contract is not present “when a purchaser is motivated by a desire to use or consume the item purchased. . . .”²⁶ Thus, in *United Housing Foundation, Inc. v. Forman*, the Court held, among other things, that shares in a nonprofit, cooperative housing corporation were not investment contracts because “investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments.”²⁷

Similarly, the Court has suggested that an agreement reflecting a private commercial transaction is not an investment contract. For example, in *Marine Bank v. Weaver*,²⁸ the Court held that a privately negotiated loan agreement was not an investment contract when that agreement provided that the lenders would receive a set monthly payment, a share of the profits of a company owned by the borrowers, the right to use a barn and a pasture owned by that company, and the right to veto future borrowings by the company.²⁹ The Court held that the private nature of the agreement and the unique, individually tailored provisions of the agreement demonstrated that the agreement was not a security.³⁰ Subsequently, however, in *Landreth Timber Co. v. Landreth*, the Court rejected the suggestion that the 1933 and 1934 Acts “were intended to cover only ‘passive investors’ and not privately negotiated transactions involving the transfer of control to ‘entrepreneurs.’”³¹

1933 Act and remanding the case for consideration of whether the flexible fund was an investment company under the 1940 Act).

²³ See *Forman*, 421 U.S. at 852 n.16 (expressing no view on the omission of the word “solely” from the *Howey* test).

²⁴ 439 U.S. 551 (1979). See Chapter 34 for a discussion of *Daniel* and employee benefit plans.

²⁵ *Id.* at 559–62.

²⁶ See *Forman*, 421 U.S. at 852–53.

²⁷ See *id.* at 853.

²⁸ 455 U.S. 551 (1982).

²⁹ *Id.* at 553.

³⁰ *Id.* at 559–60.

³¹ 471 U.S. at 692.

The Court has suggested that the term “instrument commonly known as a security,” as used in the definition of the term “security” in the 1933 and 1934 Acts, has the same meaning as the term “investment contract.”³²

³² See, e.g., *Forman*, 421 U.S. at 852 (“We perceive no distinction, for present purposes, between an ‘investment contract’ and an ‘instrument commonly known as a “security.””). See also *Landreth*, 471 U.S. at 691–92 n.5 (referring to the relevant portion of its decision in *Forman*).