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Reves Revisited

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I. Introduction

The go-go financial markets of the 1980s have come to a crashing halt in a flood of litigation. Actions which seemed bold and daring during those prosperous times are viewed as reckless in the current recession. Among the more difficult issues faced by the courts is determining which of the creative transactions of the 1980s the Federal Securities laws should protect. Courts must make the more difficult of these determinations when analyzing instruments labeled "notes."

The Securities Act of 1933 (1933 Act) includes in its definition of a security "any note."[1] The Securities Exchange Act of 1934 includes in its definition any note, except notes with a maturity of nine months or less.[2] The courts have universally agreed that the introductory language "unless the context otherwise requires" in both def-

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1. Section 2 of the 1933 Act provides,

> When used in this subchapter, unless the context otherwise requires—
>
> (1) The term "security" means *any note*, stock, treasury stock, bond, debenture, evidence of indebtedness . . . or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (West 1981) (emphasis added).

2. Section 3 of the 1934 Act provides:

> (a) When used in this subchapter, unless the context otherwise requires—
>
> (10) The term "security" means *any note*, stock, treasury stock, bond, debenture . . . but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10) (West 1981).

initions, read in light of the wide variety of transactions which are evidenced by "notes," means that not *all* notes are "securities" under these acts. "Some notes, such as publicly offered and traded long-term corporate notes, are clearly securities and some, such as residential mortgage or consumer finance notes, are just as clearly not."[3] Difficulty arises with regard to the vast number of instruments which are not so clearly categorized.[4] The circuit courts have spent more than two decades struggling to develop an adequate definition to separate security notes from non-security notes, with little success.

In 1990, the United States Supreme Court heard this issue for the first time in *Reves v. Ernst & Young.*[5] In its opinion, the court attempted to reconcile several different tests which were being utilized by the circuit courts. Unfortunately, as commentators have noted, the test adopted by the court has created as much confusion as it eliminated.[6]

This paper will examine the *Reves* opinion and the problems that have arisen from its application. Part I examines the history of the various tests used by the circuit courts prior to the decision in *Reves*. Part II briefly analyzes the test adopted in *Reves*. Part III examines the application of the test by the lower courts, and the inconsistencies which have resulted. Finally, Part IV proposes an alternative analysis of the issue which could lead to more consistent predictable results.

II. HISTORICAL BACKGROUND

The definitions of a security contained in the 1933 and 1934 Acts encompass a broad range of investment instruments. However, courts have recognized that Congress did not "intend to provide a broad federal remedy for all fraud."[7] Both definitions consist of a large laundry list of instruments which are securities, unless "the context otherwise requires."[8] Courts have established several tests to

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3. Brief for the Respondent at 20, Reves v. Ernst & Young, 494 U.S. 56 (1990) (No. 88-1480).

4. *See* Brief for North American Securities Administrators Ass'n Inc. at 7-10, Reves v. Ernst & Young, 494 U.S. 56 (1990) (No. 88-1480).

5. 494 U.S. 56 (1990) (*cert. denied*, 112 S. Ct. 1165 (1992) [hereinafter subsequent history omitted].

6. James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383, 402-04 (1990); Randall W. Quinn, *After Reves v. Ernst & Young, When Are Certificates of Deposit "Notes" Subject to Rule 10b-5 of the Securities Exchange Act?* 46 THE BUS. LAW. 173 (1990); Marc I. Steinberg, *Notes as Securities: Reves and Its Implications*, 51 OHIO ST. L.J. 675, 678-85 (1990).

7. Marine Bank v. Weaver, 455 U.S. 551, 556 (1982). For a complete examination of the procedural benefits which accompany coverage by the securities acts, see Harlan S. Abrahams, *Commercial Notes and Definition of 'Security' under Securities Exchange Act of 1934: A Note is a Note is a Note?* 52 NEB. L. REV. 478, 508-510 (1973).

8. 15 U.S.C. § 77a, 15 U.S.C. § 78c(a)(10) (West 1981). *See supra* notes 1 and 2.

apply this context clause to different financial transactions and instruments. Regarding instruments labeled "stock," the Supreme Court in *Landreth Timber Co. v. Landreth*[9] recognized an extremely strong presumption in favor of coverage by the acts.[10] In *SEC v. W.J. Howey Co.*,[11] the Supreme Court developed a definitive test to determine when a transaction constituted an "investment contract," and consequently a security.[12] Courts have successfully applied the *Howey* test for forty-five years. However, a workable test for determining when a "note" should be considered a security eluded the courts.

Prior to the decision in *Reves*, the United States circuit courts had adopted four different tests to determine whether a note should be considered a security.[13] These tests were similar in that they attempted to determine the "economic realities" of the transaction.[14] Yet there were enough differences that an examination of the issue by the Supreme Court was necessary to ensure consistency. It is helpful to review briefly the application of these other tests in order to fully understand the high court's actions in *Reves* and the subsequent application of that opinion by the lower courts.

A. *The "Howey" Investment Contract Test*

The Eighth Circuit and District of Columbia Circuit applied the aforementioned *Howey* test to notes as well as investment contracts.[15] The *Howey* test requires the satisfaction of four factors. A

9. 471 U.S. 681 (1985).

10. *Id.* at 686-87. The court in *Landreth* held that the Act would cover any stock bearing the common characteristics of stock. *Id.* at 686. These characteristics include voting rights, the right to collect dividends based upon corporate profitability, and equity rights upon liquidation. *Id.* For an example of application of this test, see 22 SECURITIES REG. AND LAW REP. 1226 (1990) (discussing an SEC no action letter dated 7/30/90).

11. 328 U.S. 293 (1946).

12. *Id.* at 298-99. The Court held that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *Id.*

13. These four tests are: The Commercial/Investment Dichotomy test, *infra* notes 21-24 and accompanying text; The Risk Capital Test, *infra* notes 25-27 and accompanying text; The *Howey* investment contract test, *infra* notes 15-20 and accompanying text; and The Family Resemblance Test, *infra* notes 28-34 and accompanying text.

14. This approach is based largely on the suggestions of an article by Professor Ronald Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967).

15. As noted above, this test is derived from the Supreme Court's decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

contract must involve:

(1) the investment of money,
(2) in a common enterprise,
(3) for profit,
(4) based upon the managerial efforts of others.[16]

Some authorities suggest that the Supreme Court added a fifth prong to this test in *Marine Bank v. Weaver*:[17] whether an alternative regulatory scheme existed to protect investors.[18]

The problem with this test was that it was intended to define an investment contract, which is a very different instrument from a note.[19] For example, the fourth factor of the *Howey* test is intended to separate passive from active common enterprises. Yet profits derived from notes are always "based upon the managerial efforts of others." Therefore, application of the fourth *Howey* factor adds nothing to an analysis of the investment nature of the note.[20]

B. The Commercial/Investment Dichotomy Test

The Third, Fifth, Seventh and Tenth Circuits attempted to determine the "economic realities" of a note transaction by using independently developed lists of factors. Each of these circuits referred to their analysis as the Commercial/Investment Dichotomy test. The makeup of this test, however, varied from circuit to circuit, and sometimes from case to case. The Tenth Circuit looked at:

> (1) use of proceeds to buy specific assets or services (commercial) rather than general financing (investment), (2) risk to initial investment, (3) giving certain rights to a payee (investment), (4) repayment contingent on profit or out of production (investment), (5) a large number of notes or payees (investment), (6) a large dollar amount (investment), (7) fixed time notes (equivocal) rather than demand notes (commercial), and (8) characterization by the parties themselves.[21]

The Seventh Circuit suggested that the following factors helped, but that in the end a court must judge each case on its facts:

> (1) how is the instrument characterized in the business community? (2) how are the proceeds to be used (if for consumer goods or particular business goods or services—not covered, but if for general financing of borrower's enterprise—covered) (3) extent of reliance on efforts of others (placing funds at

16. *See*, Arthur Young & Co. v. Reves, 856 F.2d 52, 54 (8th Cir. 1988) *rev'd sub nom.* Reves v. Ernst and Young, 494 U.S. 56 (1990); *Accord* Baurer v. Planning Group, Inc., 669 F.2d 770 (D.C. Cir. 1981).

17. 455 U.S. 551 (1982).

18. *See* Gordon III, *supra* note 6, at 385.

19. *See* Reves v. Ernst & Young, 494 U.S. 56, 64. Justice Marshall argues that, "[t]o hold that a 'note' is not a 'security' unless it meets a test designed for an entirely different variety of intrument 'would make the Acts' enumeration of many types of instruments superfluous . . . .'" *Id.* (citing Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985).

20. For a full discussion of the *Howey* test and its application to investment contracts, see Scott FitzGibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893 (1980).

21. Zabriskie v. Lewis, 507 F.2d 546, 551 n.9 (10th Cir. 1974).

great risk, giving note payee extensive collateral rights, and making repayment of funds contingent upon some event all tend to indicate security rather than loan); (4) number of notes issued, number of payees, dollar amount of transaction; (5) payable on demand or, if payable at fixed time, how long is the time between issuance and maturity? and (6) characterization of notes on relevant financial statements.[22]

The Fifth Circuit also adopted the Commercial/Investment Dichotomy test; however, it limited its discussion to two factors which the court found generally present when a note constituted a security.[23] The key factors, according to that court were (1) whether the note was offered to a large class of investors, or acquired by the purchaser for speculation or investment (implying an investment), and (2) whether the note was given in exchange for a loan to pay off general business debt.[24]

C. *The Risk Capital Test*

The Ninth and Sixth Circuits utilized the Risk Capital test, sometimes in conjunction with and sometimes instead of the commercial/investment dichotomy test. This test analyzed "the nature and degree of risk accompanying the transaction to the party providing the funds" to determine "whether the funding party invested 'risk capital.' "[25] To answer this question, the courts tried to distinguish between risky loans and risk capital.[26] These circuits considered only transactions involving the latter as investment securities. To make this determination, these courts looked at a number of factors, including:

1) length of time the funds are at risk; (2) collateralization; (3) form of the obligation; (4) circumstances of the issuance; (5) relationship between amount borrowed and size of borrower's business; and (6) contemplated use of funds.[27]

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22. C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354, 1361 (7th Cir. 1975) (quoting, Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?* 52 NEB. L. REV. 478, 510-24 (1973).

23. *See* McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490 (5th Cir. 1974).

24. *Id.* at 493-94.

25. Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1256-57 (9th Cir. 1976) (citing El Khadem v. Equity Securities Corp., 494 F.2d 1224, 1229 (9th Cir. 1973)).

26. *Id.* at 1257 (quoting Motel Co. v. Commissioner, 340 F.2d 445, 446 (2d Cir. 1965)).

27. Danner v. Himmelfarb, 858 F.2d 515, 519 n.3 (9th Cir. 1988) (citing Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976)); *see also* American Bank & Trust Co. v. Wallace, 702 F.2d 93, 96 (6th Cir. 1983).

C. *The Family Resemblance Test*

Finally, the Second Circuit adopted a test it labeled the Family Resemblance test. This test begins by reviewing the plain language in both the 1933 and 1934 Acts, specifically the words "any note."[28] This language by itself implies a presumption of coverage for *any* instrument called a note.[29] However, the courts recognized that certain notes are clearly commercial in nature and securities laws intended to protect the *investing* public should not govern.[30] Therefore, by determining that a note belonged to a family of non-security notes, defendants could rebut this presumption. The court in *Exchange National Bank of Chicago v. Touche Ross & Co.*[31] developed a list of members of the family, including:

> (1) the note delivered in consumer financing, (2) the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, (3) the note evidencing a 'character' loan to a bank customer, (4) short-term notes secured by an assignment of accounts receivable, or (5) a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).[32]

Unless the examined note bears a "strong family resemblance" to one of the instruments on this list, it constitutes a security covered by the Acts.[33]

Again, looking to the plain language of the act, however, the Second Circuit recognized that the short-term exemption in section 3(a)(10) eliminated the presumption of coverage for some "notes." *Zeller v. Bogue Electric Manufacturing Corp.*[34] determined which short-term notes the Act would exempt through application of this exemption. The court in *Zeller* adopted the distinction drawn in an SEC Release that:

> [t]he legislative history of the Act makes clear that section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper used to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks.[35]

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28. Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1131 (2d Cir. 1976).

29. *Id.* at 1131-33. Actually, the Second Circuit applied this presumption only to notes which did not fall within the short-term exception of the Acts. *Id.* at 1132.

30. *Id.* at 1133-35; *see also* Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1973).

31. 544 F.2d 1126 (2nd Cir. 1976).

32. *Id.* at 1138.

33. *Id.* The Second Circuit declined to explore fully the impact of the exclusion of notes with a maturity of nine months or less on the test. However, the implication is that the presumption would shift, but that it could be rebutted, and such notes could be governed by the act if they were clearly investment in nature. *Id.* at 1138 n.19.

34. 476 F.2d 795 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1973).

35. *Id.* at 799-800, (quoting Exchange Act Release No. 4412, 26 Fed. Reg. 9158, 9159 (1961)).

Although this narrowing of the short-term exception seems logical given the legislative history of the Acts, it has become quite controversial in subsequent opinions, including *Reves*.

III. THE REVES OPINION

Finally in 1989, the United States Supreme Court granted certiorari to the Eighth Circuit in order to alleviate the confusion in choosing from among various tests.[36] The majority opinion, written by Justice Marshall, set down a uniform test for determining which notes constitute securities.[37] Unfortunately, the test he devised is filled with enough ambiguities that its application has led to widely varying results.[38]

Reves v. Ernst & Young[39] involved holders of demand notes issued by the Farmer's Cooperative of Arkansas and Oklahoma, which had filed for bankruptcy.[40] The note holders sued the accounting firm which audited the co-op under the antifraud provision of the Securities Exchange Act.[41] The Supreme Court granted certiorari on the issue of whether the notes were securities within the meaning of both the Arkansas and Federal securities laws.[42]

The majority opinion first looked to the statutory definition of "security."[43] Next, the Court examined some of the past decisions, in-

36. Reves v. Arthur Young & Co., 490 U.S. 1105 (1989) (Mem. opinion granting certiorari). The accounting firm of Arthur Young was the original defendant in the case. However, pending appeal, the firm merged with another accounting firm, Ernst and Whinney to form Ernst and Young, hence the name change.

37. Justice Marshall authored a number of securities opinions in addition to his more well known civil rights decisions. In addition to *Reves* he wrote five other major securities opinions during the last ten years of his tenure. *See* 23 Securities Reg. and Law Report 1028 (1991).

38. See section III *infra*.

39. 494 U.S. 56 (1990).

40. *Id.* at 59.

41. *Id.* The note holders claimed that Arthur Young was liable for aiding and abetting a 10b-5 violation by the cooperative. The accountants had failed to follow accepted accounting purposes, and the plaintiff class alleged that had they done so, the shaky financial position of the co-op would have been exposed.

42. The specific question presented to the court by the Petitioners was, "Did the Eighth Circuit err when it held, in conflict with other courts of appeals, that uninsured demand notes sold to thousands of passive investors are not 'securities'?" Petition for Writ of Certiorari at i, Reves v. Ernst and Young, 494 U.S. 56 (1990) (No. 88-1480). The petition emphasized the split among the circuits in its petition. *Id.* at 3-5.

43. 494 U.S. at 62. The Court deals only with the definition in section 3(a)(10) of the Securities Exchange Act of 1934, since it is that act which the plaintiffs invoke. However, since this definition is virtually identical to the definition in section 2(1) of the Securities Act of 1933, but with the added exclusion for short term securities, any

terpreting and limiting the application of the Acts to the laundry list of items in this definition. In particular, the opinion focused on the holding in *Landreth Timber Co. v. Landreth*[44] in which the Court laid down the test to determine whether a "stock" is a security.[45] The *Landreth* opinion held that since "stock" is "the paradigm of a security,"[46] a plaintiff need only show that the instrument was called stock and had the "common characteristics of stock" to establish that the securities laws governed the instrument.[47] However, a note does not encompass the same investment—i.e., characteristics of stock—according to Marshall, and therefore, the Court needed to adopt a more demanding test to distinguish securities from non-securities.[48]

In search of such a test, the Court examined the variety of tests previously adopted by the circuits. Of the possibilities, the Court concluded that the "family resemblance test is the best."[49] It accepted the Second Circuit's interpretation of the statutory definition of security, that the language "any note" establishes a presumption that a note is a security.[50] However, the Second Circuit's presumption applied only to notes with a maturity of more than nine months, based upon "its interpretation of the statutory exception for notes with a maturity of nine months or less."[51] Justice Marshall neither adopted nor accepted this interpretation, leaving an unanswered question which has led to confusion among the lower courts.[52] Even when the

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instrument which would be a security under the 1934 Act would presumably qualify under the 1933 act as well.

44. 471 U.S. 681 (1985).

45. What the majority opinion fails to mention is that it laid the basis for *Reves* in *Landreth* by stating, "We here expressly leave until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.' " *Landreth*, 471 U.S. at 694 (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943)).

46. *Landreth*, 471 U.S. at 693 (quoting Daily v. Morgan, 701 F.2d 496, 500 (5th Cir. 1983)).

47. *Id.* at 690.

48. *Reves*, 494 U.S. at 63. The court states that "[w]hile common stock is the quintessence of a security, and investors therefore justifiably assume that a sale of stock is covered by the Securities Acts, the same simply cannot be said of notes, which are used in a variety of settings." *Id.* at 62 (citation omitted).

49. *Id.* at 65. The majority rejected the application of the *Howey* test, finding it appropriate for defining an investment contract, but not an investment-oriented note. *Id.* The risk-capital test is mentioned only parenthetically as "virtually identical to the *Howey* test." *Id.* Finally, the Court states that the two remaining tests, commercial/investment and family resemblance, are essentially the same approach, with the latter being slightly more "promising." *Id.* Therefore, the winner is. . .the family resemblance test.

50. *Id.* at 65.

51. *Id.* at 65 n.3.

52. *Id.* n.3. *See supra* notes 2-4 and accompanying text. *See also* Marc I. Steinberg, *Notes as Securities:* Reves *and Its Implications*, 51 OHIO ST. L.J. 675, 681-82 (1990) (discussing the confusion associated with notes exceeding nine months).

presumption clearly applies, however, it is rebuttable.[53] The majority found that the judicially crafted list of securities established by the Second Circuit insufficiently determines whether the presumption is rebutted, and "more guidance is needed."[54] To provide this guidance, it looked at what characteristics made the listed instruments non-securities, then fashioned factors to apply to each note to determine whether it possessed these same characteristics. If the note satisfies these factors, the new instrument should be added to the list and the securities laws would not govern it.[55] Four factors comprise the test:

1) the motivations of the buyer and seller[56]
2) the plan of distribution[57]
3) the reasonable expectations of the investing public[58]
4) the presence of other risk-reducing factors.[59]

By using these factors, the Court found that the notes issued by the co-op were "securities" and therefore covered by the Securities Exchange Act of 1934.[60]

Only after having reached this conclusion did the Court address the crucial issue in the decision of the court below—the effect of the demand feature of the notes.[61] The Securities Exchange Act specifi-

53. *Reves*, 494 U.S. at 65. The Court noted that the presumption must be rebuttable to be consistent with the limited purpose of the securities regulations. *Id.*

54. *Id.*

55. *Id.*

56. *Id.* at 65-66. The Court stated:

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."

Id. at 67.

57. Specifically, the Court stated, "Second, we examine the 'plan of distribution'. . . to determine whether it is an instrument in which there is 'common trading' for speculation or investment." *Id.*

58. *Id.* The Court stated: "Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be 'securities' on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction." *Id.*

59. *Id.* The Court finally turned to "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." *Id.*

60. *Id.* at 66.

61. *Id.* at 67-68. In Arthur Young & Co. v. Reves, 856 F.2d 52, 54 (8th Cir. 1988), the Eighth Circuit based its decision on a *Landreth Timber* analysis, examining the de-

cally excludes, "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."[62] The respondents had argued that demand notes had an immediate maturity, and therefore fell within this exception.[63] The petitioners, on the other hand, argued that the exception in section 3(a)(10) of the Exchange Act was designed to exclude only high-quality commercial paper.[64] Justice Marshall chose not to adopt either of these two interpretations. Instead the Court insisted that it matters not which interpretation is correct since the notes do not fall within the short-term exception under either.[65]

This was the sole issue which divided the court. While there was unanimous support for the above outlined test, five justices disagreed with Justice Marshall's analysis of the maturity of the notes.[66] Justice Stevens concurred with Justice Marshall that the notes were securities.[67] However, his conclusion was based on his statutory interpretation that the short-term maturity exception of section 3(a)(10) excluded high-quality commercial paper only.[68]

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mand notes for the common characteristics of a security. In the opinion of the court, "[T]he demand nature of the notes [was] very uncharacteristic of a security." *Id.* at 54. Therefore, the only remaining question was whether application of the *Howey* test overrode this implication. *Id.*

62. The Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1934).

63. *Reves*, 494 U.S. at 70-72. Respondents relied upon McMahon v. O'Keefe, 213 Ark. 105, 106, 209 S.W.2d 449, 150 (1948), which held, "a note payable on demand is due immediately."

64. *See* Reply Brief for the Petitioners at 5-12, Reves v. Ernst and Young, 494 U.S. 56 (1990) (No. 88-1480).

65. *Reves*, 494 U.S. at 71. The court further explained that demand notes do not necessarily have a maturity of nine months or less since demand might not be made for years. *Id.* at 72-73.

66. Justice Stevens agreed that the demand notes did not fall within the short term exception set forth in § 3(a)(10) of the 1934 Act; however, he reached this conclusion by adopting the petitioners interpretation that the exception applied only to commercial paper. *Id.* at 76 (Stevens, J., concurring).

In reaching this conclusion, Justice Stevens relied on two Courts of Appeals cases which interpreted section 3(a)(10). *Id.* (Stevens, J., concurring). *See, e.g.*, Sanders v. John Nuveen & Co., 463 F.2d 1075, 1079-80 (7th Cir. 1972) (outlining the legislative history of Section 3(a)(3) of the 1933 Securities Act, which sets forth the four requirements for commercial paper exemption from the definition of a security); Zeller v. Bogue Elec. Mfg. Corp., 472 F.2d 795, 799-800 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1973) (applying the legislative history of Section 3(a)(3) of the 1933 Act to Section 3(a)(10) of the 1934 Securities Exchange Act.

Justice Rehnquist wrote a separate opinion, joined by Justices White, Scalia, and O'Connor, arguing that in fact the note was within the exception. *Id.* at 80-81 (Rehnquist, C.J., concurring in part and dissenting in part).

67. *Reves*, 494 U.S. at 76 (Stevens, J., concurring).

68. *Id.* at 74 (Stevens, J., concurring). Justice Stevens cited to the "unanimous" interpretation by the courts of appeals that, "when Congress spoke of notes with a maturity not exceeding nine months, it meant commercial paper, not investment securities." *Id.* (Stevens, J., concurring) (citing Sanders v. John Nuveen & Co., 463 F.2d 1075,

The Chief Justice, joined by Justices White, O'Connor and Scalia asserted that the notes at issue, based solely on their maturity, were not securities.[69] The Chief Justice looked to the historically accepted meanings of the terms "note" and "maturity," insisting that they "did not spring full-blown from the head of Congress in 1934."[70] Buttressing their argument with case law and dictionary definitions from the 1920s and 1930s, the dissenting justices found that "instruments payable on demand were considered immediately 'due.' "[71] Therefore, under the analysis of Chief Justice Rehnquist, all demand notes would be included in the short-term exemption of section 3(a)(10) of the 1934 Act.

IV. Application of the Test by the Lower Courts

The deficiency of the test established in *Reves* is exemplified by the inconsistency in its application by the lower courts. An examination of these subsequent decisions reveals that the enumerated factors have been applied differently in almost every case.[72]

A. *The Second Circuit*

Given that the Second Circuit first adopted, and was the sole circuit using, the family resemblance test prior to *Reves*,[73] one would expect the courts in this jurisdiction to most consistently apply the test. However, this has not been the result. While no cases yet have reached the Court of Appeals for the Second Circuit, the district courts under this circuit have applied the *Reves* test in at least eight

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1080 (7th Cir. 1972), *cert denied*, 409 U.S. 1009 (1972)). Furthermore, he noted that the SEC adopted this interpretation as well. *Id.* at 75 (Stevens, J., concurring) (citing Securities Act Release No. 33-4412, 26 Fed. Reg. 9158 (1961)).

69. *Id.* at 81-82 (Rehnquist, C.J., concurring in part and dissenting in part).

70. *Id.* at 77 (Rehnquist, C.J., concurring in part and dissenting in part).

71. *Id.* (Rehnquist, C.J., concurring in part and dissenting in part). The cases discussed by the dissenting justices analyzed the maturity in order to determine when the statute of limitations began to run. *Id.* (Rehnquist, C.J., concurring in part and dissenting in part). However, Rehnquist insisted that the maturity date which held the maker liable to his obligation was analogous to the situation in *Reves*. *Id.* at 78 (Rehnquist, C.J., concurring in part and dissenting in part).

72. *See infra* notes 73-218 and accompanying text. This article discusses only those cases which fully apply the *Reves* test. Several cases mention the opinion, and undoubtedly other courts made determinations based on *Reves*, especially at the pretrial stage. However, it is likely that the cases in the former category provide the best insight into the usefulness of the test.

73. *See supra* notes 28-35 and accompanying text.

cases, almost as many as all of the other federal courts combined. Vast inconsistencies have developed in the interpretation of *Reves*.

Singer v. Livoti[74] involved allegations of securities fraud by an attorney who had arranged financing for a failed real estate transaction.[75] The defendant moved to dismiss for lack of subject matter jurisdiction and for failure to state a claim, on the ground that the short-term note involved was not a security.[76] Attorney Livoti allegedly made misrepresentations which induced the plaintiffs, who were his clients, to make a loan to Frank Nocito, another client of Livoti's, in connection with a real estate development project.[77] The loan was evidenced by a promissory note carrying interest payable at maturity, at an annual rate of ten percent.[78]

In reaching a decision, the court was first faced with interpreting the short-term exception to section 3(a)(10) of the 1934 Act, since the note had a maturity of six months.[79] The court recognized that this question was unresolved by *Reves*.[80] Therefore, it relied on Second Circuit precedent indicating that, like long-term instruments, this type of non-security, short-term note should be presumed to be a security.[81] The court then applied the *Reves* test to determine whether the presumption was rebutted. Since the note was secured by a mortgage on several homes, the court held that it clearly resembled one of the enumerated categories.[82] Thus, it reasoned that the note was not a security.[83] However, it still applied the *Reves* factors.[84]

The court made several observations while applying the *Reves* factors. With regard to the motivations of the buyer and seller, the court noted that "[t]his transaction shows all of the economic context of a temporary loan to solve cash flow difficulties, not a permanent

74. 741 F.Supp. 1040 (S.D.N.Y. 1990).

75. *Id.* at 1041.

76. *Id.*

77. *Id.* at 1042. Mr. Singer and his wife loaned money to Frank Nocito. In exchange, the Singers received a note, secured by a mortgage on the property in New York under development by Mr. Nocito. *Id.*

78. *Id.* There had been some discussion of giving the Singers an equity interest in the development; however, only the claim under the note was asserted at trial.

79. *Id.* at 1046-49.

80. *Id.* at 1048.

81. *Id.* at 1049. "On the assumption that *Zeller's* restrictive interpretation of the statutory exception for short-term promissory notes [that the exception applies only to high grade commercial paper] is still good law in this Circuit, the Note and Refinanced Note initially must be presumed to be 'securities.'" *Id.* *See* Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 799-800 (2d Cir. 1973), *cert. denied*, 414 U.S. 908 (1973) (pointing out that under Section 3(a)(10) of the Exchange Act, only high grade commercial paper is exempted from the definition of a security).

82. *Singer*, 741 F.Supp. at 1049. The list includes "the note secured by a mortgage on a home." Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d at 1126, 1138 (1976).

83. *Id.*

84. *Singer*, 741 F.Supp. at 1049.

or semi-permanent source of capital investment."[85] Further, it found no plan of distribution; rather, it noted that the transaction involved a one-on-one arm's-length transaction.[86] The court also rejected any public expectation that the note was a security, since "the most that any purchaser could derive would be the collection of interest at ten percent for less than a year and the cementing of good will with [the real estate developer]."[87] Finally, the court mentioned the existence of several risk-reducing factors, including the presence of a professional intermediary, such as an attorney or broker licensed and regulated by the state, and the state's requirement that all mortgages be recorded to protect against subsequent encumbrance of the property.[88] These risk-reducing factors point to treating this note as a commercial loan. The fact that the mortgage was not recorded in this case was immaterial.[89] Therefore, the court concluded that this note was not a security.[90]

The Southern District of New York next applied *Reves* in *Mishkin v. Peat, Marwick, Mitchell & Co.*[91] In *Mishkin*, a Securities Investor Protection Association (SIPA) trustee appointed for a broker/dealer in Chapter 7 bankruptcy brought an action against an accounting firm which had audited the broker/dealer prior to the bankruptcy filing.[92] In addition to negligence claims, the trustee asserted claims of aiding and abetting a violation of section 10(b).[93] The securities charge involved: 1) alleged sales of non-existent banker's acceptances with maturities of less than nine months to two banks and two savings and loans; 2) participations in groups of these banker's acceptances; and 3) a non-existent thirty-year treasury note to a third bank.[94] In discussing the status of the participations in the banker's acceptances, the court propounded that they were not securities because:

> 1) Banker's acceptances and participations therein with maturities not exceeding nine months are themselves exempt from the definition of "secur-

85. *Id.* at 1050.
86. *Id.*
87. *Id.*
88. *Id. See generally* N.Y. JUD. LAW § 460 (McKinney 1992 and Supp.).
89. *Singer*, 741 F. Supp. at 1050. The court failed to note that the mere existence of the collateral also reduced the lender's risk.
90. *Id.* at 1051.
91. 744 F. Supp. 531 (S.D.N.Y. 1990).
92. *Id.* at 535.
93. *Id.* at 551.
94. *Id.*

ities" under section 3(a)(10) of the Exchange Act.[95]

2) There is no reason to remove this type of short-term commercial lending transaction from the class of non-securities.[96]

3) [P]urchasers of participations in a banker's acceptance (generally financial institutions) are looking for a low risk, short-term, fixed interest rate investment. There is no significant secondary market for such participations; investors generally have the intention of holding the participations to maturity. Investments in participations of a banker's acceptance are investments in the short-term money market.[97]

The court concluded that because no purchase or sale of a security was involved in those four counts, it did not have jurisdiction over those claims.[98]

In *Premier Microwave Corp v. Comtech Telecommunications*,[99] plaintiff Purnendu Chatterjee formed a corporation to acquire the assets of the Premier Microwave division of Comtech, along with a warrant entitling him to purchase 500,000 shares of Comtech common stock at $2 per share for a period of five years.[100] The purchase price was $7.5 million, which consisted of $6.5 million in cash and a seven-year note issued by PMCC, the acquisition corporation.[101] The note was for a principal amount of $1,000,000 with an 8.5 percent annual interest rate.[102] In examining the 10(b) claim, the court had to determine whether the fraud occurred "in connection with the purchase or sale of a security," necessitating the application of *Reves*.[103]

After ascertaining that the existence of the warrant did not satisfy this requirement, the court turned its attention to the note.[104] In applying the *Reves* factors, the court first presumed that the note was a security.[105] Second, it recognized that the note did not exactly fit any of the enumerated categories of non-securities.[106] Third, it applied the four *Reves* factors and concluded the note was not a security because:

> [i]n particular, the second *Reves* factor, the "plan of distribution" is inapplicable to the Note here. There was no such plan and there was no "common

95. *Id.* at 553. The court found this fact dispositive for those defendants who believed they were purchasing banker's acceptances, noting that "[b]ecause banker's acceptances are exempt non-securities under the Exchange Act, this court has no subject matter jurisdiction over the four claims based on purchases of the banker's acceptances." *Id.*

96. *Id.* at 553 (citing Reves v. Ernst & Young, 494 U.S. 56 (1990)).

97. *Id.* at 554.

98. *Id.*

99. Fed. Sec. L. Rep. (CCH) ¶ 95,789; No. 88 Civ. 2570 (KMW), 1991 U.S. Dist. LEXIS 846 (S.D.N.Y. Jan. 28, 1991).

100. 1991 U.S. Dist. LEXIS at 846.

101. *Id.*

102. *Id.*

103. *Id.* at *4.

104. *Id.* at *11-12.

105. *Id.* at *12.

106. *Id.*

> trading for speculation or investment." Similarly the third general factor, public expectation that the note is a security, is inapplicable here. Surely there was no public expectation that the promissory Note between Premier's buyer and seller would be traded or speculated in as a security.[107]

The court did not even mention the other two factors before concluding that the note was not a security.

In *Varnberg v. Minnick*,[108] the plaintiffs inherited an investment portfolio valued at nearly $6 million.[109] They invested this money in various tax shelter limited partnerships organized by the defendant, Wendall Minnick.[110] Between June 1978 and September 1980, the plaintiffs made forty-eight separate "loans" to the partnership in exchange for a note.[111] In determining whether this note was a security, the court referred to *Reves*, but did not explicitly apply the test. However, the court did discuss facts which apply to many of the *Reves* factors. For example, the court mentioned that the note covered loans made "for a variety of different business ventures of the partnership."[112] This implied that the motivations were commercial rather than investment in nature. Next, the court seemed to address the plan of distribution by mentioning a number of facts which indicated an arm's-length transaction.[113] The court found that the investing public could not have expected the note to be a security as it had no knowlege to base such an expectation.[114] Finally, it concluded that "it appears that the note was drafted as a means of recording open account loans made by Gail Varnberg and for tax purposes."[115] Consequently, the court only partially based its reasoning on *Reves* when it held that the note was not a security.[116]

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107. *Id.* at 860 (citing Singer v. Livoti, 741 F. Supp. 1040 (S.D.N.Y. 1990)).

108. 760 F. Supp. 315 (S.D.N.Y. 1991).

109. *Id.* at 318.

110. *Id.*

111. *Id.* at 320 n.8.

112. *Id.* at 325.

113. *Id.* The court found that the note "was evidently custom-drafted by [the tax attorney retained by the plaintiffs]. Although the note was convertible into a 15% interest in BW Partners, [one of the partnerships organized by the defendant], the interest rate was considerably below the rates prevailing in 1978." *Id.* The court also found little possibility that the note was offered to any other investor, or that a there was any intent to create a secondary market. *Id.*

114. *Id.* at 325-26. "[The note] was payable on demand from a closely-held partnership which . . . had no apparent investment strategy." *Id.* at 326.

115. *Id.* at 326. The court made this observation to point out the "economic realities" of the transaction. This appears to be a throwback to the language of pre-*Reves* Second Circuit cases. *See, e.g.,* Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 942 (2nd Cir. 1984); Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1138 (2nd Cir. 1984).

116. *Varnberg*, 760 F. Supp. at 326.

In *Banco Español de Credito v. Security Pacific National Bank*,[117] the plaintiffs purchased, from Security Pacific, participations in short-term bank loans which Security Pacific had loaned to another customer.[118] A Master Participation Agreement (MPA) evidenced these purchases.[119] Security Pacific made the short-term loans to Integrated Resource Inc. (Integrated) to facilitate current operations.[120] As such, these underlying loans were clearly not securities.[121] However, plaintiffs asserted that participations in non-securities may still be securities.[122]

The court accepted this reasoning,[123] and applied the *Reves* test. First, it opined that the instruments bore "a strong family resemblance to 'loans by commercial banks [to customers] for current operations.' "[124] The court next applied the *Reves* factors in order to determine whether the note should be considered a non-security. First, it explained that the motivation of Security Pacific was to increase lines of credit to a current customer.[125] On the other hand, it asserted that Integrated was motivated by a need for short-term funds, while the opportunity to earn greater than market interest rates motivated the participants.[126] Therefore, according to the court, "the overall motivation of the parties was the promotion of commercial purposes and not investments in a business enterprise.[127] Secondly, it stated that "[t]he plan of distribution was a limited solicitation to sophisticated financial or commercial institutions and not to the general public."[128] Third, it noted that perceptions of the investing public depended upon the particular investing public:[129] if the investing public was the general public, there was no perception, because they had no knowledge of the program's existence;[130] if only

117. 763 F. Supp. 36 (S.D.N.Y. 1991).

118. *Id.* at 38.

119. *Id.*

120. *Id.*

121. *Id.* at 41. This note bears a strong resemblance to a short term note secured by an assignment of accounts receivable, which is a member of the family of non-securities. *See supra* note 31 and accompanying text.

122. Plaintiffs do not argue for a "Mishkin Analysis," which acknowledges the possibility that participation in non-securities may be a security, but concludes that traditional loan participation is not a security. *Id.* at 42. *See* Mishkin v. Pean, Marwick, Mitchell & Co., 744 F.Supp. 531, 553 (S.D.N.Y. 1990). Rather, plaintiffs contend that "the participations at issue arising in a short-term loan program are wholly different from traditional loans." *Banco Español*, 763 F.Supp. at 42.

123. *Banco Español*, 763 F.Supp. at 42 (citing Commercial Discount Corp. v. Lincoln First Commercial Corp., 445 F.Supp. 1236, 1267 (S.D.N.Y. 1978)).

124. *Id.* at 42 (quoting Reves v. Ernst & Young, 494 U.S. 56, 64 (1990)).

125. *Id.*

126. *Id.* at 43.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

the offeree is the investing public then it could be seen "only as loan participations;[131] [a] reasonable sophisticated . . . institution [as an investing public] was on notice through the contractual provisions that the instruments are participations in loans and not investments in business enterprise."[132] Finally, the court recognized the existence of another regulatory scheme, specifically guidelines issued by the Office of the Comptroller regarding the purchase or sale of loan participations.[133] Therefore, it found that this was not a security.

Although all of the loans and the participations had maturity dates of less than six months, the court did not discuss the short-term exclusion. This was because this case concerned a violation of section 12(2) of the 1933 Act, which does not contain the broad short-term exemption in its definition of a security.[134]

In *Iacobucci v. Universal Bank of Maryland*,[135] the plaintiffs had deposited money in savings accounts to secure credit cards issued to them.[136] The court quickly held that this activity did not involve the purchase or sale of a security, noting that "[t]he cash management accounts fail on at least two of the *Reves* factors:"[137] first, the plaintiffs were motivated by receipt of the credit cards; secondly, any reasonable member of the public would perceive the receipt of the credit cards as the motivation behind the transaction.[138] Thus, the court dismissed the claim.[139]

One of the most interesting cases examined by the Southern District of New York was *National Bank of Yugoslavia v. Drexel Burnham Lambert*.[140] The Bank of Yugoslavia deposited more than $71 million with Drexel in 1989 and 1990, which Drexel agreed to pay back with interest within three months.[141] While the Bank expected Drexel to invest the money, the money was actually used to alleviate

131. *Id.*

132. *Id.*

133. *Id.*

134. 15 U.S.C. § 771(2) (1981).

135. Fed. Sec. L. Rep. (CCH) ¶ 96,075; 1991 U.S Dist. LEXIS 7843 (S.D.N.Y. 1991). For a brief analysis of this opinion, see 23 SEC. REG. AND L. REP. 1034 (1991).

136. *Id.* at *1.

137. *Id.* at *15-16.

138. *Id.* at *17. The court did not discuss any other *Reves* factors. Apparently, they felt that the two factors alone were dispositive.

139. *Id.*

140. 768 F. Supp. 1010 (S.D.N.Y. 1991).

141. *Id.* at 1012. Drexel accepted 70 million deutsche marks followed by an additional 40 million dollars. *Id.*

Drexel's cash flow problems.[142] In February of 1990, Drexel informed the Bank that due to its financial problems, it would be unable to return approximately $71 million.[143] Shortly thereafter, Drexel sought protection under Chapter 11 of the Bankruptcy Code.[144] The Bank filed suit in the Southern District of New York, claiming that Drexel violated numerous securities laws.[145] Drexel moved for dismissal based on the Bank's failure to state a claim and the lack of subject matter jurisdiction.[146] To rule on these motions, the court had to determine whether the note given by Drexel to the Bank was a "security."[147] In applying *Reves*, the court first examined the effect of the short-term exemption. The defendants argued that under Second Circuit precedent, short-term notes are presumed *not* to be securities.[148] The court responded that "[t]he Supreme Court interpreted the law of this circuit differently, stating that in the Second Circuit, '[n]o presumption of any kind [is] attached to notes of less than nine months' duration.' "[149] The court also rejected Drexel's next argument that the time deposits closely resembled " 'notes evidencing loans by commercial banks for current operations.' "[150] Therefore, the court used the *Reves* factors to determine whether this instrument should be added to the list.

The court examined:

1) *The motivations of the buyer and seller.* For purposes of a motion to dismiss, the court intially found that the motivations alleged by the complainant must be accepted as true.[151] The Bank asserted that the transaction was motivated by a desire to profit from Drexel's investment.[152] Drexel naturally claimed that the transaction was a loan to cover general business expenses.[153] Thus this case raised, but

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142. *Id.* at 1012-13.

143. *Id.* at 1013.

144. *See* Kurt Eichenwald, *The Drexel Collapse: For Drexel, Creditors Galore*, N.Y. TIMES, Feb. 15, 1990, at D1. Drexel made its bankruptcy filing at 11:07 p.m. on February 13, 1990. *Id.* The filing was precipitated by a "rapid cash squeeze because of a shortage of short-term financing." *Id.*

145. *Bank of Yugoslavia*, 768 F. Supp. at 1012.

146. *Id.* The court found the FED. R. CIV. P. 12(b)(1) motion without merit since, "there is no contention that the Bank's securities laws claims are frivolous and interposed to manufacture jurisdiction . . . ." *Id.* at 1012 n.1. *See generally* FED. R. CIV. P. 12(b)(1) and 12(b)(6).

147. *Bank of Yugoslavia*, 768 F.Supp. at 1014.

148. *Id.* at 1014 n.3 (citing Varnberg v. Minnick, 760 F. Supp. 315, 325 (S.D.N.Y. 1991)).

149. *Id.* (quoting Reves v. Ernst & Young, 494 U.S. 56, 65 n.3).

150. *Id.* at 1014 (quoting *Reves*, 494 U.S. at 65). The court distinguished this transaction because "[t]he Bank is not a commercial lending institution, but the central bank of a sovereign state." *Id.* It also explained that the transaction did not involve the normal formalities involved in a commercial loan transaction. *Id.*

151. *Id.* at 1013.

152. *Id.* at 1015.

153. *Id.* at 1013, 1015.

did not decide, whose motivations should control in situations regarding this jurisdictional issue.[154]

2) *The plan of distribution.* The court next recognized there was no widespread plan of distribution, but opined that "the absence of such an allegation is not fatal to the Bank's securities laws claims."[155] If this factor could negate the existence of a security, the court believed that the purpose of the securities laws would be undermined.[156]

3) *The reasonable expectations of the investing public.* The court claimed that since the public was unaware of the transaction, it would be too speculative to determine the public's expectations.[157] The court rejected Drexel's argument that the one-on-one transaction would lead the investing public to expect that no security is involved.[158]

4) *The presence of other risk-reducing factors.* Finally, the court concluded that while the short maturity of the notes should be considered, this alone does not satisfy this factor.[159] It noted that the common law and federal bankruptcy law offered the only protection for the Bank.[160] Since both of these existed prior to enactment of the securities laws, the court reasoned that the latter would not have been enacted had the former afforded adequate protection to the investor.[161]

Finally, the court examined the short maturity of the notes, and concluded that the exemption in Section 3(a)(10) applies only to commercial paper.[162]

B. The Third Circuit

In *Fulton Bank v. McKittrick & Briggs Securities*,[163] Fulton Bank purchased participations in lease payments to be made under a Lease Payment and Services Agreement (LPSA) between McKittrick's subsidiary, Impact Management Systems, and York County Penn.[164]

154. *Id.* at 1015.
155. *Id.*
156. *Id.* at 1016.
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.*
162. *Id.*
163. Nos. 88-0144 & 88-0882, 1990 U.S. Dist. LEXIS 11371 (E.D. Pa. Aug. 27, 1990).
164. *Id.* at *2-3.

McKittrick marketed the participations through Kidder Peabody, by representing to the plaintiff that the resulting interest earned would be tax-free.[165]

In order to establish its subject matter jurisdiction, the court first examined whether the participations were securities.[166] Therefore, the court applied the *Reves* test, finding that:

1) the seller was motivated by its need to raise money for general use to meet obligations under the LPSA, and the buyer was motivated by profit and tax benefits;[167]

2) there was no trading in this instrument, noting that it was "nonetheless distributed by one registered broker/dealer to another registered broker/dealer, and was ultimately resold to a sophisticated investor as an investment;"[168]

3) since this was a common investment at the time, the public would reasonably expect this instrument to be a security;[169]

4) no other regulations governed this type of transaction.[170]

Therefore, the court deemed the participations to be securities.[171]

C. The Fourth Circuit

The Fourth Circuit's only application of *Reves* occurred in *Zolfaghari v. Sheikholeslami*.[172] The case involved the First American Mortgage Corporation (FAMCO), a company which allegedly granted and serviced mortgages, and sold mortgages and interests in pools of mortgages to investors.[173] In reality, FAMCO acted fraudulently, selling numerous notes allegedly secured by the same mortgage.[174] The plaintiffs were a group of Iranian immigrants who believed that they had purchased notes secured by first mortgages.[175] The court explained that "[a] note secured by a mortgage on a single home is typically not a security because the return on investment therefrom is not derived from the entrepreneurial or managerial efforts of others."[176] Yet, once the mortgages are pooled and interests in the pool are sold to investors, the court recognized that they could

165. *Id.* at *4-5.
166. *Id.* at *9.
167. *Id.* at *11.
168. *Id.* at *14.
169. *Id.* at *15-16 (citing *Trends in Municipal Leasing: Tax-exempt Leases Spread in Popularity*, WALL ST. J., May 4, 1988, at 25).
170. *Id.* at *16.
171. *Id.*
172. 943 F.2d 451 (4th Cir. 1991).
173. *Id.* at 453.
174. *Id.*
175. *Id.* at 453-54.
176. *Id.* at 455 (citing Reves v. Ernst & Young, 494 U.S. 56, 65 (1990). This is an interesting interpretation of why the items on the family resemblance list are not securities, in that it sounds more like the *Howey* test than the *Reves* test.

be classified as securities.[177] Because there was evidence that the plaintiffs purchased such participations, the court held that summary judgment on the securities claim was premature.[178] Thus, while the court mentioned *Reves*, it applied none of the Supreme Court's analysis in reaching its conclusion.[179]

D. *The Fifth Circuit*

Reeder v. Palmer[180] examined a scheme whereby the plaintiffs "invested" in a program to sell travel junkets which turned out to be fictitious.[181] In return for providing customers for the junkets, the plaintiffs were given post-dated checks.[182] To resolve the 12(b)(6) motion to dismiss, the court questioned whether these checks were securities.[183] Because the checks are payable on demand, the court determined that they were excluded under the short-term exemption.[184] Nonetheless, like other courts, the court still applied the *Reves* factors, even though the instruments technically were not notes.[185] The first factor failed under the court's analysis, because the investors could have no expectation of profit, given the fixed rate of interest and the use of the money for the general needs of the "business."[186] The court asserted that the second factor failed because there was no "plan of distribution" or secondary trading market.[187] It found no need to examine the third prong since the public

177. *Id.* In support of this assertion, the court chose not to apply the *Reves* factors; instead, it analogized to the "mortgage-backed *securities*" sold by Government National Mortgage Association, pursuant to 12 U.S.C. § 1719(d) (1988).

178. *Id.* at 456.

179. *Id.* at 455-56.

180. 736 F.Supp. 128 (E.D.La. 1990), *aff'd per curiam*, 917 F.2d 560 (5th Cir. 1990).

181. *Id.* at 129. Reeder alleged that the travel club he invested in was really a "Ponzi" scheme. *Id.*

182. *Id.*

183. *Id.* The court noted that the case must involve a security in order to state a claim under both federal and Louisiana securities laws, and that, "instruments which are not 'securities' under federal law are not securities under Louisiana Law." *Id.* (citing Rogillio v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 448 So.2d 1340, 1346 (La. App. 1984)).

184. *Id.* at 130 (relying on the definition of "check" and the 1933 and 1934 Acts).

185. *Id.* at 131. "Although this case does not involve notes, the Court must recognize the Supreme Court's recent decision in *Reves v. Ernst & Young*, 494 U.S. 56 (1990)." *Id.*

186. *Id.* at 131. This is a much more narrow definition of profit expectation than that apparently applied by the Supreme Court in *Reves*. The notes in *Reves* also paid a fixed rate of interest, and yet the court found a profit motive on the part of the lenders/investors. *See Reves*, 494 U.S. at 68.

187. *Id.* at 131.

could have no expectation about something it never saw.[188] Finally, as to other risk-reducing factors, the court announced, "Although the fraud perpetrated by Martin is not covered by any regulatory scheme, the holder of a worthless check has a right—albeit a hollow one in this case—under Louisiana law to pursue an action against the issuer."[189] Hence, the mere presence of a common law remedy is deemed sufficient to satisfy this prong. The court then rejected the checks as investment contracts under *Howey*, and therefore found them not to be securities.[190]

In *Guidry v. Bank of LaPlace*[191] the court faced the same facts with different plaintiffs. However, the court in *Guidry* was less cautious, and dismissed any application of *Reves*.[192]

E. The Sixth Circuit

Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.[193] was decided just two months after *Reves*, yet the opinion includes a suprisingly in-depth application of the test. The case grew out of the actions of an interrelated group of bankrupt corporations which had previously marketed mortgages.[194] The remaining defendants were those individuals who allegedly aided and abetted those corporations in committing common law fraud and violations of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.[195] The defendants moved for summary judgment on the 10b-5 claim on the grounds that neither the notes nor the CML shares were securities.[196]

The first mortgage notes were analyzed under *Reves*. The court recognized that "the notes secured by a mortgage on a home" are on

188. *Id.* This is a common yet seemingly unintended interpretation of this prong of the *Reves* test, whereby courts have held that if there was no widespread distribution, the third factor is moot because the public had no expectations.

189. *Id.*

190. *Id.* at 131-32. Its application of all possible tests greatly reduces the court's chances of being overturned, and was probably the primary motivator for their application.

191. 740 F. Supp. 1208 (E.D.La. 1990) *aff'd as modified*, 954 F.2d 278 (5th Cir. 1992).

192. *Id.* at 1214-15.

193. 736 F.Supp. 764 (W.D. Mich. 1990) (*aff'd per curiam*, 933 F.2d 1008 (1991)).

194. *Id.* at 766. The plaintiff corporation, A.J. Obie & Associates, Inc. ("Obie"), was a registered broker/dealer which sold both individual mortgage backed promissory notes marketed by Diamond Mortgage Corp. ("Diamond"), and shares in a real estate investment trust, Commerce Mortgage Investments, Ltd., ("CMI"), which held mortgage notes marketed by Diamond. *Id.*

195. *Id.* The defendants were: 1) Attorney Ronald M. Barron, and his law firm Ronald M. Barron & Associates, P.C.; 2) James Karpen, former Director of Enforcement of the Michigan Corporations and Securities Bureau; and 3) Frederick Hoffecker, Assistant in Charge of the Michigan Attorney General's Consumer Protection Division. *Id.*

196. *Id.* at 768. The CML shares were quickly deemed to be securities under the *Landreth Timber* common characteristics test. *Id.* For a discussion of *Landreth Timber*, see *supra* notes 9-10 and accompanying text.

the list of "non-securities" adopted in *Reves*.[197] However, the court insisted that this list was "not graven in stone" and could be expanded *or interpreted*.[198] The court proceeded to expand and interpret the list, finding that these particular "notes secured by the mortgage on a home" were securities because they had been sold in a secondary market, thus changing the nature of the instrument.[199] In other words, mortgage-backed notes become securities once they are sold in the secondary market.[200] The court then applied the four factors enunciated in *Reves* to support this interpretation and specifically ascertained that:

1) the buyer's motivation was profit, and the seller intended to "finance investment, chiefly the purchase of additional mortgages";[201]

2) the notes were widely traded for "speculation and investment";[202]

3) the public would reasonably conclude the notes were securities, since the offering circular states that "[t]he First Mortgage Notes are deemed to be 'securities' as defined by state and federal securities laws and their offering and sale to the public is subject to the . . . antifraud provisions of state and federal securities laws";[203]

4) while the collateralization of the notes is a risk-reducing factor, there was no such risk reduction since the collateralization was fraudulent.[204]

The court concluded that there was no reason to reconsider its conclusion that these notes are securities.[205]

The only other Sixth Circuit case is *In Re Southern Industrial Banking Corp.*.[206] It arose from the efforts of a trustee in Bank-

197. *Id.* at 769. (citing, Reves v. Ernst & Young, 494 U.S. 56, 65 (1990); Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976)).

198. *Id.* at 769 (citing, *Reves*, 494 U.S. at 65).

199. *Id.* The court reasoned that the "[n]otes secured by the mortgage on a home" category on the list, referred only to such notes evidencing an individually bargained-for transaction. *Id.* Under those circumstances the parties involved are generally a consumer lender and a borrower, rather than "an individual investor and a broker/dealer selling the notes on a mass market basis." *Id.* (citing Stone v. Mehlberg, 728 F. Supp. 1341, 1344-45 (W.D.Mich. 1990)).

200. *Id.*

201. *Id.* at 770 (citing *Reves*, 494 U.S. at 65).

202. *Id.*

203. *Id.* at 769.

204. *Id.*

205. *Id.*

206. 126 B.R. 294 (E.D. Tenn. 1991).

ruptcy of Southern Industrial Banking Corp. (SIBC) to recover an alleged fraudulent conveyance to the law firm of Kennerly, Montgomery, Howard & Finley (KMH & F).[207] Mr. C.H. Butcher, CEO of SIBC and owner of numerous Tennessee banks, entered into a transaction to purchase two Florida savings and loans in 1982.[208] KMH & F acted as an escrow agent in a transaction involving the deposit of $10.4 million of SIBC money into an escrow account.[209] In return, SIBC received notes from Butcher, which the bankruptcy court found to be worthless.[210] The court declined to apply the *Reves* test, concluding that no more damages could be recovered under the securities laws than those already due under bankruptcy.[211] Therefore, it saw no reason to disturb the earlier dismissal of this claim.[212]

F. The Seventh Circuit

The Northern District Court of Illinois needed only a footnote to apply the test in its first post-*Reves* examination in *Rayman v. Peoples Savings Corp.*[213] The court evaluated whether a note issued by Peoples Savings Corporation, in connection with an attempt to acquire the shares of Crest Savings, was a security.[214] The note was a "demand note" which was the same note addressed in *Reves*.[215] It then applied the *Reves* test, finding that "the notes in this case do not qualify as securities where (1) Rayman's purpose in accepting the notes was not for investment but to finance temporarily a deal that had originally been planned as all cash, (2) the notes are not traded for investment or speculation[,] and (3) the notes are all held by one party."[216]

Korpai v. Individuals Financial Group, the second case decided by the Northern District of Illinois, only seven days after *Rayman*, dismissed *Reves* in an equally perfunctory manner.[217] There the plaintiff purchased demand promissory notes issued by the defendant.[218]

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207. *Id.* at 296.
208. *Id.* at 297.
209. *Id.* at 298.
210. *Id.*
211. *Id.* at 303.
212. *Id.* at 304.
213. 735 F.Supp. 842, 845 n.9 (N.D. Ill. 1990).
214. *Id.* at 843-44.
215. *Id.* at 845 n.9. The court failed to mention that the demand nature of the notes was also the issue which split the court in *Reves* and which was not decided by a clear majority. They also completely failed to address the application of the short-term exemption to these notes.
216. *Id.* Interestingly, the court did not mention the fourth *Reves* factor, the presence of risk reducing factors, even though the transaction involved two institutions heavily regulated by the FSLIC.
217. No. 88 c 9401, 1990 WL 51186 (N.D. Ill. Apr. 17, 1990).
218. *Id.* at *1.

Since the case was heard so soon after *Reves*, the court did not believe it could apply the test properly.[219] Thus, it merely assumed the notes satisfied the test and were therefore securities.[220]

G. *The Ninth Circuit*

The first Ninth Circuit case decided after *Reves* to truly apply the test was *First Citizens Federal Savings & Loan Association v. Worthen Bank & Trust Co.*[221] In that case, twenty savings and loan institutions entered into a loan participation agreement to fund a real estate development project.[222] The question before the court was whether the agreement was a security under the Arizona Blue Sky Statute.[223] It found that the underlying loan to a real estate developer to finance his project qualified as "a note evidencing a loan made by a commercial bank to finance current operations of a borrower," one of the items on the list of non-securities.[224] Thus, the court concluded that it fell "squarely into the . . . exception and [did] not constitute a 'security.' "[225] Further, it claimed that the participation agreement itself was not a security since it could only qualify as such under the *Howey* investment contract test, which it subsequently failed.[226] The most recent Ninth Circuit case to apply *Reves* was *SEC v. R.G. Reynolds Enterprises*.[227] The case involved an investment program called a "Managed Account" which was run by the defendant, R.G. Reynolds.[228] The defendant "borrowed" funds from clients for an orginal six-month term at variable interest rates.[229] When these loans became due, Reynolds began issuing promissory notes to the investors at a rate of twenty to twenty-five percent, to be

219. *Id.* at *2.

220. *Id.* In doing so, it gave the benefit of the doubt to the party opposing the motion for summary judgment. *Id.*

221. 919 F.2d 510 (9th Cir. 1990).

222. *Id.* at 512.

223. *Id.* at 515 n.4. *See also* ARIZ. REV. STAT. ANN. § 44-1801 (1987) (which contained a definition similar to that under the 1934 Act). Arizona courts had interpreted the law based upon federal analysis. *First Citizens*, 919 F.2d at 515 n.4.

224. *First Citizens*, 919 F.2d at 515 (citing Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir. 1984)).

225. *Id.* at 515-16.

226. *Id.* at 516. Consequently, the summary judgment against the plaintiffs' securities fraud claim was upheld. *Id.*

227. 952 F.2d 1125 (9th Cir. 1991).

228. *Id.* at 1128. The account was actually referred to by a number of names, including "discretionary account," "30% Net Investment Program," and "Loan Program." *Id.*

229. *Id.*

paid at a specified date, usually six to twelve months in the future.[230] The SEC brought an action against Mr. Reynolds, alleging that he violated both antifraud provisions.[231] Reynolds argued that the investments at issue were not securities.[232] The court applied the *Reves* factors to the promissory notes and determined that they were securities because:

1) Reynolds allegedly raised money to finance a substantial investment, and the investors looked solely to profit in the form of interest;[233]

2) "[t]he notes were 'offered and sold to a broad segment of the public' which suggests that the notes are securities";[234]

3) [t]he public could reasonably infer that the notes were securities, based upon letters from Reynolds which characterized them as investments;[235]

4) there were no risk-reducing factors.[236]

The court next questioned the effect of the short-term nature of some of the notes.[237] Since *Reves* had left this question open, the court focused on other circuit opinions.[238] In particular, it cited numerous cases which limited the short-term exceptions under both acts[239] to apply only to commercial paper,[240] stating, "We agree with

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230. *Id.*

231. *Id.* at 1129. The Securities Act of 1933 and the Securities Exchange Act of 1934 both contain "anti-fraud" provisions. While the provisions are similar, the courts have found an implied private right of action under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (West 1981), but have not found a similar right under § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (West 1981). Therefore, only the SEC may bring an action under § 17(a), which has led to a smaller body of law interpreting the definition of a security under the 1933 Act.

232. *Id.* As such, he argued that the summary judgment granted for the SEC was improper. *Id.* The court found that two distinct interests needed to be examined: "(1) the somewhat ill-defined interest initially offered, in which investors gave Reynolds cash in return for his promise of a high rate of return; and (2) promissory notes issued to ivestors who had already entered the program." *Id.* at 1130. The court applied the *Howey* test to the first category and found that the interests were in fact investment contracts, and hence securities. *Id.* at 1130-31.

233. *Id.* at 1131.

234. *Id.* (quoting Reves v. Ernst & Young, 494 U.S. 56, 65 (1990)).

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.* at 1132.

239. Section 3(a)(3) of the 1933 Act provides a similar short term exemption, except that it is more clearly limited to commercial paper instruments. This section exempts:

> Any note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace or any renewal thereof . . . .

240. *R.G. Reynolds*, 952 F.2d at 1132 (citing Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir. 1972), *cert. denied*, 414 U.S. 908 (1973); Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485 (10th Cir 1989), *cert. denied*, 111 S.Ct. 386 (1990); Baurer v. Planning Group, Inc., 669 F.2d 770 (D.C. Cir. 1981); McClure v. First Nat'l Bank, 497

these circuits that logic and legislative history favor limiting the short-term note exception to commercial paper and hold that the presumption that a note is a security applies equally to notes of less than nine months' maturity that are not commercial paper."[241] This interpretation rendered the different terms of the notes irrelevant to the court's earlier conclusion that the notes were securities.

H. The Tenth Circuit

One of the most interesting post-*Reves* decisions is the remanded decision of *Holloway v. Peat, Marwick, Mitchell & Co.*,[242] This case had already been decided under the Commercial/Investment Dichotomy test in *Holloway I*.[243] Given the facts, it is rather remarkable that the court concluded that the securities laws applied, under either test. The instruments involved were "thrift certificates" and "passbook savings certificates" issued by Republic Bancorporation, Inc. and its subsidiaries, Republic Trust & Savings (RTC), a trust company, and Republic Financial Corporation (RFC), a finance company.[244] The court first determined that these certificates were essentially debt instruments, and therefore should be analyzed using the test for "notes."[245] In *Holloway I*, the court focused on specific factors of the commercial investment dichotomy test which it felt were "particularly important in this case."[246] This focus revealed that:

> (1) RTS and RFC solicited the general public for investments in their . . . certificates.[247]
> (2) The instruments were issued as a vehicle for raising capital which was apparently used as general financing for RTS and RFC, and which involved the

F.2d 490, (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1971), *cert. denied*, 409 U.S. 1009 (1972)).

241. *Id.*

242. 900 F.2d 1485 (10th Cir. 1990) (hereinafter Holloway II); This case was the result of the remand of Holloway v. Peat, Marwick, Mitchell & Co., 879 F.2d 772 (10th Cir 1989) ("Holloway I") by the U.S. Supreme Court with orders to be reheard in accordance with *Reves*. *See* Holloway v. Peat, Marwick, Mitchell & Co., 110 S. Ct. 1314 (1989) (vacating judgment and remanding for rehearing in accordance with *Reves*).

243. 879 F.2d 772 (10th Cir. 1991); *see also*, 22 SEC. REG. AND L. REP. 1567 (1990).

244. *Holloway I*, 879 F.2d at 774-75.

245. *Id.* at 777. The court described the certificates as, "representing a promise by the issuing entity to repay the principal amount, plus accrued interest at a specified rate, within a specified time period or on demand." *Id.*

246. *Id.* at 779.

247. *Id.* The court found the public solicitation to be nearly determinative since a crucial purpose of the securities laws was to protect the generally uninformed public from investment fraud. *Id.* at 780.

> risk of total loss for the investors.[248]
>
> (3) The record shows that at least some of the offering materials used to induce purchases of instruments issued by RTS and RFC referred to the contributions . . . as "investments," expressly disclaiming that they were "deposits."[249]

Therefore, by discussing three factors from the Commercial/Investment Dichotomy test, which parallel the first three factors of the *Reves* test, the court held that the certificates were securities.[250] In reaching this conclusion, the court mentioned but dismissed the importance of two key facts: 1) the demand nature of the certificates, and 2) the federal regulations of savings and loans.[251] Addressing the demand nature of the notes, the court stated that "the maturity of a note does not determine its commercial or investment character."[252] Because the regulation of the entities provided insufficient protection of investors, the federal regulatory scheme covering the issuing entities was deemed not to preclude coverage by the securities laws.[253]

Because of this unusual application and use of selected factors of the Commercial/Investment Dichotomy test in *Holloway I*, the Tenth Circuit in *Holloway II* could easily dispose of the case when it was instructed to apply the *Reves* test. All of the factors applied by the court in *Holloway I* were incorporated into the family resemblance test in *Holloway II*.[254] These identical results indicate that the newly styled family resemblance test suffers from the same defects as the prior tests which involved factors, in that these factors are manipulatable.[255]

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248. *Id.* at 781.

249. *Id.*

250. *Id.* at 788.

251. *Id.* at 782-83, 785-88.

252. *Id.* at 783 (citing McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974)).

253. *Id.* at 785-86.

254. *See Holloway II*, 900 F.2d at 1488 n.1. The court mentioned but dismissed one factor which was substantially changed by *Reves*, noting:

> The major analytical difference between *Reves* and *Holloway [I]* lies in the treatment of other federal regulatory schemes. Our analysis in *Holloway* provided that even if the instrument otherwise qualified as a security under the "investment versus commercial" test, other federal regulation governing the transaction might still remove the instrument from the protection of the federal securities laws. [citation omitted]. *Reves* alters our original analysis in that we now view the existence of another regulatory scheme which significantly reduces the risk of the instrument as one of four factors used to determine whether the instrument is or should be categorized as a nonsecurity [citation omitted]. The change in emphasis does not affect the outcome in this case.

Id.

255. In its Amicus Brief, the SEC argued for adoption of the family resemblance test primarily because it had no factors, stating,

> In focusing on the statutory language, [the family resemblance test] mirrors the analysis of this Court applied in *Landreth* [Timber Co. v. Landreth], 471 U.S. [681,] 685-692 [(1985)], and provides useful guidance and a degree of certainty regarding the status of particular types of notes under the securities laws. Indeed, as Judge Friendly has pointed out, the other "note" tests inject

V. PROBLEMS WITH THE APPLICATION OF REVES

As illustrated above, many inconsistencies have arisen among lower courts applying the *Reves* test. However, to appreciate these differences, each portion of the test must be examined separately.

A. *When is a note presumed to be a security?*

In *Reves*, the Supreme Court began its analysis by presuming the "note" to be a security, then applying the factors only to determine whether the instrument should be removed from the class of securities covered by the act.[256] This approach was followed by most of the lower courts using *Reves* to examine longer term instruments. However, the applicability of this presumption to notes of maturities of nine months or less was left open.[257] Without a clear holding with respect to short-term notes, the courts used their own discretion in deciding whether or not to apply the presumption.[258] This issue is

a variety of *factors into the analysis "without any instructions as to relative weights."*

See Brief for the United States and The Securities And Exchange Commission as Amici Curiae at 17-18, *Reves v. Ernst & Young*, 494 U.S. 56 (1990) (No. 88-1480) (emphasis added).

256. *Reves*, 494 U.S. at 65. "The test begins with the language of the statute; because the Securities Acts define 'security' to include 'any note,' we begin with a presumption that every note is a security." (Footnote omitted).

257. *Id.* at 65 n.3. Justice Marshall's opinion did not rule on the application of the statutory exception for "notes with a maturity of nine months or less" on this presumption. *Id.* The dissent by Chief Justice Rehnquist insisted that demand notes fall into this category of exempted securities; however, he did not explain whether a finding of short term status should end the court's inquiry, or merely establish a presumption against coverage which can be rebutted by application of the factors. *See id.* at 76-78 (Rehnquist, C.J. dissenting)).

258. The post-*Reves* cases examining short-term instruments have been widely divergent on this issue. Singer v. Livoti, 741 F. Supp. 1040 (S.D.N.Y. 1990), applied the presumption because the notes in question did not fit the Second Circuit's established definition of commercial paper. *Id.* at 1049. National Bank of Yugoslavia v. Drexel Burnham Lambert, Inc., 768 F. Supp. 1010 (S.D.N.Y 1991), however, ignored this Second Circuit precedent and did not apply a presumption of coverage, or no coverage under the Act allegedly following a mandate from *Reves*. *Id.* at 1013, 1017. Mishkin v. Peat, Marwick, Mitchell & Co., 744 F. Supp 531 (S.D.N.Y. 1990), and Reeder V. Palmer, 736 F.Supp. 128 (E.D. La. 1990), (*aff'd per curiam*, 917 F.2d 560 (5th Cir. 1990), applied apparently conclusive presumptions against coverage for notes which were clearly akin to commercial paper, and utilized the *Reves* factors only to give the moving party the benefit of any doubt. Varnberg v. Minnick, 760 F.Supp. 315 (S.D.N.Y. 1991), applied a rebuttable presumption against coverage. Finally, Banco Español de Credito v. Security Pacific Nat'l Bank, 763 F. Supp. 36 (S.D.N.Y. 1991), Rayman v. Peoples Savings Corp., 735 F. Supp. 842 (N.D. Ill. 1990), and Iacobucci v. Universal Bank of Maryland, Trust Co., Fed. Sec. L. Rep. (CCH) ¶ 96,075 (S.D.N.Y. 1991) all managed to avoid the issue entirely.

the basis for large inconsistencies among the lower court opinions and will probably require review by the high court in the near future.

Resolution of this issue requires two levels of analysis: 1) determining which instruments Congress intended to include in its exception, and 2) whether short-term instruments are presumed not to be securities, or whether courts should not apply any presumption for or against coverage under the Act.[259]

Before deciding which notes should be exempted, it is necessary to determine what exactly is meant by a maturity of nine months or less. The plurality in *Reves* implied that demand notes fell outside of the exception since they would not necessarily mature within nine months.[260] However, in *Varnberg* the court accepted as a given that the demand notes examined fell within the exception, so that the party asserting Securities Act coverage must show that the context does *not* otherwise require.[261] On the other hand, the Southern District of New York, in *National Bank of Yugoslavia* continued to apply the Second Circuit interpretation that the exemption from coverage by the securities acts applies only if high-quality commercial paper is exempted from coverage by the Securities Acts.[262] Any other short-term instrument is therefore treated like any other note, and is presumed to be a security.[263] This allowed the court to sustain the dismissal of a summary judgment motion by the defendant Drexel, Burnham, Lambert, which argued that the Securities Acts could not apply since the notes were to be paid within three months.[264] *Singer v. Livotti* took a similar approach.[265]

Many of the courts which applied the presumption in favor of cov-

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259. *See Reves*, 494 U.S. at 65 n.3.

260. *Id.* at 72-73. The court insisted:

> If it is plausible to regard a demand note as having an immediate maturity because demand *could* be made immediately, it is also plausible to regard the maturity of a demand note as being in excess of nine months because demand *could* be made many years or decades into the future. Given this ambiguity, the exclusion must be interpreted in accordance with its purpose.

Id. at 73 (emphasis in original). Then the court held that in view of "Congress' broader purpose in the acts of ensuring that investments of all descriptions be regulated to prevent fraud and abuse, we interpret the exception not to cover the demand notes at issue here." *Id.* (emphasis in original).

261. *Varnberg*, 760 F. Supp. at 325. The court cited to Second Circuit precedent, most notably Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) to support the idea that notes payable on demand fit into the exception. Then it analyzed the effect of this determination, noting, "A party such as Gail or Robert Varnberg asserting that a given note with a maturity of less than nine months is within the 1934 Act has the burden of demonstrating that 'the context otherwise *requires*.' " *Varnberg*, 760 F. Supp. at 325 (citing *Exchange Nat'l Bank*, 544 F.2d at 1137-38) (emphasis in original)).

262. *National Bank of Yugoslavia*, 768 F. Supp. at 1017.

263. *Id.* at 1014.

264. *Id.*

265. Singer v. Livotti, 741 F.Supp. 1040, 1049 (S.D.N.Y. 1990).

erage were hearing cases on appeal from summary dismissals. By applying the presumption which most favored the moving party and then refuting that presumption, these courts were governed more by the Rules of Civil Procedure than by *Reves*.[266] Thus application of the presumption under those circumstances is not necessarily a sanction of its application by trial courts.

B. Application of the Factors

In its amicus brief for *Reves*, the SEC supported adoption of the family resemblance test because, unlike the alternatives, it did not require application of "open-ended, multi-factor analyses."[267] Unfortunately, Marshall's test added factors and all of the ambiguity inherent in their application.[268] Much of the inconsistent application of *Reves* stems from two basic problems with these factors: 1) the meaning of each factor, and 2) whether an instrument needed to satisfy each factor or whether the overall balance favoring coverage or non-coverage was sufficient.

1. What Exactly Do the Factors Mean?

Justice Marshall's factors are ambiguous enough to be given a variety of interpretations. An examination of each factor illustrates this variety.

a. The Motivations of Buyer and Seller

The problem with this factor is that it can mean whatever any court decides it means. The motivations can be determined through subjective or objective tests.[269] If a subjective test is used, the motives of the parties are often at odds with each other.[270] The best ex-

266. *See e.g.*, *Fulton Bank v. McKittrick & Briggs Securities, Inc.*, No. 88-0144 and 88-0882 1990 U.S. Dist. LEXIS 11371 (E.D. Pa. (appeal from a motion to dismiss, applying *Reves*) 1990)).

267. Brief for the Securities and Exchange Commission at 8, Reves v. Ernst and Young, 494 U.S. 56 (1990) (No. 88-1480).

268. *Reves*, 494 U.S. at 64-65. Justice Marshall intended his factors to reduce the uncertainty of the Second Circuit test. He reasoned that "[i]t is impossible to make any meaningful inquiry into whether an instrument bears a 'resemblance' to one of the instruments identified by the Second Circuit without specifying what it is about *those* instruments that makes *them* non-'securities.'" *Id.* at 66.

269. There is no indication in the court's opinion how the motivations are to be determined. *See id.* at 66-67.

270. In National Bank of Yugoslavia v. Drexel, Burnham, Lambert, Inc., 768 F.Supp 1010 (S.D.N.Y. 1990), there was *objective* evidence of a lack of understanding between the parties, in addition to the testimony of the parties. Drexel referred to borrowing

ample of this problem is seen in *National Bank of Yugoslavia*.[271] The plaintiff bank claimed its motivations were clearly investment-oriented.[272] However, the defendant Drexel Burnham Lambert responded that it used the note to solve its cash flow problems,[273] a purpose which *Reves* labels as characteristic of a non-security.[274] This forces the court to choose between the two theories on a motion to dismiss. Because a court must presume the truth of the allegations contained in the complaint when hearing a motion made pursuant to Federal Rule of Civil Procedure 12(b)(6), the choice was simple. The court merely deferred to the Bank's motivations in ascertaining the intent of the transaction.[275] On summary judgment or at trial, this determination would be much more difficult. For example, what if the court found that the seller's motives were truly commercial in nature and that the buyers were truly investment-oriented, but the parties failed to properly communicate?

b. The Plan of Distribution

The *Reves* test requires the court to examine the plan of distribution to determine whether the note in question is "an instrument in which there is 'common trading for speculation.' "[276] This factor or a similar factor was contained in all of the tests adopted by the circuits prior to *Reves*.[277] The securities laws generally emphasize the regulation of instruments sold to a broad segment of the public, unrelated to the issuer, and therefore without access to pertinent financial in-

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money from the bank, while the bank communicated that it would "place" the money with Drexel. *Id.* at 1012-13.

271. 768 F. Supp 1010 (S.D.N.Y. 1990).

272. *Id.* at 1012.

273. *Id.* at 1012-13.

274. Reves v. Ernst & Young, 494 U.S. 56, 66-67 (1990). "If the note is exhanged to facilitate the purchase and sale of a minor asset or consumer good, *to correct [] the seller's cash-flow difficulties* . . . the note is less sensibly described as a security." *Id.* at 66 (emphasis added).

275. The court's reliance on the allegations of the complaint is crucial. The defense argued that the notes resemble "notes evidencing loans by commercial banks for current operations," and the court refuted this assertion, stating that "[u]nder the allegation in the complaint, the time deposits bear little resemblance to such loans." *Nat'l Bank of Yugoslavia*, 768 F. Supp. at 1014. This pattern is used to defeat other defense arguments and support the reversal of the dismissal.

276. *Reves*, 494 U.S. at 66 (citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943)).

277. The risk capital approach looked generally at the "circumstances of the issuance," which included the extent of distribution. *See supra* notes 25-27 and accompanying text for a discussion of the approach.

The commercial/investment dichotomy test contained two factors which implicated widely distributed instruments, requiring both "a large number of notes or payees," and "a large dollar amount." *See supra* notes 21-24 and accompanying text.

The *Howey* test "looked to the managerial efforts of others," which required that there be other similarly situated buyers. *See supra* notes 16-20 and accompanying text.

formation.[278] This emphasis includes greater regulation for instruments issued to a large number of investors and those which are later traded.[279]

The lower courts applying *Reves* have had less trouble applying this factor than the others, but some confusion remains. Courts are not certain how to treat instruments which resemble an item on the list when issued, but which are later traded in a secondary market. For example, in *Mercer v. Jaffe, Snider, Raitt and Heuer*,[280] the notes in question were "first mortgage notes" and thus resembled "the note secured by a mortgage on a home," an item on the list of "non-securities."[281] Nonetheless, the court held that these notes were securities because once they were sold to a mass market, they no longer possessed the characteristics which caused them to be placed on the list originally.[282]

A similar conclusion was reached by the court in *Banco Español de Credito v. Security Pacific National Bank*[283] where the court examined participations in short-term bank loans sold by Security Pacific. The underlying notes were commercial in nature, yet the court found it necessary to apply the *Reves* factors because "a particiption in a non-security could itself be a security."[284] On the other hand, the court in *Mishkin v. Peat, Marwick, Mitchell & Co.*[285] examined participations in banker's acceptances, and held that "[b]ecause a participation in a banker's acceptance does not have an identity separate from the banker's acceptance, the participation is not a 'security' for purposes of the Exchange Act."[286]

278. The number and nature of offerees are of utmost importance when an issuer seeks exemption from the registration requirements of § 5 of the 1933 Act. *See* 15 U.S.C § 77(e) and Regulation D, 17 C.F.R. §§ 230.501-.508 (1990) promulgated thereunder.

279. Stringent restrictions on resale are placed on securities which are exempt from registration. *See generally* J. WILLIAM HICKS, RESALES OF RESTRICTED SECURITIES (1991).

280. 736 F.Supp. 764 (W.D. Mich. 1990).

281. *Id.* at 769.

282. *Id.* The court looked at the underlying reasoning for placing these notes, noting language which emphasized the one-on-one negotiation which ususally surrounds such an instrument, and found such no arm's-length transaction. *Id.* It then defended its position by quoting language in *Reves*, stating, "whether a particular note is a 'security' may not be entirely clear at the time it is issued." *Id.* (quoting Reves v. Ernst & Young, 494 U.S. 56, 63 n.2 (1990)).

283. 763 F.Supp. 36 (S.D.N.Y. 1991).

284. *Id.* at 41 (citing Commercial Discount Corp. v. Lincoln First Commercial Corp., 445 F.Supp. 1263, 1267 (S.D.N.Y. 1978)).

285. 744 F.Supp. 531 (S.D.N.Y. 1990).

286. *Id.* at 553.

c. *The Reasonable Expectations of the Investing Public*

The lower courts have applied this factor inconsistently because it is unclear what is meant by "investing public."[287] The court in *Banco Español de Credito* recognizes this ambiguity, stating:

> Since the Supreme Court has not defined "investing public" in the context of this *Reves* factor, it is unclear whether a subset of the general public could satisfy the definition. As previously noted, the general public was excluded from purchasing these instruments and were not targeted with promotional information. There is no indication that the general public was even aware of the existence of this program.[288]

There are three basic ways to interpret Justice Marshall's factor. First, courts can apply an objective theoretical approach, looking to the reasonable expectations of the average reasonable investor.[289] Second, the court may look to the objectively reasonable expectations of the particular segment of the investing public which made up the offerees.[290] Finally, the court may view this as an extension of the plan of distribution leg of the test. As such, the factor can be applied only if the instrument was actually offered to "the investing public."[291] Under this last approach, the reasonable expectation prong is inapplicable to a one-on-one transaction.

d. *The Presence of Risk-reducing Factors*

The final factor in Justice Marshall's test requires courts to determine "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."[292] However, this mandate contains many ambiguities, namely, whether the regulatory scheme must be federal or state regulations, and whether

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287. Justice Marshall's opinion gives very little guidance. *See Reves*, 494 U.S. at 66-67.

288. Banco Español de Credito v. Security Pacific Nat'l Bank, 763 F. Supp 36, 43 (S.D.N.Y. 1991).

289. *See* Varnberg v. Minnick, 760 F.Supp. 315 (S.D.N.Y. 1991); Iacobucci v. Universal Bank of Maryland, No. 90 Civ. 2719 (JFK) 1991 U.S. Dist. LEXIS 7843 (S.D.N.Y. June 4, 1991); National Bank of Yugoslavia v. Drexel Burnham Lambert, Inc., 768 F.Supp. 1010 (W.D.N.Y. 1991).

290. *See Banco Español de Credito*, 763 F. Supp. at 43; Mercer v. Jaffe, Snider, Raitt and Heuer, 736 F. Supp. 764 (W.D. Mich. 1990); Fulton Bank v. McKittrick & Briggs Secs., Inc., No. 88-0144, 88-0882 1990 U.S. Dist. LEXIS 11371 (E.D. Pa. Aug. 27, 1990); Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485 (10th Cir. 1990); Securities Exchange Comm'n v. R.G. Reynolds Enters., 952 F.2d 1125 (9th Cir. 1991). Of these only *Banco Español* involved sales to only a small segment of the public. The other cases seemed willing to look at the particular offerees because the instrument was offered to "the investing public."

291. *See* Reeder v. Palmer, 736 F.Supp. 128 (E.D. La. 1990), *aff'd per curiam* 917 F.2d 560 (5th Cir. 1990); Singer v. Livoti, 741 F.Supp. 1040 (S.D.N.Y. 1990); Premier Microwave Corp. v. Comtech Telecommunications Corp., No. 88 Civ. 2570 (KMW) 1991 U.S. Dist. LEXIS 846 (S.D.N.Y. Jan. 28, 1991).

292. *Reves*, 494 U.S. at 67 (citing Marine Bank v. Weaver, 455 U.S. 551, 557-59 (1982). For a discussion of *Marine Bank*, see *supra* note 7 and accompanying text.

other aspects of a transaction could sufficiently reduce the risk. Because Justice Marshall's opinion cited to *Marine Bank v. Weaver,*[293] courts have sought guidance from the language in that opinion. The portions of *Weaver* cited in the majority opinion refer exclusively to federal regulations.[294] *Weaver* fails to mention other risk-reducing factors such as state regulation, underlying collateral, or the existence of common law or state law remedies. However, some courts could extend the analysis to include regulation by state Blue Sky laws or even common law fraud.

2. How Should the Factors Be Applied?

The second problem with the *Reves* factors stems from their application. *Reves* provides no indication whether these factors should be balanced, as were the factors in the Commercial/Investment Dichotomy test, or whether each factor must be satisfied in order to rebut the presumption of coverage under the Act.[295] Most courts seem to have adopted a balancing approach.[296] On the other hand, some courts have only discussed a few of the factors which they found dispositive. Of these, several held that the strong presence of a few factors was enough to rebut the presumption.[297] Other lower courts took a more stringent approach, holding that the absence of even one factor could not rebut the presumption of coverage.[298]

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293. 455 U.S. 551 (1982).

294. In *Weaver* the question before the court was whether Certificates of Deposit issued by federally insured and regulated banks were securities. *Id.* at 552. The court held that the presence of these regulations negated the need for coverage under the Securities Acts. *Id.* at 559-60. In support of this conclusion, the *Weaver* court quoted language from Teamsters v. Daniel, 439 U.S. 551 (1979) which stated that ERISA coverage had the same effect. *Id.* at 558 n.7.

295. *Compare* Arthur Young & Co. v. Reves, 856 F.2d 52, 54-55 (8th Cir. 1988), *rev'd sub nom,* Reves v. Ernst & Young, 494 U.S. 56 (1990) *and* Zabriskie v. Lewis, 507 F.2d 546, 551-52 (10th Cir. 1974).

296. *See, e.g.,* Reeder v. Palmer, 736 F.Supp. 128 (E.D. La. 1990), *aff'd per curiam,* 917 F.2d 560 (5th Cir. 1990); Singer v. Livoti, 741 F.Supp. 1040 (S.D.N.Y. 1990); Banco Español De Credito v. Security Pacific Nat'l Bank, 763 F. Supp. 36, 43 (S.D.N.Y. 1991); Mercer v. Jaffe, Snider, Raitt and Heuer, 736 F. Supp. 764 (W.D. Mich. 1990); Holloway v. Peat, Marwick, Mitchell & Co., 900 F.2d 1485 (10th Cir. 1990); Securities Exchange Comm'n v. R.G. Reynolds Enters., 952 F.2d 1125 (9th Cir. 1991); Varnberg v. Minnick, 760 F.Supp. 315 (S.D.N.Y. 1991); National Bank of Yugoslavia v. Drexel Burnham Lambert, Inc., 768 F.Supp. 1010 (W.D.N.Y. 1991).

297. Premier Microwave Corp. v. Comtech Telecommunications Corp., No. 88 Civ. 2570 (KMW), 1991 U.S. Dist. LEXIS 846 (S.D.N.Y. Jan. 28, 1991); Rayman v. Peoples Savings Corp., 735 F. Supp. 842 (N.D. Ill. 1990).

298. Iacobucci v. Universal Bank of Maryland, No. 90 Civ. 2719 (JFK), 1991 U.S. Dist. LEXIS 7843 (S.D.N.Y. June 4, 1991).

VI. Proposed Clarification of the Test

It is crucial to orderly commerce that more certainty exist as to what instruments are and are not securities.[299] After examining these problems, the following clarification and interpretation of Justice Marshall's test is proposed. The proposed test merely refines and explains the *Reves* test, taking into account legislative history, case history, and the ever-popular economic reality.

A. *Only Long-Term Notes Are Presumed to Be Securities*

The first aspect of the test which must be clarified is when to apply a presumption of coverage by the Securities Acts. A note with an initial term of greater than nine months is presumed to be a security.[300] If a note has a shorter maturity, including demand notes, no presumption applies, unless it is found to be high-grade commercial paper.[301] Furthermore, a rebuttable presumption exists against applying the securities laws to all commercial paper.[302] With respect to other short-term notes, no presumption applies, but the burden of proof is on the plaintiff to show that the note is a security.[303] If a long-term "note" clearly fits one of the categories on the list, the presumption shifts to non-security.[304] All of these presumptions are re-

299. *See* Harlan S. Abrahams, *Commercial Notes and Definition of a Security Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 Neb. L. Rev. 478, 481 (1973).

300. This rule is clearly mandated by *Reves*, 494 U.S. at 64 n.3 (which questions only the application of the presumption for notes with a maturity of nine months or less).

301. Although Justice Stevens was the only Justice to adopt this approach in *Reves*, there is ample support from other sources, most notably, the SEC, in Securities Act Rel. No. 4412, 26 Fed. Reg. 9158, 59 (1961), prior Second Circuit cases, and prior Supreme Court precedent. *See* Securities Industry Ass'n v. Board of Governors of the Federal Reserve System, 468 U.S. 137, 150-52 (1984). Petitioners Reply Brief insists that any other interpretation of this section is radical. Reply Brief for the Petitioner, Reves v. Ernst & Young, 494 U.S. 56 (1990) (No. 88-1480). It noted that the four-word phrase preceding the exemption includes "notes, drafts, bills of exchange, or banker's acceptances" which are all "instruments used to evidence commercial paper." *Id.*

302. Commercial paper instruments are not the kind of instruments which the securities laws were intended to regulate. First, these notes generally evidence transactions between sophisticated financial institutions. Second, both federal regulation of those institutions, and the Uniform Commercial Code provide sufficient protection for purchasers of these instruments. Finally, because the notes are short-term, the risk of loss is greatly reduced.

303. This assignment of the burden of proof merely follows the accepted principle that the plaintiff always bears the burden of proof on jurisdictional issues. *See, e.g,*, Fed. R. Civ. Pro. 8(a).

304. By shifting the presumption rather than allowing resemblance to an item on the list to be conclusive proof of non-security status, as the Court proposed in *Reves*, 494 U.S. at 67, lower courts will more easily analyze notes whose character changes after issuance. Specifically, holding that mortgage backed notes which are traded in a secondary market are securities will require less strain. *See* Mercer v. Jaffe; Snider, Raitt and Heur, 736 F. Supp. 764 (W.D. Mich. 1990), *aff'd sub nom*; Schreimer v. Greenburg, 931 F.2d 893 (6th Cir. 1991).

buttable by showing a resemblance or a lack of resemblance to a member of the family, through application of the factors.[305]

If the "note" is not on the list, then, in order to remove the presumption of coverage by the Acts, the plaintiff must demonstrate that all four factors are present.[306] On the other hand, to transform a non-security family member into a security there are two key factors: 1) the plan of distribution, and 2) the absence of any alternative risk-reducing factors. These factors reflect the concerns that unregulated and widely distributed invesment instruments will be purchased by an unsuspecting public, a concern at the heart of the creation and continued importance of the federal Securities Acts. If the public is not involved or if another *federal* regulating body adequately protects the public's interests, there is no need to apply the securities laws. Hence, the remaining factors of the *Reves* test become incidental.

B. Application of the Factors

1. Motivations of Buyer and Seller

The goal of this factor is to distinguish investors from lenders. The former are passive; the latter are active. The seller's motivation is immaterial—only the buyer's motivation should be at issue.[307] This is because securities laws seek to protect the buyer or investor, and not the seller.[308] However, determining the buyer's motivation re-

305. Unless a note is clearly a member of the family, the courts should look to the factors, either to determine the resemblance to a member, or to ascertain that the note has the same non-security characteristics as the members of the family. This is consistent with Justice Marshall's reasoning in outlining the factors. *See Reves*, 494 U.S. at 65-66.

306. This follows the general preference of the courts to be overinclusive rather than underinclusive when determining which instruments are covered by the Acts.

307. This alteration of the first factor reflects the changing financial markets. At one time corporations generally borrowed from banks to meet some financial needs and met other needs by turning to the public. With the advent of junk bond-financed LBOs, however, the lines between public and private financing have blurred.

308. The legislative history of both acts indicates concern primarily for the investor. S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933) states:

> The purpose of this bill is to protect the *investing public* and honest business. The basic policy is that of informing the *investor* of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation (emphasis added).

Id. The same emphasis on the investor is evident in the 1934 Act history. S. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934) states:

> Subsection (b) authorizes the Commission by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interests of the *investor* (emphasis added).

quires an objective element.

2. Plan of Distribution

This is a key factor, because it reflects the underlying purpose of the securities laws.[309] If the transaction is arm's-length and the instrument is specially designed as a result of those negotiations, the note is not a security.

If multiple investors are similarly situated—even if the transaction involved some separate negotiation—public distribution has occurred, which makes the note a security. Once the note is publicly distributed, it is always covered by the Acts, even if the transaction at issue was an arm's-length negotiation.[310] However, if the original distribution is merely a one-on-one exchange, it can attain security status if the note is subsequently traded publicly.[311]

3. Reasonable Expectations of the Investing Public

When applying this factor to a note, the courts should look to the average reasonable investor. Thus, the court should ask: if the aver-

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Id.

309. The Legislative History of the Acts offers ample support for an argument that Congress was concerned with speculation by vast segments of the public ignorant of the underlying worth of their investment. *See, e.g.*, 77 Cong. Rec. 2982-83 (1933) (where Senator Fletcher stated, "People have been persuaded to invest their money in securities without any information respecting them, except the advertisements put forth by the agents or representatives of those issuing the securities."). The drafters were also disturbed by pre-1929 market manipulations. Rep. Sabath remarked that "a small group of men . . . ruthlessly manipulated the markets and brought about the conditions from which the Nation is now suffering." 78 CONG. REC. 7689 (1934).

310. For example, even when the investors are both sophisticated, which occurs in transactions involving the exchange of marketable securities by banks or corporations, and an individually negotiated contract controls, the Securities Acts should cover the transaction because of the nature of the instrument. The danger of allowing a security to cease being a security was outlined by Professor Scott FitzGibbon in a 1980 article:

> This approach would produce anomalous results, such as causing the same instrument to be a security at one time but not at another according to the type of transaction involved, and causing some instruments to be deemed securities and others of an identical issuer and class not to be, according to their different trading patterns. Neither common usage nor the syntax of the securities laws countenances such results, which would make a hash of some of the major provisions.

Scott FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 909 (1980).

311. Although this would require courts to view the same instrument as a non-security in one instance and as a security in another, the situation differs from the situation enumerated above. If an individually negotiated note could never be a security, even if offered to hundreds or thousands of investors, it would allow issuers to circumvent the securities laws by entering into negotiated transactions first. The fact that this potential is unacceptable is evidenced by the resale restrictions imposed by the SEC on securities issued pursuant to a registration exemption. *See* Hicks, *supra* note 279. This restriction has become more critical as banks and savings and loans have begun to create markets for their debt contracts.

age reasonable person were a party to this transaction, what would be his expectations? If the test is limited to the parties to this transaction, then the factor becomes meaningless because the first factor already examines the expectations of these buyers.[312] The courts should use this factor to distinguish between unique and garden variety notes. In reality, as discussed above, this factor should be little more than an objective check on the subjective motivations of the buyer.[313] The addition of this factor means that a buyer cannot turn the transaction into a securities transaction by irrationally viewing the deal. Nor can an unsuspecting buyer be denied the protection of the securities laws merely because he or she did not perceive the instrument as an investment.

4. Presence of Other Risk-reducing Factors

First, only federal regulations should satisfy the Court's "alternative regulatory scheme" factor.[314] The existence of alternative federal regulations removes the need for coverage by the securities acts only if the alternative regulations provide a sufficient remedy for the alleged wrongdoing. If the instrument is peripherally covered by ERISA, but no remedy for fraud exists, then it should still be considered a security.[315] The remedy need not be as lucrative (such as treble damages) nor as easy to attain through procedural advantages (such as nationwide service of process). No state regulation should preclude coverage since Blue Sky laws and common law fraud are designed to supplement, not replace securities regulations.[316]

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312. *See supra* notes 307-309 and accompanying text.

313. This distinction is essential to determining which instruments are securities. In an early article on this topic, Professor Ronald Coffey argued that "a security is a transaction whose characteristics distinguish it from the generality of transactions so as to create a need for the special fraud procedures, protections, and remedies provided by the securities laws." Ronald J. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula*, 18 CASE W. RES. L. REV. 367, 373 (1967).

314. This appears to be the focus of Justice Marshall's opinion. Most courts have followed this interpretation. *See supra* notes 296-98 and accompanying text.

315. Determining the jurisdictional scope of ERISA has been particularly troublesome for courts and beyond the scope of this Article.

316. As noted by Professor FitzGibbon:

> It seems most unlikely that the lawmakers thought that fraud, inadequate disclosure, market manipulation, or many of the other things prohibited by the securities laws were wrongful or undesirable only when securities were involved. Evidently, they decided to legislate as to only some of the conduct they believed wrongful—not an unusual procedure for lawmakers—with the common law as a backstop, especially when they are federal lawmakers acting during a major crisis in an area that is widely regulated at the state level.

FitzGibbon, *supra* note 310 at 912.

Other elements of a transaction may sufficiently reduce its risk as well. For example, collateral, if truly sufficient, may preclude the need for coverage under the Acts. This is especially true when the collateral is bargained for, which implies a one-on-one transaction. If, however, the instrument is backed by nonexistent or insufficient collateral, there is no risk reduction. Thus, this factor is not satisfied. Finally, a short-term note, even if it is not commercial paper, is generally less risky than a long-term note. Therefore, if the other factors are met, and if the note has a maturity of nine months or less, this final factor may be satisfied.

VII. Conclusion

Despite the Supreme Court's attempt in *Reves* to fashion a definitive and uniform test to determine when a note is a security, inconsistencies and ambiguities have abounded from the case's application. At least prior to *Reves*, one could anticipate with some certainty which test would be applied depending on the circuit in which one filed. Until the issues raised in this article are fully resolved, the *Reves* decision provides little guidance or comfort.