**What is a Security?**
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Everyone knows that common stock is a security. But is it always? And why is it a security? The answers to those two questions are not often readily apparent, nor sometimes as clear as we would like.

The threshold question though is why is it important whether a financial instrument is or is not a "security"? The answer is simple. Once a financial instrument is found to be a "security" it is covered by the full protections of federal securities laws. To decide if a financial instrument is indeed a security, the first place to start any analysis is the Securities Act of 1933, as amended, particularly the definition of "security" set out in Section 2(a)(1).

The "default" definition in Section 2(a)(1) is the term "investment contract". If something is an "investment contract" it is a "security". Often, then, it is best to start any analysis of whether a given financial instrument is a security is to test it against the investment contract test set out by the Supreme Court in the case of SEC v. W.J. Howey Company (the "Howey" test). The Howey test simply put is that an "investment contract" (and therefore a "security") is any contract, transaction or scheme whereby a person invests money (you may infer in addition: invests something of value) , in a common enterprise and is led to expect profits from the efforts of others. That simple test is one of the most profound and important definitions in all of securities regulation. Complex financial instruments and dealings have stood or fallen in light of SEC regulation based on this simple test.

Although the Howey case dealt with investment contracts, it has been extended, at least in United Housing Foundation v. Forman, another Supreme Court case, as the "essential" test to all securities. As a practical matter one should begin any analysis of any financial instrument, even if called something else, such as stock with the Howey test. The reason for this is that the term "investment contract" as intended to be a catch all definition.. If any instrument, no matter what it is called, meets the Howey test, it is a security. If it does not meet the Howey test it may still be a security, but will have to justify its status as a security in some other definitional manner.

United Housing Foundation v. Foreman also added two interesting insights. It said first that just because something is call "stock" doesn't necessarily mean it is a security, notwithstanding the language of Section 2(a)(1) that specifically includes "stock" as a "security". This has come to be known as the "economic reality" test....or as some like to call it, the basic common sense test. Take a look at a given transaction and try and figure out what is really going on. The Foreman case dealt with a situation where individuals were renting an apartment and as part of the transaction had to buy 25 shares in a management company. When they left the apartment, they also sold the shares in the management company for the same price at which they bought them. When things went sour some tenants sued on securities fraud claiming the stock they bought was a security and therefore that gave them the right to sue for securities fraud. The court answered logically. Yes, there was a sale of “stock” involved, but were the tenants really making an “investment” when they bought the “stock”? Of course not. They were renting an apartment. This leads to one of the insights of the Foreman case, that is, that the first Howey test should not be brushed aside lightly. An investment contract requires an “investment of money”. Focus on the word “investment” or “invest”. That means the intention that the money is given over with the expectation that profit or return will follow. Was there any true “investment” of money in Foreman? No. So in addition to the economic reality, or common sense, test, Foreman also failed the first Howey test.

The second Howey test is that there must be a “common enterprise.” So what is a common enterprise? The easier definition, the so-called “horizontal” commonality test requires there to be at least two investors who have a similar relationship in the business enterprise, that is, they all pool their investments and share in the profits. The other test is the “vertical” commonality test. This test will find a commonality (meeting the Howey requirement of a common enterprise) if the promoter and at least one investor share in the success (or failure) of the business venture

The third leg of the Howey test is “efforts” of others. The investor must rely strongly on the efforts of others. That is why franchise transactions, where an owner-operator must manage the franchise, even if he or she gets much support and direction from the franchiser (such as a McDonalds or Burger King franchise), are generally not held to involve a security.

By the way, it is because of the Howey case that general partnership interests are thought not to be securities, but limited partnership interests are. There are basically two types of partnerships, general partnerships and limited partnerships. Since in a real general partnership each general partner manages the business, or at least has the right to, a general partnership interest is ordinarily not considered a security, as it fails an essential element of the Howey test (reliance on the efforts of others). Of course, even if a partnership calls itself a general partnership, but has few of the attributes of a “true” general partnership, a security may still be found. In a limited partnership the limited partners have no management control, therefore under the Howey analysis a security is generally found, based on the “efforts of others” test.

Notes are specifically mentioned in the definition of a security in Section 2(a)(1) of the Securities Act of 1933, as amend. Therefore you could say with notes, as well as stock, if the very name of the instrument is mentioned in the statutory definition there is a presumption that it may be a security, but some notes are securities and some notes are not securities. This is because many “notes” are used for commercial purposes and not investment purpose If a note is used for “commercial” purposes, like bank financing, commercial asset financing, inventory financing, such notes are generally found not to be securities. On the other hand “investment” notes are viewed as securities. That is what makes an analysis of notes a little more complicated. In the case of notes you have to look a little more at the intent of the parties. In Reves v. Ernst & Young the court tried to deal with the issue of separating an investment note (which is a security) from a commercial note (which is not a security). And to do this the court came up with the “family resemblance” test. Essentially this test is the motivations of the parties ( is the motivation an investment or a commercial finance arrangement), is the instrument meant to be traded (investment notes often have the ability to be traded, commercial notes almost never do), what are the reasonable expectations of the public ( would the financial world consider the note an investment note or a commercial note) and is there any other regulatory scheme better suited to deal with the instrument (banking laws for example).

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