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THE NAKED COMMODITY OPTION CONTRACT AS A SECURITY

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A new investment concept, the naked commodity futures option contract, has swept the country over the past two years.¹ Although ostensibly representing an option to buy or sell underlying commodity futures contracts, the naked option contract is in substance nothing more than

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1. A careful distinction should be drawn between the naked commodity option contract and the even newer *stock* option contract presently being offered to the public by a subsidiary of the Chicago Board of Trade. There is no question that the *stock* option contract is a security. See SEC Rule 12a-6, 38 Fed. Reg. 11449 (1973); Proposed SEC Rule 9b-1, SEC Securities Exchange Act Release No. 10397, CCH FED. SEC. L. REP. ¶ 79,517 (Sept. 21, 1973). The definition of a security in section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970), specifically provides that any right to purchase a security is itself a security. Clearly, what the purchaser of a stock option receives is the right, for a specific period of time, to purchase or sell the underlying stock at a fixed price. Such an option, therefore, is a right to purchase a security and, by definition, itself a security. See 1 H. BLOUMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW, § 2.21 (1972); 1 L. LOSS, SECURITIES REGULATION 467-69 (2d ed. 1961). Whether the commodity futures contracts underlying, or ostensibly underlying, commodity option contracts are themselves securities remains, to an extent, unsettled. See notes 75-97 *infra* & accompanying text. For discussion of stock option contracts, see 1971 Op. ATT'Y GEN. (Ga.) 141; H. FILER, UNDERSTANDING PUT AND CALL OPTIONS (1959); Gates, *The Developing Option Market: Regulatory Issues and New Investor Interest*, 25 U. FLA. L. REV. 421 (1973).

a bet between the investor and his dealer that the price of a given commodity future will rise or fall during a particular time period. The label "naked" is applied because dealers in such options do not maintain adequate inventories of the underlying futures and there generally is no intent that they will ever change hands. The device, therefore, is quite unlike conventional commodity option contracts, which normally do involve the actual exchange of the underlying commodity futures contracts upon exercise of an option.

As with many speculative investment schemes, the market in naked commodity option contracts offers many hidden dangers for the unwary investor. Unfortunately, protection has not been forthcoming, primarily because the courts have been unable or unwilling to ascertain the important differences between conventional commodity options, which at least arguably do not exhibit the characteristics of securities, and the new naked option contracts, which clearly should be classified as securities and regulated accordingly under state and federal law.

There not only is a manifest need to regulate the purchase and sale of naked commodity options but also numerous theories under which regulation may be accomplished within the framework of existing securities legislation. The various arguments that the naked commodity option falls within the definition of a security in state and federal legislation require an understanding of the unique characteristics of this new investment device. It is thus necessary initially to examine the mechanics of the commodity option market, the historical background of commodity options, and the differences between naked options and the conventional option contract.

THE NAKED COMMODITY OPTION TRANSACTION

Theoretically, the mechanics of commodity option transactions are quite simple. The purchaser, for a fee,² receives from the option seller

2. This fee is known as the "premium" and is normally set by the option seller without negotiation with the purchaser. In some cases it appears that dealers charge "all the market will bear." See Higashi, A Report to the Honorable Frank J. Healy, Corporation Commissioner, State of Oregon, On Commodity Put and Call Operations 1 (undated, issued Spring 1972). Other dealers indicate that the premium is at least in part based upon the length of time the option is to be outstanding—the longer the option, the higher the premium. It has been estimated that premiums constitute from five to 15 percent of the current value of the underlying commodity futures contracts. See First Federated Commodity Option Co., *The Power of Commodity Options* 2 (undated, issued Spring 1973). Harold Goldstein has indicated that 30 percent of the premium price covers selling charges. BARRON'S, Mar. 5, 1973, at 5, col. 3.

the contract right to buy from, or sell to, the grantor the underlying commodity futures contracts at a fixed price (the "striking price"³) at any time during the life of the option. The option period is usually fixed, ranging anywhere from one month to a year or 18 months.⁴ If the purchaser buys an option to *sell* the underlying commodity futures to the option seller, the option contract is known as a *put*. If, on the other hand, the option is to *buy* futures contracts, then it is known as a *call*. It is also possible for the purchaser to buy both a put and a call on the same commodity at the same time; such a purchase is referred to as a *straddle*, or, more commonly, simply as a double option.⁵

The purchaser of a call theoretically makes his profit when the market for the underlying commodity futures rises. If this occurs, he exercises his option, purchasing the commodity futures contracts from the seller of the option at the striking price and reselling them in the open market; his profit is the difference between the striking price and his selling price, less the fee he paid for the option.⁶ In the case of a put, the option purchaser is betting that the market for commodity futures contracts which he holds will fall. If his hopes are realized, he delivers the contracts to the option seller and receives the striking price; his profit derived from the option is the difference between the striking price and the market price at the time he exercises the option, less the option premium.

Historical Development

Commodity option contracts, in various forms, have been present in the financial marketplace for a number of years. Before 1934, contracts on domestic commodities, such as wheat and cotton, were traded ex-

3. The "striking price" is normally the market price of the underlying commodity futures contract on the day that the option contract is sold. Higashi, *supra* note 2, at 2.

4. *Id.*

5. *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). See also Cal. Corp. Comm'n Release No. 29-C, 1 BLUE SKY L. REP. ¶ 8679 (Feb. 8, 1973).

6. The mechanics of this procedure may be illustrated by the following example. Assume that on September 1, Mr. Brown, expecting the price of silver to rise, paid \$1,200 for a one-year call option on a December New York Silver contract with a striking price of \$1.50 an ounce. If, during the year, the price of December New York Silver rises to \$1.80 an ounce, Mr. Brown can obtain a return of \$0.30 an ounce by buying at his contract striking price of \$1.50 an ounce from the option dealer and then selling at \$1.80 an ounce on the open market. If the underlying contract calls for 10,000 ounces, Mr. Brown would recover his capital and realize an \$1,800 net profit. If, however, Mr. Brown had exercised his call option when the market price was only

tensively on the major American exchanges. In that year, however, the Commodity Exchange Authority banned trading in options on domestic commodities because of the abuses which had developed in the commodity option market.⁷ Trading in international or worldwide commodities, including silver, silver coins, platinum, cocoa, plywood, copper, coffee, and world sugar, was not affected, since such items are not subject to the CEA's jurisdiction.⁸

For many years commodity option contracts also have been traded on the London market,⁹ although the London contracts have never achieved popularity in this country. In addition, there are several metal companies, such as the Mocatta Metals Corporation, which have issued commodity options in the United States,¹⁰ but they too have not received widespread investor acceptance.

A new breed of commodity options which has proved quite popular in this country was the ingenious or misguided, depending upon one's point of view, creation of Harold Goldstein, the founder of the largest of the new naked commodity option firms. Beginning April 28, 1971, Mr. Goldstein parlayed, in less than two years, an investment of only \$800 into Goldstein Samuelson, Inc.,¹¹ a corporation with more than 100 outlets throughout the world selling over 175,000 options valued at \$88 million.¹² As a result of the phenomenal success of this enterprise,

\$1.60 an ounce and sold the underlying contract for the same price, he would have suffered a net loss of \$200. See Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, *SEC v. Goldstein Samuelson, Inc.*, Civ. A. No. 73-472 (C.D. Cal. Oct. 11, 1973) [hereinafter cited as Stipulation].

7. See *The Wall Street Journal* (SW ed.), Feb. 22, 1973, at 1, col. 1.

8. There have been suggestions that trading in options on these commodities be brought under the regulatory control of the CEA. It has been reported that the CEA will propose legislation to accomplish this purpose. *Id.* Feb. 7, 1973, at 7, col. 2; *id.* June 29, 1973, at 32, col. 2.

9. The London market is comprised of a series of exchanges, including the London Metal Exchange, a member of which issues options.

10. *The Wall Street Journal* (SW ed.), Feb. 22, 1973, at 1, col. 1; *id.* Mar. 6, 1973, at 14, col. 2.

11. The business was first organized as Goldstein, Samuelson and Associates, a sole proprietorship which sold its first option for \$250 on the day of its founding. Stipulation, *supra* note 6, at 3, 5. The firm went through a series of incorporations and mergers until it was adjudged bankrupt on April 30, 1973. *Id.* at 5. No additional capital was contributed by Mr. Goldstein. The entire capital of the corporation consisted of this \$800, plus premium fees from the sale of commodity options and income generated from the reinvestment of such fees. *Id.* at 19.

12. *Id.* at 7. Over a third of the gross sales, \$31 million, were made in the last 18 trading days in February 1973, shortly before the company was placed in temporary receivership. *Id.*

other firms offering similar options were quickly formed.¹³ Although the majority of these firms, including Goldstein Samuelson, have been forced out of business, either because of bankruptcy or as a result of increased regulatory pressure, a small group of second generation firms, some operated by the promoters of the original companies, have begun to appear in states which have not attempted to regulate trading in naked options.¹⁴

The financial bonanza began to evaporate for Harold Goldstein and the other naked commodity option dealers in October 1972, when the Oklahoma Securities Commission gave Goldstein Samuelson notice of its intent to issue a cease and desist order against the firm for violations of the state securities law.¹⁵ Public hearings were held in November 1972, and an order was issued barring further sales of naked options in late February 1973.¹⁶

During the same period, other state securities administrators began to take cognizance of the abuses inherent in the sale of naked options and to evaluate the need for protective regulation. In early February 1973, Washington and Oregon securities authorities persuaded a number of option dealers to refrain voluntarily from further sales in those states.¹⁷ Moreover, on February 8, 1973, the California commission, after holding public hearings on the problem, issued an interpretative release stating that it considered the "new" commodity option contracts to be securi-

13. Three of the larger firms were First Federated Commodity Trust Co., which operated out of Baltimore, Commodity Options International, founded by Josef Rotter, an early promoter in the area, and Puts and Calls, Inc., a California operation. For a discussion of the rise of these firms in the wake of Goldstein Samuelson, see BARRON'S, Jan. 8, 1973, at 5, col. 2.

14. For example, the American Board of Trade was offering commodity options in the Wall Street Journal during the summer of 1973, and Preferred Commodity Options Corp., an Oklahoma firm, was licensed by the Oklahoma Securities Commission as a broker-dealer in commodity options on July 24, 1973. For a summary of the activities of these new second generation option dealers, see The Wall Street Journal (SW ed.), June 28, 1973, at 32, col. 2.

15. Notice of Intention to Issue Cease and Desist Order, Okla. Sec. Comm'n (Oct. 26, 1972).

16. *In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). This order was followed by a series of summary orders against other commodity option firms operating in Oklahoma. See, e.g., *In re* P & W Inv. Co., Summary Cease and Desist Order, Okla. Sec. Comm'n (Feb. 26, 1973); *In re* Puts and Calls of Okla., Inc., Summary Cease and Desist Order, Okla. Sec. Comm'n (Feb. 23, 1973).

17. The Oregon Journal, Feb. 6, 1973, § 4, at 7, col. 1. The Oregon Corporation Commission had filed suit in state court against Goldstein Samuelson in November 1972. *Id.* The case has not come to trial.

ties.¹⁸ Three weeks later, the California Corporation Commissioner, upon receiving information that Harold Goldstein was attempting to transfer Goldstein Samuelson funds to a private account in Canada,¹⁹ issued a cease and refrain order against the firm barring further sales of naked options.²⁰ Simultaneously, the Securities and Exchange Commission re-instituted a suit to have a temporary receiver appointed to hold the assets of Goldstein Samuelson and its one-time parent corporation.²¹

Other firms specializing in the sale of naked commodity option contracts have met a similar fate. The Maryland Securities Commission,

18. Cal. Corp. Comm'n Release No. 29-C, 1 BLUE SKY L. REP. ¶ 8679 (Feb. 8, 1973). See also Press Release of Brian R. Van Camp, Cal. Corp. Comm'r (Feb. 22, 1973).

19. See Declaration of Arthur H. Maslansky, filed in *People v. Goldstein Samuelson, Inc.*, Civ. A. No. C 50847 (Cal. Super. Ct., L.A. County, filed Feb. 27, 1973). See also BARRON'S, Mar. 5, 1973, at 5, col. 1.

20. *In re Goldstein Samuelson, Inc.*, Cease and Refrain Order, Cal. Corp. Comm'n (Feb. 27, 1973). Similar cease and refrain orders were issued the day before against World-Wide Commodity Options, Inc. and Puts and Calls, Inc. In each of these cases, the California Corporation Commission also filed suit requesting the appointment of a receiver and a temporary restraining order. In the World-Wide suit, the temporary injunction and appointment of a receiver were refused. *People v. World-Wide Commodity Options*, Civ. A. Nos. 51070, 51130 (Cal. Super. Ct., L.A. County, Mar. 6, 1973). In the case against Puts and Calls, Inc., the temporary injunction and receivership were denied, but the court later granted a permanent injunction. *People v. Puts and Calls, Inc.*, 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., L.A. County, June 21, 1973). The Commission also instituted proceedings against New Life Management, Inc., International Commodity Options Underwriters, and Option/Economics Corp. CALIF. CORP. SEC. NEWSLETTER No. 11, at 4 (Apr. 1973). The New Life order subsequently was challenged in an administrative hearing, and a hearing officer's finding that the naked options were securities was affirmed by the Commission. *In re New Life Management, Inc.*, File No. Alpha L-4072, Cal. Corp. Comm'n Ad. Hearing (June 8, 1973).

21. SEC v. First Leisure Corp., Civ. A. No. 72-2616 (C.D. Cal. Feb. 27, 1973). On March 11, 1973, however, the district court refused to continue the temporary receivership. This decision was appealed immediately to the Court of Appeals for the Ninth Circuit, but before the appeal could be heard, Goldstein Samuelson was forced into involuntary bankruptcy and the temporary receiver discharged. The case is presently before the bankruptcy court. Letter from Gerald E. Boltz, Regional Adm'r, SEC, to the author, Oct. 17, 1973. In the meantime, the SEC filed another suit seeking a civil injunction and the appointment of a receiver. SEC v. Goldstein Samuelson, Inc., Civ. No. 73-472 (C.D. Cal., filed Mar. 5, 1973), summarized in [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,800. This suit is still pending, but recently the parties entered into a stipulated agreement of facts. Stipulation, *supra* note 6. It appears that the case may be settled by consent decree. Letter from Gerald E. Boltz, *supra*. The SEC also filed a suit against Commodity Options International, Inc., which was settled by consent decree. The Wall Street Journal (SW ed.), Apr. 9, 1973, at 15, col. 4.

for example, obtained a court order enjoining further sale of option contracts by First Federated Commodity Trust Company on the ground that such sales violated the Maryland Securities Act.²²

These actions proved to be a harbinger of rulings by a number of other state securities commissions that the "new" options are securities and subject to regulation under state blue sky laws.²³ The courts, however, have been more cautious in dealing with the question. In the only federal court decision other than that involving Goldstein Samuelson in which the issue has been decided, it was held that the SEC had not established that the options are securities;²⁴ the court refused to enjoin sales of option contracts by the Continental Commodities Corporation. Decisions in the state courts are conflicting. In *International Commodity Trust, Inc. v. Fisher*,²⁵ an Oklahoma court held that the options are not covered by the state's securities law. Classification of naked options as securities has been upheld, however, in the Maryland case,

22. *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,058 (Md. Cir. Ct., Baltimore County, Feb. 27, 1973), *injunction made permanent*, 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973).

23. *In re Commodity Options*, 1 BLUE SKY L. REP. ¶ 9722 (Colo. Sec. Comm'n May 22, 1973); *In re Commodity Options*, General Cease and Desist Order, 2 BLUE SKY L. REP. ¶ 41,358 (Pa. Sec. Comm'n May 29, 1973); *In re Commodity Options*, Notice and Order, 3 BLUE SKY L. REP. ¶ 47,656 (Utah Sec. Comm'n Mar. 2, 1973) (see also Letter of Explanation of Order, Utah Sec. Comm'n, Mar. 16, 1973); Letter from William W. Ladwig, Sec. Exmr., State of Alaska, to William G. Fisher, Adm'r, Okla. Sec. Comm'n, May 30, 1973; Statement of the Georgia Securities Commissioner concerning Commodities Trading and the Georgia Securities Law, 1 BLUE SKY L. REP. ¶ 14,612 (Sept. 18, 1973) [hereinafter cited as *Commodities Trading*]; INDIANA SEC. DIV. MONTHLY BULL. 3 (July 1973); MICH. SEC. BULL. 1 (Mar. 1973); Letter from James Kirkpatrick, Secretary of State of Missouri, to Commerce Clearing House, Inc., 2 BLUE SKY L. REP. ¶ 28,651 (1973); Statement of Pat McKeever, Commissioner of Securities, State of South Dakota, BLUE SKY L. REP. No. 477, at 3 (Sept. 26, 1973).

24. *SEC v. Continental Commodities Corp.*, Civ. No. CA 3-6976-D (N.D. Tex. Apr. 9, 1973). Issues raised in a pending appeal include several besides whether commodity options are securities. Letter from Gerald E. Boltz, Regional Adm'r, SEC, to the author, Oct. 17, 1973. In another case, *In re Traders Int'l, Ltd.*, Bankruptcy No. 7350 (D. Nev. Aug. 23, 1973), the referee in bankruptcy held that commodity options are securities. This determination is being reviewed by the district court.

25. 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Okla. County, May 14, 1973) (permanent injunction against the administrator preventing further enforcement of the securities laws against the plaintiff). This decision was not appealed because on the day following its announcement the Governor of Oklahoma signed emergency legislation specifically including commodity option contracts within that state's definition of a security. See OKLA. STAT. tit. 71, § 2(20)(0) (1971), as amended by Okla. Laws 1973, H.B. 1035, § 1 (May 15, 1973).

Shapiro v. First Federated Commodity Trust Co.,²⁶ and, more recently, by a California court in *People v. Puts and Calls, Inc.*²⁷

It is significant to note that the only decisions dealing with naked options have been at the trial level. In addition, appeal of most of the present cases is unlikely, since the offending companies are bankrupt²⁸ and no longer selling option contracts. Nevertheless, since new companies are being formed, it is essential that the courts comprehend the abuses inherent in the naked commodity option transaction and develop theories to protect the investing public.²⁹

Conventional Options vs. The New "Naked" Options

The key to understanding the argument that the "new" option contract should be deemed a security and thus subject to regulation under the federal and state securities laws while the traditional commodity

26. 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973).

27. 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., L.A. County, June 21, 1973). The status of naked options also has been raised in a series of recent Texas cases. In *State v. King Commodity Co.*, Civ. A. No. 73-7339G (Tex. Dist. Ct., Dallas County, Oct. 18, 1973), the court held commodity options to be securities and granted a temporary injunction against their further sale. This order has been appealed to the Court of Civil Appeals. Appeal No. 18291, 5th Sup. Jud. Dist., filed Nov. 14, 1973. Temporary restraining orders have been secured in two other cases. *State v. Stocks Int'l Commodities, Inc.*, Civ. A. No. 73-3423-J (Tex. Dist. Ct., Dallas County, Nov. 6, 1973); *State v. Southwest Bd. of Trade, Inc.*, Civ. A. No. 73-7741D (Tex. Dist. Ct., Dallas County, Oct. 11, 1973). However, in *Great S. Brokerage, Inc. v. Mouer*, Civ. A. No. 211,259 (Tex. Dist. Ct., Travis County, Nov. 1, 1973), the plaintiff obtained a declaratory judgment that naked commodity options are not securities. This case will be appealed. Letter from Richard D. Latham, Director of Enforcement, Texas State Sec. Bd., to the author, Nov. 15, 1973.

28. See, e.g., *In re Puts and Calls, Inc.*, Civ. A. No. 73-02706 (C.D. Cal., filed May 3, 1973); *In re King Commodity, Inc.*, Bankruptcy No. 73-H-446 (S.D. Tex., filed Oct. 1, 1973). It has been estimated that Goldstein Samuelson left unsatisfied option holder claims of between \$14 and \$85 million. The exact amount is unknown because the temporary receiver has been unable to put in order the financial records of the company. Already, many suits have been filed in an attempt to shift the loss from the option dealers to the issuing firms. See, e.g., *Eckman v. Jackson*, Civ. No. 93-73 (D. Utah, filed Mar. 19, 1973); *Midgley v. Traders Int'l, Ltd.*, Civ. No. C69-73 (D. Utah, filed Mar. 4, 1973). These bankruptcy actions will have to decide whether the options are securities, since the holder of a security issued without required registration, upon rescinding an alleged purchase, obtains a status equal or superior to other general creditors. See Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U.L. REV. 261 (1973).

29. The abuses which have occurred in the naked option market are not surprising when one considers the statement by Josef Rotter, one of the leading option dealers, that 50 to 60 percent of individuals in the industry could not meet the registration re-

option perhaps should not be so classified is an appreciation of the differences in substance between the two types of transaction. The primary purpose of the London or Mocatta option, issued against *an existing stock of the commodity* owned by the optionor,³⁰ is to serve as a hedge for the optionor against a price increase or decrease in the commodity, which often constitutes an integral part of his business.³¹ These options are sold in relatively small numbers to a small group of highly sophisticated investors thoroughly familiar with the commodity market and the purpose and workings of the commodity option. Such investors do not have to rely upon the expertise of the option seller for advice on which options to buy. Moreover, since there is a market for these options, which, like the underlying commodity futures, are freely tradable from one investor to another, the option holder has several ways in which he may realize a profit. He may, for example, sell his option to another investor during the course of the option period. Alternatively, he may exercise his option, taking delivery of the underlying commodities or futures contracts, in the case of a call, or selling the commodities or futures to the option issuer, where a put is involved. The result in each case is an actual movement in the underlying goods.

Sellers of the "new" option contracts have adopted the technical legal form of the older option, but nothing else. First, the "new" options

quirements for dealers and registered representatives under the various securities acts because of past felony convictions or securities law violations. The Wall Street Journal (SW ed.), Feb. 22, 1973, at 1, col. 1.

30. BARRON's, Mar. 5, 1973, at 5, col. 3. It is beyond the scope of this Article to discuss in detail the mechanics of the London or Mocatta-type option. It is the author's understanding that the principal difference between naked options and London options is that the latter normally are fully covered by existing stocks of the commodity held by the person issuing the option. As a result, the person who invests in London options does not have to bear the additional "enterprise risk" that the issuer of the option will be unable to perform. Commodities Trading, *supra* note 23. Recently, however, London options have been the subject of investigation by the Texas Securities Board. The Transcript of Hearings before the Texas Securities Commissioner in *In re* Clayton Brokerage (Nov. 2-3, 6-7, 1973) describes in detail the workings of the London options. From this testimony, it appears that not all such options are sold against existing commodity stocks or futures contracts. In such case, there would be little difference between them and the naked options discussed in this Article. The Texas Commissioner recently held that the London options as sold by Clayton Brokerage did involve the sale of securities. *In re* Clayton Brokerage, Order No. 24-513 (Tex. Sec. Bd., Dec. 18, 1973), summarized in SEC. REG. & L. REP. No. 235, at A-16 (Jan. 16, 1974). An appeal from this holding was filed immediately. A similar conclusion was reached in a consent decree entered in *In re* Traders Int'l, Ltd., Bankruptcy No. 7350 (D. Nev. Aug. 23, 1973) (opinion of referee).

31. Cf. Texas Arizona Mining Co., [1971-72 transfer binder] CCH FED. SEC. L. REP. ¶ 78,626 (no action letter, Jan. 19, 1972).

are *not* sold against an existing inventory of underlying commodities. In the trade they are called "naked options" because they represent nothing more than the seller's unsupported promise to perform. Since an inventory of commodities or futures is not required, any person can enter the business merely by opening an office and selling naked options.³² The leading option dealers, although maintaining that it would be economically impossible to maintain a complete inventory to back the options, claim that they limit their potential liability on outstanding options by purchasing a certain percentage of underlying futures contracts.³³ The formula for determining this percentage, however, remains a secret.

The potential for abuse inherent in such an unregulated system is manifest. The ramifications are very similar to those which would result if, without provision for controlling cash reserves and investments, banks were permitted to accept deposits in exchange for their promises to honor demands.³⁴ Since the formula for purchasing is itself secret (rumor has it that it was claimed to be 35 to 40 percent) and unregulated, there is no way to determine whether dealers are maintaining adequate percentages of underlying futures contracts to protect in-

32. This conclusion is well supported by the fact that Harold Goldstein began Goldstein Samuelson with a capital investment of only \$800 on April 28, 1971, and on the same day sold his first option for \$250. Stipulation, *supra* note 6, at 5.

33. Testimony of Harold Goldstein, Transcript of Hearings before the Okla. Sec. Adm'r, *In re* Goldstein Samuelson, Inc., 91-92 (Nov. 21, 1972) [hereinafter cited as Testimony]. Of course, the maintenance of such an inventory is physically impossible when the dealer sells puts, because such options represent the right of the optionee to sell the underlying futures contract to the optioner. The only method of hedging available to the optioner in such a case is to go into the market and sell futures contracts short. If, however, the option is not exercised, the optioner will still have to meet his obligation to supply the futures contracts.

34. Realizing that the potential for abuse would bother investors, Harold Goldstein forged a letter stating that American Bankers Insurance Company of Miami had written a \$1 million performance bond to ensure the payment of the Goldstein Samuelson options. This forged letter was shown to many of Goldstein Samuelson's representatives and potential customers. Stipulation, *supra* note 6, at 15. In subsequent prosecutions for these activities, Mr. Goldstein pleaded guilty to three counts of mail fraud and was sentenced to 15 years' imprisonment. The Wall Street Journal (SW ed.), Nov. 12, 1973, at 11, col. 1.

Goldstein Samuelson is not the only firm in the naked commodities industry which has engaged in fraudulent practices. For example, the King Commodity Co. set up Investor Guaranty Corp., which, as its name suggests, was to "guarantee" that King would meet its naked option obligations. Investigation, however, has revealed that the two corporations were not separate entities, but the same corporation doing business under two names. See State's Brief, *State v. King Commodity Co.*, Civ. A. No. 73-7339G (Tex. Dist. Ct., Dallas County, Oct. 18, 1973).

vestors.³⁵ Indeed, as a result of the collapse of several of the leading option dealers, evidence has come to light which indicates that the claim of hedging was only a cruel hoax and that no hedging was ever in fact done.³⁶

Furthermore, the practice of hedging would be counterproductive for a dealer with calls outstanding, since it would tend to force upward the price of the underlying commodity futures; the result would be a guaranteed profit to holders of the calls. The natural tendency of option dealers thus would appear to be to use their market activities to minimize the market movement of underlying futures. In short, in order to reduce their potential liability on calls, they will sell, rather than buy for hedging purposes, futures contracts in an attempt to stabilize the market price at, or as near as possible, the striking price of the options.

A major reason for the ultimate collapse of Goldstein Samuelson was such an attempt to manipulate the futures market in an effort to reduce the firm's losses on option contracts. In the fall of 1972, it had outstanding a substantial number of calls on world coffee. That year the price of world coffee futures rose significantly. The appropriate course of action under the hedging policy the firm now claims it followed would have been to enter the market and *buy* futures to back its out-

35. According to Mr. Goldstein, this is no problem, since, in his view, the purpose of hedging is to protect the dealer and not the investor. He maintains that the investor has no interest in or claim to the premium fee once it is paid to the option dealer, who, according to Mr. Goldstein, is free to use it in any manner he wishes, including investment in the futures market, stocks, or real estate, or for payment of his overhead costs. Testimony, *supra* note 33, at 59.

36. In the case of Goldstein Samuelson, it appears that the firm did engage in hedging operations from April to September 1971, at which time the practice was discontinued in order to generate additional operating capital. In February 1972, as the result of inquiries from the public and various regulatory agencies concerning its hedging practices, Goldstein Samuelson again opened trading accounts. These accounts, however, were used for speculation, not hedging. Stipulation, *supra* note 6, at 13, 15. It appears that First Federated Commodity Trust Co. never bought or sold commodity futures contracts. *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973); *id.* (opinion on Lombard Street Account, May 30, 1973) (unreported). Claims of successful option holders were satisfied in one of two ways. The dealers either persuaded them to leverage their profits by reinvesting in additional options or paid them off with money generated from the sale of options to others. Because of constantly increasing sales, most dealers were able to continue this practice, even when bankruptcy appeared imminent. During the calendar year 1972, for example, Goldstein Samuelson sold \$45 million worth of options. The firm's business continued to expand, and in a period of only 18 days in February 1973, it sold \$31 million in options. The firm was adjudged bankrupt on April 30, 1973. Stipulation, *supra* note 6, at 5, 7.

standing options. This would, of course, have had the effect of driving the price even higher. Instead, it appears that Goldstein Samuelson sold futures in a deliberate effort to depress the market. This attempt, however, proved unsuccessful, and Goldstein Samuelson apparently lost a vast sum of money as a result.³⁷ Although the loss was significant in that it was detrimental to the financial solvency of the company, and ultimately injurious to its customers, much more importantly it demonstrates the serious conflict often present between the interests of the option dealer and his customers. Such a conflict may not be important where the parties deal at arm's length, as in the London or Mocatta option markets. It is, however, extremely significant in the naked option market, where, as will be seen, the option dealer clearly operates from a fiduciary, rather than an arm's length, position.

The second major difference between the London or Mocatta option and the new "naked" option involves the type of investor to whom they are sold. As was previously noted, purchases of conventional commodity options generally are by a small group of highly sophisticated large investors thoroughly familiar with the mechanics of the commodity option market. In contrast, dealers in naked option contracts have taken pride in testifying that they seek out small investors, that is, those with from \$1,000 to \$2,000 to invest. In fact, Mr. Goldstein has indicated that most of his customers had been refused trading accounts with other brokerage houses because of the small nature of their transactions.³⁸

The thrust of statements made in sales literature issued by the new option dealers tends to confirm Mr. Goldstein's assertions.³⁹ This literature is not directed toward the large, knowledgeable professional investor but rather at the ribbon clerk or other amateur investor willing to speculate with his life's savings. The very tone of the literature indicates that it is not intended for someone familiar with the commodity market or the workings of commodity options. Instead, it attempts to give the reader an oversimplified view of commodity investing, with an emphasis on the spectacular profits which allegedly can be made with

37. It is estimated that the loss from market transactions was over \$1 million. The Wall Street Journal (SW ed.), Feb. 26, 1973, at 9, col. 2. Moreover, option holders who sold during this period netted between \$2 million and \$3 million. The entire transaction, therefore, may have cost Goldstein Samuelson as much as \$4 million.

38. Testimony, *supra* note 33, at 89. See also *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

39. Goldstein Samuelson, Inc., An Investment Opportunity (undated, issued 1972); First Federated Commodity Option Co., The Power of Commodity Options (undated, issued Spring 1973); P & W Investment Co., An Unexploited Financial Opportunity (undated, issued early 1973).

a minimal capital expenditure and without the risk of further investment demands by way of margin calls. No attempt is made to point out that the vast majority of investors in the commodity futures market lose money.⁴⁰ A reasonable conclusion is that it is greed, and not an understanding of the commodities market, which causes an investor to speculate in naked option contracts.⁴¹ It is this type of investor whom provisions in the various securities laws proscribing fraud and requiring disclosure in the sale of securities were enacted to protect.

Because the small investor generally is uninformed about developments in the financial communities, he is extremely dependent upon the option dealer and his salesmen for advice as to which options to purchase. Mr. Goldstein reluctantly admitted that Goldstein Samuelson and its salesmen provided "tips" to customers on the options most likely to generate a profit.⁴² By engaging in such a practice, the dealer is faced with an extremely serious conflict of interest; since there is no ready market for naked options, the issuing firm must be prepared to take up all profitable options and itself sustain a loss.⁴³ The conflict ultimately must lead either to investment advice which is less than fair or to the sustaining of large losses by the dealer; the potential harm to the investor in either case is evident. In any event, relegation of the purchaser to a passive role in the investment process is a highly significant factor in determining whether the naked option is a security under state and federal securities laws.⁴⁴ In this regard, it has been established that at

40. The Wall Street Journal quotes several commodity experts as indicating that small speculators in commodities futures suffer losses in 90 percent of their transactions. The Wall Street Journal (SW ed.), Feb. 22, 1973, at 1, col. 1. The SEC and Harold Goldstein agree that the figure is 75 percent or higher. Stipulation, *supra* note 6, at 21. Goldstein Samuelson, however, claimed that 70 percent of its option purchasers were winners. *Id.* This figure is not supported by the record, which reveals that before bankruptcy, Goldstein Samuelson wrote 175,000 options, only 85,000 of which were subsequently repurchased for about \$19 million. *Id.* at 7.

41. See *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

42. Testimony, *supra* note 33, at 57-59, 89-91. See also Testimony of Joe L. Samuel, Transcript of Proceedings before the Okla. Sec. Adm'r, *In re Goldstein Samuelson, Inc.*, 53-54; Findings of Fact, *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

43. Testimony, *supra* note 33, at 88.

44. See Findings of Fact, *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). This factor is at the heart of the distinction the federal courts have drawn between commodity futures contracts and discretionary accounts which trade in such futures, holding only the latter to be securities. Compare *McCurnin v. Kohlmeyer & Co.*, 340 F. Supp. 1338 (E.D. La. 1972) and *Schwartz v. Bache & Co.*, 340 F. Supp. 995 (S.D. Iowa 1972) with *Commercial Iron*

least some of the option firms have a standing policy of automatically exercising any outstanding option in which the customer has a profit on the last day of the option period, even if it has not received instructions from the customer to do so.⁴⁵

At least one court, in holding that a naked option is not a security, naïvely assumed that trading in such options is a matter where a knowledgeable investor, utilizing his own insight and business experience, selects his investment, purchases it from the dealer, and holds it until, in his judgment, it is time to sell in order to make a profit.⁴⁶ If, however,

& Metal Co. v. Bache & Co., 478 F.2d 39 (10th Cir. 1973) and Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D.N.Y. 1968). But see Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972). That the purchaser depended on a third party to select the investment was one of the major reasons given by recent decisions holding that the sale of scotch whiskey warehouse receipts involved the sale of securities. SEC v. Haffenden-Rimar Int'l, Inc., 362 F. Supp. 323 (E.D. Va. 1973); SEC v. M.A. Lundy Assoc., 362 F. Supp. 226 (D.R.I. 1973); Pa. Att'y Gen. Op. No. 49, 3 BLUE SKY L. REP. ¶ 71,094 (July 17, 1973). See also SEC v. Glen-Arden Commodities, Inc., CCH FED. SEC. L. REP. ¶ 94,142 (S.D.N.Y., filed Aug. 23, 1973).

It is interesting to note that Goldstein Samuelson originally offered discretionary accounts in commodity options guaranteeing the customer a 10 percent return on his investment. The SEC claimed that these discretionary accounts were securities, and Goldstein Samuelson entered into a consent decree in which it agreed to discontinue this service. SEC v. First Leisure Corp., Civ. A. No. 72-2616 (C.D. Cal. Nov. 3, 1972). In Commercial Iron & Metal Co. v. Bache & Co., *supra*, and Berman v. Orimex Trading, Inc., *supra*, it was held that even though a brokerage contract does not expressly create a discretionary account, if the actual selection of options in fact is left to the option dealer, a discretionary arrangement can be implied.

45. Testimony, *supra* note 33, at 24. See also Findings of Fact, *In re* Goldstein Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973); First Federated Commodity Option Co., The Power of Commodity Options 3 (undated, issued Spring 1973); King Commodity Co., Commodity Options, What Can They Do for You? 3 (undated, issued Spring 1973). Such a procedure clearly is contrary to the normal practice in the sale of options. See, e.g., London Metal Exchange, Rules and Regulations, Rule J (1968). It certainly is not in the economic interests of the option dealer to pick up a profitable option which the option holder intentionally or negligently has allowed to lapse. Again, however, the practice reflects the realization by the dealers that the unskilled investor is often completely dependent upon them. If the investor is so lacking in knowledge concerning his investment that he does not know when the option lapses or that it has an expiration date, he will be very unhappy with the dealer when he learns that he has lost a profit because of his own inaction. Some dealers have limited their costs under the automatic repurchase feature by reinvesting the investor's "profits" in a new option, also automatically. King Commodity Co., Commodity Options, What Can They Do for You? 2 (undated, issued Spring 1973); Testimony of Mr. Kimmons, Transcript of Trial, at 40-41, State v. King Commodity Co., Civ. A. No. 73-7339G (Tex. Dist. Ct., Dallas County, Oct. 18, 1973), *appeal pending*.

46. International Commodity Trust, Inc. v. Fisher, 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Okla. County, May 14, 1973).

the substance of the transaction is examined, as courts constantly are admonished to do in securities cases,⁴⁷ it becomes evident that naked options are being sold to individuals with no information or investment experience on which to base their option selection and who, therefore, are tied to the tips or suggestions of the option dealer or his salesmen. Furthermore, because such an investor is incapable of making an intelligent decision as to when to exercise his option, the decision is automatically made for him by his dealer. Thus, without ever possessing any knowledge of the investment medium or exercising any discretion,⁴⁸ the investor can purchase an option contract relying solely upon the expertise of the option dealer or his representative, retain the option for its life, and, if it is profitable, receive a return at the end of the option period through operation of a standing automatic repurchase policy. Under this arrangement, the holder of a naked option is nothing more than a passive investor expecting his return solely through the efforts of others.⁴⁹

The automatic repurchase policies emphasize the final significant difference between conventional and naked options. Rarely are naked options settled by the actual exchange of the underlying futures contracts. Instead, the option dealer merely "repurchases" the option from the holder, paying him the difference between the striking price of the option and the current market value of the underlying futures contracts.⁵⁰ Harold Goldstein recently testified that customers of Goldstein Samuelson had never demanded acceptance by the firm of underlying futures contracts when put options were exercised and that delivery of underlying futures had been demanded in less than one-half of one percent of the cases in which call options were exercised.⁵¹ Other option dealers have given up any pretense of satisfying naked options

47. See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

48. *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

49. See *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

50. *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

51. Testimony, *supra* note 33, at 77. See also Testimony of Joe L. Samuel, Transcript of Proceedings before the Okla. Sec. Adm'r, *In re Goldstein Samuelson, Inc.*, 21, 24 (Nov. 22, 1972). This is confirmed by the stipulation between Goldstein Samuelson and the SEC indicating that although the firm sold over 175,000 options during its life, on only four occasions did it attempt to deliver the commodities and in only one case did it buy the commodity futures contracts from the customer. Stipulation, *supra* note 6, at 11.

by actual exchange of the underlying futures contracts, indicating in their sales literature that settlement will be made by "repurchase."⁵²

The emphasis on repurchase as the means for settlement of naked commodity option transactions is significant for a number of reasons. First, it raises the question whether these options have any economic justification. As previously noted,⁵³ the London or Mocatta option does serve a valid economic purpose by permitting the actual user of the commodity to hedge against a fluctuation in the price of the commodity and thereby shift his risk of loss to others.⁵⁴ On the other hand, because naked option contracts generally are not settled by the actual exchange of underlying futures contracts and thus do not serve any hedging function, they are nothing more than a vehicle for speculative investment.

Indeed, if holders of naked option contracts realistically had the right to demand delivery of the underlying futures contracts, there are strong indications that trading in such options could have a very detrimental effect on an orderly market. Only a small number of futures contracts on the unregulated "international" commodities are outstanding at any given time, and an even smaller number actually appear in the trading market. Since, however, there is no limit on the number of naked options which can be issued on a particular commodity, it is likely that in an active market outstanding naked options will greatly outnumber outstanding futures contracts.⁵⁵ Market chaos would

52. First Federated Commodity Option Co., *The Power of Commodity Options* 2-3 (undated, issued Spring 1973).

53. See notes 30-31 *supra* & accompanying text.

54. Futures contracts on commodities also permit the user to hedge against price fluctuation. Trading in options on the futures contracts, however, results in an additional level of hedging and speculation; if the number of options becomes too great, the underlying futures market may be adversely affected. Indeed, widespread trading in options apparently was one of the causes leading to the price collapse of the Chicago Board of Trade in 1932. It has been estimated that options accounted for about 15 percent of the total trading volume on the exchange. See *The Wall Street Journal* (SW ed.), Feb. 23, 1973, at 1, col. 1. In recognition of the problems and abuses inherent in option trading, the Commodity Exchange Authority in 1934 proscribed such trading with respect to all commodities subject to its jurisdiction. See note 7 *supra* & accompanying text.

55. In an informal conversation with Michael Alpert, Chief Deputy California Corporation Commissioner, the author was told that a California investigation disclosed that such a situation actually had occurred on several occasions in late 1972 and early 1973 when the volume of naked option sales reached new highs. This fact is confirmed in the stipulation between Goldstein Samuelson and the SEC. Stipulation, *supra* note 6, at 26.

result in such a situation if option holders, attempting to realize a profit in a rising futures market, demanded actual delivery of the futures contracts. Attempts by option dealers to outbid each other for the limited number of outstanding futures contracts would artificially inflate the price of such contracts and could force legitimate buyers out of the market.

Because it generally is not necessary that there be an actual delivery of underlying futures contracts in order to settle naked options, many informed observers have concluded that such options represent nothing more than a sophisticated form of gambling.⁵⁶ Recently, three state securities administrators have commented unofficially⁵⁷ that the naked option transaction is just a variation of the classic "bucket shop" operation,⁵⁸ a practice which for years has been illegal in most states.⁵⁹

56. See *The Wall Street Journal* (SW ed.), June 28, 1973, at 32, col. 1 (comments of Alex Caldwell, Adm'r, CEA). Many individuals in the option business do not deny this. Lew Watts of the New York Mercantile Exchange, for example, has said: "Sure, it's like playing the numbers. But everyone does it. You should hear how everybody yells and screams around the exchange when the cops pinch our members' runner." *Id.* Feb. 23, 1973, at 1, col. 1. Even Harold Goldstein has admitted that an investment in a naked option is a gamble. *FORBES*, Aug. 15, 1973, at 66.

57. The California Corporation Commissioner, Brian Van Camp, is quoted in *BARRON'S*, Mar. 5, 1973, at 21, col. 2, as stating that the options violate the California bucket shop act. This proposition will soon be tested, since the Commission, through the Los Angeles District Attorney, has secured a forty-count grand theft and bucket shop indictment against Feta Kandriu. *State v. Kandriu*, Case No. 300,860 (Cal. Super. Ct., L.A. County, filed Sept. 20, 1973). The securities administrators of Colorado and Utah have taken similar positions. *In re Commodity Options*, 1 BLUE SKY L. REP. ¶ 9722 (Colo. Sec. Comm'n May 22, 1973); *In re Commodity Options*, Notice and Order, 3 BLUE SKY L. REP. ¶ 47,656 (Utah Sec. Comm'n Mar. 2, 1973); Explanatory Notice and Order to the Utah Investing Public, Utah Sec. Comm'n (Mar. 16, 1973). The Georgia Attorney General also has issued a formal opinion that *stock* option contracts (see note 1 *supra*) may violate that state's bucket shop act if the parties do not intend to settle by actual delivery. 1971 OP. ATT'Y GEN. (Ga.) 141.

58. A "bucket shop" is "a place where wagers are made on the fluctuations of the market price of grain and other commodities." *Bergstrom v. Ridgway Co.*, 138 App. Div. 178, 181, 123 N.Y.S. 29, 32 (1910), *quoting* *Bryant v. Western Union Tel. Co.*, 17 F. 825, 828 (C.C. Ky. 1883). Professor Loss describes the operation of a bucket shop as follows: "The customer may think he is effecting a legitimate purchase, but the broker 'buckets' the order instead of executing it. If the market goes down, as the broker hopes, he purports to sell the customer out and pockets the difference; if it goes up and the broker is not able or willing to cover from profits on other transactions, he either defaults or decamps." 1 L. LOSS, *SECURITIES REGULATION* 39 n.62 (2d ed. 1961). See also *BARRON'S*, Mar. 5, 1973, at 21, col. 2.

59. See, e.g., OKLA. STAT. tit. 15, §§ 561-70 (1971). The key provision is section 564, which provides in pertinent part:

Any contract of sale for the future delivery of cotton, grain, stocks or other commodities, which is to be settled according to or upon the basis of

Furthermore, the Georgia Commissioner has announced that if violations of that state's "bucket shop" act are established, naked options may not be registered as securities, even if all other registration requirements are satisfied.⁶⁰ The state securities authorities, unlike their federal counterparts, have the ability, either directly⁶¹ or through their "fair, just, and equitable" powers,⁶² to prevent a registration which violates provisions of state law outside the securities area. Consequently, even if naked options are classified as securities and thus made subject to the registration and antifraud provisions of a state's securities act, such options may nonetheless fail to qualify for registration because their sale contravenes a law not directly pertaining to the sale of securities. If the position taken by the Georgia Commissioner is adopted by administrators in other states, it would appear that the naked commodity option industry may be forced to change its settlement procedure or go out of business.⁶³

The settlement procedures in naked option transactions represent a significant departure from the normal option trading pattern. It may be that the holder of a London or Mocatta put option often will not have the underlying futures in his inventory and must therefore purchase them in the market immediately before exercising his option. Likewise,

the public market quotations or prices made on any board of trade, exchange or similar institutions, upon which contracts of sale for future delivery are executed and dealt in without any actual bona fide execution and the carrying out or discharge of such contracts upon the floor of such exchange . . . in accordance with the rules thereof, shall be null and void and unenforceable in any court of this State, and no action shall lie thereon at the suit of any party thereto.

See also *Jacobs v. Sam I. Hynds & Co.*, 83 Okla. 20, 200 P. 162 (1921). Section 567 makes the operation of a bucket shop a criminal offense.

60. *Commodities Trading*, *supra* note 23.

61. See, e.g., Uniform Securities Act § 306(a)(D) (1956), which provides that a securities administrator may refuse registration of any security if "the issuer's enterprise or method of business includes or would include activities which are illegal where performed."

62. See, e.g., ORE. REV. STAT. § 59.105 (1971), which provides that the Commissioner may deny registration if the "proposed plan of business of the issuer, the characteristics and terms of the securities to be sold or the proposed methods of sale and distribution are unfair, unjust or inequitable."

63. In states in which it has been settled by statute that commodity options are securities but where they remain exempt from regulation, as presently is the case in Oklahoma and Wisconsin, their sale may be regulated through rules governing the activities of brokers and agents. The Oklahoma Administrator, for example, can prevent sales to the small unsophisticated investor by enforcing "know your customer" and "suitability" rules. Okla. Sec. Comm'n Rule R-204(G), 2 BLUE SKY L. REP. ¶ 39,605 (1970).

the holder of a conventional call option in many cases will dispose of the futures immediately upon taking delivery from the option dealer. The profit derived from a London or Mocatta option, however, is not necessarily tied to the difference between the striking price and the current market price, as is the case with a naked option. The holder of the put could have owned the futures at the time he purchased the option or acquired them at some time during the life of the option. Similarly, the holder of the call could have sold the futures short and exercised his option in order to cover his sales, or he could have taken delivery and held the futures for sale at a later date.

By limiting, either tacitly or by contract, the optionee's right to one of repurchase of the option by the dealer rather than actual exchange of the underlying futures, the option dealer is restricting the option holder's possible range of profit opportunities and thereby materially altering the normal option pattern. Apparently, the vast majority of naked option purchasers accept this limitation as the price they must pay for speculating in the commodities market. Otherwise, they would be unable to participate in this type of trading, since they do not maintain the commodity trading accounts necessary to consummate actual exchange of futures contracts.⁶⁴

The holder of a conventional commodity option normally realizes a profit by buying or selling the underlying futures contracts in the market. In the naked option transaction, however, the source of the option holder's profit is the contractual promise of the dealer to pay on a specified date the difference between the striking price and the current market value of the underlying futures. As a consequence, the option holder assumes the risk that the dealer will not conduct his affairs in such manner that he will be able to meet his contractual obligations. He has, in effect, invested money in a business in the management of which he does not participate.

An analysis of the significant differences between conventional and naked commodity options demonstrates that the parties to a naked option contract adopt the name and form of the conventional option but do not intend to create the rights and obligations normally associated with that transactional arrangement. In reality, the naked commodity

64. Cf. Testimony, *supra* note 33, at 77, 89. A similar inability of the investor to take actual delivery of scotch whiskeys because he did not have necessary licenses and permits was a factor in a determination that whiskey warehouse receipts were securities in *SEC v. Haffenden-Rimar Int'l, Inc.*, 362 F. Supp. 323 (E.D. Va. 1973). See also *SEC v. M.A. Lundy Assoc.*, 362 F. Supp. 226 (D.R.I. 1973); Pa. Att'y Gen. Op. No. 49, 3 BLUE SKY L. REP. ¶ 71,094 (July 17, 1973).

option is not an option at all, since the option holder rarely can demand delivery of the underlying futures contracts. It is submitted that a piercing glance through the form to the substance of the transaction clearly reveals that the naked option contract is a security within the definition of that term in state and federal securities laws. Indeed, there are several theories which can be utilized to subject naked options to regulation.

THEORIES SUPPORTING THE INCLUSION OF THE NAKED COMMODITY OPTION CONTRACT WITHIN THE DEFINITION OF A "SECURITY"

The definition of a security is the obvious starting point in examining arguments for inclusion of naked commodity option contracts within existing regulatory mechanisms. Section 2(1) of the Securities Act of 1933 provides 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*.⁶⁵

This definition was adopted with only minor variations into the Securities Exchange Act of 1934⁶⁶ and the Uniform Securities Act,⁶⁷ the latter of which serves as the basis for the blue sky laws of over 30 states and territories;⁶⁸ definitions in securities laws of the remaining states also are similar to that in the Securities Act. Consequently, unless otherwise indicated, the discussion which follows will be based upon the definition of a security set forth above.

It has been argued that the naked commodity option contract may come within any one of the following four categories of the standard

65. 15 U.S.C. § 77b(1) (1970) (emphasis supplied).

66. *Id.* § 78c(10).

67. UNIFORM SECURITIES ACT § 401(1) (1956).

68. 1 BLUE SKY L. REP. ¶ 4901 (1973) indicates that 29 states, the District of Columbia, and Puerto Rico have adopted the Act. Delaware must now be added to this list. See Del. Laws 1973, H.B. 416, *reprinted in* 1 BLUE SKY L. REP. ¶ 11,102 (1973).

definition of a security: (1) evidence of indebtedness; (2) investment contract; (3) any interest or instrument commonly known as a "security"; or, (4) a guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.⁶⁹

Guarantee of or Right to Purchase Any of the Foregoing

The position that the "new" options are securities because they come within the "guarantee of, or . . . right to . . . purchase, any of the foregoing" portion of the definition is the weakest of the four arguments for classifying the naked option as a security. The key aspect of this provision is the phrase "any of the foregoing," which refers to the other parts of the definition of a security. Thus, if someone other than the holder of an evidence of indebtedness or investment contract guarantees that evidence or contract, the guarantee is itself a security separate and apart from the evidence of indebtedness or investment contract.⁷⁰ The same would be true of a right to purchase a bond or corporate stock. The guarantee or right to purchase, however, cannot be deemed a security unless that which is guaranteed or of which there is a right to purchase can also be classified as a security.

Applying this analysis to option transactions generally, it is clear that an option is a right to purchase or sell, and, therefore, that the first requirement of the classification is satisfied. A cursory reading of the limited treatments given options by Professor Loss⁷¹ and Mr. Bloomen-

69. In Delaware, Hawaii, and Oklahoma, the problem recently has been settled by amending the definition of a security specifically to include options on commodity futures. Del. Laws 1973, H.B. 416, § 2(m), *reprinted in* 1 BLUE SKY L. REP. ¶ 11,102 (1973); Hawaii Laws 1973, Act 208, § 1, *reprinted in* 1 BLUE SKY L. REP. ¶ 14,701 (1973); OKLA. STAT. tit. 71, § 2(20)(0) (1971), *as amended by* Okla. Laws 1973, H.B. 1035, ¶ 1 (May 15, 1973).

70. 1 L. LOSS, SECURITIES REGULATION 467 (2d ed. 1961). This situation may arise in the naked option market. Because of the obvious risk involved in the sale of naked options, several companies have attempted to allay customer fears by establishing a guarantee of the option. In the case of the options sold by King Commodity Co., the literature indicated that the options were "guaranteed" by Investor's Guaranty Corp. King Commodity Co., Commodity Options, What Can They Do for You? 3 (undated, issued Spring 1973). It subsequently was established that Investor's Guaranty Corp. was not a separate corporation but a fictitious name used by King Commodity. *State v. King Commodity Co.*, Civ. A. No. 73-7339G (Tex. Dist. Ct., Dallas County, Oct. 18, 1973). If the naked option is a security, a guaranty of the option is also a security. *See* Brief for State at 7, *State v. King Commodity Co.*, *supra*. Cf. *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,058 (Md. Cir. Ct., Baltimore County, Feb. 27, 1973).

71. 1 L. LOSS, SECURITIES REGULATION 467-69 (2d ed. 1961). *See also* 4 *id.* at 2493-95 (1969 supp. to 2d ed.).

thal⁷² would suggest that the second criterion also is fulfilled. Indeed, at least one agency has cited these authorities as supporting its conclusion that the commodity futures underlying commodity options are securities and thus that the options themselves are securities.⁷³ A more careful reading, however, reveals that both authors limit their discussions to the stock option, in which case the underlying stock clearly is a security.⁷⁴

A series of recent federal district court cases have held that commodity futures contracts⁷⁵ are not securities.⁷⁶ Since this position is supported by dicta in at least two federal appellate decisions,⁷⁷ it would appear that

72. 1 H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 2.21 (1972).

73. Letter from Beverly B. Hall, Ass't Att'y Gen., State of Oregon, to the Honorable Frank Healy, Corp. Comm'r, State of Oregon, Jan. 26, 1973.

74. See note 1 *supra*. Professor Loss cites two cases to support his position: *SEC v. Todd*, Litig. Rel. 576 (S.D.N.Y. 1950) (consent decree); *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743 (1965). The SEC recently has refused to issue no action letters in this area. *Volt Sec. Corp.*, SEC. REG. & L. REP. No. 144, at C-2 (no action letter, Mar. 22, 1972); *Dean Witter & Co.*, [1971-72 transfer binder] CCH FED. SEC. L. REP. ¶ 78,602 (no action letter, Dec. 6, 1971). See also Gates, *The Developing Option Market: Regulatory Issues and New Investor Interest*, 25 U. FLA. L. REV. 421, 437-50 (1973).

75. Although it is not the purpose of this Article to discuss the intricacies of the commodity futures market, the following statement by the Georgia Securities Commissioner provides an excellent summary of the economic purposes of this unique investment device:

[A commodity future] is simply a contract to buy and sell a specified quantity of a specified commodity on a specified date in the future. Both the producer and the consumer of commodities find such contracts extremely useful. It enables the farmer to plant his crop in the spring and sell it then, thus freeing him of the necessity of speculating on what the price will be when his crop matures. It enables consumers of commodities, such as mills, to know in advance what the cost of their raw materials will be and frees them from speculating on future prices.

Through the years, the necessity of bringing potential buyers and sellers of commodities futures contracts together has caused commodities exchanges to be formed. These exchanges have also attracted large numbers of speculators who are willing to assume the speculative risk that the producers and consumers of commodities wish to be rid of. These speculators therefore perform a valuable service to producers and consumers of commodities, making the market "liquid" by their willingness to buy and sell at the current market price.

Commodities Trading, *supra* note 23, at 10,503.

76. See, e.g., *McCurnin v. Kohlmeyer & Co.*, 340 F. Supp. 1338 (E.D. La. 1972); *Schwartz v. Bache & Co.*, 340 F. Supp. 995 (S.D. Iowa 1972); *Sinva v. Merrill, Lynch, Pierce, Fenner & Smith*, 253 F. Supp. 359 (S.D.N.Y. 1966).

77. *Commercial Iron & Metal Co. v. Bache & Co.*, 478 F.2d 39 (10th Cir. 1973); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

for purposes of the federal securities laws, commodity futures contracts, by themselves, will not be treated as securities. Two reasons may be utilized to justify this result at the federal level. First, because of the independent development of the commodities and securities markets, Congress created a separate system of regulating commodities under the Commodities Exchange Act.⁷⁸ Since this statute has been construed as creating a private cause of action⁷⁹ similar to that found under SEC Rule 10b-5,⁸⁰ it would appear unnecessary to employ the federal securities laws to protect investors in commodity futures.⁸¹

Second, and perhaps more importantly, the dominant theme in the recent history of securities regulation is that in order for an investment to be a security, the investor must be passive and derive his profits from the active management of some other person.⁸² Probably the most

78. 7 U.S.C. § 1 *et seq.* (1970).

79. *See, e.g., Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132 (8th Cir. 1970).

80. 17 C.F.R. § 240.10b-5 (1973).

81. It is interesting to note, however, that the "bucket shop" acts (*see* notes 57-59 *supra* & accompanying text) regulate spurious trading in both commodities and stocks. *See, e.g., OKLA. STAT. tit. 15, §§ 562, 564* (1971). There is thus some precedent for joint control under a single system of regulation.

82. An examination of cases interpreting early state securities acts indicates that the purpose of these statutes was not merely to protect passive investors but to provide a broad range of protection. For example, the court in *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937, 938 (1920), applying a standard dictionary definition, stated that an investment involves "[t]he placing of capital or laying out of money in a way intended to secure income or profit from its employment" and concluded that any contract involving such an investment is a security. Under this definition, almost any investment, be it in real property, commodity futures, or an annuity-type insurance policy, would come within the definition of a security. Today in some states there are lingering vestiges of this early concept, as is evidenced by the continued classification as securities of investments in real property, particularly if located outside the state. *See, e.g., OHIO REV. CODE ANN. § 1707.01(B)* (1964); *TENN. CODE ANN. § 48-1602(J)* (1964). However, following the enactment of the federal securities acts and the subsequent definition of an investment contract by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), to be considered in detail in a subsequent section, the trend, reaching a peak in the late 1950's and 1960's, was to hold that an instrument would not be deemed a security unless it was traded in the normal securities market. Because of the reemergence of promotional schemes such as those of Glenn Turner and the founder-membership crowd (apparently, this type of scheme has been with us as long as securities regulation (*see* note 147 *infra*)), courts have rediscovered the original intent of the securities acts and now are applying a broad definition of a security to such investment transactions. *See, e.g., SEC v. Glenn W. Turner Entpr., Inc.*, 348 F. Supp. 766 (D. Ore. 1972), *aff'd*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973); *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971). *See also State v. Investors Security Corp.*, — Minn. —, 209 N.W.2d 405 (1973). For a discussion of some of the early cases,

famous expression of this concept is found in *SEC v. W.J. Howey Co.*,⁸³ in which the Supreme Court enunciated the classic definition of an investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party" ⁸⁴ Thus, under the *Howey* test, an investment contract is a security only where there is a common enterprise and only if the management of that enterprise is left in the hands of someone other than the investor.

As will be discussed in a subsequent section, the courts have experienced some difficulty in applying the *Howey* test to particular factual situations. Nevertheless, it would seem clear that commodity futures contracts do not satisfy either the common enterprise or third party management requirements of the definition.⁸⁵ Since the commodity investor decides what futures contracts to invest in and when he will buy or sell, he exercises complete control over his investment and is entirely responsible for its profitability. Obviously, there is no common enterprise involved because the investor acts alone.

On the other hand, a slight alteration in this pattern may bring the transaction within the *Howey* definition of an investment contract. If the investor pays an *expert* to select the futures to be purchased, to decide when they should be sold, or to care for the underlying commodities, his *agreement* with the expert should be classified as a security.⁸⁶ In this situation, however, it is important to note that it is the transactional arrangement the parties have selected, and not the commodity

see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

83. 328 U.S. 293 (1946).

84. *Id.* at 298-99 (emphasis supplied).

85. This blanket statement should be qualified to the extent that if the person offering the commodity futures contracts originally does not have the underlying commodities to deliver on the date agreed upon, the situation is similar to the sale of a naked commodity option contract, since in both cases the purchaser must assume the additional enterprise risk that the person issuing the contract will be unable to perform. The Georgia Securities Commissioner recently indicated that in such circumstances, he considers a commodity futures contract as much an investment contract as he does a naked option. *Commodities Trading*, *supra* note 23.

86. Cf., e.g., *SEC v. Haffenden-Rimar Int'l, Inc.*, 362 F. Supp. 323 (E.D. Va. 1973) (whiskey warehouse receipts); *SEC v. M.A. Lundy Assoc.*, 362 F. Supp. 226 (D.R.I. 1973) (same); *SEC v. First Leisure Corp.*, Civ. A. No. 72-2616-RJK (C.D. Cal. Nov. 3, 1972) (consent decree) (discretionary trading account in commodity options); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968) (discretionary trading account).

futures, which constitutes the security.⁸⁷ As a result of this agreement, the investor furnishes the capital which the expert agrees to invest in the commodities market in order to achieve the common enterprise's profitmaking objective. Since the commodity futures in this situation are nothing more than the medium used to generate the profit, the same result would obtain if any other medium, such as real estate investment or cattle feeding, were used.⁸⁸

The status of commodity futures under state blue sky laws is less clear. In two states, Oklahoma⁸⁹ and Wisconsin,⁹⁰ commodity futures are specifically included within the definition of a security. In both cases, however, they are exempted from registration requirements. Statutory coverage, therefore, is limited to antifraud provisions and dealer registration requirements for firms selling the futures contracts. Three other states include warehouse receipts within the definition of a security.⁹¹ Because most futures contracts are not settled by the actual delivery of the commodity, but rather by the negotiation of a warehouse receipt, it can be argued that in these states the futures contract is a security because it is a "temporary or interim certificate for" or "receipt for" another security, the warehouse receipt.

Even in the vast majority of states which have adopted a definition of a security similar to that in the federal securities laws, the argument has been made that commodity futures are investment contracts. Prior to the passage of the new Wisconsin statute specifically including commodity futures within the definition of a security, for example, the Wisconsin Commissioner took this position in an administrative release.⁹²

87. See *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935). The agreement can be a security even though it is not in writing and there is only an informal understanding between the parties. *Commercial Iron & Metal Co. v. Bache & Co.*, 478 F.2d 39 (10th Cir. 1973); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968).

88. *SEC v. Lake Havasu Estates*, 340 F. Supp. 1318 (D. Minn. 1972) (land); *People v. Witzerman*, 29 Cal. App. 3d 169, 105 Cal. Rptr. 284 (Dist. Ct. App. 1972) (cattle feeding); *State v. Investors Security Corp.*, — Minn. —, 209 N.W.2d 405 (1973).

89. OKLA. STAT. tit. 71, § 2(20)(0) (1971), as amended by Okla. Laws 1973, H.B. 1035, § 1 (May 15, 1973). Coverage of this statute is limited to commodities not regulated by the Commodity Exchange Authority. *Id.*

90. WIS. STAT. § 551.02(13) (a) (1971).

91. FLA. STAT. § 517.02 (1973); LA. REV. STAT. § 51:701(1) (1950); N.H. REV. STAT. ANN. § 421:2 (1955).

92. WIS. SEC. COMM'N, MONTHLY SEC. BULL. 2 (Feb. 1968), cited in 4 L. LOSS, SECURITIES REGULATION 2504 (1969 Supp. to 2d ed.). In the statement, Commissioner Nelson, in response to a series of questions raised by the Wisconsin bar, indicated his belief that commodity futures fell within those portions of the Wisconsin definition of a security dealing with "investment contracts" and "interests in property." This latter portion of the definition was dropped when the new Wisconsin law was enacted.

His announcement was in the form of a brief statement of policy, however, and did not contain a discussion or citation of authority.⁹³

There are special reasons for treating commodity futures as investment contracts under the state securities laws. Unlike the situation at the federal level, only one state has legislation specifically regulating the sale of commodity futures contracts.⁹⁴ Thus, in an attempt to provide needed protection to the commodities investor, state courts and securities commissions may feel compelled to hold that commodities futures are investment contracts and thus securities within the conventional definition.⁹⁵ Although such an approach might be tempting, it is difficult to support under existing definitions of an "investment contract."

As will be indicated, the states generally have accepted, with some modifications, the basic definition of an "investment contract" established by the Supreme Court in *Howey*. One modification which has received recent acceptance by a few courts is the elimination of the common enterprise requirement.⁹⁶ Even with this alteration, however, it remains clear that the commodity futures purchaser is still the master of his own destiny and is not relying upon someone else to make investment decisions for him. Indeed, the presence or absence of the ability to make management and investment decisions, and thereby to control the success or failure of the investment, has been the key to the coverage of modern state and federal securities laws. Until such time as the state courts abandon this concept in favor of the older and much broader basis for securities status,⁹⁷ commodity futures contracts, standing alone, will not be classified as securities. If the futures contracts underlying a commodity option cannot be deemed securities, the option

93. More recently, the author argued this position for the Oklahoma Securities Commission in its case against Goldstein Samuelson. Legal Memorandum of the Staff at 3-4, *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

94. Cal. Laws 1973, Ch. 854, WEST CAL. LEGIS. SERV. 1714-31 (Sept. 25, 1973). The act regulates the exchanges, dealers, and agents selling futures contracts, but not the contracts themselves. In addition, it covers commodity transactions not regulated under the federal act, that is, the so-called "world" commodities, such as silver, coffee, and plywood.

95. Cf. Brief for Plaintiff at 3, *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,058 (Md. Cir. Ct., Baltimore County, Feb. 27, 1973).

96. *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973); *State v. Investors Security Corp.*, — Minn. —, 209 N.W.2d 405 (1973). See also 5 CAL. CORP. COMM'R OFFICIAL OP. 73/42C (Mar. 20, 1973).

97. See note 82 *supra*.

itself cannot be classified as "a guarantee of . . . or right to purchase" a security.

Evidence of Indebtedness

A much stronger case can be made for the inclusion of naked commodity options within the portion of the standard definition of a security pertaining to evidences of indebtedness. Unfortunately, as with most of the general categories within the definition, the concept of "evidence of indebtedness" has not received extensive treatment by the courts, agencies, or legal scholars. This is not to say that many of the more common forms of indebtedness have escaped securities regulation.⁹⁸ For example, the standard definition of a security specifically categorizes and includes bonds, debentures, and promissory notes. In addition, other common forms of indebtedness, such as savings accounts and certificates of deposit, generally are recognized as securities.⁹⁹

There have been a few scattered cases involving several of the more unusual types of evidences of indebtedness. In 1931, the Wisconsin Attorney General was asked to consider the legality of a scheme involving the sale of coupon books with goodwill bonds attached.¹⁰⁰ The coupon books were priced at either \$100 or \$35, and the goodwill bond was included at no additional cost. The proceeds from the sale of the coupon books were to be used to build gas stations at which the coupons could be redeemed. The goodwill bond provided that the company would set aside from each sale of gasoline and oil a certain amount, which, after a period of time or when the fund reached a given level, would be distributed to the holders of the bonds. The attorney general ruled that the coupon books and goodwill bonds were both evidences of indebtedness and therefore securities under Wisconsin law. The following year

98. In a recent development, the Interstate Commerce Commission, which has control over the securities issued by the various common carriers in the United States, used its power to define terms to bring all common carrier debts, regardless of whether they are evidenced by promissory notes, within the definition of a security. CCH FED. SEC. L. REP. No. 495, pt. 1, at 4 (Sept. 6, 1973).

99. SEC v. First Am. Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973); SEC v. W.L. Moody & Co., [1972-73 transfer binder] CCH FED. SEC. L. REP. ¶ 93,619 (S.D. Tex. 1972); Ariz. Att'y Gen. Op., [1954-71 transfer binder] BLUE SKY L. REP. ¶ 70,246 (1954); 1 OP. ATT'Y GEN. (Ohio) (Bricker) 572 (1933); 1 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.17 (1972). Cf. SEC v. C.H. Wagner & Co., [1971-72 transfer binder] CCH FED. SEC. L. REP. ¶ 93,380 (D. Ore. 1972); SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830 (S.D. Cal.), *modified*, 285 F.2d 162 (1960), *cert. denied*, 366 U.S. 919 (1961).

100. 20 OP. ATT'Y GEN. (Wis.) 176 (1931).

this characterization was sustained by the Wisconsin Supreme Court in *Brownie Oil Co. v. Railroad Commission*,¹⁰¹ the court stating:

No doubt exists as to the purposes of the certificates. *The issuing corporation seeks, first, to have financed a particular service station by means of customer advances*, and, second, to secure the custom and recommendation of those who purchase certificates by offering certain returns based upon the volume of business done. It is probably not important in this action that the relations between the certificate holder and the corporation be definitely labeled. . . . *This is a device for financing a corporation.* The inducement to secure this financing is the promised creation of a fund which will later be distributed to the person making the investment or furnishing the financing. This person waives his right to any interest or dividends as such, but he does invest with the hope or expectation that the money invested will be returned to him together with some payment for its use. He acquires the right to have the fund accumulated and receive his distributive share when it is accumulated. *He accepts the risk that the enterprise will be unable to get into operation and that the period of its operation will be neither sufficiently long nor successful to bring him the expected returns.*¹⁰²

More recently, in *State v. Hodge*,¹⁰³ a promoter was convicted of a securities law violation for selling "Receipts in Lieu of Promissory Contract." The receipts provided that the corporation receiving the investment would return twice the amount listed on the face thereof one year after the initial investment.¹⁰⁴ The Supreme Court of Kansas stated that these receipts were evidences of indebtedness and upheld the conviction.

A Canadian court recently considered an interesting debt instrument in *In re Sanderson and Ontario Securities Commission*.¹⁰⁵ Using advertisements in local papers, Sanderson offered to pay \$70 a week for 16 weeks to anyone making a \$400 initial investment. The investor could demand a refund at any time, and his original \$400, less any \$70 pay-

101. 207 Wis. 88, 240 N.W. 827, 829 (1932).

102. *Id.* (emphasis supplied). The court held that the coupons and bonds were securities within that portion of the Wisconsin definition including "evidence of debt, or interest in or lien upon any or all of the property or profits of a company." *Id.* at 828.

103. 204 Kan. 98, 460 P.2d 596 (1969).

104. *Cf. In re Prestige Fin. Corp.*, Summary Cease and Desist Order, Okla. Sec. Comm'n (Aug. 29, 1973) (the corporation offered to return \$1,900 for every \$100 invested).

105. 28 D.L.R.3d 171 (Ont. 1972).

ments already received, would be returned to him. Sanderson intended to generate a return by taking the investments to several race tracks in the United States and betting on the ponies. When the Ontario Commission ordered a halt to the sale of the agreements, Sanderson sought judicial review. The court held that the agreements were securities within that portion of the Ontario act covering income and annuity contracts.¹⁰⁶

In most of these cases, the courts, although holding that particular interests were securities because of their "debt" characteristics, have not attempted to formulate a definition of the term "evidence of indebtedness."¹⁰⁷ Such an effort recently was made, however, by the Court of Appeals for the Tenth Circuit in *United States v. Austin*.¹⁰⁸ Austin and several other defendants sought out construction companies in need of money to complete various projects and offered, for a price, "letters of commitment," which, in essence, were promises by the defendants to secure funds from a third party or, if a third party lender could not be found, to advance the money themselves.¹⁰⁹ In upholding a finding that the letters of commitment were evidences of indebtedness and thus securities, the court stated:

The term "evidence of indebtedness" is not limited to a promissory note or other simple acknowledgment of a debt owing and is held to include all contractual obligations to pay in the future for consideration presently received.

. . . .

It is true that the letter of commitment is not an indicium of debt in the same sense as a promissory note, but as used in the Se-

106. For other cases involving unusual evidence of indebtedness, see *Strauss v. State*, 113 Ga. App. 90, 147 S.E.2d 367 (1966) (money orders); *Donovan v. Dixon*, 261 Minn. 455, 113 N.W.2d 432 (1962) (guarantee fund certificates); *State ex rel. Healy v. Cathedral of Tomorrow, Inc.*, 3 BLUE SKY L. REP. ¶ 71,052 (Ore. Cir. Ct., Marion County, Oct. 9, 1972) (time payment certificates).

107. Of course, the formulation of such definitions would be no problem if the courts were willing to recognize that all securities have certain common characteristics. If a court applies these characteristics in determining whether a particular instrument is a security, the label that is given to that instrument (e.g., evidence of indebtedness or investment contract) is unimportant. For this author's catalogue of the common characteristics of securities, see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971). Unfortunately, all too often the courts are more interested in a label than the substance of the transaction.

108. 462 F.2d 724 (10th Cir.), cert. denied, 409 U.S. 1048 (1972).

109. For variations on this basic fraud scheme, see MICH. SEC. COMM'N SEC. BULL. 1 (Sept. 1, 1972).

curities Act no such restriction is appropriate. In last analysis, this letter of commitment was sold for a substantial consideration, and the buyer received what appeared to be an enforceable obligation which contemplated the flow of funds. It indicated a binding and legally enforceable right. Therefore, we can find no fault with the ruling of the trial court insofar as it regarded the letter of commitment as plainly being a security.¹¹⁰

A close reading of the *Austin* case reveals that the court, unable to find a definition of evidence of indebtedness in any of the reported securities cases, applied a general common law definition drawn from nonsecurities contexts.¹¹¹ Although this in itself is not an uncommon practice,¹¹² the court in *Austin* appears to have broadened substantially the definition it adopted, which had emphasized the obligation of the person receiving the initial consideration *to make a future payment in return*.¹¹³ In *Austin*, however, the obligation of the issuer of the letters of commitment was to find a third party willing to lend money and only in the event third-party financing could not be obtained itself *to make a loan*. Nevertheless, the court held that the conditional promise to make a loan contained in the letters of commitment constituted an evidence of indebtedness.

Under the *Austin* definition, even the London or Mocatta options could be deemed to be evidences of indebtedness. The essence of these options, as with options in general, is that for consideration received the optionor stands ready to buy or sell the underlying property at a fixed price. There would seem to be little significant legal difference between an obligation to buy or sell and an obligation to loan money. Although neither is an unqualified obligation to pay money, under the

110. 462 F.2d at 736. The Michigan Securities Commission has taken a similar stand on such advance fee schemes. MICH. SEC. COMM'N SEC. BULL. 1 (Sept. 1, 1972).

111. The court relied upon definitions supplied in *Keller v. City of Scranton*, 200 Pa. 130, 49 A. 781 (1901), and *Nelson v. Wilson*, 81 Mont. 560, 264 P. 679 (1928), as well as in three federal cases dealing with the question of what is a security under the Stolen Property Act, 18 U.S.C. § 2311 (1970): *Merrill v. United States*, 338 F.2d 763 (5th Cir. 1964); *Barack v. United States*, 317 F.2d 619 (9th Cir. 1963); *United States v. Jones*, 182 F. Supp. 146 (W.D. Mo. 1960).

112. See, e.g., *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920).

113. This does not mean that such an obligation to pay cannot be made conditional on the happening of certain events. As will be noted subsequently, a conditional obligation to pay money is as much an evidence of indebtedness as an absolute obligation to pay. See notes 128-31 *infra* & accompanying text.

Austin rationale each is "an enforceable obligation which contemplate[s] the flow of funds."¹¹⁴

It seems unlikely that this attempt to broaden the definition of evidence of indebtedness will receive widespread acceptance.¹¹⁵ Even so, the decision in *Austin* stands as support for the argument that the naked commodity option is an evidence of indebtedness for securities classification purposes. As noted earlier,¹¹⁶ the dealer in naked options, instead of making a delivery of the underlying futures contracts, "repurchases" the option from the contract holder, paying him the difference between the current market price and the option striking price. In some cases, the sales literature specifically indicates that this is the way the transactions are to be handled. For example, one dealer in its literature states: "First Federated Commodity Option Company is the granter of the options and *guarantees upon demand to redeem* any and all Options, either Put or Call, or Put and Call (Double Options) which have been duly registered on its books, for their value."¹¹⁷ In other cases, it appears that the essence of the buy-back agreement, although not specifically mentioned in the sales literature, is conveyed to the customer as a part of the sales promotion.¹¹⁸ Furthermore, it would appear the first generation naked option firms apparently all had the policy of automatically repurchasing any option in which the holder had a "profit" on the last day of the option period, even if they had not received instructions from the holder to do so. It is submitted that this automatic repurchase feature converts the option dealer's obligation from one to buy or sell the underlying futures contracts to one to *pay* a monetary return at some time in the future and thus brings it within the definition of an "evidence of indebtedness" as applied by the *Austin* court.

114. 462 F.2d at 736.

115. See *Wisconsin S. Gas Co. v. Public Serv. Comm'n*, 3 BLUE SKY L. REP. ¶ 71,046 (Wis. Cir. Ct., Dane County, May 8, 1972), rejecting the claim that an agreement to purchase stock in another corporation was an evidence of indebtedness within the meaning of either the securities act or the public service act.

It will be seen that many of the instruments which appear to fall within the extended scope of the *Austin* test for an evidence of indebtedness may also be classified as investment contracts.

116. See notes 50-52 *supra* & accompanying text.

117. First Federated Commodity Option Co., *The Power of Commodity Options* 2-3 (undated, issued Spring 1973) (emphasis supplied). See also Goldstein Samuelson, Inc., *An Investment Opportunity* 7 (undated, issued 1972), indicating that the firm would always buy back profitable options.

118. *People v. Puts and Calls, Inc.*, 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., L.A. County, June 21, 1973).

The discussion cannot end at this point, however. Unfortunately, during the past 25 years there has been a growing reluctance by the courts to include certain promissory notes or evidences of indebtedness within the coverage of the securities acts, even though they clearly come within the definitional language.¹¹⁹ In most cases the courts have not attempted to explain why a particular instrument is held not to be a security, except to state that Congress or the state legislature did not intend to include it within the coverage of the securities act.¹²⁰ The net result has been that the courts have resorted to a rather tortured construction of the definitional language to escape inclusion.¹²¹

This conservative attitude is reflected in the decision of the Supreme Court of Oregon that merchant trading stamps are not securities. In explaining its position that instruments should not necessarily be deemed securities merely because they technically fall within the categories contained in statutory definitions, the court in *Sperry & Hutchinson Co. v. Hudson*¹²² stated:

119. See, e.g., *Lino v. City Investing Co.*, CCH FED. SEC. L. REP. ¶ 94,124 (3d Cir. Aug. 20, 1973); *Janssen v. Tri-Pac Dev. Corp.*, Civ. A. No. 72-1200 (E.D. Pa. Dec. 1, 1972); *Joseph v. Norman's Health Club, Inc.*, 336 F. Supp. 307 (E.D. Mo. 1971) (all involving promissory notes arising out of consumer sales transactions); *Forman v. Community Servs., Inc.*, CCH FED. SEC. L. REP. ¶ 94,139 (S.D.N.Y. Sept. 6, 1973) ("stock" in publicly financed co-op housing project); *Wisconsin S. Gas Co. v. Public Serv. Comm'n*, 3 BLUE SKY L. REP. ¶ 71,046 (Wis. Cir. Ct., Dane County, May 8, 1972) (evidences of indebtedness issued in connection with a purchase of corporate stock). But see *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), cert. denied, 409 U.S. 1009 (1972); *MacAndrews & Forbes Co. v. American Barmag Corp.*, 339 F. Supp. 1401 (D.S.C. 1972), discussed in Long, *Don't Forget the Securities Acts!*, 26 OKLA. L. REV. 160 (1973).

120. See, e.g., *Lino v. City Investing Co.*, CCH FED. SEC. L. REP. ¶ 94,124 (3d Cir. Aug. 20, 1973); *McClure v. First Nat'l Bank*, 352 F. Supp. 454 (N.D. Tex. 1973).

121. This construction takes two basic forms. The definitional provisions in most securities acts are preceded by the statement that the definitions outlined shall govern, *unless the context otherwise requires*. See, e.g., UNIFORM SECURITIES ACT, § 401 (1956). Seizing upon this language and stating its belief that the securities acts were not intended to cover a certain type of instrument or transaction, the court then indicates either that the instrument is not a security within the definition of a security (e.g., *McClure v. First Nat'l Bank*, 352 F. Supp. 454 (N.D. Tex. 1973); *Joseph v. Norman's Health Club, Inc.*, 336 F. Supp. 307 (E.D. Mo. 1971)) or that there is no sale of the instrument within the definition of "sale" (e.g., *Lino v. City Investing Co.*, CCH FED. SEC. L. REP. ¶ 94,124 (3d Cir. Aug. 20, 1973); *McClure v. First Nat'l Bank*, *supra*). The soundness of these conclusions concerning legislative intent, which is usually taken as an article of faith, is open to question.

122. 190 Ore. 458, 226 P.2d 501 (1951). It is submitted that these stamps clearly constitute an evidence of indebtedness, since the company is obligated to redeem them in exchange for merchandise or cash. The further holding of the court that there

The terms "evidence of indebtedness," "certificate of interest or participation in any profit-sharing agreement," and "investment contract" as used in the act refer only to such of those types as are commonly known as "securities"; *they contemplate the presence of the investment process*, that is, "the investment of funds . . . with a view of receiving a profit through the efforts of others than the investor."¹²³

It is submitted that even under this rationale, naked options can be classified as securities, since they are evidences of indebtedness arising out of the investment process. The most graphic means of illustrating this point is to compare the purchaser of a naked commodity option with a savings account holder. It is well established that savings accounts are evidences of indebtedness of the investment type and thus clearly within the coverage of the securities acts.¹²⁴ The savings account holder turns his money over to the bank in exchange for its promise to pay him a certain rate of interest; the bank must reinvest this money in order to generate sufficient funds to pay that interest. Although the investor in no way shares in the investment decisions of the bank's officers and directors, he must bear the risk of their making unsound or unproductive investments, as a result of which the bank will be unable to pay the promised interest.

was no "sale" of the stamps within the meaning of the act also is suspect. The standard definition of "sale" in the securities acts indicates that whenever a security is received as a bonus on any other purchase, the security is considered to constitute a part of the purchase and therefore sold for value. *See, e.g.,* UNIFORM SECURITIES ACT § 401(j)(3) (1956). It is interesting to note that almost twenty years earlier, the Oregon Attorney General, taking the language of the statute at face value, held a somewhat similar stamp plan to be a security. [1932-34] OR. ATT'Y GEN. (Ore.) 499 (1933).

123. 190 Ore. at —, 226 P.2d at 505 (emphasis supplied). It should be apparent that this formulation is essentially the *Howey* test for an investment contract. The Oregon court, however, took this quotation from the definition of a *security* found in 37 C.J. *Licenses* § 168 (1925). For a detailed discussion of this test and an expansion of the theme that there are certain factors common to all securities, see Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971).

124. SEC v. First Am. Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973); SEC v. W.L. Moody & Co., [1972-73 transfer binder] CCH FED. SEC. L. REP. ¶ 93,619 (S.D. Tex. 1972); Ariz. Att'y Gen. Op., [1954-71 transfer binder] BLUE SKY L. REP. ¶ 70,246 (1954); 1 OR. ATT'Y GEN. (Ohio) (Bricker) 572 (1933). Cf. *Reiger v. Commissioner*, 139 F.2d 618 (6th Cir. 1943); *Young v. Seaboard Corp.*, 360 F. Supp. 490 (D. Utah 1973); SEC v. C.H. Wagner & Co., [1971-72 transfer binder] CCH FED. SEC. L. REP. ¶ 93,380 (D. Ore. 1972).

The buyer of a naked option assumes a similar risk when he opens an account with an option dealer. The investor is sold an option contract, and, in exchange for a fee or premium, the dealer agrees to repurchase the option on a specified date. Thus, like the savings account holder, the purchaser of a naked option expects to receive a monetary return from the person to whom he has given his funds. The option dealer functions much like a bank, in that it must use option premiums to generate the funds necessary to honor its repurchase obligations.¹²⁵ All investment decisions are made by the dealer, and, as has been demonstrated by the bankruptcy of most of the first generation option firms,¹²⁶ the investor bears the risk that the dealer will not be in a position to honor its obligation to repurchase.¹²⁷

The analogy between savings accounts and naked option contracts admittedly is imperfect. Nevertheless, it is submitted that there is no distinction between the two transactional arrangements relevant to the question of securities classification. It might be argued, for example, that the savings account holder's right to receive payment of his interest is absolute, while the option holder can profit only if there is a fluctuation in the price of a particular commodity futures contract.¹²⁸ Many

125. Unlike banks, however, most option dealers are very thinly capitalized and, as investigation of the first generation option companies has revealed, rarely have the opportunity to undertake significant investment.

126. See, e.g., *In re Traders Int'l, Ltd.*, Bankruptcy No. 7350 (D. Nev. Aug. 23, 1973) (decision of the referee that commodity options are securities); *In re Puts and Calls, Inc.*, Civ. A. No. 73-02706 (C.D. Cal., filed May 3, 1973). It has been estimated that losses to option holders, including premiums and profits from options exercised, have exceeded \$100 million. *The Wall Street Journal* (SW ed.), June 28, 1973, at 32, col. 1. Some of these losses may be recouped if the bankruptcy courts follow the lead of the court in *Traders International* and hold that the options are securities, since a strong argument can be made that the purchaser of an unregistered security who rescinds his transaction stands ahead of, or on a par with, other general creditors of a corporation. See Slain and Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U.L. REV. 261 (1973).

127. Cf. *People v. Puts and Calls, Inc.*, 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., L.A. County, June 21, 1973).

128. It is really a misnomer to refer to naked options as "futures options," since the only part played by the futures market in the option transaction is in determining the amount of the holder's profit. Obviously, any other measuring device subject to unpredictable variations would serve the same function. For example, the contract could provide that the holder would be entitled to one dollar for every degree that the temperature fell below, or rose above, the mean average temperature in Oklahoma City on any given day between July 1 and December 31. The commodity market was no doubt selected to give the contracts an investment flavor, while avoiding any superficial connection with the securities market.

securities, however, such as preferred stock, provide that payments will be made only upon the happening of certain specified events.¹²⁹

The insignificance of the conditionality of an obligation to pay for purposes of classification as an evidence of indebtedness is demonstrated by *Curtis v. Johnson*,¹³⁰ which involved a rather unusual trust receipt agreement contemplating the eventual formation of a limited partnership. Once the partnership was formed the receipt holder could demand the return of his investment with interest for the period it was held. In rejecting the argument that the receipts were not evidences of indebtedness because the obligation to pay was conditional, the court observed: "The mere fact that the trust receipt provides for a redemption or repayment under certain conditions and at times selected by the promoters, i.e., at such time as ' . . . the Limited Partnership Agreement is ready to be executed, . . . ' does not make it any less a certificate of indebtedness" ¹³¹

A second arguable difference between the two investment mediums is that normally the savings account holder receives a fixed return, while the option holder's return is governed by the changes in price of the underlying commodity futures. Although debt obligations generally are thought of as carrying a fixed rate of return, this is not always the case. The interest rates of many large commercial loans and newer mortgages, for example, often vary according to changes in the prime lending rate, which is set by the larger banks in New York City. Furthermore, the interest on savings accounts technically is not fixed, since the practice in recent years has been for banks to pay the "highest interest allowable by law." In reality, the interest rates on savings accounts follow the changes in the maximum rates permitted by the Federal Reserve Board. It is significant, moreover, that irrespective of the agency making the adjustment in interest rates (FRB, investment bank, or local bank), the variation is caused by external factors, either economic or governmental, which are beyond the control of either the savings account holder or the bank.¹³²

129. For example, the dividend may be payable only out of earnings and profits. In addition, preferred dividends are often noncumulative, which basically means that preferred shareholders have no right to dividends unless they are declared by the board of directors.

130. 92 Ill. App. 2d 141, 234 N.E.2d 566 (1968).

131. *Id.* at 150, 234 N.E.2d at 571.

132. It might also be argued that savings accounts and naked options should be treated differently because the option holder actively participates in the determination of his return by selecting which option to buy and how long to hold it. Since this

In summary, it is clear that naked commodity option contracts are within the broad definition of an evidence of indebtedness outlined in *Austin*, as well as the more stringent standard, requiring that the transaction arise out of an investment situation, set forth in *Sperry & Hutchinson*. This conclusion is made manifest by consideration of the similarities between savings accounts, which clearly are securities, and naked options. Despite insignificant differences between the two forms of transaction, the basic economic effect of the two is the same, and they therefore should be treated alike for purposes of securities classification.¹³³

Investment Contracts

An equally strong argument can be made for including naked commodity option contracts within the investment contracts category of the definition of a security.¹³⁴ Much has been written on the attempts of courts and legal scholars to arrive at an adequate definition of an investment contract. Although it is not the purpose of this Article to give a full account of these efforts,¹³⁵ it will be necessary to describe the

argument relates to that portion of the *Howey* definition of an investment contract requiring that profits be derived "solely" through the efforts of others, full treatment of this issue will be reserved until the next section. However, two comments should be made at this point. First, the savings account holder in part determines his return by selecting the institution and the type of account in which he will deposit his money. The government traditionally has permitted savings and loan institutions to pay a slightly higher rate of return than commercial banks on the same type of passbook account. Furthermore, most banks offer different rates of interest depending upon the length of time funds are invested and the amount of notice required for withdrawal. Of course, the savings account holder also in part determines his return by deciding when to withdraw his money.

In any event, investor participation under the *Howey* test does not mean participation in the determination of the *amount* of the return but rather participation in the management and investment decisions leading to the *generation* of a return. The *Howey* test thus considers whether the investor has a say with respect to whether he will receive *any* return on his investment.

133. Naked commodity options were held to be "evidences of indebtedness" under the Oklahoma statute in *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973).

134. *People v. Puts and Calls, Inc.*, 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., L.A. County, June 21, 1973); *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973). *But see SEC v. Continental Commodity Corp.*, Civ. A. No. 3-6976-D (N.D. Tex. Apr. 9, 1973); *International Commodity Trust, Inc. v. Fisher*, 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Oklahoma County, May 14, 1973).

135. See, e.g., Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967); Long, *An Attempt to Return*

controversy which has surrounded this definition in order to develop the argument that naked options should be deemed investment contracts.

In drafting the first comprehensive federal legislation dealing with securities regulation, Congress borrowed many concepts and features from existing state securities laws. Indeed, the definition of a security in the Securities Act of 1933 contains many general terms, such as "investment contract," which were derived from state statutes. However, as noted in the now-famous case of *State v. Gopher Tire & Rubber Co.*,¹³⁶ state legislatures had left to the courts the task of providing definitions for these terms, including "investment contract."

The first Supreme Court decision to consider this definitional category was *SEC v. C.M. Joiner Leasing Corp.*¹³⁷ The Court wisely refused to enunciate a comprehensive definition of an investment contract, believing that any such definition would be evaded immediately by the development of new financing interests. Instead, the Court held that the oil leases and accompanying test well drilling contracts sold by the defendant corporation were securities on the ground that "trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end."¹³⁸ In addition, the Court noted that the descriptive terms within the definition of a security, such as "investment contract" and "transferable share," created generic rather than specific classifications:

We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are

"Investment Contracts" to the Mainstream of Securities Regulation, 24 OKLA. L. REV. 135 (1971). For excellent summaries of developments within the last several years, see Note, *Pyramid Schemes: Dare to Be Regulated*, 61 GEO. L.J. 1257 (1973); Note, *Regulation of Pyramid Sales Ventures*, 15 WM. & MARY L. REV. 117 (1973); 51 TEX. L. REV. 788 (1973).

136. 146 Minn. 52, 177 N.W. 937 (1920). In *Gopher Tire*, the Supreme Court of Minnesota determined that certificates issued in consideration of a sum paid by the purchaser and of his assistance in promoting a sale of goods manufactured by the corporation were not contracts for the performance of services by agents but rather were within the scope of the state's statute listing investment contracts as securities.

137. 320 U.S. 344 (1943).

138. *Id.* at 349.

also reached if it be proved as 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," . . .¹³⁹

In rejecting the defendants' argument that their offerings were beyond the scope of the Securities Act because they purported to convey only interests in real estate, the Court stated: "The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. *In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be.*"¹⁴⁰

In *SEC v. W.J. Howey Co.*,¹⁴¹ decided just three years after *Joiner*, the Supreme Court did an about-face and held that "an 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 a third party" ¹⁴² Apparently in deference to the principles enunciated in *Joiner*, however, the Court admonished that "[t]he statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."¹⁴³

There are four basic elements to the *Howey* test: (1) the investment of money; (2) in a common enterprise; (3) with the expectation of a profit; (4) to come solely through the efforts of others.¹⁴⁴ Since

^{139.} *Id.* at 351.

^{140.} *Id.* at 352-53 (emphasis supplied).

^{141.} 328 U.S. 293 (1946). The defendant company was an established Florida citrus fruit growing firm which desired to increase its production. The company was able to secure an additional 500 acres of suitable land, but it had to sell half of the land in small plots to investors in order to raise development capital. Since purchasers of the land were not in a position to develop and care for their plots, they also were offered management contracts with an affiliated corporation, *Howey-in-the-Hills Service, Inc.*

^{142.} *Id.* at 298-99.

^{143.} *Id.* at 301.

^{144.} In announcing this definition, the Court claimed that it was not formulating a new test but merely adopting that employed by state courts prior to the Securities Act of 1933. The Court's theory was that Congress, in including the term in the definition of a security in the Securities Act, was aware of and intended to adopt the existing definition. An examination of state cases decided prior to 1933, however, reveals that the "common enterprise" and "solely through the efforts of others" portions of the definition have no basis in pre-1933 case law. For a discussion and detailed analysis of these state cases, together with the early federal cases, see Long, *An Attempt to Return*

Howey, the state courts, although not compelled to do so,¹⁴⁵ generally have applied this four-part test in securities cases to determine whether a particular instrument is an investment contract. When a standard such as the *Howey* test is repeated over a period of time, it often becomes a rubric, the courts tending to lose sight of its original meaning and purpose. As a result, the test becomes wooden and artificial and its application mechanical. Obviously, the unthinking repetition of the test may be justified when a particular instrument is clearly an investment contract.¹⁴⁶ Nevertheless, as recognized by the Supreme Court in *Joiner*, there is a danger that unusual financial arrangements, such as referral sales, founder-membership plans, and pyramid sales schemes,¹⁴⁷ will escape regulation if courts insist upon applying inflexible standards.

Initially, it appeared that promoters could avoid the requirements of the securities acts by devising schemes which did not fall within the precise language of the *Howey* definition.¹⁴⁸ As new investment schemes

"Investment Contracts" to the Mainstream of Securities Regulation, 24 OKLA. L. REV. 135 (1971).

145. Since the *Howey* decision involved an interpretation of a federal statute rather than the Constitution, state courts may regard the case as persuasive, but not binding, authority. *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971). See *Department of Indus. Relations v. Drummon*, 30 Ala. App. 76, 1 So. 2d 395, *cert. denied*, 241 Ala. 142, 1 So. 2d 402 (1941).

146. A basic problem with the *Howey* test is that it was formulated in a case where the investor was completely passive, since *Howey-in-the-Hills Service, Inc.* furnished both the management and physical labor necessary to raise the citrus fruit. It thus was unnecessary for the Court to specify the type and degree of investor participation necessary for a scheme to escape classification as an investment contract. The same has been true with respect to most of the decisions applying the test. See, e.g., *Tcherepnin v. Knight*, 389 U.S. 332 (1967); *Ahrens v. American-Canadian Beaver Co.*, 428 F.2d 926 (10th Cir. 1970); *Roe v. United States*, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961). Courts, however, recently have become more critical in their analyses as a result of the blatant attempts of promoters, in requiring investors to perform some minor function in the enterprise, to remove their operations from the scope of the *Howey* test.

147. These schemes appear to be as old as securities regulation. See, e.g., *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920), involving a "booster" contract. In the mid-1920's, the Indiana Attorney General was called upon to consider several schemes strikingly similar to those used recently by Glenn Turner. See 1925-26 OP. ATT'Y GEN. (Ind.) 154 (1925); *id.* at 254 (1926).

148. In *Commonwealth ex rel. Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc.*, 414 Pa. 253, 199 A.2d 428 (1964), and in *Emery v. So-Soft, Inc.*, 30 Ohio Op. 2d 226, 199 N.E.2d 120 (Ct. App. 1964), classification of referral selling schemes as securities was denied on the basis that the *Howey* test requires the company paying the return to make a profit; under the referral schemes in question the fee was paid without regard to whether the paying company made a profit. This approach was soundly rejected in *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971); a careful

proliferated and investors' complaints of sharp practices increased,¹⁴⁹ however, many courts saw the need to develop new and more flexible tests for determining whether particular instruments are investment contracts. For example, in refusing a mechanical application of the *Howey* test, the court in *State ex rel. Park v. Glenn Turner Enterprises, Inc.*¹⁵⁰ stated: "As a matter of fact, such a test provides a built-in loophole for any . . . person to devise methods to avoid the purpose of the Securities Law. The *Howey* test constitutes an invitation to defraud the public and accordingly could not be expected to stand as an exclusive test." The change in judicial attitude also is reflected in the fact that since mid-1970 only one case dealing with founder-membership plans or pyramid sales schemes has applied the *Howey* test without questioning its continued validity.¹⁵¹

Although some of the courts which have reevaluated the *Howey* test have completely rejected it in favor of what they deemed more appropriate standards, others have modified that portion of the test re-

reading of *Howey* indicates that the reference to "profit" is to the investor's profit, not that of the paying enterprise. Similarly, in a series of four cases, Alabama, Georgia, and Texas courts mechanically applied the solely through the efforts of others portion of the test to exclude instruments where the investor's participation was minor, had nothing to do with the management of the enterprise, and did not affect the success or failure of his investment. *Gallion v. Alabama Mkt. Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968); *Georgia Mkt. Centers, Inc. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969); *Bruner v. State*, 463 S.W.2d 205 (Tex. Crim. App. 1970); *Koscot Interplanetary, Inc. v. King*, 452 S.W.2d 531 (Tex. Civ. App. 1970). See also *SEC v. Koscot Interplanetary, Inc.*, 365 F. Supp. 588 (N.D. Ga. 1973).

149. SEC Commissioner Hugh Owens recently estimated that the loss to investors in pyramid sales schemes alone has amounted to more than \$1 billion. Address of SEC Commissioner Hugh F. Owens to the North American Securities Administrators Association, San Antonio, Texas, SEC. REG. & L. REP. No. 222, at G-1 (Oct. 10, 1973).

150. 3 BLUE SKY L. REP. ¶ 71,023, at 67,201 (Idaho Dist. Ct., Ada County, Mar. 29, 1972).

151. See *SEC v. Koscot Interplanetary, Inc.*, 365 F. Supp. 588 (N.D. Ga. 1973). It is clear that this court did not wish to apply the *Howey* test strictly and that it did so only because it felt it had no alternative. It is interesting to note that most of the cases which have applied the test without modification are federal decisions involving franchise agreements. See, e.g., *Nash & Associates, Inc. v. Lum's of Ohio, Inc.*, 484 F.2d 392 (6th Cir. 1973); *Cobb v. Network Cinema Corp.*, 339 F. Supp. 95 (N.D. Ga. 1972). Recently two federal courts have shown a willingness to recognize the similarity between franchise arrangements and pyramid sales schemes and hold that in some situations franchises may be investment contracts. *Lino v. City Investing Co.*, CCH FED. SEC. L. REP. ¶ 94,124 (3d Cir. Aug. 20, 1973); *Mitzner v. Cardet Int'l, Inc.*, 358 F. Supp. 1262 (N.D. Ill. 1973).

quiring that profits be derived solely through the efforts of others.¹⁵² Those courts opting for modification have either reexamined the *solely* requirement or attempted to define what is meant by *efforts* of others. For example, the trial court in *State v. Hawaii Market Center, Inc.*¹⁵³ held that an investment contract exists as long as profits are generated *substantially* through the efforts of others. Under such an interpretation the transaction would be subject to regulation under the securities laws even though the investor participated to a limited extent in the common enterprise.

This modification of the *Howey* test, although quickly adopted by a Colorado court in *D.M.C. v. Hays*,¹⁵⁴ initially was not accepted by many jurisdictions. In *SEC v. Glenn W. Turner Enterprises, Inc.*,¹⁵⁵ however, the Court of Appeals for the Ninth Circuit applied a similar test in holding that the "Adventures" sold by the "Dare to Be Great" portion of the Turner empire were investment contracts. Noting that a rigid application of the *Howey* test would defeat the general purposes of the securities laws, the court stated:

Strict interpretation of the requirement that profits to be earned must come "solely" from the efforts of others has been subject to criticism. . . . Adherence to such an interpretation could result in a mechanical, unduly restrictive view of what is and what is not an investment contract. It would be easy to evade by adding a requirement that the buyer contribute a modicum of effort. Thus the fact that the investors here were required to exert some efforts if a return were to be achieved should not automatically preclude a finding that the Plan or Adventure is an investment contract. To do so would not serve the purpose of the legislation. Rather we adopt a more realistic test, *whether the efforts made by those other than the investor are the undeniably significant ones, those*

152. For general discussion of these decisions, see Note, *Pyramid Schemes: Dare to Be Regulated*, 61 GEO. L.J. 1257 (1973); Note, *Regulation of Pyramid Sales Ventures*, 15 WM. & MARY L. REV. 117 (1973); 51 TEX. L. REV. 788 (1973).

153. [1961-1971 transfer binder] BLUE SKY L. REP. ¶ 70,880 (Hawaii Cir. Ct., 1st Cir., Oct. 21, 1970), *aff'd on other grounds*, 52 Hawaii 642, 485 P.2d 105 (1971).

154. [1961-1971 transfer binder] BLUE SKY L. REP. ¶ 70,897 (Colo. Dist. Ct., Denver County, Feb. 26, 1971). This approach may also be the basis for the earlier decision in *Florida Discount Centers, Inc. v. Antinori*, 226 So. 2d 693 (Fla. Dist. Ct. App. 1969), *aff'd and opinion adopted*, 232 So. 2d 17 (Fla. 1970). See also *In re Discount Mart Corp.*, 3 BLUE SKY L. REP. ¶ 71,003 (Okla. Sec. Comm'n Oct. 28, 1970).

155. 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973), *aff'g* 348 F. Supp. 766 (D. Ore. 1972). See also *Hurst v. Dare to Be Great, Inc.*, 474 F.2d 483 (9th Cir. 1973).

*essential managerial efforts which affect the failure or success of the enterprise.*¹⁵⁶

Since its promulgation in February 1973, this test has been approved by a number of other federal courts.¹⁵⁷

In *State v. Hawaii Market Center, Inc.*,¹⁵⁸ the Supreme Court of Hawaii affirmed the trial court's decision that the founder-member agreements sold by the defendant were securities under the Hawaii Uniform Securities Act. However, it specifically rejected any test emphasizing the quantity rather than the quality of investor participation in the enterprise:

Finally, as previously stated, it is irrelevant to the remedial purposes of the Securities Act that an investor participates in a minor way in the operations of the enterprise. Courts should focus on the quality of the participation. In order to negate the findings of a security the offeree should have practical and actual control over the managerial decisions of the enterprise. For it is this control which gives the offeree the opportunity to safeguard his own investment, thus obviating the need for state intervention.¹⁵⁹

Like the "substantial efforts" approach employed by the Court of Appeals for the Ninth Circuit in *Glenn Turner*, this "managerial efforts" test has met with wide acceptance.¹⁶⁰

156. 474 F.2d at 482 (emphasis supplied).

157. See, e.g., *Lino v. City Investing Co.*, CCH FED. SEC. L. REP. ¶ 94,124 (3d Cir. Aug. 20, 1973); *Mitzner v. Cardet Int'l, Inc.*, 358 F. Supp. 1262 (N.D. Ill. 1973).

158. 52 Hawaii 642, 485 P.2d 105 (1971).

159. *Id.* at —, 485 P.2d at 111.

160. See, e.g., *Venture Inv. Co. v. Schaefer*, 3 BLUE SKY L. REP. ¶ 71,031 (D. Colo. June 16, 1972), *aff'd on other grounds*, 478 F.2d 156 (10th Cir. 1973); *SEC v. Glenn Turner Entrp., Inc.*, 348 F. Supp. 766 (D. Ore. 1972), *aff'd on other grounds*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973); *State ex rel. Park v. Glenn Turner Entrp., Inc.*, 3 BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Ada County, Mar. 29, 1972); *State ex rel. Fisher v. World Mkt. Center, Inc.*, 3 BLUE SKY L. REP. ¶ 71,034 (Okla. Dist. Ct., Okla. County, June 2, 1972), *aff'd*, 44 Okla. Bar J. 2218 (Okla. App. 1973).

Although both the "substantial efforts" and "managerial efforts" tests emphasize managerial rather than physical efforts, the standard formulated in *Hawaii Market Center* would eliminate a particular investment from securities coverage if the investor has *any* actual management control. On the other hand, the "substantial efforts" test adopted by the Ninth Circuit in *Glenn Turner* would eliminate coverage only if the investor plays a *significant* role in the management of the enterprise. Although the result will be the same in many cases, application of the "substantial efforts" test could lead to some anomalous results. For example, assume that a general accounting partnership has 100 general partners, not an uncommon situation in this age of national accounting firms. Since a general partnership interest carries with it a right

Although one jurisdiction appears to have completely rejected the *Howey* test,¹⁶¹ others have held that it is only one of several tests which can be applied to determine whether a particular instrument is an investment contract.¹⁶² For example, in *Silver Hills Country Club v. Sobieski*,¹⁶³ the defendants solicited capital to construct the facilities for a newly formed country club. In return for his money, the investor received only the right to use the facilities, since the legal title to the country club and all rights to profits from operation of its facilities remained with the defendants. Applying what subsequently has been termed a "risk capital test," the California Supreme Court held that the subscription agreements were investment contracts. Justice Traynor, writing for the majority, observed: "We have here nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is

to participate in the management of the partnership, such an interest would not be a security under the "managerial efforts" test adopted in *Hawaii Market Center* so long as the partner had not formally or informally contracted away his right to participate. This would be true whether there were two or 10,000 partners. On the other hand, under the "substantial efforts" test as applied in *Glenn Turner*, the interest in the general accounting firm probably would be a security, since the management interest is insignificant, that is, one vote in a hundred. If, however, the firm had only five partners, the same interest would not be a security because each partner would assume a more significant role in the firm's management. Thus, it appears that the "substantial efforts" test makes the size and quality of the management interest, not the mere existence of a management right, the hallmark of securities classification. In this light, the "managerial efforts" test of the Hawaii court may be preferable to avoid anomalous classifications.

161. In *Florida Discount Centers, Inc. v. Antinori*, 226 So. 2d 693, 695 (Fla. Dist. Ct. App. 1969), *aff'd and opinion adopted*, 232 So. 2d 17 (Fla. 1970), the court stated: "We read Chapter 517 [the Florida Blue Sky Law] without once encountering any suggestion that the efforts productive of profit must be limited to others than the investors." The present state of the law in Florida is unclear. Subsequent decisions considering the question, *Frye v. Taylor*, 263 So. 2d 835 (Fla. Dist. Ct. App. 1972), *Bond v. Koscot Interplanetary, Inc.*, 246 So. 2d 631 (Fla. Dist. Ct. App. 1971), *second appeal*, 263 So. 2d 835 (Fla. Dist. Ct. App. 1973), although apparently following *Florida Discount* and rejecting *Howey*, have failed clearly to indicate what test is being applied.

162. *State v. Investors Security Corp.*, — Minn. —, 209 N.W.2d 405 (1973); *State ex rel. Healy v. Consumer Business Sys., Inc.*, 92 Ore. 287, 482 P.2d 549 (Ct. App. 1971); *State ex rel. Park v. Glenn Turner Entrp., Inc.*, 3 BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Ada County, Mar. 29, 1972); *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973).

163. 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). *Silver Hills* is not the first case to apply a risk capital concept. See *Brownie Oil Co. v. Railroad Comm'n*, 207 Wis. 88, 240 N.W. 827 (1932); 27 OP. ATT'Y GEN. (Wis.) 598 (1938); 26 *id.* 370 (1937).

labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of the club membership will materialize.”¹⁶⁴

The risk capital test applies to all situations in which the investor contributes to the capital necessary to finance an enterprise and receives in return the right to some benefit. Under the *Silver Hills* decision it is not necessary that the investor receive an equity interest¹⁶⁵ or a right to profits.¹⁶⁶ Moreover, a recent case apparently has extended the *Silver Hills* rule in holding that an agreement to contribute capital to an existing enterprise was an investment contract.¹⁶⁷

The “managerial efforts” standard set forth by the Supreme Court of Hawaii in *State v. Hawaii Market Center, Inc.*¹⁶⁸ actually was only part of a comprehensive new definition of investment contracts formu-

164. 55 Cal. 2d at 814, 361 P.2d at 908, 13 Cal. Rptr. at 188. Unfortunately, the opinion was not clear as to the effect of the risk capital test on existing California securities law. Did the court intend to create an exclusive test or an alternative to the *Howey* test, or did it intend merely to add an additional element to the *Howey* analysis? All three interpretations have been given the *Silver Hills* opinion. Because the California court earlier had adopted the *Howey* standards in *People v. Syde*, 37 Cal. 2d 765, 235 P.2d 601 (1951), and since both *Howey* and *Syde* were cited in *Silver Hills* with apparent approval, it would not seem that the *Silver Hills* case replaced the *Howey* test completely. The California Corporation Commission has treated the *Silver Hills* case as establishing an alternative test and appears to use the *Silver Hills* and *Howey-Syde* tests interchangeably. Compare 5 CAL. CORP. COMM’R OFFICIAL OP. 73/42C (Mar. 20, 1973) with 5 CAL. CORP. COMM’R OFFICIAL OP. 73/81C (May 31, 1973). This view was expressed by the Oregon court in *State ex rel. Healy v. Consumer Business Sys., Inc.*, 92 Ore. 287, 482 P.2d 549 (Ct. App. 1971). On the other hand, it could be argued that the *Silver Hills* court was attempting to isolate and identify an element of an investment contract not accounted for in the *Howey* definition. This was the approach adopted by the court in *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971).

165. Capital in the broad economic sense should be distinguished from capital in the narrow balance sheet sense. A person who lends an enterprise money and receives a bond or promissory note in return contributes to the economic capital of the enterprise but has no interest in its equity. The same may be true in the investment contract situation. But see *International Commodity Trust, Inc. v. Fisher*, 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Okla. County, May 14, 1973), where the court failed to make this distinction with respect to commodity options.

166. This is made clear in the following statement by the *Silver Hills* court: “Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.” 55 Cal. 2d at 816-17, 361 P.2d at 908-09, 13 Cal. Rptr. at 188-89.

167. *State ex rel. Park v. Glenn Turner Entrp. Inc.*, 3 BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Ada County, Mar. 29, 1972).

168. 52 Hawaii 642, 485 P.2d 105 (1971).

lated by the court, which, influenced by Professor Coffey's argument that courts should recognize the economic realities of securities transactions,¹⁶⁹ attempted to combine the best features of the *Howey* test with the risk capital formula:

[W]e hold that for the purposes of the Hawaii Uniform Securities Act (Modified) an investment contract is created whenever:

- (1) An offeree furnishes initial value to an offeror, and
- (2) a portion of this initial value is subjected to the risks of the enterprise, and
- (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
- (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.¹⁷⁰

As the foregoing discussion suggests, the courts have not agreed upon one definition of investment contracts. It is submitted, however, that application of any of the four major tests which have been developed, either as modifications of the *Howey* definition or as alternatives thereto, results in the conclusion that naked commodity options are investment contracts.

The risk capital theory in its purest form requires nothing more than the investment of money in an enterprise which may or may not yield some benefit to the investor. Applying this test to the "naked" commodity option, it should be clear that there is an investment of money in the form of the option premium or fee. In addition, there is the obvious expectation of a benefit in the form of the payment of money when the option dealer repurchases a profitable option. The only remaining question is whether this money is invested in the risk or eco-

169. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 W. RES. L. REV. 367 (1967).

170. 52 Hawaii at —, 485 P.2d at 109 (footnotes omitted). This test has been accepted by a number of courts. SEC v. Glenn W. Turner Entpr., Inc., 348 F. Supp. 766 (D. Ore. 1972), *aff'd on other grounds*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973); Venture Inv. Co. v. Schaefer, 3 BLUE SKY L. REP. ¶ 71,031 (D. Colo. 1972), *aff'd on other grounds*, 478 F.2d 156 (10th Cir. 1973); State *ex rel.* Park v. Glenn Turner Entpr., Inc., 3 BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Ada County, Mar. 29, 1972); State *ex rel.* Fisher v. World Mkt. Centers, Inc., 3 BLUE SKY L. REP. ¶ 71,034 (Okla. Dist. Ct., Okla. County, June 2, 1972), *aff'd*, 44 Okla. Bar J. 2218 (Ct. App. June 26, 1973).

conomic capital used to generate the monetary benefit expected by the option purchaser. As previously indicated, the vast majority of option dealers are woefully undercapitalized.¹⁷¹ It is manifest that in order to honor their repurchase commitments, these dealers must either invest the money they take in as premiums or use the money received from the sale of new options to repurchase older options as they are exercised.¹⁷² In the latter case, the firm will go bankrupt if it suffers an adverse cash flow.

Applying the *Hawaii Market Center* test, the transaction clearly entails the transfer of initial capital from the purchaser of the naked option to the dealer. This investment is induced by the promise that if certain events occur, a benefit will accrue to the option holder, that is, on the agreed-upon date, the dealer will pay the holder the difference between the striking price of the option and the current market value of the underlying commodity futures. Furthermore, because the dealer must invest the capital within its control to generate the funds required to satisfy its repurchase obligations,¹⁷³ the option holder's investment is

171. Goldstein Samuelson was formed on April 28, 1971, with about \$800 of capital. Stipulation, *supra* note 6, at 3. During its entire life, the capital of Goldstein Samuelson consisted of this initial \$800, the premiums received from the sale of the options, profits from its own commodity futures speculation, interest on certain business loans, and returns from investments in other business enterprises. *Id.* at 19. Therefore, the \$800 original capital was used to finance a business which sold 175,000 naked options for \$88 million. *Id.* at 7. Not bad leverage!

172. A number of second generation option dealers claim that option premiums will be held in an escrow account until their repurchase obligations are satisfied. The California Corporation Commissioner has held that funds placed in an escrow account until after the completion of a construction contract may be classified as risk capital. 5 CAL. CORP. COMM'R OFFICIAL OP. 73/18C (Feb. 2, 1973); 5 CAL. CORP. COMM'R OFFICIAL OP. 73/49C (Mar. 21, 1973). The same rationale should apply when option premiums are placed in an escrow account if the dealer uses interim financing to meet his repurchase obligations. In such a situation, the option holder, although assured that he will recoup his original investment, still must assume the risk that his option will not yield a profit. Such an arrangement thus would not appear "to afford those who risk their capital at least a fair chance of realizing their objectives," which is the stated purpose of the risk capital test. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 816-17, 361 P.2d 906, 908, 13 Cal. Rptr. 186, 188 (1961).

173. In discussing the risk assumed by the investors in the founder-membership scheme in *Hawaii Market Center*, the Supreme Court of Hawaii stated: "[A] very large percentage of founder-members will be totally dependent on sales commissions to recover their initial investment plus income. It is thus apparent that the security of the founder-members' investment is inseparable from the risks of the enterprise. The success of the plan is the common 'thread on which everybody's beads [are] strung.'" 52 Hawaii at —, 485 P.2d at 110, *citing* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 348 (1943). It therefore appears the *Hawaii Market Center* court would

subject to the risks of the enterprise. Finally, the investor clearly has no practical or actual control over the investment policies of the option dealer.

In the context of the two recent variations of the *Howey* test, it is clear that the purchaser of a naked commodity option contract contributes capital to a common enterprise and expects to receive a return on his investment. It is submitted that a court's view of the degree of investor participation necessary for an instrument to escape inclusion within the *Howey* test should not affect the ultimate conclusion that naked options are investment contracts. The important factor is whether such participation is directed toward the *generation of the expected return*, not merely the *determination of the amount of that return*. It is evident that the naked option dealer makes all the investment decisions concerning the generation of funds necessary to meet his contractual repurchase obligations. As Mr. Goldstein carefully has pointed out, once the naked option contract is executed, the investor has no right to participate in decisions involving the investment of his money.¹⁷⁴ It is the hallmark of the securities laws that protection be afforded passive investors against the risk that those with whom they deal will be unable to perform their contractual obligations.¹⁷⁵ In this context, purchasers of naked options clearly qualify for protection.

require that the risk capital be invested in the common enterprise. For a consideration of the problems that some courts have had in finding a common enterprise in the case of commodity options, see notes 176-92 *infra* & accompanying text.

174. Testimony, *supra* note 33, at 59. See also Stipulation, *supra* note 6, at 9.

175. Recently, this concept was expressed very well by the Georgia Securities Commissioner:

When an investor buys or sells a commodities future contract or option, he assumes two risks. First he assumes the obvious risk that the market trend may be unfavorable to his investment position. . . . This risk is inherent in any investment, and does not, of itself, make a commodities transaction a security. There is, however, a second risk which the investor assumes when he deals in commodities futures and options. He assumes the risk that the person on the other side of the contract . . . will be unable or unwilling to perform his part of the contract when called on to do so. This is known as the "enterprise risk."

If the seller (with respect to a long contract), buyer (with respect to a short contract), or writer (with respect to an option contract) actually owns the commodity or contract to which the sale relates, the enterprise risk is no more than it is in any contractual relationship, and no security is present. . . .

The enterprise risk becomes critical, however, in the case where the seller, buyer, or writer is not fully "covered." In such a case, his ability to perform his contractual obligation to the investor is solely dependent on the

Unfortunately, two of the four courts which have considered the issue have held that naked option contracts are not investment contracts on the ground that such agreements do not involve a common enterprise.¹⁷⁶ It is significant that this portion of the *Howey* definition is not even mentioned in any of the state court decisions from which that standard supposedly was derived.¹⁷⁷ Consequently, the validity of this requirement lately has been questioned,¹⁷⁸ even in one case involving commodity options.¹⁷⁹

Several recent decisions, however, not only have applied the requirement but also have deviated from the original concept of a common enterprise. In *Milnarik v. M-S Commodities, Inc.*,¹⁸⁰ for instance, the issue was whether a discretionary commodities futures trading account is an investment contract.¹⁸¹ Holding that such accounts are not securities because they do not involve a common enterprise, the court stated that under the *Howey* formulation a common enterprise requires a "pooling of capital," that is, a number of investors must turn their

skill and ability with which he invests the money and hedges the contracts of his numerous investors whose funds he has received. Here we have a classic example of a case in which "the scheme involves an investment of money with profits to come solely from the efforts of others." In such a case, the sale of commodities contracts or options is a security and subject to the provisions of the Georgia Securities Law.

Commodities Trading, *supra* note 23, at 10,504.

176. SEC v. Continental Commodities Corp., Civ. A. No. CA 3-6976-D (N.D. Tex. Apr. 9, 1973); International Commodity Trust, Inc. v. Fisher, 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Okla. County, May 14, 1973).

177. See note 144 *supra*.

178. The California Corporation Commission has held that the existence of a common enterprise is not an essential element of an investment contract under California law. 5 CAL. CORP. COMM'R OFFICIAL OP. 73/42C (Mar. 20, 1973). A similar position was taken in *State v. Investors Security Corp.*, — Minn. —, 209 N.W.2d 405 (1973), in which the court stated: "The existence of a 'common enterprise' has never been the acid test to determine whether an investment contract is present. 'Common enterprise' can be no more than an aid to reasoning rather than a strict mechanical test." 209 N.W.2d at 411.

179. *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973).

180. 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

181. Earlier cases had held that such accounts are securities. See, e.g., *Bache & Co. v. Commercial Iron & Metal Co.*, CCH FED. SEC. L. REP. ¶ 93,114 (S.D.N.Y. 1971); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423 (S.D.N.Y. 1967). Subsequently, this position was reaffirmed in *Commercial Iron & Metal Co. v. Bache & Co.*, 478 F.2d 39 (10th Cir. 1973) and *Johnson v. Arthur Espey, Shearson, Hammill & Co.*, 341 F. Supp. 764 (S.D.N.Y. 1972). See also *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968).

money over to a promoter in exchange for a share in a common investment fund. In *Milnarik*, it was held that there was no common enterprise because the defendant brokerage house treated each discretionary account separately and not as a part of a common fund. A similar result was reached in *Wasnowic v. Chicago Board of Trade*.¹⁸²

This "pooling of capital" concept was applied to naked commodity option contracts in *SEC v. Continental Commodities Corp.*¹⁸³ and *International Commodity Trust, Inc. v. Fisher*,¹⁸⁴ both courts holding that a common enterprise was not established because the defendants maintained separate trading accounts for each option purchaser. It is submitted that these decisions have misapplied the *Howey* concept of a common enterprise, which requires only that the investor associate with another person or persons in an enterprise created for the purpose of making a profit.¹⁸⁵ In addition, they indicate a fundamental lack of appreciation of the economic realities of the naked option market as it presently is constituted. As stated earlier,¹⁸⁶ it is probably correct for a court to hold that agreements to buy or sell commodity futures are not securities on the ground that such transactions do not involve a common enterprise.¹⁸⁷ The investor in the futures market generally makes unilateral decisions with respect to the selection of the futures contracts he will purchase and the timing of his transactions. On the surface, the same reasoning would seem to apply to naked commodity op-

182. 352 F. Supp. 1066 (M.D. Pa. 1972).

183. Civ. A. No. CA 3-6976-D (N.D. Tex. Apr. 9, 1973).

184. 3 BLUE SKY L. REP. ¶ 71,075 (Okla. Dist. Ct., Okla. County, May 14, 1973).

185. Thus, a common enterprise should be found to exist whenever two or more investors furnish the capital used in an enterprise. See *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968); *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935). Similarly, there is a common enterprise when a single person furnishes the capital and two or more people are involved in using that capital to generate profits. In its simplest form, a common enterprise exists where two persons, one with capital and the other with an idea or special skills, combine their resources in order to produce a monetary return. This is exactly the situation with respect to the discretionary commodity futures accounts considered in the *Milnarik* case. Since the common enterprise requirement is really an economic concept, the legal relationship between the parties to the enterprise should be irrelevant. Therefore, contrary to the *Milnarik* holding and a decision of the California Corporation Commissioner, 4 CAL. CORP. COMM'R OFFICIAL OP. 72/137C (Oct. 12, 1972) (involving the management of trotting horses), a common enterprise may exist even though the parties assume a relationship of principal and agent.

186. See notes 82-85 *supra* & accompanying text.

187. This appears to be the view of the federal courts. See *Wiggin v. Kohlmeyer & Co.*, 446 F.2d 792 (5th Cir. 1971); *Berman v. Dean Witter & Co.*, 353 F. Supp. 669 (C.D. Cal. 1973); *Schwartz v. Bache & Co.*, 340 F. Supp. 995 (S.D. Iowa 1972).

tion contracts. It is clear, however, that in practice the option holder can realize a profit only if his dealer invests in the commodities market or is successful in selling a large number of options. Because the option dealer must use the funds obtained from many investors in order to satisfy his repurchase obligations, the transaction involves the pooling of capital and should be classified as a common enterprise, even under the *Milnarik* application of that concept.

Implicit in the decisions in *Continental Commodities* and *International Commodity Trust* is a refusal to examine the substance of the naked option transaction and a naïve acceptance of its legal form.¹⁸⁸ To do so is to disregard the admonition of the Supreme Court in *Howey* that investor protection "is not to be thwarted by unrealistic and irrelevant formulae."¹⁸⁹

The better reasoned opinions have examined the mechanics of the naked commodity option transaction and have held that under the *Howey* test such options are securities. For example, in *People v. Puts and Calls, Inc.*,¹⁹⁰ the court had little difficulty in finding that the options sold by the defendant were investment contracts in which purchasers could expect to receive a profit *substantially* through the efforts of others. In disposing of the common enterprise requirement, the court stated:

As to the common enterprise the *Los Angeles Trust Deed* case¹⁹¹ . . . defined such an enterprise as 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.

It was highly significant to me that stipulated here—that the return on the money put in by the customers of Puts and Calls,

188. Even if a court is unwilling to go behind the legal form of the naked commodity option, it could be argued that an investment contract exists in those cases where the dealer or his representative selects the commodity options to be purchased and either decides when to sell the options or automatically repurchases them at the end of the option period. As previously noted, this is a common practice among the naked option dealers. See note 45 *supra* & accompanying text. Moreover, such a discretionary account may exist as the result of a tacit agreement between the parties. See *Johnson v. Arthur Espey, Shearson, Hammill & Co.*, 341 F. Supp. 764 (S.D.N.Y. 1972); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968). This analysis, however, would require the court to reject the *Milnarik* concept of a common enterprise, since there is no pooling of funds and each account is treated separately.

189. 328 U.S. at 301.

190. 3 BLUE SKY L. REP. ¶ 71,090 (Cal. Super. Ct., L.A. County, June 21, 1973).

191. *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1969), *cert. denied*, 366 U.S. 919 (1961) [editor's note].

Inc. could come only from the resources of that organization, that the resources of that organization were limited to the investment success that the company itself had, and the premium income coming from other companies, plus the very minor amount of capital and the hope that a few loans that were made would be repaid.

I combine that with the fact that there was no rebuttal offered of the deposition testimony of the witness Gish concerning the defendant's displeasure when Mr. Gish attempted to have his customers exercise and cash in their options, as showing rather vividly that the customers' fortunes were in Puts and Calls' boat and Puts and Calls was doing the rowing—or lack of rowing. I think that shows a common enterprise.¹⁹²

In conclusion, it is submitted that the naked commodity option contract comes within any of the recent definitions of an investment contract. This result can be reached easily if courts employ the type of fair, accurate, and realistic analysis applied in *Puts and Calls* to a transaction which clearly should be regulated under the securities laws.¹⁹³

Instruments Commonly Known as Securities

Finally, a strong argument can be made that the naked commodity option is an "instrument commonly known as a 'security'" and thus a security within the standard definition. Like evidences of indebtedness, this definitional category until recently had not received extensive treatment by the courts, agencies, or legal scholars. In addition, before the decision of the trial court in *SEC v. Glenn W. Turner Enterprises, Inc.*,¹⁹⁴ it had never been used as an independent basis for subjecting an investment scheme to regulation under the securities laws.¹⁹⁵ Subsequent

192. 3 BLUE SKY L. REP. ¶ 71,090, at 67,386.

193. Two other cases have concluded that naked options are investment contracts. *In re Traders Int'l, Ltd.*, Bankruptcy No. 7350 (D. Nev. Aug. 23, 1973) (decision of the referee); *In re Goldstein Samuelson, Inc.*, 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Comm'n Feb. 23, 1973). The SEC has taken the same position. See Pretrial Memorandum of Fact and Law, *SEC v. Goldstein Samuelson, Inc.*, Civ. A. No. 73-472 (C.D. Cal., filed April 2, 1973); Address of SEC Commissioner Hugh F. Owens to the North American Securities Administrators Association, San Antonio, Texas, SEC. REG. & L. REP. No. 222, at G-1 (Oct. 10, 1973).

194. 348 F. Supp. 766 (D. Ore. 1972), *aff'd on other grounds*, 474 F.2d 476 (9th Cir.), *cert. denied*, 94 S. Ct. 117 (1973).

195. See, e.g., *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); *Curtis v. Johnson*, 92 Ill. App. 141, 234 N.E.2d 566 (1968); *First Nat'l Sav. Foundation, Inc. v. Samp*, 274 Wis. 118, 80 N.W.2d 249 (1956).

to that decision, the court in *SEC v. Koscot Interplanetary, Inc.*¹⁹⁶ also indicated that the securities classification issue could be disposed of by holding that a particular instrument is commonly known as a security but stated that existing authority did not support such an approach with respect to the investment scheme under consideration.¹⁹⁷

The district court in *Glenn Turner*, after stating that the defendant's pyramid sales scheme could be classified as a security under this definitional category, attempted to formulate a test which could be used to determine what interests are commonly known as securities. Although the opinion is unclear on this point,¹⁹⁸ it appears that the court utilized the *Silver Hills* risk capital test. As noted in the previous section, it is manifest that naked commodity options satisfy the risk capital test, since they involve the investment of money in an enterprise which may or may not yield some benefit to the investor. Therefore, employing the *Glenn Turner* rationale, naked options are instruments commonly known as securities. In reaching this conclusion, the court in *Shapiro v. First Federated Commodity Trust Co.*¹⁹⁹ stated: "[The naked commodity options] sold by First Federated [were] . . . within the definition of 'security' in the Maryland Securities Act, whether [they were] investment contract[s] or [fall] within the catchall phrase 'in general, any interest or instrument commonly known as a security.'"

CONCLUSION

Whether naked commodity option contracts should be classified as securities cannot be resolved properly without a complete understanding

196. CCH FED. SEC. L. REP. ¶ 93,960 (N.D. Ga. 1973).

197. The *Koscot* decision raises the question of what standard should be used to determine whether a particular instrument is commonly known as a security. The district court in *Glenn Turner* indicated that an instrument would be classified as a security if it is commonly treated as such by the law. 348 F. Supp. at 773. This also seems to be the view of the court in *Shapiro v. First Federated Commodity Trust Co.*, 3 BLUE SKY L. REP. ¶ 71,071 (Md. Cir. Ct., Baltimore County, May 30, 1973). On the other hand, the *Koscot* court indicated that the test should be whether the instrument is commonly known as a security in *financial*, rather than legal, circles. The legal standard would appear preferable.

198. The court cited not only "pure risk capital test" cases, such as *State ex rel. Healy v. Consumer Business Sys., Inc.*, 92 Ore. 287, 482 P.2d 549 (Ct. App. 1971), and *Hurst v. Dare to Be Great, Inc.*, 3 BLUE SKY L. REP. ¶ 71,012 (D. Ore. Dec. 23, 1971), *aff'd*, 474 F.2d 483 (9th Cir. 1973), but also cases which are properly classified as "combined risk capital and *Howey* test" cases, such as *State v. Hawaii Mkt. Center, Inc.*, 52 Hawaii 642, 485 P.2d 105 (1971), and *State ex rel. Park v. Glenn Turner Entrp., Inc.*, 3 BLUE SKY L. REP. ¶ 71,023 (Idaho Dist. Ct., Ada County, 1972).

199. 3 BLUE SKY L. REP. ¶ 71,071, at 67,336 (Md. Cir. Ct., Baltimore County, May 30, 1973).

of the manner in which such options are traded. The remedial purposes of the securities laws can be achieved only if courts construe the securities acts liberally and examine the economic realities of particular transactions. It is submitted that naked options can no longer be viewed as rights to buy or sell "underlying" futures contracts. Instead, the courts must recognize that the only promise made by the option dealer is to repurchase the option if the price of particular commodity futures contracts deviates from the option striking price. Since naked option dealers typically are thinly capitalized, the optionee must bear the risk that the dealer, through investment decisions in which the optionee takes no part, will be unable to generate sufficient funds to satisfy his repurchase obligations. Viewed in this light under established case law, naked options can be classified as securities on any one or more of the grounds that they are evidences of indebtedness, investment contracts, or instruments commonly known as securities.

Although the first generation of naked commodity option firms have come and gone, it appears that new dealerships are being formed to take their place. Thus, the problem of classifying naked options for securities purposes is by no means moot. Because of the patent need to regulate trading in these options, it is hoped this Article will assist the courts in understanding this new investment concept and the reasons for treating it as a security within existing state and federal regulatory frameworks.