

Chapter 2

What is a security?

Introduction

The U.S. securities laws apply to transactions in securities. Consequently, whether the securities laws apply depends on whether a 'security' is involved.

The term 'security' is defined in the Securities and Exchange Acts in broad terms which are intended to include within the definition the many types of instruments commonly thought of as securities within the commercial world.

The Securities Act defines 'security' as follows:

Section 2. When used in [the Securities Act], unless the context otherwise requires:

- (1) The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, 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.

The Exchange Act defines 'security' as follows:

Section 3(a) When used in [the Exchange Act], unless the context otherwise requires:

- (10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, 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 instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

While there are very slight differences between the two lists, the U.S. Supreme Court has stated that the definitions of security under the two statutes will be treated as virtually identical.

Generally, the Supreme Court has held that each type of financial instrument must be analyzed separately using a different test appropriate for each instrument. If an instrument is clearly within the statutory definitions, like common stock, then the instrument is a security. If an instrument is unusual and not easily characterized as a security within the definitions, then the analysis should look to the economic realities of the transaction, rather than just its form, to determine whether the securities laws apply.

Investment contracts and unorthodox securities

The definitions of a security include a category of instruments called ‘investment contracts’, which is a catch-all term for transactions not specifically included in the definition lists. The courts have created rules based largely on the words ‘investment contract’ for determining what elements of a transaction constitute a security in situations not specifically enumerated in the Acts in order to prevent evasion of the protections intended by the Acts.

The touchstone case is a Supreme Court case, *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), which has been modified by later cases. Generally, under the *Howey* test an investment contract is defined as a contract, transaction or scheme whereby a person a) invests money (or other consideration); b) in a common enterprise; c) is led to expect profits; d) substantially from the efforts of others.

In *Howey*, the defendants sold the plaintiffs small plots of land in citrus groves together with a service contract for the cultivation, harvesting and marketing of the fruit. The defendants then gave each investor a percentage of the overall profits. Looking at the underlying economic reality, the Supreme Court examined the investment as a whole and how it was marketed and found the transaction to be an investment contract under the federal securities laws.

Other instruments

Stock

Generally, where an instrument is labeled stock and possesses the characteristics of stock, the instrument will be considered a security. This includes sales of securities as part of the sale of an entire business but excludes sales of shares in cooperative apartments.

Notes

Based on the statute, notes with a term of more than nine months are presumed to be a security. However, that presumption may be refuted by showing that the note in question is within a previously recognized judicial exception, or is sufficiently similar to a previously recognized judicial exception, or by convincing the court to add a new instrument to the list of judicial exceptions (the ‘family resemblance test’).

Partnership, joint-venture and limited liability company interests

Partnership, joint-venture and limited liability company interests may be securities depending on the circumstances. The test used for determining whether these interests are securities in a

U.S. SECURITIES REGULATION

particular case is the *Howey* test. Generally, interests in general partnerships and similarly structured limited liability companies are not considered securities because the partners (and members) are involved in the activities of the entity and do not rely on the efforts of others. However, interests in limited partnerships and similarly structured limited liability companies are securities because investors rely on the management efforts of others.