Securities Regulation

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This Article examines significant securities regulation cases originating in the Eleventh Circuit Court of Appeals during 2003 and 2004. In particular, Part I of this Article addresses a recent decision in the area of insider trading and familial relationships. Part II analyzes two recent cases involving the definition of "security" under the Securities Act of 1933.[1] The three cases discussed below address two very different issues and draw from two separate areas of securities law, the Securities Act of 1933 and the Securities Exchange Act of 1934.[2] However, a common theme connects these cases: the preservation of flexibility within the securities laws. As demonstrated in the following holdings, courts have long recognized the overarching principle in federal securities laws to provide a flexible body of law that may be interpreted and applied to situations not originally contemplated by the laws' drafters and to situations conceived for the purpose of circumventing such laws. Although the courts temper such principles through application of certain general tests and the requirement of certain elements, the courts have, with little exception, refused to adopt bright-line or rigid tests when it comes to interpreting the securities laws.

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1. 15 U.S.C. §§ 77a-77aa (2004).

2. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2004).

I. THE ELEVENTH CIRCUIT CLARIFIES THE ELEMENTS OF INSIDER TRADING CLAIMS BROUGHT UNDER THE MISAPPROPRIATION THEORY OF LIABILITY

Although sharing confidences may strengthen the bonds of familial relationships, in the contentious realm of "insider trading," exchanging business-related confidences with family members could have the deleterious side-effect of triggering the attention, and then the wrath, of the Securities and Exchange Commission ("SEC"). In *SEC v. Yun*,[3] the Eleventh Circuit clarified its position with respect to two of the elements of proof under the misappropriation theory of liability for securities fraud: (1) the establishment of a duty of loyalty and confidentiality owed to the source of confidential information in the context of non-business relationships, such as husband/wife or parent/child, and (2) the requisite showing that the tipper intended to benefit from her disclosure of confidential information.[4] With respect to both matters, the Eleventh Circuit stopped short of adopting the SEC's position, apparently rejecting the SEC's attempts to lessen its burden of proof in insider trading cases brought under the increasingly popular misappropriation theory of liability.[5]

First, the court rejected the bright-line rule set forth in Rule 10b5-2 of the Securities Exchange Act of 1934 (the "Exchange Act"),[6] which mandates that a duty of trust and confidence is presumed to exist when a person receives or obtains material, nonpublic information from spouses, parents, children, and siblings.[7] The court instead concluded the existence of a duty of loyalty and confidentiality (a phrase used interchangeably with the duty of trust and confidence) turns on whether

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3. 327 F.3d 1263 (11th Cir. 2003).

4. *Id.* at 1272-74.

5. *Id.* at 1273, 1274-80. The Eleventh Circuit has similarly rebuffed attempts by the SEC to reduce its burden of proof in insider trading cases. For example, in *United States v. Adler*, 137 F.3d 1325 (11th Cir. 1998), the Eleventh Circuit refused to eliminate the SEC's burden of proof to show that the alleged "insider" actually *used* material, nonpublic information in making the decision to trade, which is a required element of a Rule 10b-5 insider trading violation. *Id.* at 1337 ("We believe that the use test best comports with precedent and Congressional intent, and that mere knowing possession—i.e., proof that an insider traded while in possession of material nonpublic information—is not a per se violation"). Instead, the court held that a strong inference arises when an insider trades securities in possession of material, nonpublic information that such information was used by the insider in making the decision to trade. *Id.* The burden of proof then shifts to the defendant to prove that the material, nonpublic information was not a part of the trading decision. *Id.*

6. 17 C.F.R. § 240.10b5-2 (2004).

7. *Id.*

the confiding spouse granted access to confidential information to her spouse based upon (1) an express promise or (2) a reasonable reliance that she would safeguard the information when reliance would be proven by evidence of a history or pattern of sharing and keeping business confidences.[8] Second, the court soundly rejected the SEC's attempt to lessen its burden of proof in insider trading cases by steadfastly requiring proof of tippers' intent to benefit from their disclosure of confidential information under the misappropriation theory of liability.[9]

A. *The Misappropriation Theory of Liability for Insider Trading*

In *Yun* the SEC brought charges against "tipper" Donna Yun and fellow real estate agent and "tippee" Jerry Burch for violations of Section 10(b) of the Exchange Act,[10] which governs the disclosure of material, nonpublic or "insider" information, and Rule 10b-5 of the Exchange Act,[11] promulgated under the SEC's Section 10(b) rulemaking authority.[12] Allegations of Section 10(b) and Rule 10b-5 violations are typically categorized by the SEC under one of two complementary theories of liability, "each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities," but distinguishable by the degrees of separation between the source of confidential information and the ultimate tipper and tippee.[13] Insider trading

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8. *Yun*, 327 F.3d at 1273.
9. *Id.* at 1274-80.
10. 15 U.S.C. § 78j(b) (2004).
11. 17 C.F.R. § 240.10b-5 (2004).
12. *Yun*, 327 F.3d at 1268-69 n.9. In pertinent part, Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

Rule 10b-5 provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, . . . (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1996).

13. United States v. O'Hagan, 521 U.S. 642, 652 (1997). In *O'Hagan* the United States Supreme Court, for the first time, explicitly adopted the misappropriation theory of insider

liability arises under the "traditional" or "classical theory" when a corporate insider trades in his company's securities on the basis of material, nonpublic (or, as used interchangeably herein, "confidential") information.[14] This action violates the relationship of trust and confidence and breaches the attendant duties that exist between the corporation's shareholders and the corporation's insiders, who have obtained confidential information by reason of their corporate position.[15]

The misappropriation theory of liability, on the other hand, is designed to address "outsider" situations where the relationship between (1) the corporate shareholders injured by insider trading, (2) the corporate insider and source of confidential information, and (3) the tipper and the tippee is more attenuated.[16] Under the misappropriation theory, a person commits fraud "in connection with" a securities transaction when she misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information.[17] As explained by the United States Supreme Court in *United States v. O'Hagan*,[18] the rationale behind the misappropriation theory is as follows:

> [A] fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-

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trading, overruling the decision in the Eighth Circuit and resolving disparate treatment of the theory by the circuit courts. *Id.* at 644 ("[T]he Eighth Circuit misread this Court's precedents when it ruled that . . . only a breach of a duty to parties to a securities transaction, or, at the most, to other market participants such as investors, is sufficient to give rise to § 10(b) liability."). To ensure that the misappropriation theory of liability was not too indefinite in scope, as alleged by defendant O'Hagan, the Supreme Court further emphasized that the government must prove a willful violation of Rule 10b-5 or "culpable intent" to establish criminal liability. *Id.*

14. *Id.* at 652.

15. *Id.* at 651-52 (citing Chiarella v. United States, 445 U.S. 222, 228 (1980)). The Supreme Court further clarified that "[t]he classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation." *Id.* at 652 (citing Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)).

16. *Id.* at 652-53.

17. *Id.* at 652.

18. 521 U.S. 642 (1997).

turned-trader's deception of those who entrusted him with access to confidential information.[19]

Accordingly, the elements of a misappropriation claim include at a minimum: (1) the misappropriation of material, nonpublic information; (2) a breach of a duty arising out of a relationship of trust and confidence, regardless of whether such duty was owed to the shareholders of the traded stock; and (3) the use of the material, nonpublic information in a securities transaction.[20] Moreover, as more fully discussed below, the Eleventh Circuit (among other federal courts) requires proof of a fourth element: that the tipper derived a personal benefit, directly or indirectly, by communicating the material, nonpublic information in breach of his or her duty.[21]

B. *SEC v. Yun*

In February 1997, the SEC launched its investigation into certain trades of real estate agent Jerry Burch in Scholastic Corporation stock. Within a few hours, Burch realized a 1300 percent return on his investment and profits of $269,000 on Scholastic put options he purchased during the prior two days.[22] The Burch investigation led the

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19. *Id.* at 642.

20. George F. Gabel, Jr., Annotation, *Who may be Liable under "Misappropriation Theory" of Imposing Duty to Disclose or Abstain from Trading under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b)) and SEC Rule 10b-5 (17 C.F.R. § 240.10b-5)*, 114 A.L.R. FED. 323 (2005).

21. *Yun*, 327 F.3d at 1274-80 (discussing at length the rationale behind requiring proof that the tipper intended to benefit from the communication of confidential information to the tippee under the misappropriation theory). Federal courts, however, are inconsistent in their treatment of the "intent to benefit" element. For example, the United States District Court for the Central District of California required a showing of the expected benefit to the tipper. *Id.* at 1274-75 n.25 (citing SEC v. Trikilis, Fed. Sec. L. Rep. (CCH) ¶ 97,015, ¶ 94,462 (C.D. Cal. July 28, 1992), *vacated on other grounds*, Fed. Sec. L. Rep. (CCH) ¶ 97,375, ¶ 95,981 (C.D. Cal. Jan. 22, 1993)). On the other hand, although the issue was never addressed squarely, both the First and Second Circuits appear to concur that no benefit is required under the misappropriation theory. *Id.* at 1274-75 n.26 (citing SEC v. Willis, 777 F. Supp. 1165, 1172 n.7 (S.D.N.Y. 1991); SEC v. Sargent, 229 F.3d 68, 75 (1st Cir. 2000); United States v. Libera, 989 F.2d 596, 600 (2d Cir. 1993)).

22. *Id.* at 1268. Burch thereby proved the SEC's oft-repeated maxim that, with respect to investments, if it sounds too good to be true, it probably is. *See, e.g.*, United States Securities and Exchange Commission, *"Wrong Numbers" and Stock Tips on Your Answering Machine*, *at* http://www.sec.gov/investor/pubs/wrongnumberscam.htm (last modified Jan. 11, 2005) (warning that investment opportunities that promise huge guaranteed rewards sound too good to be true because they are). Burch also neglected to realize that the SEC's Office of Market Surveillance in the Division of Enforcement monitors market activity by obtaining information through referrals from Self-Regulatory Organizations and through its own surveillance, including reviews of filings and trading data. "When the Office

SEC to fellow real estate agent Donna Yun, who shared an eleven-by-thirteen-foot real estate sales trailer with Burch. Donna, in turn, was (or is) married to David Yun, president of Scholastic Book Fairs, Inc., which is a subsidiary of Scholastic Corporation, a publicly-traded company.[23]

It appears undisputed that Donna learned material, nonpublic information regarding Scholastic's stock from her husband, David, in January 1997, following David's attendance at a management retreat. David learned that his company would post a loss for the current quarter and, as a result, would make a public announcement revising its earnings forecast downward. During this same period, Donna and David were in the process of negotiating "a post-nuptial division of assets."[24] David, therefore, explained to Donna that he had assigned a lower value to his Scholastic stock options in his list of assets than the current trading price because he believed that Scholastic's share price would decrease following the pending earnings announcement scheduled for February 20, 1997. David asked Donna not to disclose the news and Donna agreed to keep the nonpublic information confidential, with the exception of the necessary disclosure of David's explanation of his asset valuation to Donna's attorney.[25]

Two days before the announcement of Scholastic's earnings forecast, Donna shared David's confidential information with her attorney during a telephone call, which took place in the small sales trailer she shared with Burch and others. Burch entered the office during her call and

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receives or identifies information on suspicious trading patterns (insider trading or market manipulation), it conducts additional analysis. If warranted, based on materiality and other considerations, the Office refers the matter internally within the Division of Enforcement or to the appropriate region." United States Securities and Exchange Commission, *Enforcement Surveillance of Markets*, *at* http://www.sec.gov/about/oig/audit/-246fin.htm (last modified Aug. 18, 2004).

23. *Yun*, 327 F.3d at 1267. The Yuns were still married as of June 2002, when the United States District Court for the Middle District of Florida found Donna in contempt for her failure to post a full security supersedeas bond pending the result of her appeal to the Eleventh Circuit. SEC v. Yun, 208 F. Supp. 2d 1279, 1282 (2002). In that decision, the district court sanctioned Donna and threatened her with incarceration, at one point noting:

> Although Yun has emptied her accounts several times, David Yun, Yun's husband, has made periodic deposits into her checking account each time she has run out of money . . . . In examining the ups and downs of Yun's checking account, the Court finds the series of Mr. Yun's deposits and Mrs. Yun's withdrawals to be nothing more than a thinly veiled attempt to allow Yun to insist that she has no money to pay this Court's judgment while continuing to live a life of leisure and overindulgence.

Id. at 1286 n.17.

24. *Id.* at 1267.

25. *Id.*

heard Donna tell her attorney about the impending earnings announcement and related price drop.[26] That evening, Donna, Burch, and another real estate agent attended a reception together, carpooled to the banquet, and stayed at the reception for three hours before departing.[27]

Although Burch apparently had no experience dealing in put options, the next morning he phoned his broker requesting authority to purchase put options in Scholastic based upon information he had received at the cocktail party the night before.[28] Despite his broker's warnings about the risks involved with trading in options and about insider trading prohibitions, Burch nonetheless proceeded in spending the equivalent of two-thirds of his total income for the previous year, or nearly half the value of his entire investment portfolio, on the purchase of almost $20,000 in Scholastic put options, some of which were scheduled to expire within forty-eight hours.[29] On February 20, 1997, after Scholastic made its planned earnings forecast announcement, the stock price dropped by approximately forty percent, allowing for Burch's unprecedented success with trading in put options.[30]

The SEC's complaint alleged that Donna violated Section 10(b) and Rule 10b-5 of the Exchange Act under the misappropriation theory of liability because Donna, an outsider, had breached her fiduciary duties to her husband David by divulging confidential information to fellow outsider Burch for her direct or indirect benefit. Burch, in turn, knew or should have known of Donna's breach of her duty to David, but nonetheless traded on the material, nonpublic information provided by Donna for his own benefit, thereby violating Section 10(b) and Rule 10b-5. The remedy sought was disgorgement of profits from the put options trades and civil fines. In their reply, defendants Donna and Burch admitted that Burch traded in the Scholastic put options, but averred that neither defendant violated Section 10(b) and Rule 10b-5 because (1) no fiduciary duty existed between Donna and David, and (2) in the alternative, even if Donna owed David a fiduciary duty not to disclose

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26. *Id.* at 1268. Burch testified at trial that he "did not learn enough from what he overheard to feel 'comfortable' trading in Scholastic's stock." *Id.*

27. *Id.*

28. *Id.*

> A put option is an option contract that gives the holder of the option the right to sell a certain quantity of an underlying security to the writer of the option, at a specified price up to a specified date. The value of a put increases as the price of the stock decreases.

Id. at 1268 n.6.

29. *Id.* at 1268 n.8.

30. *Id.* at 1268.

the confidential information, she did not breach such duty because she did not expect to benefit from the disclosure to Burch.[31]

C. *Did a Fiduciary Duty Exist Between Donna and David?*

In its discussion in *Yun* regarding the elements required to establish a duty of loyalty and confidentiality owed to the source of material, nonpublic information, the Eleventh Circuit addressed and rejected the line of argument adopted by the majority opinion in *United States v. Chestman*,[32] the leading case on the topic.[33] In *Chestman* the Second Circuit rejected the presumption that "marriage alone creates a relationship of loyalty and confidentiality."[34] Instead, the majority in *Chestman* concluded the elements of reliance and de facto control and dominance, which are "[a]t the heart of the fiduciary relationship," must be present to establish the functional equivalent of a fiduciary relationship.[35] The dissent in *Chestman* took issue with the narrowness of the majority's opinion and instead concluded that "a confidential relationship existed between the husband and wife which gave rise to a duty of loyalty and confidentiality on his part not to disclose the sensitive information."[36]

The SEC understandably opted to adopt the simple, clear-cut presumption set forth in the dissenting opinion in *Chestman*, which eases its burden of proof in causes of action involving family members brought under the misappropriation theory of liability.[37] Effective October 23, 2000, the SEC adopted Rule 10b5-2, which "provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the 'misappropriation' theory of insider trading under Section 10(b) of the [Exchange] Act and Rule 10b-5."[38] Although Rule 10b5-2 has all of the benefits of clarity usually

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31. *Id.* at 1270.
32. 947 F.2d 551 (2d Cir. 1991) (en banc).
33. *Yun*, 327 F.3d at 1271-72.
34. *Id.* at 1271 (citing *Chestman*, 947 F.2d at 568). This was a divided en banc decision.
35. *Chestman*, 947 F.2d at 568.
36. *Id.* at 579 (Winter, J., dissenting).
37. *See Yun*, 327 F.3d at 1270, 1274.
38. 17 C.F.R. § 240.10b5-2 (2005) (Preliminary Note). Specifically, Rule 10b5-2 states:

> (a) This section shall apply to any violation of Section 10(b) of the Act (15 U.S.C. 78j(b)) and § 240.10b-5 thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.
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> (b) *Enumerated "duties of trust or confidence."* For purposes of this section, a "duty of trust or confidence" exists in the following circumstances, among others:
>
> (1) Whenever a person agrees to maintain information in confidence;

found in bright-line rules, in *Yun*, the Eleventh Circuit rejected the presumption of a relationship of trust and confidence amongst close family members, electing instead to better define the circumstances under which a spouse has a reasonable expectation of confidentiality and, in the process, effectively adopted the first two prongs of Rule 10b5-2, but rejected the third.[39] As a result, with respect to the determination of a fiduciary relationship between spouses, the Eleventh Circuit stated,

> [i]f the SEC can prove that the husband and wife had a history or practice of sharing business confidences, and those confidences generally were maintained by the spouse receiving the information, then in most instances the conveying spouse would have a reasonable expectation of confidentiality such that the breach of the expectation would suffice to yield insider trading liability. Of course, a breach of an agreement to maintain business confidences would also suffice.[40]

With respect to the facts set forth in *Yun*, the court concluded that the SEC had presented sufficient evidence that (1) Donna agreed to safeguard the confidential information provided to her by her husband David and (2) Donna and David had a "history or pattern of sharing and keeping of business confidences . . . such that David could have reasonably expected Donna to keep confidential what he told her about Scholastic's pending announcement."[41] Having determined that the SEC satisfied the breach of duty element under the misappropriation theory of liability, the court then turned its attention to "an issue we have not been called upon to decide," whether the SEC must prove that

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> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
> (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

Id.

39. *Yun*, 327 F.3d at 1272-73 n.23.
40. *Id.* at 1273.
41. *Id.* at 1273-74.

Donna expected to benefit from the disclosure of the confidential information to Burch.[42]

D. *Is the "Intent To Benefit" Element Applicable in Cases Brought Under the Misappropriation Theory of Liability?*

The "benefit to the tipper" requirement originated in the United States Supreme Court landmark decision of *Dirks v. SEC*.[43] The court in *Yun* held that the tipper must intend to benefit personally, either via pecuniary gains or reputational benefits, from the disclosure of confidential information to the tippee in order to make the requisite showing of breach of duty to the corporation's shareholders.[44] In its creative response to *Dirks*, the SEC argued that, while applicable under the classical theory of insider trading, the intent to benefit element has no application in misappropriation cases because no showing of a breach of fiduciary duty *to the shareholders* is required; outsiders, by definition, owe no duty to corporate shareholders.[45] The Eleventh Circuit, however, rejected the SEC's attempt to "construct an arbitrary fence between insider trading liability based upon classical and misappropriation theories" and to "unduly dichotomiz[e] the two theories of insider trading liability."[46] The court instead opted to require an intent to benefit regardless of the theory of insider trading to equalize the position of tippers and tippees.[47]

The Eleventh Circuit ultimately summarized its view of insider trading liability succinctly as follows: "(1) an insider who trades is liable; (2) an insider who tips (rather than trades) is liable if he intends to benefit from the disclosure; (3) an outsider who trades is liable; (4) an outsider who tips (rather than trades) is liable if he intends to benefit from the disclosure."[48] This approach carries the touted benefits of simplicity without creating formulaic boundaries between the two theories of liability that were developed, after all, with the same purpose in mind: to address efforts to capitalize on nonpublic information through the purchase or sale of securities.[49] In the instant case, because the SEC had presented evidence that Donna and Burch were

42. *Id.* at 1274.
43. 463 U.S. 646 (1983).
44. *Yun*, 327 F.3d at 1275 (citing *Dirks*, 463 U.S. at 662).
45. *Id.*
46. *Id.*
47. *Id.* at 1276.
48. *Id.* at 1280.
49. *O'Hagan*, 521 U.S. at 642. In *O'Hagan* the Supreme Court, for the first time, explicitly adopted the misappropriation theory of insider trading, resolving disparate treatment of the theory by the circuit courts. *See* discussion *supra* note 13.

friendly, worked together for several years, and split commissions on real estate transactions, the court determined that a jury could reasonably conclude that Donna at least expected reputational benefits from Burch for her tip about Scholastic's pending earnings release.[50] Therefore, the SEC had discharged its duty with respect to proving a breach of Donna's duty of loyalty and confidentiality to her husband by disclosing confidential information with the intent to benefit from such disclosure.[51]

E. Conclusion

The Eleventh Circuit's refusal to adopt a rebuttable presumption of a duty of trust or confidence when a person receives or obtains material, nonpublic information from spouses, parents, children, and siblings, or to eliminate the element of intent to benefit in misappropriation cases honors the foundational premise that insider trading prohibitions are premised on fraud.[52] A necessary element in virtually any action for fraud, whether under the securities laws or under state tort laws, is scienter—the intent to deceive, manipulate, or defraud.[53] Accordingly, in harmony with the express goals of Section 10(b) of the Exchange Act, to combat manipulation and deception in the securities markets the Eleventh Circuit has rightfully placed the burden on the SEC to show both the existence of a fiduciary duty in close family relationships and the intent to benefit on the part of the misappropriating outsider. Any other conclusion would run the risk of prosecuting individuals who, perhaps foolishly or recklessly, disclosed information received from family members without the requisite state of mind demanded by Section 10(b).[54]

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50. *Yun*, 327 F.3d at 1280.

51. *Id.* at 1280-81.

52. *Id.* at 1277-78 n.31.

53. Black's Law Dictionary defines "scienter" as:

> 1. A degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act's having been done knowingly, esp. as a ground for civil damages or criminal punishment . . . . 2. A mental state consisting in an intent to deceive, manipulate, or defraud. • In this sense, the term is used most often in the context of securities fraud. The Supreme Court has held that to establish a claim for damages under Rule 10b-5, a plaintiff must prove that the defendant acted with scienter.

BLACK'S LAW DICTIONARY 1373 (8th ed. 2004).

54. *Yun*, 327 F.3d at 1278 n.34. The court in *Yun* provided the following helpful example of just such a scenario:

> Suppose the CEO of a public company decides, after conferring with select members of the company's management, to confide in his wife that he is an alcoholic and is entering a rehabilitation center. Suppose he has continually

II. RECENT DEVELOPMENTS IN WHAT CONSTITUTES A "SECURITY"

At the dawn of the twentieth century, numerous states began to see the need for legislation aimed at regulating securities issuances, due in large measure to the proliferation of passive investing and the rapid growth in the United States' economy. The laws enacted by these states, collectively referred to as "blue sky" laws, are the foundation of the securities laws as they exist today.[55] In the wake of the stock market crash of 1929, Congress developed the two major sources of federal securities laws, the Securities Act of 1933 (the "Act")[56] and the Securities Exchange Act of 1934.[57] Congress built upon the existing blue sky laws in drafting these two acts, not with the intent to predict and address all possible situations that could arise in the capital markets, but instead to build a flexible body of law that would protect the public from unscrupulous promoters of stock and other fraudulent securities schemes. The evolving definition of a security evidences this concept of flexibility.

The Act defines a security as:

> confided with her over the years and she has never broken his trust. Also suppose that the day after he enters rehab, his wife discovers that he was having a love affair with another woman. Angry, the wife decides to humiliate her husband by disclosing his alcohol problems to the local newspaper editor. The editor is savvy, and realizes that news of the CEO's alcoholism would likely cause the stock price to fall. Accordingly, the editor buys put options in the husband's company before printing the story. When the story hits the newsstand, and the stock price falls, the editor makes lots of money. The question is whether the wife and the editor are liable. The information regarding her husband's alcoholism is material and nonpublic, the wife breached a duty of loyalty and confidentiality with her husband, the editor was aware of the wife's breach, and the husband is harmed (emotionally, financially, and in terms of his reputation). But, the wife did not disclose the information with the intent that anyone would trade or benefit; she merely wanted to harm her husband emotionally.
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> Under the SEC's approach the wife would be liable for the disgorgement of all of the editor's profits. The securities laws, however, are not designed to impose liability on a person who had no intent to trade or manipulate the market. Section 10(b) requires fraud "in connection with" the purchase or sale of securities.

Id.

55. There are numerous theories on the origin of the term "blue sky." Most notable are that the term refers to shady schemes that "had no more basis than so many feet of blue sky," and that the term refers to unscrupulous promoters who "would sell building lots in the blue sky in fee simple." SEC v. Mut. Benefits Corp., 323 F. Supp. 2d 1337, 1340 n.6 (S.D. Fla. 2000); SEC v. Edwards, 540 U.S. 389, 394 (2004).

56. 15 U.S.C. §§ 77a-77aa (2004).

57. 15 U.S.C. §§ 78a-78nn (2004).

> any note, stock, treasury stock, security future bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[58]

Congress adopted broad terms in this definition in an attempt to prevent circumvention of the Act's regulations through use of form over substance.

Within this definition, the term "investment contract" has been the subject of numerous legal actions.[59] Some view this term as a catch-all, allowing courts and regulators to apply their discretion when faced with whether the investment before them constitutes a security. Investment contract is not defined in the Act; however, the United States Supreme Court has established the test to determine if an investment constitutes an investment contract.[60] In *SEC v. W.J. Howey Co.*,[61] the Court held that an investment contract involves an investment of money in a common enterprise with profits coming solely from others' efforts.[62] During 2004 there were two cases originating in the Eleventh Circuit that were called upon to interpret and apply the *Howey* test: *SEC v. Edwards*[63] and *SEC v. Mutual Benefits Corp.*[64] As discussed below in greater detail, each of these cases addresses a new issue within the interpretation of the *Howey* test, and both cases preserve the breadth and flexibility of the security definition originally intended by Congress.

58. 15 U.S.C. § 77b(a)(1) (2004) (emphasis added).
59. *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293 (1946).
60. *See id.*
61. 328 U.S. 293 (1946).
62. *Id.* at 301.
63. 540 U.S. 389 (2004).
64. 323 F. Supp. 2d 1337 (S.D. Fla. 2004).

A. *Fixed versus Variable Rates of Return—No Affect on Security Analysis*

In *Edwards* the investment scheme at issue was the sale and leaseback of payphones. Defendant's wholly-owned company, ETS Payphones, Inc. ("ETS"), sold and leased payphones to the public through independent distributors.[65] Although ETS offered payphones under multiple sales and lease terms, the vast majority of ETS payphone purchasers opted for a package involving a site lease and leaseback to ETS. This package included a management agreement under which ETS would install the payphones, perform day-to-day payphone operations, and if necessary, repair the payphones. The purchasers would not be involved in any aspect of the management and operations of the payphones. Pursuant to this sale and leaseback arrangement, the payphone purchasers would pay ETS $7000 per phone and receive $82 per month per phone as lease payments, representing a fixed fourteen percent annual return based upon a five year lease term.[66]

ETS became unable to make the payments under the leaseback agreements and resorted to using new investment funds to cover such payments.[67] After some time operating under this system, ETS filed for bankruptcy protection. Shortly thereafter, the SEC brought an enforcement action alleging, among other matters, that defendant violated the registration requirements of Sections 5(a)[68] and 5(c)[69] of the Act because the sale and leaseback arrangements constituted an investment contract under the Act's definition of a security.[70] Defendant argued that the *Howey* precedent required an investment contract to involve variable profits, and because the payphone arrangement involved fixed profits, such an arrangement was not an investment contract as contemplated by the Act. The district court disagreed and held that the sale and leaseback arrangement was an investment contract under the Act's definition of a security; therefore, the Act was

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65. *Edwards*, 540 U.S. at 391. It is reported that ETS sold payphones to approximately 10,000 investors and collected approximately $300 million in proceeds therefrom. *Id.*

66. *Id.*

67. *Id.* at 392. Although not addressed directly in the Court's opinion, ETS's actions of taking investment proceeds to cover the lease payments looked very similar to the traditional Ponzi scheme.

68. 15 U.S.C. §§ 77a-77aa.

69. *Id.*

70. *Edwards*, 540 U.S. at 391. In addition to the registration requirement violations, the SEC alleged that ETS violated the antifraud provisions of Section 17(a) of the Act and Section 10(b) of the Exchange Act. *Id.*

applicable.[71] The Eleventh Circuit reversed, holding that the sale and leaseback arrangement was not an investment contract for the following reasons. First, an investment contract must "offer either capital appreciation or a participation in the earnings of the enterprise," thus excluding the payphone sale and leaseback where the purchasers received a fixed rate of return.[72] Second, a return on investment for an investment contract must be "derived solely from the efforts of others," which was not satisfied in the leaseback arrangement because the purchasers had a contractual entitlement to a return.[73]

In reviewing the Eleventh Circuit's holding, the United States Supreme Court identified the only issue to be "whether a moneymaking scheme is excluded from the term 'investment contract' simply because the scheme offered a . . . fixed, rather than variable, return."[74] The Court began by stating that the overarching intent of the securities laws is to regulate investments "in whatever form they are made and by whatever name they are called."[75] Within this intent, the definition of security was born, broad enough to "encompass virtually any instrument that might be sold as an investment."[76] The Court then looked to the test established in *Howey*: "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."[77]

Defendant argued the definition of an investment contract cannot include an investment providing a fixed rate of return due to the *Howey* test's requirement that "profits to come solely from the efforts of others" referred to the variable profits of the scheme and not fixed payments to the investor.[78] Thus, defendant asserted the sale and leaseback arrangement did not meet this requirement because the investors did not share in the payphone operation's profits but merely a fixed payment therefrom.[79]

In considering the *Howey* test, the Court looked to the original "blue sky" laws, which interpreted investment contracts to be present in "a variety of situations where individuals were led to invest money in a common enterprise with the expectation that *they* would earn a profit

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71. *Id.* at 392, 394-95.
72. *Id.* at 392-93 (citing SEC v. ETS Payphones, Inc., 300 F.3d 1281, 1284-85 (11th Cir. 2002) (per curiam)).
73. *Id.*
74. *Id.* at 391.
75. *Id.* at 393 (citing Reves v. Ernst & Young, 494 U.S. 56, 61 (1990)).
76. *Id.* (quoting *Reves*, 494 U.S. at 61).
77. *Id.* (quoting SEC v. W.J. Howey Co., 328 U.S. 293 (1946)).
78. *Id.* at 395.
79. *Id.* at 397.

solely through the efforts of a promoter."[80] In light of this state law interpretation, the Court determined that "profits [to] come solely from the efforts of others" spoke to the "profits that investors seek on their investment, not the profits of the scheme in which they invest," and that "profits" referred to income or return to the purchaser in the form of "dividends, other periodic payments, or the increased value of the investment" among others.[81] The Court concluded that "[t]he fact that investors have bargained for a return on their investment does not mean that the return is not also expected to come solely from the efforts of others."[82] Therefore, the Court held there is no differentiation between fixed returns and variable returns for purposes of defining an investment contract; thus, "an investment scheme promising a fixed rate of return can be an 'investment contract' . . . subject to the federal securities laws."[83] The Court stated that reading, as suggested by defendant, such a differentiation into the Act would in itself undermine the Act.[84]

B. *Vertical Commonality and Post-Investment Efforts of Others*

The district court was faced with a more morbid issue in *Mutual Benefits Corp.* than the one addressed by the Court in *Edwards*: viatical settlements.[85] A viatical settlement is a transaction where a terminally or chronically ill holder of a life insurance policy sells the rights to the future payout of such policy in consideration for an immediate lump-sum payment equaling a percentage of the policy's face value.[86] Thereafter, fractional interests in these policy benefits are sold to investors.[87]

Defendant, Mutual Benefits Corp. ("MBC"), was a viatical settlement provider who both procured life insurance policies and sold fractional interests therein to investors. Specifically, MBC located life insurance policies, negotiated purchase prices, prepared the legal documents necessary to effectuate the transactions, solicited funds from investors, paid the policy premiums, monitored the insured's health, collected the policy benefits upon death, and distributed the policy proceeds to the

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80. *Id.* (quoting *Howey*, 328 U.S. at 298 (emphasis added)).

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* In so holding, the Court reasoned that investments with fixed returns are "particularly attractive to individuals more vulnerable to investment fraud" and "unscrupulous marketers of investments could evade the securities laws by picking a rate of return to promise." *Id.* at 394-95.

85. *Mut. Benefits Corp.*, 323 F. Supp. 2d at 1337.

86. *Id.* at 1338.

87. *Id.* (citing BLACK'S LAW DICTIONARY 1377 (7th ed. 1999)).

investors. MBC promised investors in viatical settlements rates of return ranging from twelve percent to seventy-two percent, depending on the term of the investment, which was determined by a life expectancy evaluation performed by MBC. MBC attempted to match investors' preferred terms with the life expectancies of policy holders. In the event the insured lives beyond MBC's estimated life expectancy, the investment term is extended and premiums are paid either from new investor funds or additional funds from existing investors.[88]

The SEC brought an action against MBC to stop its sale of viatical settlements, alleging such sales violated the registration requirements of the federal securities laws.[89] MBC argued that investments in viatical settlements are not covered by the federal securities laws because such investments failed to meet the second and third elements of the *Howey* test (commonality and profits derived from others' efforts); therefore, the action must be dismissed for lack of subject matter jurisdiction.[90]

In hearing the case, the court defined "the narrow issue" as "whether investments in viatical settlements constitute securities."[91] The court identified two principles upon which the federal securities laws are based: (1) flexibility in the law's application and (2) promotion of full disclosure.[92] With regard to these principles, the court concluded that "courts should determine the contours of the term security from the posture that substance should be elevated over form, with a special sensitivity to the economic reality of the transaction, not its formal characteristics," and that courts should apply such flexibility to provide the investor with full disclosure.[93]

The court noted the use of the *Howey* test to determine what type of investments constitute an investment contract serves to temper such principles.[94] As applied by the Eleventh Circuit, three elements are required: "(1) an investment of money; (2) a common enterprise; and (3)

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88. *Id.* During approximately ten years of operations, MBC sold viatical settlements to over 29,000 investors nationwide and collected over $1 billion in proceeds therefrom. *Id.*

89. *Id.*

90. *Id.* at 1339, 1341.

91. *Id.* at 1339. The court pointed out that MBC was transacting in life settlements in addition to viatical settlements. *Id.* at 1338. Life settlements are identical to viatical settlements in every way except that in life settlements, the insured is not terminally or chronically ill. *Id.* The Court stated that it made no differentiation between life and viatical settlements for purposes of the "investment contract" analysis and holding. *Id.* at 1344.

92. *Id.* at 1339-40.

93. *Id.*

94. *Id.* at 1341.

the expectation of profits derived solely from the efforts of others."[95] With regard to the second element, MBC argued that the appropriate standard for determining a common enterprise is that of horizontal commonality, where there exists a commonality among investors.[96] MBC asserted that in the case of viatical settlements, vertical commonality is not present because there is no pooling of investor funds.[97] The court determined, however, that the Eleventh Circuit recognizes vertical commonality in determining whether a common enterprise is present.[98] Under such a standard, the investors' success only needs to be dependent on the promoter's success with the underlying investment.[99] The court held that because the "investors' return is highly dependent on MBC's . . . skill in locating, negotiating, bidding, and evaluating [insurance] policies," the investors' success is tied to MBC's success, and thus, viatical settlements satisfy the vertical commonality test.[100]

With regard to the third element, which is the expectation of profits derived solely from others' efforts, the court stated the appropriate test is whether the investments are substantially passive and dependent upon the "entrepreneurial or managerial efforts of others."[101] The court noted that "solely from the efforts of others" has been relaxed to capture situations where others' efforts are "undeniably significant ones . . . which affect the failure or success of the enterprise."[102] The court stated this test requires a determination on whether the profits from viatical settlements are derived from MBC or from external market forces beyond MBC's control.[103] MBC argued that the insureds' times of death constitute external market forces, which dictate the profits investors receive and any variations thereof, and therefore, this external market force caused MBC's efforts not to be a significant part in

95. *Id.*

96. *Id.* Horizontal commonality, recognized as a more stringent test, requires interdependency among investors, typically through pooling of investor funds or pro rata distribution of profits. *Id.*

97. *Id.*

98. *Id.* MBC pointed to the Seventh Circuit precedent in support of MBC's assertion that horizontal commonality should be applied. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* at 1342 (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 (1975)).

102. *Id.* (citing SEC v. Unique Fin. Concepts, Inc., 196 F.3d 1195, 1201 (11th Cir. 1999)).

103. *Id.* The court stated that the purpose for such distinction is that securities laws disclosure requirements "will only protect investments that depend on the efforts of promoters, not those that depend on the operation of external market forces." *Id.* (citing SEC v. G. Weeks Sec., Inc., 678 F.2d 649 (6th Cir. 1982)).

providing profits to the investors.[104] The court did not adopt MBC's position, and instead, held that the level of profits provided to investors is due in significant part to: (1) MBC's life expectancy evaluation and (2) MBC's success in negotiating a desirable price for the policy benefits—well within MBC's efforts.[105]

Lastly, the court turned to MBC's argument that the efforts of others required in the third element of the *Howey* test must occur after the investment.[106] To support this argument, MBC cited *SEC v. Life Partners, Inc.*,[107] the only federal appellate court case to address the issue of whether a viatical settlement constitutes a security.[108] The court declined to adopt the *Life Partners* bright-line rule that promoters' efforts must occur post-purchase to satisfy the third element of the *Howey* test.[109] In so doing, the court stated that bright-line tests are not appropriate in the context of federal securities laws because such tests create unintended loopholes.[110] The court also determined that the *Life Partners* rule is "inconsistent with the policies underlying the federal securities laws and misconceives the nature of investments in viatical settlements."[111] Therefore, the court held that viatical settlements are investment contracts under the *Howey* test, and thus, fall within the coverage of the Act.[112]

C. *Conclusion*

As demonstrated by the courts in *Edwards* and *Mutual Benefits*, it appears that courts are continuing to interpret the definition of security broadly to capture as many investment schemes as possible. As reflected in *Edwards*, the Supreme Court overturned the Eleventh Circuit by refusing to distinguish between fixed and variable rates of return in determining whether an investment constitutes an investment contract pursuant to the Act.[113] Further, the Eleventh Circuit, in *Mutual Benefits*, declined to adopt an appeals court precedent holding that

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104. *Id.*

105. *Id.*

106. *Id.* at 1343.

107. 87 F.3d 536 (D.C. Cir. 1996).

108. *Mut. Benefits Corp.*, 323 F. Supp. 2d at 1343 (referencing to *Life Partners, Inc.*, 87 F.3d 536).

109. *Id.* The court did note, however, that the SEC alleged MBC performed significant activities post-investment to satisfy the *Life Partners* test. *Id.*

110. *Id.*

111. *Id.* The court noted that MBC had used *Life Partners* as a guide in structuring MBC's business operations, creating what the court saw as a loophole precedent. *Id.*

112. *Id.* at 1344.

113. *Edwards*, 540 U.S. at 397.

viatical settlements are not investment contracts.[114] Both of these courts were unwilling to apply a bright-line test to the definition of security, thus preserving a broad nature of such definition.

Additionally, both *Edwards* and *Mutual Benefits* involved an analysis of the third element of the *Howey* test, which provides that the profits of an investment are derived solely from others' efforts. Although each addressed a different aspect of this element, both cases provided the definition with the greatest amount of flexibility. Specifically, the Supreme Court in *Edwards* determined that the *Howey* test's use of the term "profits" referred to the flow of funds from the enterprise to the investor, not the profits generated within the enterprise.[115] The court in *Mutual Benefits* underscored that the "solely" requirement should be lessened to "significant" efforts, declined to interpret the timing of an insured's death as a market force outside the promoter's efforts, and refused to require the promoter's efforts occur post-investment.[116] In so holding, these two courts have demonstrated the bench's unwillingness, with few exceptions, to limit the scope of what constitutes a security, and the bench's steadfast determination to preserve the breadth and flexibility of such definition.

114. *Mut. Benefits Corp.*, 323 F. Supp. 2d at 1344.
115. *Edwards*, 540 U.S. at 395.
116. *Mut. Benefits Corp.*, 323 F. Supp. 2d at 1344.