No. 02-1196

In The
Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

v.

CHARLES E. EDWARDS,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Eleventh Circuit

BRIEF FOR THE RESPONDENT

MICHAEL K. WOLENSKY
(*Counsel Of Record*)
ETHAN H. COHEN
LAURA J. SAURIOL

KUTAK ROCK LLP
225 Peachtree Street, N.E.
Suite 2100
Atlanta, GA 30303-1731
(404) 222-4600

Counsel for Respondent

COCKLE LAW BRIEF PRINTING CO. (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

Whether the court of appeals erred in dismissing the complaint on the ground that an investment scheme is excluded from the term "investment contract" in the definition of "security" under Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. 77b(a)(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), if the promoter promises a fixed rather than variable return or if the investor is contractually entitled to a particular amount or rate of return.

RULE 29.6 STATEMENT

Pursuant to Supreme Court Rule 29.6, Respondent Charles E. Edwards submits that he does not have any parent corporations or subsidiaries.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

CASES:

TABLE OF AUTHORITIES – Continued

Page

TABLE OF AUTHORITIES – Continued

Page

TABLE OF AUTHORITIES – Continued

TABLE OF AUTHORITIES – Continued

Page

TABLE OF AUTHORITIES – Continued

Page

TABLE OF AUTHORITIES – Continued

Page

TABLE OF AUTHORITIES – Continued

STATEMENT

Respondent Charles E. Edwards was the founder and controlling shareholder of ETS Payphones, Inc. ("ETS"), a Georgia corporation that has been in the business of operating and leasing coin-operated pay telephones since approximately 1994. ETS grew substantially after Congress and the Federal Communications Commission effected major regulatory changes in the pay telephone business in 1996. J.A. 48, 65-66, 151, 242-243. Until June 2000, Respondent was a member of ETS's board of directors and served as its chief executive officer. J.A. 47-48, 242. At that time, ETS had twenty-eight offices nationwide and four in Mexico, 550 employees, and was operating 47,000 pay telephones, almost all as lessee or owner, in more than thirty-five states. J.A. 58-59, 155, 168-169, 177. ETS was one of the largest privately owned payphone operators in the country. J.A. 155. ETS offered "business opportunities" subject to regulation by the Federal Trade Commission's ("FTC") disclosure regulation rule "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures." *See* 16 C.F.R. § 436 (2003). ETS provided a disclosure brochure as required by the FTC regulations to those pay telephone owners dealing with ETS (the "FTC brochure"). J.A. 121-147, 256.[1]

Respondent devoted significant resources to ensure ETS's compliance with federal, state and local laws. J.A.

[1] Business arrangements like that of ETS come within the definition of a "business opportunity" according to federal law and are subject to the enforcement authority of the FTC. *See*, *e.g.*, *FTC v. Tashman*, 318 F.3d 1273 (11th Cir. 2003); *FTC v. H.N. Singer, Inc.*, 668 F.2d 1107 (9th Cir. 1982).

56, 62, 243-244, 256-257. He relied upon the legal expertise of multiple lawyers and accountants that advised him regarding ETS's corporate structure and business, including obtaining legal opinions regarding the issue of whether ETS's business involved the sale of a security. J.A. 56, 256-258, 280-282. In 1995, Respondent and his attorney had meetings with an SEC official to respond to questions in an informal investigation initiated by the SEC regarding that issue. They presented numerous documents and records, discussed ETS's pay telephone business and corporate structure in some detail, and explained ETS's plans to separate its marketing of telephones from its leasing business in order to assure compliance with the federal securities laws. J.A. 57, 62, 159, 257, 280-281. The SEC took no action against ETS or Respondent as a result of that investigation. J.A. 64, 258; Pet. App. 3a n.1.

One result of the SEC's 1995 investigation was Respondent's decision to establish Payphone Systems Acquisitions, Inc. ("PSA"). J.A. 244, 246. PSA, initially a sister corporation and later wholly owned by ETS, was formed to purchase pay telephone equipment and sell it to independent distributors who would actually market pay telephones through professional brokers, insurance agents and others, along with various other products and services of their own, such as life insurance. J.A. 58, 246-247. The prices of equipment changed over time; however, during 2000, PSA acquired telephones from manufacturers and from existing operators at prices ranging from approximately $2,750 to $3,700, frequently adding upgrades averaging $1,200, and sold them at wholesale to distributors for $5,250. J.A. 247-251. ETS was not involved in the sale of pay telephones, but part of its business was acquiring telephone site locations from commercial property owners, such as convenience store chains, stadiums, and gas stations, where pay telephones could be installed in exchange for a percentage of the revenue or profits from those pay telephones. J.A. 48, 160, 175-177, 221-222.

In accordance with the business plan explained to the SEC in 1995, the independent distributors and ETS used separate marketing campaigns directed to their respective needs. J.A. 94-109, 111-121, 246. The independent distributors created and provided their own informational packages, which described the profitability of the pay telephone industry and the typical options available to a new pay telephone owner for commercial use of the telephone. J.A. 94-109, 246. On the other hand, ETS's materials either were directed to the property site owners, explaining why it would be profitable to agree to permit ETS to install pay telephones at their commercial establishments, J.A. 48, 111-121, 168, or the FTC brochure was sent upon request to telephone owners who were prospective customers for ETS's service and leasing business. J.A. 122-148, 168, 187, 252. ETS's website contained a discussion of the pay telephone industry, the equipment, and of ETS's business. J.A. 223-228. It did not anywhere state that lessors could expect to share in "profits" from ETS. Other website materials were posted by distributors, not ETS. J.A. 231-238.

The leasing aspect of ETS's business was conducted through typical commercial leasing arrangements, with a normal exchange of lessor-lessee duties and responsibilities whereby the owner retained full ownership and property rights to the asset, with the five-year cancelable lease giving ETS full authority over the monitoring, management, and maintenance of the pay telephones and all rights to the revenue. J.A. 269-276. These leases were standard equipment leases, not management agreements. J.A. 134-141. An individual purchasing a pay telephone and right to a site location from the independent distributor paid approximately $6,750 in 2000. J.A. 110. The new owner could rescind the purchase for any reason within fifteen days at no penalty. J.A. 110, 252. Failure to provide the pay telephone would also lead to a full refund. J.A. 110. The options for commercial use of which pay telephone owners were informed, included personal operation without use of a service company. J.A. 83, 103 (Option 1). The owner could also contact ETS, or any of the many other pay telephone management and leasing companies, to obtain pay telephone management services. J.A. 168, 187-189, 246, 255. If contacted, ETS would then provide the owner with the FTC brochure describing its "Payphone Equipment Lease Program" and the other service contracts available from ETS. J.A. 122-148, 168, 187, 252. ETS did not market its services to prospective pay telephone owners, as it became involved in the transaction *after* an individual purchased a pay telephone from an independent distributor. J.A. 48, 246, 252.[2] As described in the FTC brochure, ETS offered three options to pay telephone owners. J.A. 122-148, 253. The first two options were service contracts, under which ETS would perform specified technical services for a fee with the telephone owner performing business services and realizing the income potential of his or her particular pay telephone(s). J.A. 126-128, 253. The SEC does not contend these business arrangements are investment contracts.

The third option, and the only option at issue here, is the "Payphone Equipment Lease Program" option. J.A.

[2] Beginning in 2000, independent distributors that were properly registered under the relevant states' "Business Opportunity" laws could provide the ETS FTC brochure to the prospective purchaser at the point of sale. J.A. 247, 252.

128, 253. This option was for owners who did not want day-to-day involvement in the business of operating a pay telephone and who wanted to eliminate the fluctuation of the revenue stream related to their pay telephone. J.A. 128, 254. Under the lease program, the owner leased the pay telephone equipment to ETS under a cancelable lease agreement for a five-year term for a monthly lease payment that was fixed for the term of the particular lease and any renewals. J.A. 254, 269. By 2000, new leases carried a fixed monthly rental rate of $82.00. J.A. 254, 269. After an owner signed a lease agreement with ETS, the owner would receive an addendum from ETS identifying the site where the leased telephone was located. J.A. 191, 194. The notification of the location usually took two or more weeks due to changing inventory, replacing equipment, and the general operations and administrative aspects of the business. J.A. 190, 195. The lessor received rent payments from the commencement of the lease. J.A. 134, 269.

Since the owner had leased the pay telephone to ETS, ETS as lessee collected and kept any revenue produced by the pay telephone, shouldered any expenses incurred, and retained the right to relocate the telephone to a more profitable location if necessary, with notice to the owner. J.A. 135-136. ETS assumed the risk that the pay telephone might not be profitable. The lessor received only the fixed monthly rental amount provided in the agreement, and ETS's payment of this rent could derive from any source of funds at its disposal. J.A. 269. The lease agreement gave the lessors the right to assign, the right to switch to a service plan rather than lease, and the right to sell the equipment to ETS at the original purchase price upon 180 days written notice. J.A. 272-273.[3] The lessors could also cancel their lease and take possession of their pay telephone, with no penalty, upon 90 days written notice to ETS. J.A. 255, 269. If ETS defaulted by non-payment of rent, the lessor could terminate the lease and take immediate possession of the equipment or, without terminating the lease, take possession of the equipment and re-let, with ETS being responsible for any deficiency. J.A. 255, 271-272.[4] Because the lessors could readily recover their equipment for non-payment, the only risk they faced from default under the lease agreement was the loss of the benefit of their bargain with ETS.

Of those pay telephone owners contracting with ETS, almost all chose the leasing option. J.A. 254. The lessors expressly acknowledged that they were not required to use ETS as their leasing company, nor were they required to sign a lease agreement as a condition of purchase. J.A. 273 (Par. 18). Neither the service plans nor the lease arrangement entitled a telephone owner to a share or financial interest in ETS, or profit from its future development, or to share in any profits that ETS generated by managing the collective group of pay telephones that it owned or leased or in any profits it generated from other business activities. J.A. 126-129.

Until ETS voluntarily filed for reorganization under Chapter 11 of the Bankruptcy Code in September 2000, it

---

[3] In ETS's experience, only about one percent of lessors exercised this buy-out option. J.A. 181.

[4] The terms of the ETS lease agreement are typical of those in standard commercial equipment lease agreements. *See, e.g.,* William B. Piels, *Doing Deals 2003: Understanding the Nuts & Bolts of Transactional Practice in an Uncertain Market, Equipment Leasing*, 1356 PRAC. L. INST. 577, 635-665 (2003) (selected form equipment lease provisions).

never missed a rental payment owed to a lessor. J.A. 91. ETS's plan of reorganization was confirmed on November 14, 2001, and resulted in ETS's continuing operations and the ongoing management of tens of thousands of pay telephones. In accordance with the plan of reorganization, Respondent no longer has any interest in or connection to ETS. Findings of Fact, Conclusions of Law and Order Confirming the Joint Reorganization Plan of PSA, Inc., ETS Payphones, Inc. and ETS Vending, Inc., et al., *In re PSA, Inc.*, Ch. 11 Case No. 00-3570 (KJC) (Bank. D. Del. filed Sept. 11, 2000) (No. 1973).

On September 29, 2000, after ETS filed its bankruptcy petition, and five years after first learning the details of ETS's business from Respondent, the SEC filed an enforcement action against ETS and Respondent under the federal securities laws alleging that ETS sold "investment contracts," that the investment contracts were not registered and that misleading statements about ETS's financial condition had been made in connection with the investment contract sales.[5] Although not relevant to the issue before the Court, the SEC addresses at some length the allegations it made that ETS and Respondent had engaged in violations of the federal securities laws' antifraud provisions. SEC Brief 4-6.[6] Respondent contested

[5] The SEC alleged violations of 15 U.S.C. § 77q(a), 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (2003), and 15 U.S.C. §§ 77e(a) and 77e(c). J.A. 15-20.

[6] In one particular, the SEC states that on July 1, 2000, Respondent wrote a letter to "investors" misrepresenting that ETS was "profitable." SEC Brief 5. The letter, addressed to "leaseholders," responded to questions posed by them regarding ETS. J.A. 229. Respondent explained that ETS's revenue from payphones was down overall because of the problems collecting for certain types of calls and that ETS profited by $8.7 million in 1999. J.A. 230. The figures

(Continued on following page)

these allegations. J.A. 24-34, 36, 242-268. In light of its disposition of the case, the court of appeals did not address the SEC's allegations or Respondent's challenge to them, and they should not be allowed to influence the consideration of the issue before the Court.[7]

On November 22, 2000, after a brief evidentiary hearing, the district court granted the SEC's emergency petition against Respondent, entering an asset freeze, a preliminary injunction and other equitable relief. Pet. App. 27a. The district court concluded that ETS was selling unregistered investment contracts while failing to disclose the true financial condition of the company.[8] Pet. App. 17a-18a. The

---

presented by the SEC (SEC Brief 5), suggesting extensive operating losses and ETS's lack of profitability, are reached using accounting conventions ETS was not required to and did not utilize in preparing its financial statements. J.A. 45-46, 259. Contrary to the SEC's assertion, Mr. Edwards never testified that he was aware of ETS's poor financial condition. SEC Brief 5.

[7] *See*, *e.g.*, *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 859 (1975) (noting that the fraud claims would not be addressed where court determined there was no subject matter jurisdiction).

[8] The SEC continues to state as a "fact" that "ETS took in approximately $300 million from more than 10,000 investors." SEC Brief 4. The SEC's citation to the district court and court of appeals opinions for this statement is erroneous. It is not in the district court's opinion, and the court of appeals was merely restating the SEC's own characterization. Pet. App. 3a, 23a. The SEC also erroneously contends that the allegations of the SEC's complaint must be taken as true. SEC Br. 3 n.1. Respondent's opposition to subject matter jurisdiction, pursuant to FED. R. CIV. P. 12(b)(1), was a factual challenge, not a facial one by a motion to dismiss pursuant to FED. R. CIV. P. 12(b)(6). *KVOS, Inc. v. Associated Press*, 299 U.S. 269, 278 (1936); *Garcia v. Copenhaver, Bell & Associates, M.D.'s*, 104 F.3d 1256, 1260 (11th Cir. 1997); *Turicentro, S.A. v. American Airlines Inc.*, 303 F.3d 293, 300 n.4 (3d Cir. 2002). Because Respondent did not accept the SEC's statement of facts in the complaint and challenge the claim for relief under an applicable statute, FED. R. CIV. P. 12(b)(6) did not apply. Therefore, the Court's

(Continued on following page)

asset freeze extended to all of Respondent's assets and to his non-defendant companies' assets, not just those traceable to the alleged security offerings. Pet. App. 27a. The district court's decision spawned numerous federal court private securities actions by lessors.[9]

Respondent's appeal asserted a number of errors, including lack of subject matter jurisdiction because the SEC had not proven that the business arrangements

approach to the "facts" in *SEC v. Zandford*, 535 U.S. 813 (2002) and *Steel Co. v. Citizens for a Better Env't*, 523 U.S. 83 (1998) is not applicable here. Nor does *Saudi Arabia v. Nelson*, 507 U.S. 349 (1993) support the SEC's contention that the allegations of the complaint are to be taken as true as that decision did not address the nature of the motion that led to the order under review. Respondent's factual challenge was based upon all of the materials before the district court, including those proffered at the limited evidentiary hearing, and the court of appeals considered this evidence in determining subject matter jurisdiction. *Menchaca v. Chrysler Credit Corp.*, 613 F.2d 507, 511 (5th Cir. 1980), *cert. denied*, 449 U.S. 953 (1980); *Turicentro*, *S.A.,* 303 F.3d at 300. Throughout its brief here, the SEC has relied upon those materials as well. Accordingly, no presumptive truthfulness attaches to the allegations in the complaint. *Valentin v. Hospital Bella Vista*, 254 F.3d 358, 363 (1st Cir. 2001); *Williamson v. Tucker*, 645 F.2d 404, 413 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981).

[9] *Dassero, et al. v. Edwards, et al.*, No. 01-CV-6269 (W.D.N.Y. filed May 29, 2001); *May, et al. v. Edwards, et al.*, No. 8:01-CV-571-T-30 (M.D. Fla. filed March 15, 2001); *White, et al. v. Edwards, et al.*, No. 8:01-CV-569-T-30 (M.D. Fla. filed March 15, 2001); *Key, et al. v. Edwards, et al.*, No. 1:01-CV-0451 (N.D. Ga. filed Feb. 15, 2001); *Chissler, et al. v. Edwards, et al.*, No. 8:01-CV-262-T-26 (M.D. Fla. filed Feb. 5, 2001); *Dunstan, et al. v. Edwards, et al.*, No. 8:01-CV-265-T-30 (M.D. Fla. filed Feb. 5, 2001); *Earl, et al. v. Edwards, et al.*, No. 8:01-CV-267-T-30 (M.D. Fla. filed Feb. 5, 2001); *Higginbotham, et al. v. Edwards, et al.*, No. 8:01-CV-263-T-30 (M.D. Fla. filed Feb. 5, 2001); *McCormick, et al. v. Edwards, et al.*, No. 3:01-CV-146-J-25 (M.D. Fla. filed Feb. 5, 2001); *Porter, et al. v. Edwards, et al.*, No. 8:01-CV-264-T-30 (M.D. Fla. filed Feb. 5, 2001) and *Skidmore, et al. v. Edwards, et al.*, No. 8:01-CV-266-T-30 (M.D. Fla. filed Feb. 5, 2001).

between ETS and the lessors were investment contracts. The court of appeals stated that in order to defeat Respondent's jurisdictional challenge to the preliminary injunction, the SEC had to establish a reasonable probability of ultimate success upon the question of jurisdiction when the action is tried on the merits. Pet. App. 4a. The court of appeals reversed, concluding that there was no subject matter jurisdiction to entertain the action as the SEC had not shown that it could satisfy the third element of what defines an investment contract under the test established in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the expectation of profits solely from the efforts of others. Pet. App. 6a. The court of appeals reasoned that the SEC could not demonstrate that the pay telephone owners expected "profits" in accordance with *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). Pet. App. 6a. Relying upon *Forman*, the court of appeals noted that the definition of profits has a limited meaning in the context of investment contracts, requiring that the investor have either a participation in the earnings on his investment or an opportunity for capital appreciation. Pet. App. 6a-7a. The court noted that "there is no dispute that capital appreciation is not at issue"[10] and concluded that the fixed

[10] In its Brief, the SEC now contends that payphone purchasers had a reasonable expectation of profit from ETS in the form of capital appreciation. SEC Brief 35 n.12. The SEC did not allege this in its complaint, nor did it argue this at the evidentiary hearing before the district court, or before the court of appeals, not even on rehearing, or in its petition for certiorari. Its argument should not be considered here. *See*, *e.g.*, *Department of Treasury, IRS v. Federal Labor Relations Auth.*, 494 U.S. 922, 934 (1990). In any event, nothing the SEC relies upon supports its claim that capital appreciation was a reasonable expectation of a pay telephone lessor. The materials that described the pay telephones as a valuable asset are accurate, but lend no credence to the

(Continued on following page)

lease payments were not a participation in earnings "[b]ecause the investors received a fixed monthly sum, the actual earnings of their telephone, or ETS, were irrelevant." Pet. App. 7a. The court explained that "only ETS could reap profits as that term is understood under the federal securities law." Pet. App. 7a. Finally, the court noted that even if "profits" were found here, the second aspect of the third element of the *Howey* test remained unsatisfied; the "investors did not expect profits to be derived solely from the efforts of others" since the rental payments "were derived as the benefit of the investors' bargain under the contract." Pet. App. 7a-8a. Judge Lay, in his concurring opinion, noted that ETS "dutifully managed the phones it leased for the duration of its existence and continues to do so today under its reorganization plan," and "that ETS made a good faith effort to run a legitimate business." Pet. App. 14a.

After the SEC's petition for rehearing and rehearing *en banc* were denied, Pet. App. 28a-29a, and while the SEC's since-denied motion to stay the mandate was pending, the government seized Respondent's assets under a claim of civil forfeiture, in effect continuing the asset freeze ordered dismissed by the court of appeals. SEC Brief 6 n.3. Mr. Edwards is contesting this seizure.

---

claim of appreciation in value of the equipment as a benefit of the ETS-lessor relationship. Respondent did not describe "payphone packages" as increasing in value over time. SEC Brief 35 n.12. He did explain his belief that ETS's locations increased in value when advertising was displayed on the pay telephone booth, but that value belonged only to ETS, not the lessor. J.A. 183. Any expectations about the increase in value of the pay telephones was mere speculation. J.A. 93.

SUMMARY OF ARGUMENT

This case requires the Court to address once again the elements of the well-established test for determining whether an instrument is an "investment contract" and therefore falls within the statutory definition of "security" contained in the Securities Act and the Securities Exchange Act. In particular, the Court must decide whether the term "investment contract" has a settled interpretation with uniform characteristics such that those engaging in business arrangements can discern the legal contours of the term, or whether, as urged by the SEC, the term is sufficiently "accommodating" so that it may be used as a basis for *post hoc* enforcement initiatives directed against arrangements not having those uniform characteristics. Investment contracts have been viewed uniformly as having the variable "profit" attributes of an equity security; they do not include the fixed return attributes traditionally associated with debt securities.

The question presented by the SEC in the Petition is different than the issue ruled upon by the court of appeals. See Resp. Opp. to Pet. page 11. The court of appeals held that the fixed payments made by ETS to lessors of the pay telephones pursuant to the lease agreements did not represent either capital appreciation or a participation in the earnings of the enterprise and therefore were not the type of "profits" the Court has found in instruments that are investment contracts. The Court has twice before addressed this issue, explaining how the "profits" element of the investment contract test it announced in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), was to be construed. In *Howey*, the Court held that the "test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *See id.* at 301. Later, applying the "profits" element of the *Howey* test, the Court in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975) stated that: "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors' funds. . . . " Fifteen years later, in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Court addressed the meaning of "profits" in a somewhat broader context under the securities laws, and again stated, unanimously, that "profits" in the context of an investment contract had a more restrictive definition than it had in an analysis to determine whether other types of securities were present. The Court noted that it had "defined 'profit' more restrictively in applying the *Howey* test to what are claimed to be 'investment contracts,'" to encompass only capital appreciation and a participation in earnings. *Id.* at 68 n.4.

The SEC challenges the Court's prior decisions as not correctly reflecting the proper test for the profits element of the *Howey* test. The SEC argues that a "fixed" payment meets the *Howey* test, eschewing the Court's twice-stated formulation. The SEC fails in its effort to demonstrate that the Court erred in assessing Congressional intent in *Howey*, *Forman* and *Reves*. Indeed the SEC seeks to "expand the realm of *Howey*" (*Reves*, 494 U.S. at 68 n.4) without any principled basis and without support in the decisions of this Court or any other court interpreting the "profits" element of *Howey*. In addition, the common understanding that the essential attributes of an investment contract are those of an equity security is consistent with the decisions of this Court, decisions of the lower federal courts, the state of the law at the time these provisions were enacted, SEC statements in a long standing interpretative release, and in commentary by the leading commentator in the field.

ARGUMENT

THE PAYPHONE LEASING ARRANGEMENTS WERE NOT "INVESTMENT CONTRACTS" AS LESSORS HAD NO EXPECTATION OF "PROFITS"

A. The term "investment contract" was used by Congress to denote a class of instruments having the economic characteristics of an equity security.

1. The focus of the federal securities acts was the protection of the broad capital markets. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975). Congress took care to ensure the least possible interference from the government in legitimate business and "did not intend to provide a broad federal remedy for all fraud." *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982); *Reves v. Ernst & Young*, 494 U.S. 56, 61, 65 (1990) ("Congress was concerned with regulating the investment market, not with creating a general federal cause of action for fraud.") President Franklin D. Roosevelt wrote to Congress in 1933 that the purpose of the federal securities legislation should be the protection of the public "with the least possible interference to honest business." H.R. NO. 73-85, at 2 (1933) *reprinted in* 1 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 139 (1983). Congress determined that the best way to achieve the President's goal was to define the term "security" in terms sufficiently broad to cover the various

instruments that would develop in the commercial world and which would "'fall within the ordinary concept of a security.'" *Forman*, 421 U.S. at 848. (quoting H.R. NO. 73-85, at 11 (1933)). Thus, in the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, Congress defined the term "security" by listing in its definition a number of specific instruments well known in the securities industry (such as stocks, bonds, and debentures), and a number of more general categories of instruments, including "investment contract" and "evidence of indebtedness." Pet. App. 30a.

While it is undefined in the statutes or legislative history, "investment contract," as one of the general categories listed under the definition of "security," *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 691 n.5 (1985), has been used by the Court to identify "unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition." *Id.* at 689 n.4. In assessing whether one of these "unusual instruments" was an investment contract, the Court has applied an economic reality test, for, if the Securities Acts were to apply in those cases at all, it would have to have been because the economic reality underlying the transactions indicated that the instruments were actually of a type that falls within the usual concept of a security. *See id.* at 690. As the Court has stated, and as the SEC concedes (SEC Brief 18), by 1933, the meaning of "investment contract" had been crystallized by prior usage in the state courts to the extent that, in discerning what Congress meant when it used the term in the definition of "security," one could point to certain economic characteristics to determine if an instrument was an investment contract. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946). Those characteristics had their genesis in the state "blue sky" law decisions and have guided seventy years of jurisprudential development by this Court and the lower federal courts. Those characteristics are the essential attributes defining what is commonly understood to be an equity security: a share in the enterprise entitled to participate in the earnings of the enterprise or in the changing value of the enterprise's assets. In other words, an investor may expect a return that varies with the success of the business.

2. The first occasion the Court had to address the term investment contract was in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943), where the defendant companies provided investors the opportunity to participate in an oil exploration enterprise by purchasing assignments of oil leases in a Texas oilfield. Without engaging in a detailed analysis or describing the criteria it was applying, the Court in *Joiner* concluded that Congress' intention in using the general designation of "investment contract" to denote a security brought within the definition the "[n]ovel, uncommon, or irregular devices" offered by the defendants as investments which had the prospect of appreciating in value if the exploration enterprise were successful. *Id.* at 351. Undeniably, the Court's decision that the investors had acquired investment contracts was rooted in the concept that the investors were expecting their investment of capital to appreciate in value if the promoter's drilling venture succeeded.

Three years later, in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Court again had occasion to examine a different type of unusual investment vehicle to determine if it fell within the definition of "investment contract." There, a promoter was offering small strips of land in a citrus grove coupled with a non-cancelable service contract whereby the promoter would use the extensive facilities of its established business enterprise to cultivate, harvest, and market the fruit from the several investors' adjoining, but otherwise not commercially usable, tracts, *id.* at 295, and pay each investor his or her respective allocable share of the profits of the overall venture. *Id.* at 296. These profit shares would necessarily vary with the business performance of the enterprise and carried the risk that there might be no profits to share. The Court held that the land ownership documents coupled with the service contracts constituted investment contracts. *Howey*, 328 U.S. at 300. Unlike *Joiner*, the decision in *Howey* provided a detailed analysis of the history and meaning of the term "investment contract," noting that "emphasis was placed upon economic reality." *Id.* at 298. More significantly, in *Howey* the Court established, for federal law purposes, a three-part "test" for determining whether particular arrangements are investment contracts: there must be "an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301. The parties agree that the "*Howey* test" is the correct one to be applied here.

In determining Congress' intent as to the meaning of "investment contract," the Court looked to pre-1933 "blue sky" decisions. *Howey,* 328 U.S. at 298. The Court identified the decision in *State v. Gopher Tire & Rubber Co.*, 177 N.W. 937 (Minn. 1920) as the seminal case defining the term. *Howey*, 328 U.S. at 298. In *Gopher Tire*, the Minnesota Supreme Court acknowledged that no prior case defined the term, and began its investment contract analysis by explaining that the word "investment" as commonly used meant "[t]he placing of capital or laying out of money in a way intended to secure income or profit *from its employment. . . .*" 177 N.W. at 938 (emphasis supplied). The analysis, however, did not end on this broad definitional note. Focusing on the essential attributes of the instrument involved–a certificate sold by a manufacturer of tires and tubes promising a share in the profits of the business–the court analogized it to "stock in that [certificates] give their holders the right to share in the profits of the corporation, but their value is purely speculative, for their holders get no interest in the tangible assets of the corporation." *Gopher Tire*, 177 N.W. at 938. The certificates were found to fit within the scope of the term "investment contract" because the economic reality of the investment–or, more particularly, its investment risk–made it analogous to an equity interest in the enterprise: the investor expected to obtain a return amounting to a *pro rata* distribution of 20% of the manufacturer's net sales, as well as a bonus consisting of the excess earnings of the enterprise to be distributed, at the manufacture's option, in the form of preferred stock. *Id.* at 937-38. The SEC paints with too broad a stroke when it contends that *Gopher Tire*'s definition of "investment," "which includes both 'income' and 'profit,' is clearly *expansive enough* to include an investment having a fixed or contractually guaranteed return." SEC Brief 18 (emphasis supplied).[11] Such a position is unwarranted; it ignores both the facts deemed essential by the court in conducting its economic reality analysis and the context: the investor's interest was likened to a share of "stock"–the quintessential equity security–and the *source* of the investor's expected return

[11] Similarly, the SEC argues that the dictionary definitions of various root words comprising the statutory term "investment contract" show that it "easily accommodates an investment offering a fixed return. . . . " SEC Brief 17. Whatever these words may "accommodate" in isolation, Congress' use of the term in the statute must be considered against the legal usage of the term itself at the time and, more particularly, in light of the "context," as Congress prescribed. *See Weaver*, 455 U.S. at 556 ("The broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if 'the context otherwise requires. . . . ' ").

was a share in the enterprise's capital appreciation or its earnings.

The other pre-1933 state law cases identified by the Court in *Howey* also focused on various business arrangements where money was put at risk against the potential of a return in the form of a participation in the earnings of the enterprise or a share in expected capital appreciation.[12] An economic reality analysis showing that an investment was analogous to an equity security became the *sine qua*

---

[12] The state law cases cited by the Court, *Howey*, 328 U.S. at 298 n.4, that deal with investment contracts are readily categorized as involving investments offering a participation in earnings or a share of capital appreciation:

Participation in Earnings: *Moore v. Stella*, 127 P.2d 300 (Cal. Dist. Ct. App. 1942) (investors purchased certificates of interest in "mineral deeds" with right to participate in promoter's earnings or profits in the nature of oil royalties); *Prohaska v. Hemmer-Miller Dev. Co.*, 256 Ill.App. 331 (Ill. App. Ct. 1930) (investors in installment land contracts entitled to have the "net profit" from the promoter's harvesting of crops on the land applied to the purchase price); *Stevens v. Liberty Packing Corp.*, 161 A. 193 (N.J. Ch. 1932) (investment in rabbit breeding enterprise with investor having right to receive $1 apiece for 50 percent of the offspring from the investor's breeding rabbits); *Cf. State v. Heath*, 153 S.E. 855 (N.C. 1930) (*no* investment contract where income was obtained from the investor's own effort and his money was not placed to secure income from its employment in the conduct of the business).

Capital Appreciation: *People v. White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) (investment agreement that after one year investor will receive payment from investment company amounting to his original principal plus earnings of specified amount based on the investment company's successful use of investor's funds); *State v. Evans*, 191 N.W. 425 (Minn. 1922) (fifty payment installment purchase of land with "option" which entitled investor to receive a cash "bonus" and return of purchase money upon surrender to promoter of the real estate). *Klatt v. Guaranteed Bond Co.*, 250 N.W. 825 (Wis. 1933), discussed the scope of the term "sale" in blue sky law (without reference to the term "investment contract") and thus is not included in either category.

non of the investment contract analysis and the requisite justification for invoking the remedial purposes of the blue sky laws.[13] The SEC erroneously contends that *People v. White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) and *Stevens v. Liberty Packing Corp.*, 161 A. 193 (N.J. Ch. 1932), two of the blue sky cases cited by the Court in *Howey,* illustrate that the "meaning of 'investment contract' involved fixed or contractually guaranteed returns." SEC Brief 18. As noted in the margin, *supra* page 19 n.12, the investors in those cases expected a return from the success of the promoters' use of money in the enterprise. The SEC confuses a true "fixed return," which is to be paid without regard to enterprise success, as in the lease agreements here, with instances where promoters give hypothetical (*Stevens v. Liberty Packing Corp.*) or stated (*People v. White*) amounts of expected returns from the earnings or appreciation of the enterprise. These latter types of returns are not "fixed" in an economic sense because any economic sharing of business success necessarily implies the *caveat: "if any."*

With respect to what constituted "profits," the *Howey* Court was specific; it stated that the investors' "respective *shares* in [the] enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable *shares* of the profits. . . . Thus all the elements of a profit-seeking

[13] The blue sky laws were aimed at "speculative schemes which have no more basis than so many feet of blue sky. . . . " *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917). The state courts interpreting the blue sky laws also recognized that those laws were not intended to police contracts where service is to be rendered or other obligations are incurred that do not involve either the recognition of capital appreciation or a participation in the profits of an enterprise. *See Creasy Corp. v. Enz Bros. Co.*, 187 N.W. 666 (Wis. 1922); *Lewis v. Creasey Corp.*, 248 S.W. 1046 (Ky. 1923); *State v. Heath*, 153 S.E. 855 (N.C. 1930).

business venture are present here. The investors provide the capital and *share* in the earnings and profits. . . ." *Howey*, 328 U.S. at 300, 301 (emphasis supplied). The repeated use of the word "share" in conjunction with the word "profit" cannot be said to be inadvertent. The Court thus identified an essential attribute of an investment contract as a return which would vary based on the success of the business.

Subsequent decisions by the Court reinforce the notion that investment contracts have specific attributes, like those identified in *Howey* and found in the early blue sky law cases. The thread running through all of the Court's cases confirms that investment contracts are analogous to, and have the essential attributes of, equity securities, including a return that varies with the success of the business of the common enterprise. In *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) ("*VALIC*"), the Court held that an instrument marketed by an insurance company as an annuity was not an insurance policy exempt from the federal securities laws. Rather, the instrument was held to be an investment contract with the investment risk being borne by the policyholder, who had paid premiums, a portion of which went into the insurer's investment fund. This meant that the "benefit payments vary with the success of the [insurer's] investment policy," and "may be greater or less, depending on the wisdom of [that] policy." *Id.* at 69-70. "The [policy] holder gets only a pro rata share of what the portfolio . . . reflects–which may be a lot, a little, or nothing." *Id.* at 71. Thereafter, in *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967), the Court looked again at insurance related products and held that an annuity contract could be considered a nonexempt investment contract during the contract's accumulation phase and an exempt insurance contract once contractually guaranteed fixed payouts began. Under the contract at issue, the policyholder paid fixed monthly premiums which the issuer placed in a fund–called the "Flexible Fund"–invested by the issuer primarily in common stocks. At contract maturity, the policyholder could either withdraw the cash value of his proportionate share of the fund (which the issuer guaranteed would not fall below a specified value), or convert to a fixed-benefit annuity, with payment amounts determined by the cash value of the policy. During the accumulation phase, the fund from which the policyholder would ultimately receive benefits *fluctuated* in value according to the insurer's investment results; because the "insurer promises to serve as an investment agency and allow the policyholder to *share* in its investment experience," during this phase the policy was an investment contract. *Id.* at 208 (emphasis supplied). The SEC thus misconstrues the Court's holding when it claims that "*United Benefit* more specifically reinforces the conclusion that an investment contract may offer a fixed return. . . . " SEC Brief 12. As the Court noted, the SEC contended that only the separable variable return portion of the Flexible Fund was a security and "agreed" that the fixed payment portion was conventional insurance "beyond the purview of the SEC." *United Benefit*, 387 U.S. at 206.

The Court next addressed issues relating to the term "investment contract" in *Tcherepnin v. Knight*, 389 U.S. 332 (1967). There, the Court held that a withdrawable capital share in an Illinois savings and loan association was a security. The Court reasoned that the shares "most closely resemble investment contracts," and that the test articulated in *Howey* was met. *Id.* at 338. The Court stated: "[t]he holders of withdrawable capital shares *are not entitled to a fixed rate of return*. Rather, they receive dividends . . . based on the association's profits." *Id.* at 337 (emphasis supplied). The Court noted that the share purchasers were participants in a common enterprise dependent for its success upon the skill and efforts of the management with the shares representing an apportionment of profits, if any, from the success of the enterprise. The Court concluded: "[c]learly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3(a)(10) [of the Securities Exchange Act, 15 U.S.C. 78c(a)(10)] and as it was defined in *Howey*." *Id.* at 338-39. Although the opinion does not state so in as many words, the implication that follows from *Tcherepnin* is that a contract holder who is entitled to a fixed payment whether or not the obligor has current earnings and whose payment will not increase if the obligor has a successful year, does not, for purposes of the investment contract test, have a reasonable expectation of "profits."

The "essential attributes of investment contracts" identified by *Tcherepnin* formed the basis for analysis of the shares of "stock" in a co-op housing project alleged to be investment contracts in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975). The Court again referred to these "essential attributes" and observed that the "touchstone" of the *Howey* test is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *Forman*, 421 U.S. at 852. The Court then addressed the essential attribute of "profits" and provided a detailed statement of the characteristics of the "profits" element of the *Howey* test:

> By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in [*SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943)] (sale of oil leases conditioned on promoters' agreement to

> drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in Tcherepnin v. Knight, supra (dividends on the investment based on savings and loan association's profits).

Forman, 421 U.S. at 852. The context in which this passage appears, and the Court's ensuing analysis of the attributes of the "stock" to see if it carried an entitlement to *Howey*-type profits, suggest that the two enumerated categories of profits are exclusive.[14]

Next, the Court addressed the scope of the term investment contract in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979). The Court found a number of the essential attributes of an investment contract missing when considering whether a participant in a noncontributory, compulsory pension plan was an investor in an investment contract. Applying separately each part of the *Howey* test, the Court found that the expectation of profits element was not met because the benefits paid to a pensioner, assuming for purposes of the analysis they could be considered "profits," depended primarily on the employee's efforts to meet the restrictive vesting requirements of the pension fund, rather than the investment success of the investment fund comprised of the employer's contributions. *See id.* at 561-562. The Court also found "further evidence" that the types of pension plans involved were not subject to the Securities Acts based upon the enactment of ERISA, which provided

---

[14] The dissent in *Forman* expressed the understanding that the Court's definition of *Howey* "profits" was exclusive: the "Court must surprise knowledgeable economists with its proposition . . . that profits cannot assume forms other than appreciation of capital or participation in earnings." *Forman*, 421 U.S. at 863.

whatever disclosure benefits to employees they might derive from the effect of the Securities Acts. *Daniel*, 439 U.S. at 569-570.

In *Marine Bank v. Weaver*, 455 U.S. 551 (1982), the Court reviewed a decision which had applied the investment contract test of *Howey* to a certificate of deposit issued by a domestic bank. The Court held that it was not a security subject to claims under the securities laws' antifraud provisions. The Court distinguished the certificate of deposit from the withdrawable capital shares found to be investment contracts in *Tcherepnin,* stating: "[t]he withdrawable capital shares found [in *Tcherepnin*] to be securities did not pay a fixed rate of interest; instead, purchasers received dividends based on the association's profits." *Id.* at 557. Since the Court found the withdrawable capital shares in *Tcherepnin* to resemble most closely investment contracts, the implication that follows from the Court's language in *Marine Bank* is that the term "profits" as used in the investment contract test does not include fixed interest payments. *Marine Bank,* as had *Daniel*, noted the existence of a comprehensive set of federal regulations governing the instrument involved separate from the securities laws that made it unnecessary to subject them to securities law coverage as well. *Marine Bank,* 455 U.S. at 558-559. The Court expressly noted that Congress, in enacting the securities laws, did not intend to provide a federal remedy for all fraud. *Id.* at 556.

The Court next addressed application of the term "investment contract" in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) when it considered what had come to be known as the "sale of business" doctrine. In *Landreth*, the Court reiterated that the "*Howey* economic reality test was designed to determine whether a particular instrument is an 'investment contract'" and that the test was not to be applied to determine if other listed types of securities were present. *Landreth Timber Co.*, 471 U.S. at 691. *Landreth* emphasizes the Court's position that the several descriptive terms used by Congress to describe a "security" were used to identify different types of securities having different characteristics, including those describing a "general category" of security, such as the term "investment contract."

Finally, in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Court returned again to questions involving the *Howey* test when determining whether or not demand promissory notes paying a fixed rate of interest, allegedly sold fraudulently by a farmer's cooperative, were "securities." The Court noted the broad sweep of the securities laws' definitions of "security," but twice reiterated that Congress did not intend to create a federal remedy for all fraud when it enacted the federal securities laws. *Id.* at 61, 65. The Court rejected the use of the *Howey* test to analyze whether the notes there were securities, and explained–as it had done in *Landreth*–that *Howey* provided a mechanism to determine if an instrument was an investment contract and was not "designed for an entirely different variety of instrument. . . . " *Id.* at 64. The Court "emphasize[d]" that the term "profit" it used in analyzing whether an instrument was a "note" was different from the way the Court had "defined 'profit' " for investment contract purposes. *See id.* at 68 n.4. Thus, if any doubt remained as to what was meant by "profits" in the investment contract context after *Tcherepnin, Forman* and *Marine Bank,* those doubts were put to rest by a unanimous Court in *Reves*. The Court was unmistakably precise as to its interpretation of the "profit" element of *Howey*: it had "defined 'profit' more restrictively in applying the *Howey* test to what are claimed to be 'investment contracts,' " to encompass only capital appreciation and a participation in earnings. *Reves*, 494 U.S. at 68 n.4. The Court expressly "decline[d] to extend [*Howey's*] definition of 'profit' beyond the realm in which that definition applies." *Id.* The Court pointed out that the note category of securities, which was not subject to this "restrictive definition" of "profit," was not required to have a return on investment "keyed to the earning of the enterprise." *Id.* As the SEC correctly notes, SEC Brief 36-37, the Court did not purport to alter the meaning of "profits" from its use in *Howey*. Nor did the Court, contrary to the SEC's argument, SEC Brief 38, engage in a "mistaken" characterization of *Howey* or *Forman* when it explained why the *Howey* test was irrelevant to the analysis of "notes" as securities. This was not mere *dicta* as the SEC would have it. The SEC argues that one may participate in the earnings of an enterprise when that participation is not "measured" by the earnings. SEC Brief 36. The SEC concedes, as it must, however, that its position is directly contrary to the Court's unanimous position in *Reves*, yet it provides no principled reason why the Court should accept the SEC's claim that the Court was "mistaken." SEC Brief 37.

3. The SEC urges that the Court's observation in *Reves* of Congress' purposes for providing an expansive definition of "security"–to encompass virtually any instrument that might be sold as an investment (494 U.S. at 61)–should be given far broader reach than its import allows. Of course, all things that might be viewed as investments in common parlance are not securities, as the Court has noted, including, for example, "naked leasehold rights" (*Joiner,* 320 U.S. at 348); "fee simple interests in land" (*Howey*, 328 U.S. at 299); "a farm or orchard coupled with management services" (*id.*); the "hypothetical investment by the employee" in pension benefits (*Daniel*, 439 U.S. at 562); a bank certificate of deposit (*Marine*

Bank, 455 U.S. at 557-558); and a unique business agreement negotiated one-on-one between transacting parties (*id.* at 560). More to the point, of the instruments that might be sold as investments and *are* securities, all are not investment contracts, including, as the SEC concedes, categories of securities paying fixed returns, including "notes" and "evidence[s] of indebtedness." SEC Brief 42 n.15.

As the Court's decisions in these cases demonstrate, one defining characteristic of an investment contract is the investor's expectation of profiting from a separable financial interest that necessarily varies with the success of the enterprise, whether through market price appreciation of what is owned, as in *Joiner, VALIC* and *United Benefit*, or through an allocable share of the enterprise's earnings, as in *Howey* and *Tcherepnin*. This analysis is consistent with the pre-1933 blue sky cases and accurately reflects Congress' intent when it used the term "investment contract" in the definition of "security." In cases where the Court has concluded that the investment contract test did not supply the analytical framework for decision or where it did and the Court concluded that the instrument involved was not an investment contract, one of the factors noted by the Court was whether the return expected either varied with the success of the enterprise, as in *Reves* and *Marine Bank*, or whether the varying return that was dependent upon the efforts of others was a significant aspect of the investor's expected return, as in *Forman* and *Daniel*. Thus, the SEC is asking the Court to abandon sixty years of consistent jurisprudence and alter the well-established attributes of an investment contract to include characteristics from "an entirely different variety of instrument." *Reves*, 494 U.S. at 64.[15]

4. The SEC urges that the remedial goals of the securities laws should lead the Court to conclude that investment contracts may include the essential attributes of both debt and equity securities, and that the fixed lease payments here are *Howey*-type profits. SEC Brief 19-21. But the statute is not structured that way, and these remedial goals "are insufficient justification for interpreting a specific provision more broadly than its language and the statutory scheme reasonably permit." *Pinter v. Dahl,* 486 U.S. 622, 653 (1988) (internal quotations omitted). The linchpin of the SEC's effort to convince the Court that the common understanding of the meaning of "profits" for investment contract purposes has resulted from too narrow an interpretation is the SEC's contention that the term investment contract is a "catch-all." SEC Brief 10, 16, 19, 20.[16] However, a statutory "catchall . . . operates as a safety net that Congress used to sweep up anything it had

[15] The SEC's position ignores the basic tenet that "settled construction of an important federal statute should not be disturbed unless and until Congress so decides." *Reves*, 494 U.S. at 74 (Stevens, J., concurring) (further commenting that after a statute is construed by the Court or a course of other federal decisions "it acquires a meaning that should be as clear as if the judicial gloss had been drafted by the Congress itself").

[16] The support for its argument that the term investment contract is a "catchall" is *dicta* in *Golden v. Garafalo,* 678 F.2d 1139, 1144 (2d Cir. 1982). SEC Brief 19. In that sale of business doctrine case, the court used the term "catchall" without attribution or citation to any authority and nevertheless found the investment contract test inapplicable (as this Court later concluded in *Landreth*). Despite its unprecedented suggestion that "investment contract" was a "catchall," the court of appeals did not suggest that an investment contract could have a fixed return or that it did not have to have the economic characteristics identified by this Court's decisions.

forgotten to include in its definition." *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 587 (1995) (Thomas, J., Scalia, J., Ginsburg, J., and Breyer, J., dissenting). By arguing that the term investment contract is a "catchall," the SEC tacitly concedes that the facts here do not meet the well-established elements long recognized by this Court and the lower courts to determine the existence of an investment contract. And Congress did not "forget[ ] to include in its definition" instruments that do pay fixed returns, such as "notes, bonds, debentures," and the general category of fixed return instruments: an "evidence of indebtedness." See Pet. App. 30a.[17] The SEC notes that Congress included these investments paying a fixed return in the definition of security. SEC Brief 19. The conclusion the SEC draws from that–"it makes sense that the catch-all term 'investment contract' should also include such investments" (*Id.*)–is a non-sequitur and ignores the rule of statutory construction that "the Court will avoid a reading which renders some words altogether redundant." *Gustafson*, 513 U.S. at 574.

It is noteworthy that from among the many federal court decisions construing the term investment contract, the SEC is able to cite only an isolated, equivocal, *dicta* comment from one case to support its contention that the

[17] As noted in the dissenting opinion in *Gustafson*, the Securities Act definition of "security" does include what can be deemed a "catchall" term: " . . . or, in general, any interest or instrument commonly known as a 'security' . . . " 513 U.S. at 587 (quoting 15 U.S.C. § 77b(a)(1)). In *Forman*, the Court "for present purposes" noted that it perceived no distinction between the scope of "investment contract" and the statutory catchall. 421 U.S. 852. The Securities Exchange Act has a similar provision: " . . . or in general, any instrument commonly known as a 'security' . . . " (15 U.S.C. § 78c(a)(10)). Pet. App. 30a.

Howey investment contract test applies to equity *and* debt instruments. SEC Brief 20, citing *Wals v. Fox Hills Dev. Corp.*, 24 F.3d 1016, 1018 (7th Cir. 1994) (the statutory definition "suggests" that the term "investment contract" has the essential properties of a debt or equity security). It is significant that Professor Louis Loss, long recognized by the Court as a leading commentator on the federal securities laws, disagrees. Professor Loss, when discussing *Reves* in his treatise on the securities laws, stated that the Court was "clearly correct" in holding that the "equity" test announced in *Howey* "should not be applied to a debt instrument." 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 951 (3d ed. 1999). It cannot be denied that the SEC is inviting the Court to determine for the first time, and with no direct precedent from the lower courts, that the term investment contract is a "catchall" term broad enough to "catch" lease instruments merely because they have one characteristic in common with certain defined types of debt securities, and even though that characteristic has not heretofore been associated with investment contracts. This is not the first time the SEC has argued to the Court that a fixed payment not derived from capital appreciation or a participation in earnings is a *Howey*-type profit; this same position was advanced by the SEC in its *amicus* brief in *Reves*. See Brief for the SEC as Amicus Curiae Supporting Pet'rs at 28, *Reves*, *supra* (No. 88-1480). The Court unanimously and explicitly announced a contrary view. Nothing in the law has changed to suggest that the SEC is any more correct in this position now than it was then. On several other occasions, this Court has rejected the SEC's efforts to extend the realm of *Howey* to instruments that do not have all of the commonly understood characteristics of an investment contract. *See*, *e.g.*, *Daniel*, 439 U.S. at 566 n.20 (1979) (citing cases). The same result should obtain here. As noted at page 1, *supra*, ETS's leasing arrangements are regulated under the FTC's business opportunity regulations and are subject to the FTC's enforcement powers. Under similar circumstances, the Court has refused to extend the reach of the securities laws to cover instruments it concluded were adequately regulated under other federal statutory schemes. See pages 24-25, *supra*.

5. In seeking to extend the definition of "profits," the SEC points to the literal meaning of "guaranty," "invest," "income," "contract," and "profit." SEC Brief 14, 17, 18, 36. An examination of economic realities, not dictionary definitions, should be used to identify what is or is not an investment contract. *Forman*, 421 U.S. at 849. The economic realities presented by the record here show that lessors parted with their money to acquire a pay telephone to use for commercial purposes and then they entered into a lease agreement providing for a fixed monthly payment, an expense which ETS could pay from many sources (not "keyed" to ETS's or the pay telephone's earnings) such as revenues, borrowings, asset sales, payments from a subsidiary, or otherwise. Earnings of the business would be available only after its expenses were paid and would go only to ETS. No lessor received any share in ETS's profits or expected capital appreciation from ETS. The apparent difficulty of finding a profit expectation in lessors when the transaction is analyzed in light of "the content of the instruments in question, the purpose intended to be served, and the factual setting as a whole," *Marine Bank,* 455 U.S. 561 n.11, has led the SEC to look to isolated words or phrases in the marketing materials used by the independent distributors and by ETS for proof that a lessor could reasonably expect *Howey*-type profits from the lease arrangement. SEC Brief 4, 12, 25, 27. As noted at

page 3, *supra*, the materials included several options for a telephone owner to commercialize the telephone, including options allowing the owner to directly obtain the earnings of the telephone. Nothing in the materials describing the lease option suggests that a *lessor* could earn a "profit." J.A. 128-130. Certain of the materials referred to by the SEC in this regard were directed by ETS to potential site owners, not telephone owners. SEC Brief 4; J.A. 48, 111-121, 168. Site owners did participate in the profits from the telephones placed on their property. J.A. 177. The SEC is incorrect in contending that *lessors* were told they were able to share in any "profits." SEC Brief 12, 25, 27. Unlike the situation in *Joiner*, 320 U.S. at 353, where the promoter's offerings completely changed the tenor of what was being acquired, here, the lease presentations and instruments leave no room for doubt as to the substance, not just the name affixed to the transaction. No reasonable lessor could have believed he was acquiring a share in ETS's earnings or an opportunity for capital appreciation by his lease. The terminology "lease" was neither a misnomer nor misleading. The names of instruments used by the parties may be relevant to the determination of their status as securities. Here, no lessor was led by ETS "justifiably to assume that the federal securities laws apply." *Forman*, 421 U.S. at 850. That other options for commercialization of pay telephones were discussed in the ETS materials and were available to pay telephone owners does not alter the essential attributes of the instruments involved here.

6. While it is appropriate to consider each of the three *Howey* elements separately, *Daniel*, 439 U.S. at 559, they cannot be considered in isolation. Therefore, while it makes no difference from an analytical standpoint whether the lessors are viewed as parting with their money to buy a telephone or with their telephone to obtain

a lease agreement, *see*, *e.g.*, *Daniel*, 439 U.S. at 560 n.12, the only arguable "common enterprise" in this case is the lease arrangement between each lessor and ETS, for that bargain is the only source of alleged "profit" payments.[18] Thus, even if the telephone purchasing and leasing transaction by the lessors could be viewed as a "package," as the SEC contends, SEC Brief 3, 9, 13, the economic inducement is unchanged–it remains a fixed monthly lease payment.

After holding that ETS's lease payments were not *Howey*-type profits, the court of appeals observed that, in any event, the final element of the *Howey* test was not satisfied by the SEC because the payments the lessors expected would not be "derived solely from the efforts of others." Pet. App. 7a. According to the court of appeals, "the determining factor [was] the fact that the investors were entitled to their lease payments under their contracts with ETS" and the returns were "derived as the benefit of the investors' bargain under the contract." *Id.* The SEC attacks this conclusion as grounded in "[n]either logic nor precedent." SEC Brief 38. The SEC is in error.

---

[18] The nature of the common enterprise element is important because a lease arrangement, at most, exhibits only "vertical commonality" between ETS and the individual lessors. Respondent has maintained that "horizontal commonality" is the proper test to determine the existence of a common enterprise under *Howey*, but that neither commonality test was met. As the court of appeals noted, there is a sharp split among the circuits regarding the proper test for determining the presence of a "common enterprise." Pet. App. 5a-6a, 9a-15a (Lay, J. concurring); s*ee also Mordaunt v. Incomco*, 469 U.S. 1115 (1985) (dissent from the denial of a petition for certiorari). Application of the horizontal commonality test would also result in dismissal of the case for lack of subject matter jurisdiction. *See* Pet. App. 13a-15a (Lay, J., concurring).

Both logic and precedent support the conclusion of the court of appeals that the lessors were not dependent upon ETS's success in managing the common enterprise in order to obtain what they were entitled to in their lease arrangement. The lessors stood to recover no more nor less than the lease payments, and ETS's efforts, or lack of them, could not change that amount or alter the lessors' rights under the agreement. In short, they were not looking to ETS to add value to what they already owned at the inception of the relationship–a right to either fixed lease payments or to have their telephone back–and they did not face any investment risk affecting the value of the business arrangement with ETS. *See Guidry v. Bank of La Place*, 954 F.2d 278, 284 (5th Cir. 1992) (to be investment contract, arrangement must contemplate, at the outset, some risk that investor can lose investment or that value of his return can fluctuate). Therefore, the lessors could not "profit" in the investment contract sense from the efforts of ETS.[19]

[19] The Court should not entertain the SEC's contention that the court of appeals should have *sua sponte* remanded this case to the district court to consider whether the instruments here were "notes" or other "evidence[s] of indebtedness." SEC Brief 42 n.15. The SEC made no showing whatsoever from which the court of appeals could conclude the SEC had a " 'reasonable probability of ultimate success' " on this issue. Pet. App. 4a. The SEC has not, and cannot, point to anything issued by ETS that constitutes a "note"; the lease agreements are not notes nor are they an "evidence of indebtedness" any more than any other executory contract. The SEC's complaint expressly alleged that the "investments [by the lessors] are investment contracts *and therefore are securities*." J.A. 6 (emphasis supplied). No other type of security was mentioned in the complaint. Moreover, neither the district court nor the court of appeals entertained this contention. It should not be considered here. See page 10 n.10, *supra*. *Meason v. Bank of Miami*, 652 F.2d 542 (5th Cir. 1981), *cert. denied*, 455 U.S. 939 (1982) does not require a remand to the district court. Unlike this case, the defendants in *Meason*

(Continued on following page)

B. The courts of appeals have concluded that fixed payments do not meet the *Howey* "profits" test.

1. Four courts of appeals, in addition to the court below, have concluded that the "profits" element of *Howey* is not met by a fixed payment that is not derived from capital appreciation or a share of company earnings. In all of these cases, there were contractual arrangements involving the payment of money where one party was relying upon another party's performance, but none of these cases satisfied the expectation of profits from the efforts of others test. *See Resolution Trust Corp. v. Stone,* 998 F.2d 1534 (10th Cir. 1993); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Bus. Loans, Inc.*, 651 F.2d 1174 (6th Cir. 1981), *cert. denied*, 454 U.S. 1124 (1981); *Kansas State Bank v. Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984); *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981). *See also Lavery v. Kearns*, 792 F. Supp. 847, 853 (D. Me. 1992) (fixed returns do not equal profits because fixed payments mean that it is contractually impossible for the payee to be sharing in the profits or losses with anyone). The SEC first attempts to distinguish this line of authority by contending that the cases involve "loan participations" and not sales to "ordinary investors," and then it simply dismisses the decisions as "mistaken[ ]." SEC Brief 30 n.11. None of the cases suggested that the profits issue turned on the nature of the transaction as a loan participation or the nature of the investor as not "ordinary." Nor have any decisions of the

made a *facial* attack on federal jurisdiction, thus remand was appropriate. *Id.* at 551.

Court suggested that an instrument's classification as an investment contract was dependent upon whether the purchaser was an "ordinary investor."[20] The SEC provides no principled reason why the Court should analyze the "profit" issue on such a basis or why these courts of appeals were mistaken.

2. Since the federal securities laws were enacted, the "profits" that have led the lower federal courts to find an investment contract present have been the variable, equity-type returns discussed above. This is true for cases decided before *Howey*, including those federal cases *Howey* referred to as consistent with the test it fashioned, *Howey*, 328 U.S. at 299 n.5.,[21] and those post-*Howey* cases identified

---

[20] The federal securities laws historically have been applied to all types of investors. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (explaining that the "speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders").

[21] *SEC v. Crude Oil Corp.*, 93 F.2d 844 (7th Cir. 1937) (sale of oil delivery contracts with distribution of proceeds of oil sales at increasing prices for 25 years); *Penfield Co. of California v. SEC*, 143 F.2d 746 (9th Cir. 1944), *cert. denied*, 323 U.S. 768 (1944) (variable pro-rata sharing in the net proceeds of a bottling business); *Atherton v. United States*, 128 F.2d 463 (9th Cir. 1942) (purchasers of leased acreages to oil well and drill site to receive pro-rata share of final sale of entire acreage upon completion of oil well); *SEC v. Universal Service Ass'n*, 106 F.2d 232 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940) (contributors to receive 30% profit per year from profits of farming operations); *SEC v. Bailey*, 41 F. Supp. 647 (S.D. Fla. 1941) (sale of small tracts for cultivation of tung trees by large development company with income from sale of tung oil and capital appreciation in value of tract from development of land); *SEC v. Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940) (pro-rata sharing in the profits from breeding and selling the offspring of silver foxes); *SEC v. Bourbon Sales Corp.*, 47 F. Supp. 70 (W.D. Ky. 1942) (sharing in the profits of a whiskey bottling and selling plan); *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935) (sharing of earnings with

(Continued on following page)

by the SEC in its brief to the Court, SEC Br. 23 n.9, almost without exception.[22] The SEC discusses only two cases decided over the past 57 years to support its argument that the courts of appeals have specifically recognized fixed returns as meeting the "profits" element of *Howey, SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001) and *United States v. Carman*, 577 F.2d 556 (9th Cir. 1978). SEC Brief 27-30. While those cases did refer to the return on investment as "fixed," both courts were addressing the "common enterprise" element of *Howey* and not the "profits from the efforts of others" element; moreover, the statement by those courts that the return was "fixed" does not call into question the correctness of the Court's formulation of what constitutes "profits" for investment contract purposes.[23]

---

promoter resulting from speculative grain and stock market contracts); *SEC v. Timetrust, Inc.*, 28 F. Supp. 34 (N.D. Cal. 1939) (pooling of investor installment payments in trusts to purchase bank stock with expectation of profits from dividends and market appreciation of stock); and *SEC v. Pyne*, 33 F. Supp. 988 (D. Mass. 1940) (sale of shares in fishing boats with the right to share in the profits of the business).

[22] *Capital Appreciation: United States v. Jones*, 712 F.2d 1316 (9th Cir. 1983), *cert. denied*, 464 U.S. 986 (1983); *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir. 1974); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027 (2d Cir. 1974); *Kemmerer v. Weaver*, 445 F.2d 76 (7th Cir. 1971); and *Continental Mktg. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967), *cert. denied*, 391 U.S. 905 (1968). *Participation in Earnings: Bailey v. J.W.K. Properties, Inc.*, 904 F.2d 918 (4th Cir. 1990); *Long v. Shultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989); *Albanese v. Florida Nat'l Bank*, 823 F.2d 408 (11th Cir. 1987); and *Blackwell v. Bentsen*, 203 F.2d 690 (5th Cir. 1953), *cert. dismissed*, 347 U.S. 925 (1954).

[23] Both *Carman* and *Infinity Group* relied upon *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224 (9th Cir. 1974), *cert. denied*, 419 U.S. 900 (1974), a pre-*Forman* case, as precedent that a "fixed return" is a *Howey*-type profit. In *El Khadem* the court concluded that the tax

(Continued on following page)

Although *Forman* was at the time the Court's most recent relevant decision on the meaning of the statutory term "investment contract," *Carman* did not even mention *Forman* in its investment contract analysis. *Carman*'s focus was not on the "profits" element of the *Howey* test; it sought to determine if a common enterprise was present in a business arrangement where financial institutions (not "ordinary investors," SEC Brief 30 n.11) acquired bundled Federally Insured Student Loan notes and a service agreement providing for repurchase by the promoter of any defaulted notes. The court concluded there was a common enterprise meeting the court's "vertical commonality" criteria because the success of both promoter and investor were dependent upon the promoter's continued solvency despite the "fixed" return on the notes. *Carman*, 577 F.2d at 563. *Carman* does not lend any meaningful support to the SEC's argument for an extension of the "profits" aspect of the *Howey* test. Subsequent Ninth Circuit decisions have cited the language from *Carman* relied upon by the SEC, but only with reference to the common enterprise element of the *Howey* test. *See SEC v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1340 (9th Cir. 1994); *SEC v. Goldfield Deep Mines Co. of Nevada*, 758 F.2d 459 (9th Cir. 1985); and *Brodt v. Bache & Co.*, 595 F.2d 459, 461 (9th Cir. 1978). Two years after *Carman*, the same court, in *Noa v. Key Futures, Inc.,* 638 F.2d 77, 80

---

benefits derived from paying fixed interest on a promissory note was a "profit" that met the *Howey* test. *Id.* at 1229. That notion was fully discredited by the Court in *Forman*, 421 U.S. at 855 n.20, and *Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986) (payment of interest with consequent deductibility for tax purposes not income or profits, citing *Forman*). In any event, the court in *El Khadem* expressly stated that its holding did not apply to situations where the purchaser's collateral could be redeemed, as here. *El Khadem*, 494 F.2d at 1230 n.14.

(9th Cir. 1980), established that the risk of insolvency alone is insufficient to establish the requisite dependency for a common enterprise. *See SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1391 (9th Cir. 1986) (also citing *Noa* and noting that the greatest risk to the purchaser was the failure of the enterprise, but that this was insufficient to meet *Howey* because of its ready applicability to any sale-of-goods contract).

Likewise, in *SEC v. Infinity Group,* the third element of the *Howey* test was not at issue. The defendants *agreed* that the instruments involved, called "property transfer contracts," satisfied the "profits solely from the efforts of others" element of the *Howey* test. 212 F.3d at 187. After a cursory review of the "efforts of others" question that did not mention *Forman* or analyze the issue of "profits," the court agreed that the third element was met. *Id.* The "focus [of the courts'] analysis [was] upon the 'common enterprise,' or second prong, of the *Howey* test." *Id.* at 187. The court rejected the defendants' claim that a fixed rate of return defeated horizontal commonality because investors would not share *pro rata* in any "profit" as described by *Forman*. *Id.* at 188-189. The court noted that the "definition of security" does not turn on whether the investor's "rate of return" is fixed or variable. *Id*. at 189 (citing *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir. 1974)). (See discussion of *El Khadem* at page 38 n.24, *supra.*) While the SEC points to the promoter's "guaranteed . . . rate of return," SEC Brief 28, as a "fixed" return equivalent to the lease payments here, the guarantee was of no moment to the decision as the court found the "guarantee" illusory, and concluded that "the investors here were guaranteed nothing . . . ." *Id*. at 190. Concerned that it would create a "loophole" by accepting an argument whereby "a gossamer guarantee of seemingly impossibly high returns at no risk" would be a "fixed rate of return," thereby defeating horizontal commonality, the court found the promoter's illusory "guarantee" irrelevant to the analysis. *Id*. at 191. The SEC's argument appears to suggest that the court's comment regarding "variable or fixed rate of return," *id*. at 189, applies to the *Howey* "profits" element. SEC Brief 28. The court's discussion, while not a paragon of clarity, undeniably is directed to the "common enterprise" element of *Howey*.

The SEC's further claim to *sub silentio* support from other courts of appeals is not only a slender reed, but also is in error. SEC Brief 29. In *SEC v. S.G. Ltd.*, 265 F.3d 42 (1st Cir. 2001), investors were enlisted to play a cyberspace "stock exchange" game, paying for shares in fictitious companies, including one the promoters "boasted" would have a ten percent average monthly increase, but "conceded that a decline in the share price was theoretically possible. . . . " *Id.* at 44-45. The cyberspace "investors" were looking for market price appreciation of their shares, and its admittedly fluctuating value shows that the shares did not entitle the owner to a fixed payment, such as a lease payment. The SEC simply misreads *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), *cert. denied*, 498 U.S. 1025 (1991). SEC Brief 29-30. There, the court of appeals found that the sale of certificates of deposit in a "CD Program" satisfied the profits element of the *Howey* test because the CD program had, *inter alia*, "the potential for price appreciation due to interest rate fluctuations. . . . " *Id.* at 240. These were not, as the SEC suggests, simply "certificates of deposit paying fixed rates. . . . " SEC Brief 30. *SEC v. Professional Associates*, 731 F.2d 349 (6th Cir. 1984), a pre-*Reves* case, involved the issuance of a promissory note with respect to an escrow account fund and an interest in trusts of commingled investor funds, one of which was said to "promise[ ] 9% annually." *Id.* at 355. Not only did the court not address the *Howey* "profits" element of the "escrow fund" and trust accounts, the court noted that the defendants conceded the "profits" element of the investment contract test as to the trusts. *Id.* at 354. *SEC v. Universal Service Ass'n*, 106 F.2d 232 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940) fares no better as authority that fixed payments may be profits. In that case, the promoter agreed that after five years members of his "plenocracy" were entitled to receive a return amounting to 30% annually of the profits of the common enterprise, which was engaged in agricultural operations. *Id.* at 235, 237. The entitlement to a return of 30% *from profits* of the enterprise is entirely consistent with this Court's teachings (in *Howey* the representation was of an *expected* 10% annual return, 328 U.S. at 296) and does not represent a "fixed" payment akin to the lease payments here. Implicit in the "30% from profits" promise is the common sense notion that if the profits are less than 30 percent, or there are no profits, the member would receive less or nothing. The *Universal Service Ass'n* opinion does not support the SEC's position. Finally, the SEC's reliance upon *SEC v. Better Life Club of Am.*, 995 F. Supp. 167 (D.D.C. 1998), *aff'd*, 203 F.3d 54 (D.C. Cir. 1999) (Table), *cert. denied*, 528 U.S. 867 (1999) is surprising for several reasons. First, the district court analyzed the promissory notes sold to investors to see if they met the *Howey* test, relying upon *Baurer v. Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981), which had specifically been rejected by the Court eight years earlier in *Reves*, 494 U.S. at 64. *Better Life Club*, 995 F. Supp. at 173. Second, the promised doubling of investment money was to come from the profits generated by a pooled fund of invested money–"investment payouts disguised beneath the façade of promissory notes." *Id.* at 174.

In its analyses of these cases, and throughout its brief, see page 20, *supra*, the SEC confuses the issue by trying to equate ETS's fixed lease payments with the promise or "guarantee" of payments from what are actually participations in the varying earnings of a common enterprise. As the SEC would have it, every expected return is a "fixed return" because it can always be reduced to a percentage.[24] The economic characteristic of the payment does not change from a participation in earnings merely because a boastful "rate of return" claim is promised by the promoter. In fact, the courts often view that false promise of performance as a key fraudulent representation. Whether they call them variable or fixed, or even bother to characterize them at all, these lower courts have described, almost without exception, the amounts to be received by the investor in terms that reflect a payout based upon either capital appreciation or earnings from the use of the investor's funds. In sum, there has been a consistent course of federal decisions adhering to a construction of "profits" for *Howey* test purposes that compels the conclusion that investment contracts are equity securities.

[24] While the SEC has provided an extensive list of cases, SEC Brief 41 n.14, to prove that it polices instruments providing fixed returns under the "investment contract" rubric, we note that the "fixed return" description of many, if not most, of those cases appears to suffer from the same confusion noted in the text.

C. The policy considerations and past interpretations posited by the SEC do not warrant abandonment of the common understanding of the contours of the *Howey* "profits" test.

1. Both the SEC and certain *amici* complain that a refusal to expand the scope of the term investment contract to encompass attributes traditionally associated with non-equity securities will create a "loophole" in their respective regulatory jurisdictions and bar private actions under the securities laws for conduct involving lease instruments or others paying a fixed return. *See*, *e.g.*, SEC Brief 40-42. That argument, however, should be directed to Congress, as it cannot fairly be said that the courts "open a loophole" when they rule that the statute does not reach certain conduct. Indeed, such an argument could be made anytime the courts determine that certain activity is beyond the reach of some agency's regulatory mandate, even though, as here, it is within the statutory mandate of another.

2. The SEC urges that deference should be paid to its "longstanding view . . . that an investment contract encompasses an arrangement paying a fixed or contractually guaranteed return." SEC Brief 31. That longstanding view is said to be reflected in the agency's litigation position in various enforcement cases, SEC Brief 31, in *amicus curiae* briefs and in interpretations, SEC Brief 32, and in "two formal adjudications." SEC Brief 33. Of course, before a court considers an agency's construction of a statute that it is charged with enforcing, the Court must conclude that there is an ambiguity in the language Congress has used. *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842 (1984). The SEC has not questioned that *Howey* correctly assessed Congress' intent when it used the term "investment contract." Thus, there is no statutory ambiguity in that regard.

There is only what the SEC contends is an ambiguity or error in the Court's explanation of the elements of *Howey*, including the "profits" element. With the Court's decisions in *Forman* and *Reves*, the first step of the *Chevron* test is not met; there is no statutory ambiguity to resolve on the "profits" issue, and this Court should adhere to its earlier decisions. *Neal v. United States*, 516 U.S. 284 (1996) (once the Court has determined a statute's meaning and in the absence of intervening statutory changes casting doubt upon the Court's interpretations, *stare decisis* dictates the earlier decisions be upheld against any later agency interpretations); *Natural Res. Def. Council, Inc. v. Nuclear Regulatory Comm'n*, 216 F.3d 1180, 1185 n.11 (D.C. Cir. 2000) (citing *Maislin Indus. v. Primary Steel, Inc.*, 497 U.S. 116, 131 (1990) for the proposition that the customary deference under *Chevron* does not apply when the Supreme Court has already determined the meaning of a term in a statute).

However, even if ambiguity exists and the Court proceeds to examine the SEC interpretations of the "profits" element of the *Howey* test, the SEC should not receive deference here. *See United States v. Mead Corp.,* 533 U.S. 218 (2001).[25] There are no detailed, reasoned, and longstanding formal SEC positions supporting its claims. Rather, the SEC's interpretations are inconclusive and hardly representative of an official agency position that fixed rental payments under a lease arrangement are incorporated within the judicial and administrative

[25] Even if the pre-*Chevron* doctrine of *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944) is applicable, which permits an agency's interpretation to be given some weight due to the agency's expertise, familiarity, and its power to persuade, no weight is due the SEC's view here for the reasons given in the text.

understanding of "profits" for investment contract purposes. As noted by the Court in *Daniel*, 439 U.S. 551, 566 n.20, and in subsequent decisions, *Pinter v. Dahl*, 486 U.S. at 653 n.27, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 175-176 (1994), and *Aaron v. SEC*, 446 U.S. 680, 693-694 (1980), the Court has frequently rejected the SEC's interpretations of various provisions of the federal securities acts. The SEC also concedes it unsuccessfully advanced the same position it takes here in its *amicus curiae* brief in *Reves*. SEC Brief 32. *See Reves*, 494 U.S. at 68 n.4. While the Court has given varying reasons for rejecting the SEC's views in these cases, ultimately the agency's inconsistent approach to an issue or an interpretation at odds with the language, purpose and history of the statute's application constrains the usual deference. *Daniel*, 439 U.S. at 566 n.20.

The SEC's interpretations made for purposes of litigation, such as in pleadings to a court, consent decrees, or as interpretive guidance should be viewed cautiously unless they are supported by regulations, rulings or administrative practice. S*ee generally Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 213 (1988) (explaining that deference to "what appears to be nothing more than an agency's convenient litigating position" is inappropriate). Such positions do not carry the force of law, irrespective of whether the interpretive material was promulgated in the exercise of the agency's authority. An enforcement case cited by the SEC, *SEC v. Amtel Communications, Inc.*, Lit. Release No. 14713, 60 S.E.C. Dkt. 1753 (Nov. 7, 1995), is one example. SEC Brief 31-32. *Amtel* resulted in the denial of the SEC's motion for preliminary injunction and, after the denial, the SEC amended its complaint and the case settled. *SEC v. Amtel Communications*, No. 95-CV-1127 (S.D. Cal. filed July 17, 1995). Another case relied on by the SEC to show its longstanding litigation position, SEC Brief 31, *SEC v. Universal Service Ass'n*, 106 F.2d 232, discussed at page 42, *supra*, does not show a consistent agency position that fixed returns can be "profits" for investment contract purposes as the returns there were not fixed, just capped. The SEC interpretive guidance set forth in *Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust*, Securities Act Release No. 33,3892, Fed. Sec. L. Rep. (CCH) ¶ 2755 (Jan. 31, 1958) and *Multi-level Distributorships and Pyramid Sales Plans*, Securities Act Release No. 33,5211, Fed. Sec. L. Rep. (CCH) ¶1048 (Dec. 7, 1971) are likewise, not helpful and not official positions relevant to this issue. The leasing operations of ETS did not entail any of the sales plans–all classic participation in common enterprise earnings arrangements–described in Securities Act Release No. 33,5211. The SEC relies upon this release for its statement that, in an investment contract, "the return promised for the use of an investor's money may be something other than a share of the profits of the enterprise." SEC Brief 32. The quoted passage continues, however, by explaining that "*Howey* described an investment contract providing the investor with an *equity interest* in the common enterprise; where the interest offered is of a different nature the promised return *will necessarily vary*. Thus, for example, *market-price appreciation in value–not profits in a commercial sense*–was significant in the investment contracts recognized by the Supreme Court" in *VALIC* and *United Benefit. Multi-level Distributorships*, Securities Act Release No. 33,5211, Fed. Sec. L. Rep. (CCH) ¶1048 (emphasis supplied). "Market-price appreciation"–another way of saying "capital appreciation"–also represents an equitable interest in the common enterprise. The SEC position in the interpretative release is inconsistent with its position here and makes Respondent's point: a participation in earnings or capital appreciation are the hallmarks of an equity security and denote "profits" for investment contract purposes.

In re Abbett, Sommer & Co., Exchange Act Release No. 34,8741, 44 S.E.C. 104 (Nov. 10, 1969), which relied on *Los Angeles Trust Deed & Mortg. Exchange v. Securities and Exchange Commission*, 285 F.2d 162 (9th Cir. 1960), *cert. denied,* 366 U.S. 919 (1961), for its explanation of "profits," does not, as the SEC asserts, SEC Brief 33, present a statement of agency views on the matters before the Court. In *Abbett*, the SEC admittedly departed from the existing line of investment contract cases where the promoter's services "were designed to create a profit" and concluded that the services "were directed essentially toward minimizing the risk involved in the investment." *Abbett*, Exchange Act Release No. 34,8741, 44 S.E.C. 104. The minimizing of the risk of an investment–even if it could be "liquidated into cash," *Forman*, 421 U.S. at 855–is a far cry from a fixed lease payment; indeed, the value of the reduction of the risk of an investment, even if a "profit" under *Howey*, would be a variable, highly dependent upon circumstances. Securities Act Release No. 33,3892, *Public Offerings of Investment Contracts Providing for the Acquisition, Sale or Servicing of Mortgages or Deeds of Trust*, is to the same effect as *Abbett* and does not manifest anything other than what is a quintessential capital appreciation (or avoidance of loss) arrangement.[26] These cases and

[26] In *In re Union Home Loans*, Exchange Act Release No. 34,19346, 26 S.E.C. Dkt. 1346 (Dec. 16, 1982), the parties settled the case without admitting or denying the facts as set forth in the report and order. The case was not litigated, does not include a reasoned opinion and therefore is not a formal adjudication entitled to deference, as the agency's

(Continued on following page)

releases are not persuasive and are not entitled to deference.

The SEC's reliance upon *SEC v. American Trailer Rentals Co.*, 379 U.S. 594 (1965), a bankruptcy case, is misplaced. In the opinion, the Court described a trailer leasing business that had filed a petition under Chapter 11 of the former Bankruptcy Act, 11 U.S.C. § 701, *et seq.* (1958 ed.). It is apparent from the face of the decision that the promoters did not contest the SEC's position that the lease arrangements were investment contracts. *Id.* at 598-599. Moreover, to the extent that the sale and leaseback scenario in *SEC v. American Trailer Rentals Co.* could be said to represent the agency's view that such businesses engaged in the sale of investment contracts, that view was not consistently followed when the SEC was made aware in 1995 of the structure of Respondent's pay telephone leasing business, including the redesigned corporate structure to assure compliance with the federal securities laws.[27]

---

own precedents show. *See In re Shipley*, Exchange Act Release No. 34,10870, 4 S.E.C. Dkt. 476 (June 21, 1974) (isolated SEC order in non-litigated case "is of no general import"). Moreover, *Union Home Loans* did not reference the profits component of the *Howey* test.

[27] In *SEC v. American Trailer Rentals Co.*, 379 U.S. at 612-13, the Court rejected the SEC's interpretation of the Bankruptcy Act because the Court could find no support in either the language of the statute or its legislative history for the SEC's position.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

MICHAEL K. WOLENSKY
(Counsel Of Record)
ETHAN H. COHEN
LAURA J. SAURIOL

KUTAK ROCK LLP
225 Peachtree Street, N.E.
Suite 2100 Atlanta, GA 30303-1731
(404) 222-4600

Counsel for Respondent