Discretionary Trading Accounts in Commodity Futures Are Not Securities Absent Horizontal Commonality

Follow this and additional works at: http://openscholarship.wustl.edu/law_lawreview

Recommended Citation
Discretionary Trading Accounts in Commodity Futures are Not Securities Absent Horizontal Commonality


In the current split of authority over the scope of the federal securities laws, the Sixth Circuit Court of Appeals in Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.1 sided with those courts holding that a discretionary trading account2 in commodity futures3 is not a security.4

Plaintiffs invested in a discretionary5 trading account program that

---

2. “Typically, a customer trading in a discretionary commodity account gives the broker authority to buy and sell at the broker’s discretion, without prior consultation with the customer. Discretionary accounts are more common for commodities where fast trading is required due to sharp movement in prices . . . .” 622 F.2d at 221. For a discussion of discretionary trading accounts, see H. BINES, THE LAW OF INVESTMENT MANAGEMENT 3-47 to 3-48 (1978).
3. “A commodity future is a standardized contract for the purchase and sale of a fixed quantity of a commodity to be delivered in a specified future month at a price agreed upon when the contract is entered into.” 622 F.2d at 220 (citing A. BROMBERG, SECURITIES LAWS § 4.6 at 82.181 (1975)).
4. Section 2(1) of the Securities Act of 1933 defines security as follows:
   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, 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.
Section 3(a)(10) of the Securities Exchange Act of 1934 defines security in similar terms:
   The term “security” means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.
5. Merrill Lynch claimed that the account was in fact non-discretionary, but conceded that for purposes of the appeal it must be viewed as discretionary. 622 F.2d at 220. Courts are in general agreement that non-discretionary trading accounts are not securities. See, e.g., SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 485 (5th Cir. 1974); E.F. Hutton & Co. v. Burkholder,
had certain unique elements.\textsuperscript{6} After losing a substantial amount of money, plaintiffs filed suit under both state and federal securities laws charging Merrill Lynch with violating the registration requirements of the Securities Act of 1933,\textsuperscript{7} and the antifraud provisions of the Securities Exchange Act of 1934,\textsuperscript{8} SEC rule 10b-5,\textsuperscript{9} and the Michigan Uniform Securities Act.\textsuperscript{10} They claimed that the account program was an investment contract and qualified as a security under the Securities Act\textsuperscript{11} and the Securities Exchange Act.\textsuperscript{12}

The Sixth Circuit affirmed the district court's partial summary judgment\textsuperscript{13} for defendants and \textit{held}: A discretionary trading account in commodity futures is not a security absent a pooling of investor's interests.\textsuperscript{14}

The rapid growth\textsuperscript{15} of the commodity futures market has led to a significant increase in the number of dissatisfied investors seeking redress.\textsuperscript{16} Many of these cases state causes of action under the federal

\begin{footnotes}
\footnote{622 F.2d at 220. Specifically, Merrill Lynch's "Guided Commodities Account Program" involved three significant elements: (1) the investors could not withdraw from the program for eighteen months, (2) a single broker would direct the trading for the entire group of accounts, and (3) the effect on the market of having control over all the accounts in the program would be greater than if trading was based only on individual accounts. For the significance of these elements, see notes 78-81 \textit{infra} and accompanying text.}
\footnote{15 U.S.C. \textsection 77e (1976).}
\footnote{15 U.S.C. \textsection 78j (1976).}
\footnote{17 C.F.R. \textsection 240.10b-5 (1980).}
\footnote{15 U.S.C. \textsection 77b(1) (1976).}
\footnote{15 U.S.C. \textsection 78c(a)(10) (1976).}
\footnote{622 F.2d at 236-37. The court affirmed the partial summary judgment and reversed and remanded the order staying plaintiff's fraud claims under the Commodity Exchange Act. Subsequently, the United States Supreme Court granted certiorari on the issue of whether an implied private right of action exists under the Commodity Exchange Act. 101 S. Ct. 1971 (1981). For a review of the Sixth Circuit's reasoning on the implied right of action issue, see 22 \textsc{Wm. & Mary L. Rev.} 579 (1981).}
\footnote{622 F.2d at 222. \textit{See} note 55 \textit{infra} and accompanying text.}
\footnote{In fiscal 1978 the number of reparations complaints docketed by the Commodity Futures Trading Commission totaled 312, compared with 1,401 for fiscal 1980. \textsc{CFTC Ann. Rep.} 140 (1978).}
\end{footnotes}
securities laws because the investor protection is broader and violations are easier to prove\textsuperscript{17} than under the Commodity Exchange Act of 1933, as amended by the Commodity Futures Trading Commission Act of 1974.\textsuperscript{18} When seeking a remedy under the securities laws, an investor injured through a discretionary trading account must show that the account is an investment contract subject to the securities laws.\textsuperscript{19} The
securities laws contain no statutory definition of “investment contract.” Thus, the courts must interpret the term.20

In SEC v. W.J. Howey Co.,21 the Supreme Court defined an investment contract as a transaction in which the person invests in a “common enterprise” with the expectation that profits will result solely from the efforts of a broker or promoter.22 The Court did not elaborate on the requirement of a “common enterprise;” consequently, sharp differences of opinion exist as to what the term means.23

The courts have posited two approaches to the Howey commonality test.24 One approach25 is that discretionary trading accounts26 are se-

---

20. SEC v. W.J. Howey Co., 328 U.S. 293 (1946). "By including an investment contract within the scope of § 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by ... prior judicial interpretation." Id. at 298.

21. Id. at 293.


The Supreme Court had confronted the issue of defining a security prior to Howey in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943). In that case, the Court reasoned that the scope of the securities laws was not limited to the “obvious and commonplace”:

Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as “investment contracts,” or as “any interest or instrument commonly known as a ‘security.’”

Id. at 351.


25. Courts using the vertical commonality approach have relied primarily on Joiner and Howey as precedent. For an overview of state and federal cases defining “investment contract” prior to the enactment of the Securities Act and Securities Exchange Act, see Long, An Attempt to Return “Investment Contracts” to the Mainstream of Securities Regulation, 24 OKLA. L.REV. 135, 146-59 (1971). See also Note, Discretionary Commodity Accounts as “Securities”: Applying the Howey Investment Contract Test to a New Investment Medium, 67 GEO. L.J. 269, 283-85 (1978) (discussion of state court decisions cited in Howey). The state court decisions relied on in Howey support the argument that it is not essential for an investment contract to include an actual pool-
securities if a vertical commonality requirement is met.\textsuperscript{27} The District Court for the Southern District of New York in \textit{Maheu v. Reynolds & Co.}\textsuperscript{28} was the first to apply the vertical commonality approach. The \textit{Maheu} court, citing \textit{Howey} in support of its conclusion, considered the “vertical” relationship between investor and broker as determinative.\textsuperscript{29} The court held that even without a pooling of funds or common enterprise among investors, a joint account qualified as a security.\textsuperscript{30} In 1973 the Ninth Circuit adopted the vertical commonality approach, defining a common enterprise as an investment in which the investor depends on the efforts of the broker for its success.\textsuperscript{31} The Fifth Circuit subsequently adopted this definition in \textit{SEC v. Koscot Interplanetary, Inc.}\textsuperscript{32}
and SEC v. Continental Commodities Corp.\textsuperscript{33} Noting the purposes of the Securities Act and the Securities Exchange Act,\textsuperscript{34} the Koscot court stated that a literal reading of the Howey test would frustrate these acts' remedial purposes.\textsuperscript{35} In Continental Commodities the court stated that the inquiry should focus on whether the success of the investment is dependent upon the expertise of the broker.\textsuperscript{36}

A significant number of courts reject the vertical commonality approach and require horizontal commonality among investors before treating a discretionary trading account as a security.\textsuperscript{37} The Seventh Circuit Court of Appeals decided in Milnarik v. M-S Commodities, Inc.\textsuperscript{38} that the discretionary trading account in question was not a security subject to the registration requirements\textsuperscript{39} of the Securities Act.\textsuperscript{40} The court held that the element of commonality required by the Howey test was absent\textsuperscript{41} in an account in which the broker traded for commodity futures on margin.\textsuperscript{42} Although the investment broker in Milnarik


\textsuperscript{34} The legislative history of the securities laws clearly indicates the remedial purposes behind their enactment. See S\textsc{enate} C\textsc{omm.} on B\textsc{anking & C\textsc{urrency}}, S\textsc{ecurities R\textsc{egulation}, S. R\textsc{ep. No.} 47, 73d C\textsc{ong., 1st S\textsc{ess.}} 1 (1933). See also International Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946); Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 622 F.2d 216, 223 (6th Cir. 1980), cert. granted, 101 S. Ct. 1971 (1981).

\textsuperscript{35} SEC v. Koscot Interplanetary Inc., 497 F.2d 473, 480 (5th Cir. 1974).

\textsuperscript{36} SEC v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir. 1974).


\textsuperscript{38} 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972).


\textsuperscript{40} 457 F.2d at 279.

\textsuperscript{41} Id. at 276.

\textsuperscript{42} A margin account is the security industry's method of extending credit to customers. Under this practice, the customer—investor—purchases a specified amount of stock from the securities firm by advancing only a portion of the purchase price, while the brokerage firm extends credit for the balance due on the stock's purchase price. The firm holds the stock as collateral for
represented a group of investors, each contract between the broker and the individual investor was independent of any other contract.\textsuperscript{43} The \textit{Milnarik} court insisted that a pooling of funds and a pro rata distribution of profits among the several investors was necessary to establish a common enterprise.\textsuperscript{44}

In 1977 the Seventh Circuit reaffirmed \textit{Milnarik} in \textit{Hirk v. Agri-Research Council, Inc.}\textsuperscript{45} Rejecting the argument that a strict commonality requirement is inconsistent with the remedial purposes of the securities laws,\textsuperscript{46} the court stated that even if the broker had treated the investors' funds "as if commingled," an actual pooling must occur to satisfy the common enterprise requirement.\textsuperscript{47} The \textit{Hirk} court explained that without actual pooling, the success or failure of each account was independent of the other accounts, and therefore a common enterprise did not exist.\textsuperscript{48}

In \textit{Curran v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}\textsuperscript{49} the Sixth Circuit confronted a discretionary trading account similar to the one involved in \textit{Milnarik}. Using the three-part \textit{Howey} definition of an in-

---

\textsuperscript{43} 457 F.2d at 277. "In essence, this contract creates an agency-for-hire rather than constituting the sale of a unit of a larger enterprise." \textit{Id.} (quoting from the district court's opinion, 320 F. Supp. 1149, 1151 (N.D. Ill. 1970)).

\textsuperscript{44} 457 F.2d at 278.

\textsuperscript{45} 561 F.2d 96 (7th Cir. 1977).

\textsuperscript{46} \textit{Id.} at 100.

\textsuperscript{47} \textit{Id.} at 101.

\textsuperscript{48} \textit{Id.} "[Plaintiffs'] effort to sidestep [the unitary nature of each account] by stressing . . . that substantially similar transactions were made in all accounts and that profits or losses ebbed or flowed uniformly also fails because the necessary pooling remains unshown." \textit{Id.}

Relying primarily on the reasoning of the Seventh Circuit in \textit{Milnarik}, the Third Circuit Court of Appeals also has required horizontal commonality. \textit{See} \textit{Wasnowic v. Chicago Bd. of Trade}, 352 F. Supp. 1066 (M.D. Pa. 1972), \textit{aff'd mem.}, 491 F.2d 752 (3d Cir. 1973). "As in \textit{Milnarik}, nothing in the instant complaint suggests the type of common enterprise or pooling of funds for a common purpose required to convert the discretionary account plaintiffs had . . . into a statutory security." \textit{Id.} at 1069. Plaintiffs in \textit{Wasnowic} claimed, \textit{inter alia}, that the broker fraudulently commingled the investors' funds and that this satisfied the common enterprise requirement. \textit{Id.} at 1070. The court held that a unilateral fraud, in view of what the parties had originally intended, did not constitute an investment contract subject to the securities acts. \textit{Id.} at 1070-71.


---

Washington University Open Scholarship
vestment contract,50 the Curran court affirmed the district court's application of horizontal commonality as posited by the Seventh Circuit in Milnarik. The court, expressly rejecting the Fifth Circuit ruling in SEC v. Continental Commodities Corp.,51 reasoned that a mere showing of vertical commonality between investor and broker is inconsistent with the Howey common enterprise requirement.52 The court agreed with the conclusion reached by the Southern District of Ohio53 that without a finding of horizontal commonality the common enterprise requirement of Howey is "effectively excise[d]."54 The Curran court insisted that in addition to vertical commonality, a relationship must exist between the investors themselves such that each investment is tied to the success of the group enterprise.55

The court recognized a significant distinction between the factual allegations in Milnarik and those in Curran. Plaintiffs in Curran claimed that Merrill Lynch fraudulently promised to place their investments in a common enterprise with other accounts in the program.56 They argued that the unfulfilled promise was sufficient to bring this account within the definition of a security.57 The court rejected the argument because each customer knew from the outset that their individual return would depend only on a "one-to-one" vertical relationship with

---

50. Id. at 221. "It is universally recognized that the Howey test is comprised of three basic elements: (1) an investment of money, (2) in a common enterprise, with (3) profits to come solely from the efforts of others." Id. Some commentators have preferred to use a four-part test requiring the following: (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of the promoter or a third party. See, e.g., 3 H. Bloomenthal, Securities and Federal Corporation Law § 2.04, at 2-14 (1974); Bonnett, supra note 23, at 341; Coffey, The Economic Realities of a "Security": Is there a More Meaningful Formula?, 18 Case W. Res. L. Rev. 367, 373 (1967); Long, supra note 25, at 142.
51. 497 F.2d 516 (5th Cir. 1974). See note 33 supra and accompanying text.
52. 622 F.2d at 224.
55. 622 F.2d at 224. Although the court did not explain precisely the nature of the required relationship, the implication is that an actual pooling of investors' funds (with a corresponding pro-rata share of profits) is necessary. See note 44 supra and accompanying text.
56. 622 F.2d at 224.
57. Id. The Milnarik court did not make clear whether an allegation of fraudulent broker conduct would have resulted in a more favorable disposition of the case for plaintiffs. At least one court, addressing a similar issue, held that the broker's unilateral fraud in handling accounts was not sufficient for a finding of the required common enterprise. See note 48 supra and accompanying text. Nevertheless, plaintiffs in Curran claimed that the fraudulent promise by the broker to form a "common enterprise" was sufficient to find an investment contract security.
the broker rather than on a horizontal relationship between their account and those of other investors. The court thus required an actual pooling of investor capital. An unfulfilled promise by the broker to pool investor capital did not suffice to qualify the account as an investment contract in a common enterprise.

The current split of authority as to whether commodity trading accounts satisfy the Howey test calls for a response from the Supreme Court or clarifying legislation. Sound arguments exist for both the vertical and the horizontal commonality approaches. The vertical commonality approach, which emphasizes the need for a resilient standard, finds indirect support in several Supreme Court decisions. Furthermore, the remedial purposes underlying the federal securities laws and the need for greater investor protection are persuasive reasons to apply a flexible standard.

The horizontal commonality approach, on the other hand, adheres

58. 622 F.2d at 225.
59. See note 55 supra.
60. The deposition of a customer account executive at Merrill Lynch stated that although plaintiff's account may have been handled independently of other accounts in the program, the description of the program given to plaintiffs was such that an expectation of a common enterprise on their part was understandable. 622 F.2d at 225.
61. Id.
65. See generally Hudson, Customer Protection in the Commodity Futures Market, 58 B.U. L. REV. 1 (1978) (protection offered under the CFTC). See also Bromberg, supra note 17; Note, supra note 33.
more closely to the test enunciated in Howey.66 The requirement of an actual pooling of funds and pro-rata profit-sharing provides a clear cut rule for determining the existence of a security.67 In addition, courts adopting horizontal commonality68 have noted correctly the increasing scope of protection offered by the Commodity Exchange Act and the Commodity Futures Trading Commission Act.69

Commentators have suggested, however, that a close reading of the Howey opinion reveals faults inherent in both standards.70 The flexibility of the vertical approach depends on a de-emphasis, if not actual elimination, of the common enterprise requirement.71 The restrictive requirement of horizontal commonality fails to provide needed protection for investors in a rapidly expanding and increasingly complicated market.72 The pyramid scheme cases confronted by the Fifth and Ninth Circuits73 illustrate the susceptibility of unsophisticated investors to imaginative and potentially disastrous investment schemes.74

Until the Supreme Court clarifies its position or Congress enacts ap-

66. See, e.g., Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972). See also Bines, supra note 18 (author contended that logic underlying vertical commonality is strained). But see Bromberg, supra note 17, at 225-26; Note, supra note 33, at 411-14.

67. See Tew & Freedman, supra note 62, at 448. "Howey has certain superior qualities, one of which is certainty." Id.

68. See cases cited at note 37 supra.


70. See, e.g., Bonnett, supra note 23, at 366. Referring to the horizontal commonality approach, the author stated that "[p]roviding a simple checklist of elements that make up an investment contract is counterproductive." Id. But see Note, supra note 27, at 340-41. "[O]ne problem with [the vertical commonality] approach is that such an interpretation [of Howey] presupposes the idea that the common enterprise element of the test is mere surplusage and need not be treated as a distinct element." Id.

71. See Bonnett, supra note 23, at 366. [It] seems sufficient to recommend that courts confronted with common enterprise arguments should avoid a dogmatic four-part checklist approach to the necessary factual analysis. If the other parts of the Howey test are present, the lack of a "common enterprise" should rarely defeat the finding of an investment contract. Id. (emphasis added). Thus, the author favorably viewed the virtual elimination of the common enterprise requirement of Howey.

72. See, e.g., Bromberg, supra note 17.

73. See note 32 supra.

propriate legislation, courts must pay particular attention to the factual elements peculiar to each case. 75 Failure to account for subtle but significant differences in the various investment agreements may result in an excessively rigid application of the Howey test. 76 The Howey court recognized and warned against the potential results associated with failing to appreciate the remedial nature of the securities laws. 77 The uncertainty in the courts is the necessary result of inadequate definitions in both Howey and the securities acts.

The Sixth Circuit's strict application of Milnarik is misplaced. The Curran plaintiffs, unlike those in Milnarik, alleged that Merrill Lynch promised to place their investments in a common enterprise. 78 Because plaintiffs were unable to withdraw their investments for a specified period of time, an ostensible, if not actual, pooling of funds occurred. Merrill Lynch's plan for using this arrangement was to allow the broker's trading to have a greater effect on the market than if each account was fully independent. To a certain extent, therefore, the fortunes of the investors were tied to each other, 79 for the greater the effect on the market, the greater the possibility for success (or failure) of the group as a whole. The court, however, failed to adequately address this issue by insisting on an actual pooling of investor capital. 80 A less rigid approach would recognize that if the inducements offered for investing in such an arrangement are fraudulent, then the remedies afforded under the securities acts are more appropriate than those under the amended Commodity Exchange Act.

The Curran opinion fails to provide an analysis of important aspects

75. See, e.g., Long, supra note 25, at 139.
76. See, e.g., notes 78-81 infra and accompanying text.
77. SEC v. W.J. Howey Co., 328 U.S. 293 (1946). "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic or irrelevant formulae." Id. at 301. See also Long, supra note 25, at 139-46.

[In spite of the admonishments of the early courts and even the Supreme Court itself against the crystallization of irrelevant formulas, the courts have created a fixed and arbitrary definition of investment contract which they are showing great reluctance to abandon in the face of increased evidence of the need for public protection which an expanded definition could afford.

Id. at 139-40 (footnotes omitted).
78. 622 F.2d at 224.
79. Id. See Maheu v. Reynolds & Co., 282 F. Supp. 423, 429 (S.D.N.Y. 1967). "The joint account may constitute a security even if there was no pooling arrangement or common enterprise among investors." Id.
80. See Note, supra note 33, at 411 n.53.
81. 622 F.2d at 222-24.
of the current debate over whether a discretionary trading account in commodity futures qualifies as a security. Curran merely adds to the conflict among the courts on this important issue.

R.E.T.