Are Discretionary Commodity Trading Accounts Investment Contracts? The Supreme Court Must Decide

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ARE DISCRETIONARY COMMODITY TRADING ACCOUNTS INVESTMENT CONTRACTS?  
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Trading in commodity futures contracts\(^1\) takes place in a volatile and unpredictable market that demands quick investment decisions. An investor may choose to allow a broker to make those decisions without any consultation through employment of a discretionary trading account.\(^2\) If an investor elects to trade in commodity futures in this manner, he or she may or may not be able to invoke the sanctions and protections of the federal securities laws to remedy fraud or other wrongful conduct in the handling of the account. Because the commodity futures contracts themselves are not securities, the availability of the federal securities laws for remedial purposes depends entirely on whether the discretionary trading account itself meets the definition of investment contract employed in the federal circuit where the investor initiates suit.\(^3\)

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2. A discretionary commodity trading account is generally characterized by a customer who makes a large initial deposit with a broker and allows the broker to trade in the account with complete discretion and without any consultation. Discretionary accounts are particularly well-suited to commodities trading because the market is extremely volatile and decisions must be made quickly. Bromberg, Commodities Law and Securities Law—Overlaps and Preemptions, 1 J. CORP. L. 217, 248 (1976).

3. Section 2(1) of the 1933 Act states:
   The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein 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,
The Supreme Court has enunciated a three-part test to determine whether an investment contract exists.\(^4\) There must be an investment of money, in a common enterprise, with profits dependent upon the managerial efforts of others.\(^5\) A deep split in the federal circuit courts has developed over the criteria necessary to satisfy the second element of that test. As a result, a discretionary commodity trading account may constitute an investment contract in some circuits, though not in others.\(^6\) The facts of each case are

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\(^5\) The Howey court stated: "[A]n investment contract for purposes of the Securities Act means 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 third party . . . ." 328 U.S. at 298-99. In United Hous. Found. v. Forman, 421 U.S. 837 (1975), the Supreme Court modified the last clause of the Howey test. The Court omitted the word "solely" and stated that a reasonable expectation of profits should exist based on the "entrepreneurial or managerial efforts of others." Id. at 852. The Court also stated that the Howey test, "in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security." Id. The Court found that a sale of stock in a non-profit housing cooperative did not constitute a security because the investor-broker relationship that existed in the case lacked the expectation of profits element of the Howey test. Id. at 857.

\(^6\) This Note will not discuss the difficult problem the circuit split causes when attempts are made to determine whether other financial instruments or investment schemes constitute investment contracts. See, e.g., Hart v. Pulte Homes of Mich. Corp., 735 F.2d 1001, 1004 (6th Cir. 1984) (model home sale-leaseback transactions were held not to constitute securities because no showing was made of an investment in a common venture or horizontal commonality since "the fate of each purchaser's investment was [not] tied to that of the other investors through a common scheme"); SEC v. Professional Assocs., 731 F.2d 349, 355 (6th Cir. 1984) (horizontal commonality was held present in trust accounts, joint ventures, and escrow accounts); United States v. Jones, 712 F.2d 1316, 1321 (9th Cir.), cert. denied, 464 U.S. 986 (1983) ("Because the proof shows that the fortunes of the investors were linked with those [of
critical to the determination of whether a security is involved.

In January of this year, the United States Court of Appeals for the District of Columbia Circuit considered an appeal from an order for summary judgment in a case\(^7\) that centered in part on the definition of investment contract. Newcomb Securities Company\(^8\) claimed that its law firm wrongly advised it not to register the discretionary commodity trading account it intended to offer with the Securities and Exchange Commission.\(^9\) It claimed that this left the company potentially liable for securities laws violations and penalties.\(^10\) The court of appeals noted that the dispute turned on whether the instruments Newcomb intended to offer were investment contracts.\(^11\) If the instruments were investment contracts, they would qualify as securities under the definitions in the Securities Act of 1933\(^12\) and the Securities Exchange Act of 1934.\(^13\)

The court noted a further problem. Newcomb planned to market the instruments in the Fifth, Ninth, and Tenth Circuits where different criteria have developed for identification of an investment contract.\(^14\) A common enterprise element must be established before an investment contract can exist. The federal circuits differ on what they will accept as sufficient criteria to establish a common enterprise among investors and brokers. The Fifth, Eighth, and Tenth Circuits have concluded that a common enterprise can exist as long as the investor has placed money with a broker and depends on that broker for profit.\(^15\) The Third, Sixth, and Seventh Circuits state that a common enterprise consists of multiple investors who pool funds together into a joint venture controlled by the broker.\(^16\) The Ninth Circuit requires that the investor's success or failure must depend on the broker and that the broker's success or failure must depend on how well she performs for the investor before it will recognize a common enterprise.\(^17\) In regard to a case

\(^8\) Newcomb Securities Company was one of two partnerships and five corporations controlled by the defendants. \textit{Id.}
\(^9\) \textit{Popham}, 751 F.2d at 1264-65.
\(^10\) \textit{Id.} at 1265.
\(^11\) \textit{Id.} Investor funds placed in accounts would be reinvested by the defendants in commodity futures and in transactions involving foreign currencies and government securities. \textit{Id.}
\(^12\) See supra note 3.
\(^13\) \textit{Id.}
\(^14\) \textit{Popham}, 751 F.2d at 1265. See infra notes 44-67 and accompanying text.
\(^15\) See infra notes 56-78 and accompanying text.
\(^16\) See infra notes 102-49 and accompanying text.
\(^17\) See infra notes 44-54 and accompanying text. If the investor loses money while at the same time the broker handling those funds earns money, the Ninth Circuit will not recognize a
dealing with this issue, the District of Columbia Circuit merely noted the
split in circuits, vacated the order for summary judgment, and remanded the
case for further proceedings.\textsuperscript{18}

The Supreme Court faced but declined to resolve this same circuit split
when it denied, by a six to three vote, a petition for certiorari to the Ninth
Circuit in \textit{Mordaunt v. Incomco}.\textsuperscript{19} In \textit{Mordaunt},\textsuperscript{20} plaintiffs invested
thousands of dollars in a discretionary commodity trading account with In-
comco.\textsuperscript{21} Incomco directed the funds toward the purchase of commodity
futures contracts and had complete discretion with regard to investment de-
cisions.\textsuperscript{22} In just six months, the Mordaunts had lost approximately $27,000
while Incomco had, at the same time, earned more than $20,000 in commis-
sions.\textsuperscript{23} The Mordaunts filed suit in federal district court alleging against
Incomco several violations of state and federal securities laws.\textsuperscript{24} The district
court concluded that the discretionary commodity trading account consti-
tuted an investment contract.\textsuperscript{25}

The United States Court of Appeals for the Ninth Circuit reversed, stating
that the Mordaunt-Incomco relationship lacked the common enterprise ele-
ment necessary before an investment contract can exist.\textsuperscript{26} The court noted
that in the Ninth Circuit "there is no common enterprise unless there is
some direct relation between the success or failure of the promoter and that
of his investor."\textsuperscript{27} Because the Mordaunts had lost approximately $27,000
at the same time Incomco earned more than $20,000 in commissions, the
mutually dependent relationship required in the Ninth Circuit did not ex-
ist.\textsuperscript{28} The court rejected the Mordaunt's contention that the less stringent
definition of common enterprise of the Fifth Circuit should apply.\textsuperscript{29}

\footnotesize{common enterprise. See infra note 53 and accompanying text. In the Fifth, Eighth, and Tenth
Circuits, however, a common enterprise and investment contract will exist as long as the pro-
moter or broker exercises dominance over the funds invested, regardless of the financial out-
come. See infra note 55-78 and accompanying text.

\textsuperscript{18} \textit{Popham}, 751 F.2d at 1266.
\textsuperscript{19} 686 F.2d 815 (9th Cir. 1983), cert. denied, 105 S. Ct. 801 (1985) (White, J. with Bur-
g er, C.J. & Brennan, J. dissenting). "In light of the clear and significant split in the Circuits, I
would grant certiorari." 105 S. Ct. at 803.
\textsuperscript{20} 686 F.2d at 816.
\textsuperscript{21} \textit{Id.} at 815.
\textsuperscript{22} Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth
Circuit at E3, \textit{Mordaunt v. Incomco}, 686 F.2d 815 (9th Cir. 1983).
\textsuperscript{23} \textit{Id.} at C4.
\textsuperscript{24} \textit{Mordaunt}, 686 F.2d at 816.
\textsuperscript{25} \textit{Id.} at 817.
\textsuperscript{26} \textit{Id.}
\textsuperscript{27} \textit{Id.}
\textsuperscript{28} \textit{Id.}
\textsuperscript{29} \textit{Id.}
The Supreme Court declined to hear the case. It left intact a circuit split that pits the Fifth, Eighth, and Tenth Circuits against the Third, Sixth, and Seventh Circuits in a dispute over the definition of the common enterprise element of an investment contract. The Ninth Circuit has developed a third definition.

This Note will provide an overview of this circuit split as it concerns discretionary commodity trading accounts. It will analyze each of the leading appellate decisions from the circuits involved and the collective reasoning involved on each side. This Note will conclude with a discussion of a uniform approach as an attempt to resolve this sharp split in the circuits.

I. SEC v. W.J. Howey Co.: The Seminal Case

In SEC v. W.J. Howey Co., the Supreme Court articulated the landmark test for determining the existence of an investment contract. In Howey, the Securities and Exchange Commission (SEC) brought an action against the W.J. Howey Company to enjoin it from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered securities in violation of the Securities Act of 1933. Investors in Howey purchased small parts of a 500-acre citrus grove owned by the company, and defendants pooled the produce at harvest and distributed the net profit to investors.

The Supreme Court reversed lower court rulings to the contrary and held that the Howey citrus investment scheme constituted an investment contract. The Court's three-part definition of an investment contract, requiring a person to invest money, in a common enterprise, and depend on the managerial expertise of another for profit, remains relevant today. The Supreme Court fashioned this definition with the concern that too rigid or exact a test would lead to the development of efforts to circumvent it. Such a test, the Court postulated, would defeat the remedial intent of Con-
gress when it enacted the securities statutes. Unscrupulous traders could easily invent ways to defeat a narrow definition of investment contract, whereas Congress intended the securities laws to reach broadly. In addition, state courts had established a broad definition of investment contract prior to passage of the 1933 and 1934 Securities Acts. The Court reasoned that because Congress was aware of these decisions when it enacted the securities statutes, it must have intended a similarly broad approach.

Courts that apply the Howey definition today usually separate the test into component parts for the purposes of analysis. Courts first look for an investment of money, then for the existence of a common enterprise, and finally for investor expectation of profits from the efforts of others. A plaintiff must meet each of these elements in order to satisfy the Howey test and invoke the sanctions and protections of the securities laws.

II. THE CIRCUIT SPLIT: VERTICAL AND HORIZONTAL COMMONALITY

A circuit split has developed over the criteria necessary to establish the second prong of the three part Howey test, or what constitutes a common enterprise. The Fifth, Eighth, and Tenth Circuits state that a broadly defined “vertical commonality” will suffice for that purpose. In these circuits, vertical commonality means a relationship between an investor and a broker that is characterized simply by promoter dominance over investor funds. Multiple investors are not necessary, nor must the investors pool funds. However, in the Third, Sixth, and Seventh Circuits, multiple investors and pooling of funds, or “horizontal commonality,” must be present to create a common enterprise. It is important to note that the Fifth, Eighth, and Tenth Circuits recognize a common enterprise if pooling or multiple investors exist. Vertical commonality sets a floor, not a ceiling in those circuits. The Third, Sixth, and Seventh Circuits, however, will accept no less than horizontal commonality. The Ninth Circuit fits into neither of these categories, having developed its own version of vertical commonality.

38. Id. at 299.
39. Id.
40. Id. at 298 & n.4.
41. Id. at 298.
43. See Consolo v. Hornblower & Weeks-Hemphill, Noyes, Inc., 436 F. Supp. 447, 452-54 (N.D. Ohio 1976) (court found that a nondiscretionary trading account in commodity futures was not an investment contract because the investor’s profits did not depend on the efforts of the promoter).
A. Vertical Commonality

In the Ninth Circuit, the success or failure of the investor must depend on the broker and vice versa. For example, if the investor loses money while at the same time the broker earns money, a common enterprise will not exist. Their fortunes must be interdependent. The Ninth Circuit definitively announced its common enterprise criteria for discretionary commodity trading accounts in *Brodt v. Bache & Co.* In *Brodt*, the plaintiffs invested in a discretionary commodity trading account with Bache by placing their money in a local savings and loan association. They executed a form that allowed Bache to withdraw money without the Brodts' authorization and invest in commodity option contracts. Though Bache told the Brodts that they could expect large profits, they found that after the agent had left the company all of their money had been lost and that the company Bache had set up to make the commodity purchases had gone bankrupt. The Brodts then filed suit against the company.

A lower court granted a motion for summary judgment in favor of Bache and the Brodts appealed. Affirming the holding below, the United States Court of Appeals for the Ninth Circuit stated that the relationship between the Brodts and Bache did not constitute an investment contract. The court first rejected the pooling requirements of the horizontal commonality approach adopted in the Seventh Circuit and distinguished the Fifth Circuit's more expansive view of vertical commonality. The court then stated that

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44. 595 F.2d 459 (9th Cir. 1978). See SEC v. Goldfield Deep Mines Co., 758 F.2d 459 (9th Cir. 1985) (demonstrating the continued vitality of the court's holding here and in the *Mordaunt* case). “It is not necessary that the funds of investors are pooled; what must be shown is that the fortunes of the investors are linked with those of the promoters, thereby establishing the requisite element of vertical commonality.” *Id.* at 463.

45. *Brodt*, 595 F.2d at 459.

46. *Id.* at 459-60. A commodity option contract entitles the purchaser to buy either a specific commodity futures contract at a set price within a set period (call options), sell under the same circumstances (put options), or do either (double or straddle options). Bromberg, *supra* note 2, at 257. Partly because of its highly speculative nature, trading in agricultural commodity options has been disallowed for some time, and only recently has Congress allowed such trading to begin on a trial basis. H.R. REP. No. 964, 97th Cong., 2d Sess. 1-4 (1982).

47. *Brodt*, 595 F.2d at 460.

48. *Id.*

49. *Id.*

50. *Id.* at 462.

51. *Id.* at 461. The Fifth Circuit will recognize a common enterprise as long as the promoter or broker exercises dominance over investor funds. It does not require that the success or failure of the broker correlate directly with that of the investor. SEC v. Continental Commodities, 497 F.2d at 521. In *Brodt*, the Ninth Circuit stated:

*Carman* [a Ninth Circuit case suggesting application of the expansive approach employed by the Fifth Circuit] can be distinguished from the case at bar because the success or failure of Bache as a brokerage house does not correlate with individual
the Brodt-Bache relationship did not meet its criteria for a common enterprise because it was a "'solitary' one." Because the success or failure of the Brodts did not depend on the concomitant success or failure of Bache, the court reasoned that the company merely provided investment counsel and that no common enterprise existed. Similarly, in the Mordaunt decision this lack of mutual dependence between broker and investor led to the failure of both plaintiffs' securities law claims.

The Fifth, Eighth, and Tenth Circuits have adopted a less restrictive definition of vertical commonality and apply it in a much less stringent manner than the Ninth Circuit. The Fifth Circuit approach is illustrated in SEC v. Continental Commodities Corp., where the court considered an SEC com-

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52. Id. at 462.
53. Id.
54. Mordaunt, 686 F.2d at 817. While the First Circuit has not spoken definitively on the issue, a recent district court opinion suggests that the Ninth Circuit's version of vertical commonality has gained favor in the First Circuit. In Xaphes v. Merril Lynch, Pierce, Fenner & Smith, Inc., 597 F. Supp. 213 (D. Me. 1984), the court considered whether the plaintiff's discretionary stock option trading account with the defendant constituted an investment contract. Relying on the Ninth Circuit's Brodt case, the First Circuit court concluded that the mere investor-broker relationship present did not satisfy the common enterprise requirement of the Howey definition because no mutual dependence existed. Id. at 216.


In Holtzman, plaintiffs opened a discretionary securities account with the defendant. 528 F. Supp. at 11. After the value of their portfolio fell by more than half, plaintiffs initiated suit against defendant alleging fraud, misrepresentation and other securities laws violations. Id. The court held that plaintiffs' account did not constitute an investment contract because the profits and losses of the individual investors and those of the brokers were not interdependent. Id. at 16. In so ruling, the court stated that it adopted the narrower version of vertical commonality of Savino v. E.F. Hutton & Co., 507 F. Supp. 1225 (S.D.N.Y. 1981). Id. However, District Court Judge McNaught noted that he believed horizontal commonality was the better approach because the Howey decision required it. Id. at 15.

In Kaufman, plaintiffs brought suit alleging, among other counts, that the defendant sold them a security (their stock option account) through the use of untrue statements and omissions of material fact. 539 F. Supp. at 1096. The court allowed plaintiff's complaint to stand because it alleged an interdependent broker-investor relationship. Id. at 1097. The court stated that a mere commission arrangement was not enough, citing the Brodt definition of vertical commonality as authority. Id.

55. See supra notes 44-54 and accompanying text.
56. 497 F.2d 516. See Rasmussen v. Thomson & McKinnon Auchincloss Kohlmeyer, Inc., 608 F.2d 175 (5th Cir. 1979) (per curiam). The Fifth Circuit affirmed the decision of the
plaint seeking to enjoin Continental from alleged violations of the federal securities laws. Continental offered investors the opportunity to invest in options on commodity futures contracts under its auspices. As in most cases in this area, the defendant company allegedly misrepresented the size of potential profits associated with commodity options trading while minimizing the enormous risks inherent in the commodities markets. The District Court for the Northern District of Texas dismissed the SEC's action for lack of subject matter jurisdiction, ruling that the scheme involved did not constitute an investment contract. On appeal, the United States Court of Appeals for the Fifth Circuit reversed, holding that the requisite vertical commonality between investor and broker existed.

District Court for the Northern District of Georgia holding that the discretionary commodity trading account involved in the dispute was an investment contract. Id. at 178. The district court had cited the Continental Commodities decision as authority. Id. at 177. But see Mallen v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 605 F. Supp. 1105 (N.D. Ga. 1985). The District Court for the Northern District of Georgia challenged the continued vitality of the Continental Commodities decision that discretionary trading accounts constitute investment contracts. Id. at 1109. It held that the 1974 and 1982 amendments to the Commodity Exchange Act (CEA), which expanded the Commodity Future Trading Commission (CFTC) jurisdiction to all dealings in commodities, precluded securities actions against discretionary commodity trading account brokers. Id. at 1113-14. The court stated that to allow securities actions to stand in disputes involving commodities would be “antithetical to the congressional purpose in creating the CFTC.” Id. at 1114. For further discussion of the CFTC's expanded regulatory power over commodities and issues pertaining thereto, see infra notes 133, 161, and accompanying text. It should also be noted that the Northern District of Georgia, previously part of the Fifth Circuit, is now in the Eleventh Circuit, but that Fifth Circuit opinions are still controlling precedent until the decisions are overturned by an en banc panel of the Eleventh Circuit.

57. Continental Commodities, 497 F.2d at 519. It is important to point out that the court frequently referred to discretionary commodity trading accounts in its opinion. However, the case actually dealt with trading in naked commodity options. Bromberg, supra note 2, at 260. Naked commodity options are generally recognized as investment contracts. Id. “A naked option is a simple, unsupported promise the writer (also called optionor, grantor, or seller) makes to buy or sell a futures contract at a specified price during a specific period. The writer is betting against a customer on how the market price of the contract will move.” Id. at 257-58. Despite this factual confusion, Continental Commodities has become a leading case for the proposition that discretionary commodity trading accounts form investment contracts and, hence, securities. Id. at 260.

58. Continental Commodities, 497 F.2d at 519.

59. Id. at 518.

60. Id. at 522-23, 529. The case also contained an interesting procedural maneuver. The SEC had raised two issues in the district court prior to its appeal. The first was whether the trading in the naked options accounts constituted an investment contract. The second was whether notes issued by Continental Commodities constituted securities. The notes were issued to partially reimburse customers adversely affected when the trading in the naked options was halted due to SEC action. Id. at 519-20. The district court reached only the first issue. Id. at 520. The SEC wished to confine the appellate court to the second. Id. The Fifth Circuit nevertheless decided to consider both issues in its decision. Id.
The Fifth Circuit, like the Ninth Circuit in *Brodt*, specifically and vigorously rejected the view of the Seventh Circuit that a pooling of investor funds, or horizontal commonality, had to be present to establish a common enterprise. Yet, the *Continental Commodities* court differed from the Ninth Circuit by stating that rather than seeking mutual dependence, its “critical inquiry” centered on whether the promoter of the scheme had exercised total control over the investment decisions through its investment counseling and whether the investors had essentially depended on the promoter's expertise for their profits. The *Continental Commodities* court, however, quoted from a pre-*Brodt* Ninth Circuit case, but did not interpret that case to mean, as the Ninth Circuit has, that the success or failure of both the promoter and the investor must be mutually dependent.

The United States Court of Appeals for the Tenth Circuit took an equally expansive view of the definition of investment contract in *Commercial Iron & Metal Co. v. Bache & Co.* The dispute in this case centered on whether the defendant’s investment scheme involving copper futures contracts constituted an investment contract. The court noted that while the copper futures contracts themselves were not securities, and despite the fact that Commercial had actually taken delivery of the copper on several occasions, the investment scheme offered by Bache to Commercial could still qualify as an investment contract. The court stated that possibly the only requirements

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61. *Id.* at 522. The court stated that the language of one of its earlier decisions on the issue, SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974), “casts aspersions on the elevation of a pooling ingredient to exalted status in inquiries concerning a common enterprise.” 497 F.2d at 519.


63. SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973). In a footnote, the Ninth Circuit stated its definition of common enterprise. This definition has been used by the Ninth Circuit to demonstrate why mutual dependence is necessary, and by the Seventh Circuit to justify its horizontal commonality requirement. See Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972). The footnote read “[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.” *Glenn W. Turner*, 474 F.2d at 482 n.7.

64. *Continental Commodities*, 497 F.2d at 522. The court stated that “the essential [element is] that the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of Continental Commodities.” *Id.* at 522-23. It has been argued that the Fifth Circuit's focus on whether or not the promoter of the investment scheme controls trading decisions essentially eliminates any analysis of whether a common enterprise exists and instead collapses that second part of the *Howey* definition of investment contract into the third part, i.e., whether an investor has a reasonable expectation of profit from the efforts of others. See *infra* notes 85-93 and accompanying text (discussing the *Savino* case).

65. 478 F.2d 39 (10th Cir. 1973).

66. *Id.* at 42. Defendants argued that taking delivery of the copper made the transactions nothing more than buying and selling the mineral with no investment scheme involved. *See*
necessarily to establish an investment contract in a discretionary commodity trading account situation may be a representation of large profits and promoter dominance over investment decisions.\textsuperscript{67}

In \textit{Booth v. Peavey Company Commodity Services},\textsuperscript{68} the United States Court of Appeals for the Eighth Circuit joined the Fifth and the Tenth Circuits in a broad interpretation of common enterprise. The plaintiff in the \textit{Booth} case had opened a commodity trading account with the defendant.\textsuperscript{59} He alleged that during a two-month period in 1968, the defendant had churned, or traded excessively with his account to his detriment.\textsuperscript{70} The Eighth Circuit affirmed a directed verdict for the defendant granted in a lower court.\textsuperscript{71} While the court in the \textit{Booth} opinion never specifically stated its criteria for establishing a common enterprise, lower courts in that circuit have interpreted the opinion to mean that only a one-on-one relationship between broker and investor is necessary to establish a common enterprise.\textsuperscript{72} The actual question before the court was whether the plaintiff could bring an action against Peavey for allegedly churning his discretionary commodity trading account.\textsuperscript{73} Because the court stated that a private remedy for churning such an account was available under the securities laws, lower courts in the Eighth Circuit have treated the accounts as securities.\textsuperscript{74}

For example, in the oft-cited case of \textit{Marshall v. Lamson Bros.},\textsuperscript{75} the district court stated first that the Seventh Circuit's horizontal commonality requirement presented too strict a view of what constitutes a common

\textsuperscript{Continental Mktg. Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967). Continental offered to sell investors live beavers, encouraged the investors to leave the maintenance of the beavers to Continental, and ride the "road to riches." \textit{Id.} at 468. Despite the fact that the promoter did not retain ownership or control of the beavers, the court held that the investment scheme orchestrated by the promoter with the promise of large profits constituted an investment contract. \textit{Id.} at 470. Interestingly, the Seventh Circuit in the \textit{Milnarik} case interpreted \textit{Continental Marketing} to support horizontal commonality because the success of the individual investors depended on the success of the beaver breeding and marketing venture as a whole. \textit{Milnarik}, 457 F.2d at 276. The Tenth Circuit was actually declaring that the profits of the beaver investors depended solely on the efforts of the promoter while not supporting the view that pooling, or horizontal commonality, must exist for the recognition of a common enterprise. \textit{Continental Mktg. Corp.}, 387 F.2d at 470.

68. 430 F.2d 132 (8th Cir. 1970).
69. \textit{Id.} at 134.
70. \textit{Id.}
71. \textit{Id.} at 135.
73. \textit{Booth}, 430 F.2d at 133.
74. \textit{Id.} \textit{See infra} notes 75-78 and accompanying text.
75. 368 F. Supp. 486 (S.D. Iowa 1974).
enterprise. The court noted that while horizontal commonality may represent a reasonable interpretation of the precise facts of the Howey situation, it is still inconsistent with the general broad-minded tone of the opinion and the remedial purposes of the securities law. The court noted that vertical commonality rests more squarely on the intent of both the Supreme Court and the Congress.

Through a series of district court opinions, the Second Circuit appears to have adopted the vertical commonality requirement, but debate continues over whether to adhere to the broad view of vertical commonality championed by the Fifth, Eighth, and Tenth Circuits, or the more stringent standard of the Ninth.

In Maheu v. Reynolds, plaintiffs alleged that Reynolds stated it would remain in total control of their commodity trading account, that the company would earn substantial profits for them, and that losses would amount

76. Id. at 489.
77. Id. at 488.
78. Id. at 488-89. This court opined that the Supreme Court's definition of investment contract in the Howey case was intended to be applied in a broad manner with a good degree of flexibility enabling courts "to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." Id. at 488 (quoting Howey, 328 U.S. at 299). The Marshall court noted that this broad definition would comport with what it viewed as congressional intent that the 1933 and 1934 securities laws were remedial and should be construed broadly. Id. at 489. In discussing vertical as opposed to horizontal commonality, the court stated that

[a]t the very least, it is equally as plausible to conclude that the element of "common enterprise" is satisfied when a single investor commits his funds to a promoter in hope of making a profit as to conclude that the investor protection afforded by the '33 and '34 Acts and the complex regulatory scheme developed thereunder is available only to those hapless capitalists who are not alone in their misfortune.

Id. at 489.
79. See infra notes 80-93 and accompanying text.
to no more than $5,000. Instead, a year later, plaintiffs alleged a loss of more than $43,000 and lost profits totalling more than $287,000.

The Maheu court carefully reviewed the facts of Howey, noting particularly that the Supreme Court had overturned lower court opinions holding that where only a one-on-one, investor-broker relationship exists, no common enterprise is present. The court then plainly stated that "the joint account may constitute a security even if there was no pooling arrangement or a common enterprise among investors." Significantly, this court added no additional qualifications to its criteria.

However, in Savino v. E.F. Hutton & Co., a recent Second Circuit case, Judge Ward stated just as plainly that the broad version of vertical commonality does not comport with Howey. In Savino, the dispute centered not on a discretionary commodity trading account, but on the defendant's alleged mismanagement of stock and stock option discretionary accounts. Nevertheless, the district court opinion illustrated pointedly the ongoing debate in the Second Circuit over whether to adopt the narrow or broad view of vertical commonality. The Savino court first noted that the Howey decision called for an investor-broker relationship with some degree of interdependence, and cited the Ninth Circuit's decisions in Brodt and SEC v. Glenn W. Turner Enterprises for authority. The court stated that while some interdependence must exist, courts adopting the horizontal commonality approach have not put forward any "convincing rationale" for their view that a pooling of funds of several investors must also exist.

The court then distinguished the broad view of vertical commonality adopted by the Fifth Circuit. It stated that such a broad view essentially omitted the common enterprise element of the Howey definition of an investment contract. Without some degree of interdependence of investor and broker success or failure, the common enterprise necessary under the Howey

82. Id.
83. Id. at 429.
84. Id.
86. Id. at 1235.
87. Id. at 1238. See Brodt v. Bache, 595 F.2d 459 (9th Cir. 1978); SEC v. Glenn W. Turner Enters., 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).
88. Savino, 507 F. Supp. at 1238. But see Darrell v. Goodson, Fed. Sec. L. Rep. (CCH) ¶¶ 97,325, 97,349 (S.D.N.Y. 1980) (stating that "horizontal commonality" or a "pooling of the monies of various investors . . . is necessary to the existence of the 'common enterprise' ").
89. Savino, 507 F. Supp. at 1237-38. See supra notes 56-64 and accompanying text.
90. Savino, 507 F. Supp. at 1237 n.11.
definition would lack substance. Interestingly, however, the court then questioned whether the Howey opinion ever actually justified the great importance attached to the common enterprise element. The court cited one commentator's viewpoint that a strict reading of the Howey common enterprise element is wrong and that all discretionary accounts ought to be considered securities regardless of the nuances of the investor-broker relationship.

The United States Court of Appeals for the Eleventh Circuit also appears to have joined the vertical commonality group, although only three district court opinions thus far deal with the issue of whether discretionary commodity accounts constitute investment contracts. Two of the opinions state that such accounts are investment contracts; one holds the contrary.

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91. Id.; see also Mechigian v. Art Capital Corp., No. 84-4617 slip. op. (S.D.N.Y. June 25, 1985).
92. Savino, 507 F. Supp. at 1237 n.11.
93. Id. (citing Note, Discretionary Commodity Accounts as "Securities": Applying the Howey Investment Contract Test to a New Investment Medium, 67 GEO. L.J. 269 (1978)).
94. Two Georgia district court opinions took the broader view of vertical commonality of the Fifth, Eighth, and Tenth Circuits in Westlake v. Abrams, 565 F. Supp. 1330 (N.D. Ga. 1983) and Taylor v. Bear Stearns & Co. 572 F. Supp 667 (N.D. Ga. 1983). Importantly, however, the court in Westlake noted that the decisions of the Fifth Circuit remain binding in the Eleventh until an en banc panel of the Circuit's appeal court decides to overrule them. 565 F. Supp. at 1339 n.7. In Westlake, the court relied on the Fifth Circuit's leading case on the issue, Continental Commodities, to find that a class action suit could stand against the defendants who handled some 4,700 accounts at issue in the suit. Id. at 1338. The plaintiffs alleged that defendants sold unregistered securities and violated other applicable provisions of the securities laws. Id.
95. The Fourth Circuit has not yet spoken definitively on the issue either, but one district court opinion dealt specifically with the question of whether discretionary commodity trading accounts are investment contracts. In Rochkind v. Reynolds Sec., Inc., 388 F. Supp. 254 (D. Md. 1975), the district court first undertook a review of the circuit split as it stood in 1975, and then concluded that the more liberal view of vertical commonality better reflected the broad remedial purposes of the securities laws. Id. at 257. Similarly, the District of Columbia Circuit has not yet definitively spoken on the issue. Nevertheless, in Meredith v. Conticommodity
Though they differ in degree of application, the views of the circuits requiring vertical commonality generally reflect a broader view on what can constitute a common enterprise for purposes of the *Howey* definition of an investment contract. The opinions generally begin with a discussion of the *Howey* test, and then attempt to fit the facts in the cases before them into the requisite *Howey* elements. In *Howey*, the Supreme Court emphasized that it desired a flexible application of its definition of an investment contract because Congress intended the securities laws to be remedial in nature. The Supreme Court did not want to adopt a rigid rule, stating that such rigidity would only lead to the invention of schemes to circumvent it. The Fifth, Eighth, and Tenth Circuits generally recognize this concern.

In these circuits, the definition of common enterprise is easily met by plaintiffs who desire to bring suit against discretionary commodity account brokers under the federal securities laws. For example, in what has been called the Tenth Circuit’s leading case on the issue, *Commercial Iron & Metal*, the plaintiff and defendant were arguably engaged in nothing more than the purchase and delivery of copper. Nevertheless, the court stated that the arrangement could constitute an investment contract by applying an expansive interpretation of the *Howey* definition. Similarly, in the Fifth Circuit’s leading case, *SEC v. Continental Commodities Corp.*, the plaintiff’s had purchased so-called “naked options” contracts with the defendants, and did not technically invest in discretionary trading accounts. Again, the court applied a liberal interpretation of the *Howey* definition of common enterprise and held that the broker-investor relationship in the *Continental Commodities* case was sufficient to establish a common enterprise and investment contract. This relative ease of access to the securities laws contrasts sharply with the difficulty faced by investors in jurisdictions that require multiple investors and a pooling of funds before a common enterprise can exist.

### B. Horizontal Commonality

The Third, Sixth, and Seventh Circuits have, in separate decisions, concluded that a pooling of funds among several investors toward a common
venture, or "horizontal commonality," must exist for the establishment of a common enterprise for Howey definitional purposes. The decisions in this group of circuits reflect a uniformity of application of one version of horizontal commonality that began in the Seventh Circuit.102

In Milnarik v. M-S Commodities, Inc.,103 the United States Court of Appeals for the Seventh Circuit set forth its definition of horizontal commonality. In Milnarik, the plaintiffs opened a discretionary commodity trading account with the defendants and deposited more than $13,000.104 The agent, with whom they dealt and M-S Commodities itself maintained many similar accounts with other investors.105 After losing every penny of their initial investment while the defendants had earned commissions on trades, plaintiffs initiated an action to rescind their agreements and recover their losses.106 Milnarik and the other investors intended to show that their discretionary commodity trading accounts constituted securities, and that M-S Commodities violated the law because they had not registered the accounts with the SEC.107

A lower court dismissed the action, stating that the account constituted a private, not a public offering, and therefore did not meet the definition of security.108 On appeal, then Circuit Judge John Paul Stevens wrote a majority opinion affirming the lower court ruling.109 Relying heavily on the district court's opinion, Judge Stevens stated that he based his decision on the lack of a common enterprise between the investors and brokers.110 He quoted the district court opinion with approval regarding its statement that no matter how many other discretionary commodity accounts were under the defendant's control at any one time, the relationship with each investor remained "unitary in nature."111 Judge Stevens also noted that the M-S

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102. Because the Seventh Circuit is consistently addressing issues involving commodity trading in Chicago, a leading authority states that its opinions on the subject are very persuasive in the way that the Second Circuit's opinions on securities laws are also persuasive due to their addressing of stock trading in New York. Bromberg, supra note 2, at 252.

103. 457 F.2d 274 (7th Cir. 1972), cert. denied, 409 U.S. 887 (1972). See United States v. Di Fonzo, 603 F.2d 1260, 1264-65 (7th Cir. 1979); see also Stenger v. R.H. Love Galleries, Inc., 741 F.2d 144, 146 (7th Cir. 1984). "This Circuit has strictly adhered to the 'horizontal' test of common enterprise, under which multiple investors must pool their investments and receive pro rata profits." Id. The case involved an investor who purchased paintings from the defendant gallery allegedly after the defendant promised the art would rise in value. Id.

104. Milnarik, 457 F.2d at 275.

105. Id.

106. Id.

107. Id.

108. Id.

109. Id. at 280.

110. Id. at 276-79.

111. Id. at 277.
Commodities agent did not uniformly trade the accounts, he did not pool any of the investor funds and that each of the investors could earn a profit or take a loss without any effect on the others.\textsuperscript{112} Given these facts, a simple agency for hire, not a common enterprise, existed in this relationship.\textsuperscript{113}

Turning to the factual situation in the \textit{Howey} decision for additional support, Judge Stevens noted that while each individual in \textit{Howey} received a portion of the net profits of harvest based on the amount of fruit on the person's individual parcel of land, the "economic realities" of the \textit{Howey} investment scheme reflected a common enterprise among a group of investors who had all pooled their funds toward one common venture.\textsuperscript{114} He noted, in particular, that no one investor in the \textit{Howey} citrus grove had any right to the fruit on his parcel of land.\textsuperscript{115} Instead, all of the fruit was pooled at harvest.\textsuperscript{116} These factual distinctions regarding the \textit{Howey} pooling arrangement led Judge Stevens to conclude that a pooling of resources was necessary before a common enterprise could exist.\textsuperscript{117}

Five years later in \textit{Hirk v. Agri-Research Council, Inc.}\textsuperscript{118} the Seventh Circuit reaffirmed its \textit{Milnarik} decision and stated explicitly that either a pooling of funds or the sharing of profits on a pro-rata basis must be present to satisfy its definition of common enterprise.\textsuperscript{119} Surprisingly, the facts in \textit{Hirk} seem to indicate that such an arrangement did exist. The plaintiff opened a discretionary commodity account with the defendants. While defendants would have complete control over the trading in the account, they would also share twenty-five percent of the profits earned through the trading.\textsuperscript{120} Although the "seventy-five to twenty-five" profit sharing arrangement appears to have met at least a dictionary definition of common venture, the court in \textit{Hirk} stated specifically that not "every conceivable dictionary definition of an investment contract was intended to be included within the statutory definition of security."\textsuperscript{121} Hirk contended that horizontal commonality ran counter to the remedial nature of the securities laws by making it difficult for discretionary commodity trading account investors to

\textsuperscript{112} Id. at 278.
\textsuperscript{113} Id. at 277.
\textsuperscript{114} Id. at 278-79.
\textsuperscript{115} Id. at 279 n.7.
\textsuperscript{116} Id.
\textsuperscript{117} Id. at 279 n.7.
\textsuperscript{118} 561 F.2d 96 (7th Cir. 1977).
\textsuperscript{119} Id. at 101.
\textsuperscript{120} Id. at 102.
\textsuperscript{121} Id. (quoting Milnarik v. M-S Commodities, Inc., 457 F.2d 274, 275-76 (7th Cir. 1972)).
invoke the securities laws.\textsuperscript{122} He asked the court to adopt instead the vertical commonality requirement of the Fifth Circuit.\textsuperscript{123} The court refused to do so stating that there was "little or no substantiation for the Fifth Circuit's position" that pooling was unnecessary,\textsuperscript{124} and that horizontal commonality reflected the remedial nature of the securities laws and legislative desire for flexibility of approach.\textsuperscript{125}

The United States Court of Appeals for the Sixth Circuit adopted the same view in \textit{Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}\textsuperscript{126} In \textit{Curran}, the two plaintiffs deposited $100,000 in a discretionary commodity trading account with the defendant.\textsuperscript{127} They earned a substantial profit at first, but their account soon dwindled to just $6,000.\textsuperscript{128} In a multi-count action against the defendants, the plaintiffs alleged losses of $175,000 while Merrill Lynch had earned more than $44,000 in commissions.\textsuperscript{129}

Relying heavily on the \textit{Milnarik} decision, the court stated that because the fortunes of the Currans were not linked with those of other investors who were also dependent for their success on one venture, no common enterprise existed.\textsuperscript{130} The court defended the \textit{Milnarik} reasoning at length\textsuperscript{131} and repeated the view of the Seventh Circuit that the one-on-one relationship that could characterize vertical commonality in other circuits represented only an agency-for-hire situation and not a common enterprise.\textsuperscript{132}

\begin{itemize}
\item\textsuperscript{122} \textit{Id.} at 100.
\item\textsuperscript{123} \textit{Id.}
\item\textsuperscript{124} \textit{Id.} at 101.
\item\textsuperscript{125} \textit{Id.} at 102.
\item\textsuperscript{126} 622 F.2d 216 (6th Cir. 1980), aff'd, 456 U.S. 353 (1982). For continued vitality of the definition of common enterprise in the Sixth Circuit, see Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1183 (6th Cir.), \textit{cert. denied}, 454 U.S. 1124 (1981) (loan participation agreement held not a security because it failed the last prong of the \textit{Howey} test, but a common enterprise did exist because the relationship between broker and investors met the criteria of the approach taken in the \textit{Curran} decision); SEC v. Professional Assocs., 731 F.2d 349, 354 (6th Cir. 1984) ("This court . . . has held that there must be a common enterprise between investors, or horizontal commonality . . . [that] ties the fortunes of each investor in a pool of investors to the success of the overall venture."); Hart v. Pulte Homes of Mich. Corp., 735 F.2d 1001, 1004 (6th Cir. 1984) (model home sale-leaseback scheme held not a security because horizontal commonality did not exist between broker and investors); American Bank & Trust Co. v. Wallace, 529 F. Supp. 258, 263 (E.D. Ky. 1981) ("This Court believes that such an arrangement [promissory note] is not sufficient to constitute a common venture due to the lack of a pooling of funds.").
\item\textsuperscript{127} \textit{Id.} at 220.
\item\textsuperscript{128} \textit{Id.}
\item\textsuperscript{129} \textit{Id.}
\item\textsuperscript{130} \textit{Id.} at 224.
\item\textsuperscript{131} \textit{Id.} at 222-25. \textit{See supra} note 61 and accompanying text for criticism of the Seventh Circuit's reasoning.
\item\textsuperscript{132} \textit{Id.} at 223.
Despite the circuit split evident in the *Curran* appeals court opinion, the Supreme Court did not resolve the controversy when it granted certiorari. The defendant argued on review that a private right of action existed under the Commodity Exchange Act. The Sixth Circuit held that such an action did exist, and the Supreme Court agreed. The circuit split on the commonality issue that had to be apparent from the vigorous discussion of horizontal versus vertical commonality in the Sixth Circuit opinion, however, was not mentioned by the Supreme Court.

In the oft-cited Third Circuit district court case of *Wasnowic v. Chicago Board of Trade*, the court also relied extensively on the *Milnarik* opinion and found that because the individual investor discretionary commodity trading accounts involved in the dispute were maintained separately, and because the profits of one investor did not depend on the profits earned by the group as a whole, no horizontal commonality existed. The plaintiff, like those in *Curran*, attempted to show that his broker had actually commingled funds from other accounts in violation of the original agreement and that this produced the requisite pooling of funds for the establishment of

133. *Curran* v. Merrill Lynch, Pierce, Fenner & Smith, 456 U.S. 353 (1982). Before Congress arguably expanded the CFTC's jurisdiction to include all forms of dealings in commodities futures trading, § 2 of the CEA included only specified agricultural commodities. *Id.* at 360. These commodities included wheat, cotton, rice, corn, oats, barley, and other agricultural staples. *Id.* at 360 n.12. The amendments to the CEA in 1974 radically changed § 2 of the Act. *Id.* at 365. It now provides that the CFTC has jurisdiction over "commodities," with that word defined, in relevant part, as:

[All services, rights and interests in which contracts for future delivery are presently or in the future dealt in: *Provided*, That the [CFTC] shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to Section 7 of this title . . . .

7 U.S.C.A. § 2 (West Supp. 1985). This expanded jurisdictional definition allows CFTC regulation of contracts for copper, plywood, metals, the traditional agricultural products, and newer instruments such as heating oil futures. In addition, by using the words "accounts" and "transactions" in its definition, it can be argued that Congress vested exclusive jurisdiction over discretionary commodity trading accounts in the CFTC. *See* Mallen v. Merrill Lynch, Pierce, Fenner & Smith, 605 F. Supp. 1105 (N.D. Ga. 1985); *see also* Johnson, *The Commodity Futures Trading Commission Act: Preemption as Public Policy*, 29 VAND. L. REV. 1 (1976).

137. 352 F. Supp. 1066 (M.D. Pa. 1972). See Salcer v. Merrill Lynch, Pierce, Fenner & Smith Inc., 682 F.2d 459 (3d Cir. 1982) where the court said that a discretionary commodity trading account does not meet the Howey definition of an investment contract because "such an account is not an investment in a common enterprise. Here, as in *Wasnowic*, the investment made by Mr. Salcer was not part of a pooled group of funds and thus does not meet the second part of the Howey test." *Id.* at 460.
horizontal commonality. The court rejected this argument stating that the parties originally intended separation of accounts, and that original intention, as with any other contract, determined the question for the court.

The plaintiff also attempted to distinguish his case from the Milnarik decision on the grounds that his was an action for fraud under the Securities Exchange Act of 1934, while Milnarik involved an alleged registration violation of the Securities Act of 1933. The court did not agree with his argument. Most significantly, the court plainly rejected the plaintiff's contention that the Third Circuit should adopt the vertical commonality standard announced by the Second Circuit in the Maheu and Berman cases. Judge Nealon opined that the Milnarik view was more consistent with that expressed by the Supreme Court in Howey.

As noted earlier, the courts that have adopted the horizontal commonality approach reflect a unity of application of that test, unlike the divergent views of the vertical commonality circuits. The Third and Sixth Circuits relied extensively on the leading Seventh Circuit cases to reach the conclusion that horizontal commonality is necessary to the existence of an investment contract. Each adheres to the principle that a common enterprise must include a pooling of funds among investors united in a common venture before an investment contract will exist. Unlike courts in the vertical commonality circuits, no courts adopting the horizontal approach have modified the Seventh Circuit test for horizontal commonality. The Third, Sixth, and Seventh Circuits also remain united in the belief that this horizontal commonality approach represents a truer reading of the facts of the Howey investment scheme. These circuits contend that the investors in Howey pooled their respective financial resources in one common venture and shared in the profits of that venture on a pro-rata basis.

The holding in these circuits also evidences a desire to limit the number of

139. Id. at 1070.
140. Id.
141. Id. at 1069-70.
142. Id. at 1070.
143. Id. at 1068. See supra notes 80-84 and accompanying text.
144. 352 F. Supp. at 1068. The judge reasoned that the facts in Howey, a group of investors pooling funds in common effort to produce oranges, were closer to horizontal than vertical commonality. Id.
145. The circuits that employ vertical commonality to find a common enterprise are divided over whether the broad view of the Fifth, Eighth, and Tenth Circuits should prevail over the narrower view of vertical commonality in the Ninth Circuit. The Second Circuit remains divided on this point. See, e.g., notes 44-101 and accompanying text.
146. See supra notes 126-44 and accompanying text.
147. See, e.g., supra notes 103, 126, 137, and cases cited therein.
148. See, e.g., Milnarik, discussed supra notes 103-17 and accompanying text.
different investment schemes that could qualify as securities. Together the courts rely on a literal application of the term "common" enterprise. Invoking the Howey admonition that substance should override form and the economic realities of a broker-investor relationship should direct the court's analysis, these circuits contend that the one-on-one vertical commonality relationship reflects only a unitary, agency-for-hire situation.149

This requirement will generally cause trouble for investors in discretionary commodity trading accounts. Often, these accounts are opened with large brokerage firms that handle many other such accounts and it would be very difficult, if investor funds are segregated, to establish the pooling element of horizontal commonality.

III. TOWARD A UNIFORM APPROACH

The Supreme Court's denial of certiorari in the Mordaunt case leaves unchanged the position of investors injured by fraudulent discretionary commodity account trading.150 Depending upon the jurisdiction where the dispute arises, these investors may or may not have the ability to invoke the sanctions and protections of the securities laws against unscrupulous brokers. This unfortunate situation is inconsistent with either the flexible approach to the securities laws desired by the Howey court151 or the broad, remedial purposes Congress intended for the securities laws.152 A resolution of this definitive split in circuits would place discretionary commodity account investors and brokers alike on firm ground, allowing each to predict accurately what the law will require from their relationship. A uniform approach to the determination of whether a common enterprise exists would also spare judges the task of reviewing the confused state of the law each time a discretionary commodity trading account dispute is before the courts. Moreover, clarification of the law will increase judicial efficiency and improve public protection.

A. To Adopt Horizontal Commonality

It may be argued that the horizontal commonality test best adheres to developments in the area of commodities trading and the mandate of the Howey decision. First, because of the limited reach of the Commodities Ex-

149. See, e.g., Curran, discussed supra notes 126-36 and accompanying text.
151. See supra notes 31-41 and accompanying text.
change Act (CEA) of 1935 prior to the 1974 and 1982 amendments to it, discretionary commodity account investors could not reasonably expect to use this law to remedy losses or sue for damages against brokers.\textsuperscript{153} However, with the establishment of the Commodity Futures Trading Commission (CFTC),\textsuperscript{154} the broadening of the scope of the Commodities Exchange Act,\textsuperscript{155} and the Supreme Court's recognition of a private right of action under the CEA,\textsuperscript{156} courts arguably need not stretch the securities laws to encompass discretionary commodity trading accounts.\textsuperscript{157} In fact, a literal reading of the wording of the 1974 amendments to the CEA actually precludes SEC jurisdiction over these accounts.\textsuperscript{158} Former CFTC Chairman Phillip Johnson stated unequivocally that his former agency has sole jurisdiction over discretionary commodity trading accounts.\textsuperscript{159} Some district courts have interpreted the amendments in the same way.\textsuperscript{160} In addition, Congress created the CFTC with broad powers to register and to regulate commodities brokers.\textsuperscript{161} At least two commentators have suggested that

\textsuperscript{153} See supra note 133.


\textsuperscript{155} See supra note 133.


\textsuperscript{157} Note, Discretionary Accounts, 32 U. MIAMI L. REV. 401 (1977) (author argues that the need for the securities laws to cover discretionary commodity trading accounts has lessened as a result of the developments in commodities laws and regulations). Id. at 413.

\textsuperscript{158} See supra note 133.

\textsuperscript{159} 2 P. JOHNSON, COMMODITIES REGULATION at 50. "The [CFTC] staff has taken the position that discretionary commodity accounts are within the exclusive jurisdiction provision of section 2(a)(1)."

\textsuperscript{160} See Mallen v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 605 F. Supp. at 1114. [J]udicial application of a securities statute to a commodity transaction would force careful commodity brokers to see that the investment vehicle is registered as if it were regulated by the SEC at the same time that the board of exchange is seeking approval as a contract market under actual regulation by the CFTC. This judicial creation of a dual system of regulatory compliance is antithetical to the congressional purpose in creating the CFTC.


\textsuperscript{161} See generally 2 P. JOHNSON, COMMODITIES REGULATION (1982) (author describes the reach of the CFTC regulatory sphere, wherein the CFTC provides an administrative arbitration procedure for injured investors). The agency's jurisdiction extends to include all commodities, id. at 34, trading professionals, id. at 35, leverage contract merchants, id. at 37, and commodity trading advisors and commodity pool operators, id. at 51, among others. Its rules
these CFTC procedures provide sufficient relief to an injured discretionary commodity account investor.\textsuperscript{162} Presumably such an investor could now bring an action against a broker or brokerage house either directly under the CEA or impliedly through the private right of action under the Act recognized by the Supreme Court in Curran.\textsuperscript{163} In fact, it could be argued that investors need not even allege the existence of an investment contract when seeking a remedy for fraud or other abuse of their discretionary commodity trading account because of the opportunity to seek relief through a private right of action under the CEA. Investors can seek compensatory damages, as they can under the 1933 and 1934 securities laws.

In addition to developments suggesting a lessened need to expand the scope of the securities laws to encompass discretionary commodity trading accounts, the horizontal commonality requirement may reflect a truer reading of the factual situation presented to the Supreme Court by the Howey citrus investment plan. In Howey, investors joined together in common venture in one citrus grove directed by one promoter.\textsuperscript{164} The venture generated profits through the pooling of the harvest from all of the investors' parcels of land with profits distributed back to the investors according to their contribution to the overall success of the harvest.\textsuperscript{165} The Milnarik and Hirk decisions relied heavily on these facts to reach the conclusion that a common enterprise could not exist without a pooling of funds.\textsuperscript{166}

The Howey court also emphasized that courts should review the economic realities of an investment scheme rather than its form when identifying a common enterprise.\textsuperscript{167} In Howey, the individual investors could not, in a practical sense, have used the miniscule fractions of land that they actually owned to earn a profit.\textsuperscript{168} Instead, each small plot became economically viable only when joined with the plots of all of the other investors and the promoter in a common venture involving a 500-acre citrus grove.\textsuperscript{169} It would seem reasonable, then, to conclude as the horizontal commonality circuits have, that a pooling of investor funds in a common venture must be

\begin{itemize}
\item regulate day-to-day operations of the commodity exchanges including recordkeeping and reporting rules, \textit{id.} at 64, customer funds segregation, \textit{id.} at 63, expertise standards, \textit{id.} at 66, and ethical standards, \textit{id.} at 72.
\item See \textit{supra} discussion at notes 133-36 and accompanying text.
\item \textit{Id.}
\item See \textit{supra} notes 103-25 and accompanying text.
\item \textit{Id.} at 103-25.
\item See \textit{supra} note 33 and accompanying text.
\item \textit{Id.}
\item \textit{Id.} at 103-25.
\item See \textit{supra} note 33 and accompanying text.
\item \textit{Id.} at 300.
\end{itemize}
present before a common enterprise can exist.\textsuperscript{170} The \textit{Howey} factual situation does not suggest explicitly that a one-on-one investor-broker relationship could meet the criteria for a common enterprise.

As one commentator has noted, the \textit{Howey} decision does not suggest that one investor should receive less access to the securities laws than a group of investors, nor does the Seventh Circuit, in its leading cases on the subject, adequately address this issue.\textsuperscript{171} Yet, if horizontal commonality becomes the uniform requirement for an investment contract, this untenable position would relegate individual discretionary commodity account investors to second class status. If they are not members of a larger group of investors whose funds are pooled together, then they could not avail themselves of the remedies available under the federal securities laws.

However, given the broader protections afforded investors by the expanded reach of the commodities laws and regulations of the CFTC, and the literal reading of the facts in the \textit{Howey} investment scheme suggesting that a multiplicity of investors and pooling of funds must exist for the establishment of a common enterprise, it could be reasoned that the horizontal commonality approach of the Third, Sixth, and Seventh Circuits presents the view that the Supreme Court should adopt to resolve the split in circuits. However, stronger reasons exist to the contrary.

\textbf{B. To Adopt the Vertical Commonality Approach}

While the leading opinions of the circuits that adopt horizontal commonality state that their approach adheres to the remedial purposes intended for the securities laws, it nonetheless remains true that an injured investor will find it out of the ordinary that horizontal commonality will exist in a discretionary commodity trading account.\textsuperscript{172} With this in mind, it is difficult to understand why such a restrictive definition of common enterprise can be interpreted to be closer to the Congress' intended purposes for the securities laws or to the flexible approach the \textit{Howey} court envisioned for its definition of investment contract.\textsuperscript{173} The \textit{Howey} court specifically stated that it favored flexibility to strict formulae because investment promoters could always find new schemes to circumvent the latter.\textsuperscript{174} Discretionary commodity trading account brokers need only keep investor funds segre-

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{170} The \textit{Howey} court overturned lower court rulings that held pooling necessary. \textit{Howey}, 328 U.S. at 294.\textsuperscript{171} See Comment, \textit{Securities: Defining Investment Contracts—Alternatives for Arizona}, 1984 \textit{Ariz. St. L.J.} 489, 500.\textsuperscript{172} See Bromberg, supra note 2, at 248.\textsuperscript{173} See supra notes 31-43 and accompanying text.\textsuperscript{174} \textit{Howey}, 328 U.S. at 299-301.
\end{enumerate}
\end{footnotesize}
gated to defeat the horizontal commonality requirement. In contrast, the broad definition of vertical commonality adopted by the Fifth, Eighth, and Tenth Circuits would encompass any investment scheme that would meet the horizontal commonality requirements as well as almost any investor-broker relationship in a discretionary commodity trading account. This broad-minded approach surely adheres more closely to the remedial purposes of Congress and the flexible approach of the *Howey* court.

In addition, the requirements for vertical commonality actually track the factual situation of the *Howey* citrus investment scheme more closely than the criteria for its counterpart, horizontal commonality. As a district court in the Second Circuit pointed out in *Maheu*, the *Howey* decision specifically overturned lower court rulings that stated pooling of funds must be present before an investment contract can exist. The Supreme Court in *Howey* made no mention of a pooling requirement.

Moreover, investors in *Howey* received their share of the profits based on the fruit harvested from their individual fractions of land. An investor could then succeed or fail based on his individual part of the harvest without the concomitant success or failure of any other investor or the promoter. A poor harvest on one investor's parcel of land would not affect the profits earned by the other investors or the promoter. This strongly suggests that the formulation of vertical commonality by the Ninth Circuit runs contrary to the actual facts of *Howey*. The Ninth Circuit requires that the success or failure of both investor and promoter must be interwoven in order to recognize a common enterprise. Similarly, in *Hirk* the Seventh Circuit suggested that such interdependence may be necessary. The broader definition of vertical commonality employed in the Fifth, Eighth, and Tenth Circuits represents a more consistent approach given the remedial intent of Congress in enacting the securities laws and the broad application of them envisioned in *Howey*. The Ninth Circuit's more restrictive approach is consistent with neither.

Another factor that suggests the adoption of the broad definition of vertical commonality as a uniform approach is that the Securities Act of 1933 and the Securities Exchange Act of 1934 together represent more than one hundred years of a developed body of law, as opposed to the relatively new jurisdiction granted to the CFTC. Persons injured at the hands of unscrupu-

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176. *See supra* note 35 and accompanying text.
177. *Howey*, 328 U.S. at 296.
178. *See supra* notes 44-54 and accompanying text.
179. *See* the discussion of *Hirk*, *supra* notes 118-25 and accompanying text.
lous discretionary commodity account brokers can bring actions under the securities laws which are more familiar to the courts, possibly resulting in more predictable outcomes than those in actions brought under the commodities laws. In addition, the deterrent effect on fraudulent practices that would develop from potential dual liability under both the securities and commodities laws could also aid the investor. This is particularly true for discretionary commodity account investors given the complexities of the volatile commodities futures markets that make misrepresentation and fraud much easier to perpetrate against an unwary investor.

IV. CONCLUSION

The sanctions, protections, and remedies of the 1933 and 1934 securities laws are available to discretionary commodity trading account investors if they can demonstrate that their accounts are investment contracts. The Supreme Court has enunciated a three-part test to determine the existence of an investment contract. A deep federal circuit split, however, has developed over the second element of that three-part test—the definition of a common enterprise. The Fifth, Eighth, and Tenth Circuits have established that promoter dominance over investor funds or a broad vertical commonality will suffice to create a common enterprise. On the other hand, the Third, Sixth, and Seventh Circuits require that a pooling of funds of multiple investors or horizontal commonality, must exist to establish a common enterprise. The Ninth Circuit stands alone with a restrictive definition of vertical commonality that requires the broker and the investor to be mutually dependent upon one another for profits and losses. This circuit split places discretionary commodity trading account investors in a difficult position.

The Supreme Court should grant certiorari to a case involving whether discretionary commodity trading accounts constitute investment contracts and resolve the deep circuit split that has developed over the common enterprise element of the definition of such a contract. The settlement of this dispute would aid the courts, practitioners, and investors alike. It would also resolve the ongoing dispute between the SEC and CFTC concerning jurisdiction of these accounts.

To best serve the interest of public protection and the remedial purposes intended for the securities laws by the Congress, the Court should resolve this split in favor of the broad definition of vertical commonality espoused by the Fifth, Eighth, and Tenth Circuits. This definition provides investors the greatest access to the remedies provided by the securities laws. While a private right of action under the CEA does exist and commodity brokers might be liable under both the CEA and the securities laws, it would be preferrable
for investors to be able to use the threat of dual liability to deter fraud. The broad definition of vertical commonality also provides the most flexibility to encompass the broadest range of investment schemes and avoids the pitfalls inherent in the developments of a strict formula, warned against more than forty years ago in the *Howey* decision.

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