No. 02-1196

IN THE

Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

v.

CHARLES E. EDWARDS,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI FILED BY THE SOLICITOR GENERAL OF THE UNITED STATES ON BEHALF OF THE SECURITIES AND EXCHANGE COMMISSION

MARK J. DAVIS *
Associate Counsel
ROYCE O. GRIFFIN
General Counsel
JOHN R. VEATOR
Deputy General Counsel
STEPHEN W. HALL
Associate Counsel
NORTH AMERICAN SECURITIES
ADMINISTRATORS ASSOCIATION, INC.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900

* Counsel of Record

March 17, 2003

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

Pursuant to Supreme Court Rules 21 and 37, the North American Securities Administrators Association, Inc. ("NASAA"), respectfully moves this Court for leave to file an *amicus curiae* brief in support of the Petition for a Writ of Certiorari ("Petition") filed by the Solicitor General on behalf of the Securities and Exchange Commission.

Parties Who Have Withheld Consent

Respondent Charles E. Edwards has withheld his consent to NASAA's filing an *amicus curiae* brief in support of the Petition.

Nature of the Movant's Interest

NASAA is the nonprofit association of the state, provincial, and territorial securities regulators in the United States and Canada, and of the Mexican national government. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to the protection of investors in securities.

Two of the principal goals of NASAA and its members are protecting investors from fraud and abuse in the offer and sale of securities, and promoting uniformity in the interpretation of the securities laws. The Eleventh Circuit's decision in this case, holding that ETS pay phone investments are not securities, undermines investor protection on several levels: (1) it strips away the protections of federal securities regulation from pay phone investment contracts, which are notorious vehicles for fraud and abuse; (2) it narrows the definition of "investment contract" under *SEC v. W. J. Howey Co.,* 328 U.S. 293 (1946), creating significant loopholes for unscrupulous promoters selling other types of investments; and (3) it sets a precedent that may adversely affect the evolution of state securities law to the detriment of investors, insofar as state courts often look to federal decisions for guidance on issues common to state and federal securities law. NASAA has an interest in removing these threats to investor protection by supporting this Court's review of the lower court's decision.

The Eleventh Circuit's decision also undermines uniformity. It conflicts with decisions from the First, Third, and Ninth Circuits, as well as decisions from the Supreme Courts of Utah and Washington. *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001); *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000); *United States v. Carman,* 577 F.2d 556 (9th Cir. 1978); *Payable Accounting Corp. v. McKinley*, 667 P.2d 15 (Utah 1983); *Suave v. K.C. Inc.*, 591 P.2d 1207 (Wash. 1979). As a consequence of the Eleventh Circuit's decision, the citizens of Alabama, Florida, and Georgia face a heightened and disproportionate risk of financial exploitation because they do not receive the deterrent and remedial benefits of federal securities regulation with respect to pay phone investments and similarly structured offerings. This predicament increases the likelihood that those citizens will be the victims of fraud and abuse. NASAA therefore also has an interest in seeking to restore federal securities regulation of pay phone programs and similar investment contracts in the Eleventh Circuit to eliminate this imbalance.

Reasons for Granting the Motion

NASAA's *amicus curiae* brief should be accepted because it will assist the Court by providing it with relevant matter not likely to be advanced by the other parties to the case. *See* Sup. Ct. R. 37.1. NASAA is uniquely situated to address the deleterious impact of the appellate court's decision on public investors. For almost a century, state securities regulators have been at the forefront of the fight to protect Main Street investors from illegal and fraudulent securities offerings. NASAA, informed by its members, is intimately familiar with the toll that such schemes take on individual investors and the importance of securities regulation as a deterrent and as a remedy. Second, NASAA can speak with authority on the impact that federal decisions have on state securities law. State courts and administrative agencies often look to federal case law for guidance with respect to securities issues. The appellate court's decision, if left uncorrected, threatens to weaken state as well as federal securities law and undermine the cause of investor protection. Finally, NASAA offers legal analysis that complements the Solicitor General's arguments in support of the Petition.

In summary, NASAA and its members have a demonstrable interest in the outcome of this case and the *amicus curiae* brief will assist the Court.

Conclusion

NASAA requests that the Court grant leave to file the accompanying *amicus curiae* brief.

Respectfully submitted,

MARK J. DAVIS *
Associate Counsel
ROYCE O. GRIFFIN
General Counsel
JOHN R. VEATOR
Deputy General Counsel
STEPHEN W. HALL
Associate Counsel
NORTH AMERICAN SECURITIES
ADMINISTRATORS ASSOCIATION, INC.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900

* Counsel of Record

March 17, 2003

QUESTIONS PRESENTED

1. Whether a return on an investment should be excluded from the meaning of "profits" under the *Howey* test for investment contracts merely because the promoter of the investment offers a fixed rate of return.

2. Whether a return on an investment, which is in fact wholly dependent upon the efforts of others, should nevertheless be viewed as not "derived from the efforts of others" under *Howey* merely because the promoter contractually promises or guarantees the return.

TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

STATUTES AND REGULATIONS

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

INTEREST OF THE AMICUS CURIAE

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of the state, provincial, and territorial securities regulators in the United States and Canada, and of the Mexican national government. It has 66 members, including the securities regulators in all 50 states, the District of Columbia, and Puerto Rico. Formed in 1919, it is the oldest international organization devoted to the protection of investors in securities.[1]

Two of the principal goals of NASAA and its members are enhancing investor protection and increasing uniformity in the interpretation of the securities laws. The appellate court's decision undermines both of these interests.

A. Investor Protection

The Eleventh Circuit's decision in this case, holding that ETS pay phone investments are not securities, undermines investor protection on several levels. First, it removes the protections of federal securities regulation from pay phone investment contracts, which are notorious vehicles for fraud and abuse. Although it is to be expected that state regulation of these investments will continue unabated, eliminating the SEC's jurisdiction over such offerings will at a minimum increase the burden on state regulators and heighten the risk that investors will fall victim to these schemes. NASAA therefore has an interest in seeking the reversal of the appellate court's decision and ultimately the restoration of federal regulation of these products.

---

[1] Pursuant to Sup. Ct. R. 37.6, NASAA represents that no counsel for any party authored this brief in whole or in part, and no person or entity, other than NASAA, its members, or its counsel, made any monetary contribution to the preparation or submission of the brief.

Second, the appellate court's decision substantially narrows the definition of "investment contract" under *SEC v. W. J. Howey Co.,* 328 U.S. 293 (1946). The court held that investments offering either fixed or contractually guaranteed returns do not qualify as investment contracts. This unsupported interpretation of *Howey* creates loopholes that unscrupulous promoters will undoubtedly seek to exploit in the future as they invent new ways to defraud the investing public. NASAA has an interest in helping to prevent this potentially far-reaching impact of the appellate court's decision.

Finally, the appellate court has set a precedent that may adversely affect the evolution of state securities law to the detriment of investors, insofar as state courts often look to federal decisions for guidance on issues common to state and federal securities law. NASAA has an interest in helping to ensure that the appellate court's decision does not weaken state securities law in this way.

B. Uniformity

The Eleventh Circuit's decision also undermines uniformity in securities law. The ruling conflicts with decisions from three other federal circuit courts, as well as decisions from the highest courts of two states. As a consequence of the Eleventh Circuit's decision, the citizens of Alabama, Florida, and Georgia face a heightened risk of being victimized by pay phone promoters. Those citizens do not receive the deterrent and remedial benefits of federal securities regulation with respect to pay phone investments and similarly structured offerings. This lack of uniformity will tend to attract financial predators who have been turned away from other jurisdictions where pay phone sale and leaseback agreements are fully regulated as securities. NASAA has an interest in seeking the review of the appellate court's decision to promote fairness and to prevent any state, or group of states, from becoming a preferred haven for fraud and abuse.

SUMMARY OF THE ARGUMENT

The SEC's petition for a writ of certiorari ("Petition") should be granted, and ultimately the appellate court's decision should be reversed, for two compelling reasons. First, the court's decision, if left intact, will expose thousands of investors in the Eleventh Circuit to a heightened risk of fraud and abuse at the hands of pay phone promoters and those selling a variety of similar sale and leaseback investments no longer subject to federal regulation as securities. The decision is an unfortunate blueprint for unscrupulous promoters who will easily devise new schemes that fall outside the appellate court's narrow definition of an investment contract. Because state courts often look to federal decisions in the area of securities regulation, the appellate court's ruling can be expected to weaken state securities law over the long term if it is not reversed.

Second, the appellate court's decision is an erroneous interpretation of federal law. It conflicts with the majority of cases from federal and state courts. The decision also conflicts with the policies underlying securities law, the plain meaning and intent of the statutory provisions at issue, and the interpretation of the law by the regulatory agencies entrusted with administering it.

ARGUMENT

I. THE APPELLATE COURT'S DECISION OPENS AN ENORMOUS LOOPHOLE IN SECURITIES LAW, WHICH EXPOSES INVESTORS TO A HEIGHTENED RISK OF FRAUD AND ABUSE

By holding that the ETS pay phone investments are not securities, the court has placed investors at risk. Over the past decade, there have been widespread abuses in the marketing of pay phone schemes, and as a consequence, thousands of investors have lost money. Continued regulation of these and similar products under both federal and state securities law is essential to limit the financial harm they cause.

A. Scope of the Problem

The pattern of abuses in the marketing of pay phone sale and leaseback programs is well documented. In March 2001, NASAA announced the results of a crackdown by securities regulators in 25 states and the District of Columbia against individuals and companies that sold illegal pay phone sale and leaseback investments.[2] Nearly 4,500 people, most of them elderly, were reported to have lost $76 million investing in these schemes. Over the years, state securities regulators across the country have initiated scores of administrative and civil injunctive actions against pay phone sale and leaseback companies and their agents, including ETS, Alpha Telcom, Phoenix Telecom, QCI, and others.[3] *See, e.g.*, cease and desist orders issued by Kansas, North Carolina, and Rhode Island against ETS, Exs. 9, 10, 11; *see also* cases discussed *infra* at Part II. A.

The SEC also has vigorously pursued enforcement actions against these illegal enterprises. Examples include this case against ETS as well as four injunctive actions in federal district court in Florida and Georgia in which the SEC sought millions of dollars in disgorgement and other relief against four pay phone companies and their agents. *SEC v. Phoenix*

---

[2] NASAA, *State Securities Cops Announce Actions Against Sellers of Payphone Schemes; Losses Estimated at $76 Million So Far,* March 13, 2001, *available at* http://www.nasaa.org/nasaa/abtnasaa/display_top_story.asp?stid=108.

[3] The investments offered by these companies are essentially the same. Alpha Telcom offered investors 30% of adjusted gross revenues, but with a guaranteed minimum that equated to a 14% return. *See, e.g. In re Alpha Telcom,* No. 99-07-0220, 2002 WL 459704, *3 (Wash. Sec. Div. Mar. 13, 2002).

Telecom, No. 100-CV-1970-JTC (N.D. Ga.), 2001 WL 874314 (SEC Release No. 17089, Aug. 3, 2001); *SEC v. Linktel Communications, Inc.*, No. 100-CV-3169-WBH (N.D. Ga.), 2000 WL 1773106 (SEC Release No. 16816, Dec. 4, 2000); *SEC v. Levine*, No. 94-6898-CIV-ZLOCH (S.D. Fla.), 1994 WL 559076 (SEC Release No. 14279, Sept. 30, 1994); *SEC v. Haje,* No. 92-510-CIV-J20 (M.D. Fla.), 1993 WL 347148 (SEC Release No. 13772, Sept. 3, 1993).

The violations common to these operations include the sale of unregistered securities by unlicensed agents and fraudulent misrepresentations and omissions concerning the risks of loss, the financial condition of the enterprise, and prior disciplinary actions against the company or its principals. *See generally SEC v. Alpha Telcom, Inc.,* No. CV 01-1283 PA, 2002 WL 193093 (D. Or. Feb. 7, 2002); *SEC v. Phoenix Telecom, L.L.C.,* No. 1:00-CV-1970-JTC, 2000 WL 33956119 (N.D. Ga. Aug. 2, 2000). In short, pay phone sale and leaseback programs pose a serious risk to investors. *See Dep't of Banking & Fin. v. Mehl*, No. 02-0526, 2002 WL 31452438, at *24-25 (Fla. Div. Admin. Hgs. July 16, 2002) (Recommended Order) (multi-million dollar fine imposed against the seller of ETS pay phone investments because many investors were left in "irreversible financial ruin for the remaining years of their lives").

B. Benefits of Regulation

The SEC and state securities regulators have long viewed pay phone sale and leaseback schemes as securities and have regulated them as such. Accordingly, investors have been receiving important protections. First, those who sell securities must be tested and licensed to help ensure they have the character and fitness to accept investor funds and render investment advice. *See* 15 U.S.C. § 78o; Unif. Sec. Act of 1956 § 201 (licensing of industry participants). Second, the securities themselves must be registered so that material information about the offerings and the issuers is made available to investors. *See* 15 U.S.C. §§ 77f, 77g, 77j; Unif. Sec. Act of 1956 § 301 (registration of securities). Third, the securities laws impose stiff civil and criminal penalties as a deterrent against violations of the licensing, registration, and anti-fraud provisions. *See* 15 U.S.C. §§ 77q, 77t, 77x, 78f, 78j, 78u; Unif. Sec. Act of 1956 §§ 101, 408-410 (civil and criminal penalties). Finally, the securities laws give regulators the authority to seek important remedial measures, including injunctions, disgorgement, and restitution, to help redress violations after they occur. *See id.* (injunctive relief and civil liabilities).[4]

With these tools at their disposal, regulators can deter violations in the first instance, halt violations in progress, and attempt to recover ill-gotten gains from those who have profited at the expense of investors. All of these provisions have played an important role in limiting the harm that illegal pay phone investment schemes and other investment contracts have inflicted on the investing public.

C. Future Impact

The appellate court's decision in this case threatens harm to investors on multiple levels by stripping away these protections. Its most immediate impact is to tie the SEC's hands in the Eleventh Circuit as to pay phone sale and leaseback programs, as well as all other investment contracts that have been structured to provide fixed or guaranteed

[4] The Uniform Securities Act of 1956 is the predominant model for state securities laws. It has been adopted by 34 states, with some individual variations. *See* Chart showing states adopting Unif. Sec. Act of 1956, *available at* www.law.cornell.edu/uniform/vol7.html#secur. Even those state that have passed their own securities laws have similar regulatory requirements and remedies.

returns.[5] While indications are that state securities regulators in Alabama, Florida, and Georgia will continue to enforce their laws vigorously against promoters of these products, sidelining the SEC will increase the burden on these state regulators and expose investors to heightened risk.

The court's decision also threatens a much broader harm by fundamentally narrowing the application of the *Howey* investment contract test. "Guaranteed" and "fixed returns" are often meaningless labels that promoters attach to their investment contracts to attract investors. Under the court's decision, these same terms—easily inserted into a contract—will also serve as a convenient shield against regulation under the securities laws. Regulators can now expect to see the emergence of a wide variety of new and bogus investment contracts specifically designed to benefit from the loophole created by the appellate court.

Finally, the court's decision will undermine state, as well as federal, securities regulation. State courts and state administrative agencies often consult federal decisions for guidance on securities issues. *See, e.g., Payable Account-ing Corp. v. McKinley*, 667 P.2d 15, 17 (Utah 1983) (states frequently rely on federal case law in interpreting state security acts); *Dep't of Banking & Fin. v. Mehl,* No. 02-0526, 2002 WL 31452438, at *2 (Fla. Dep't of Banking & Fin. Oct. 17, 2002) (Final Order) ("In some instances, state and federal securities laws appear as mirror images. Both, for example, have the same definition for the term 'security.' For these reasons, in the absence of state decisional law, state courts will look to federal court decisions for guidance"); *Cf. King v. Pope*, 91 S.W.3d 314 (Tenn. 2002) (reversing Tennessee

---

[5] ATM machines and Internet kiosks are examples of other products that have been the subject of illegal investment schemes similar to the pay phone sale and leaseback programs. *See* NASAA,*"Top 10" Investment Scams Listed by State Securities Regulators"* (Aug. 26, 2002; Apr. 23, 2001), *available at* www.nasaa.org, "News and Public Affairs."

Court of Appeals, which had adopted federal rather than State commonality standard to hold pay phone contracts were not securities).

The appellate court's decision already has emboldened pay phone promoters and others to challenge prior rulings against them in state enforcement actions. These arguments are surfacing in states within the Eleventh Circuit and elsewhere. In *Iowa ex rel. Miller v. Pace,* Equity No. LA26445 (Iowa D. Ct., Warren County, Sept. 4, 2002), *appeal docketed,* No. 02-1726 (Iowa, Oct. 28, 2002), the Iowa District Court found that ETS pay phone investments were investment contracts under *Howey,* and ordered the defendant to make restitution of over $300,000 for fraud in the sale of unregistered securities. *Id.* at 16, 23-24, 27-28. The defendant has appealed the state district court's order to the Iowa Supreme Court, and is relying heavily on the Eleventh Circuit's opinion in this case for the proposition that the ETS offerings are not investment contracts, as a matter of law. *See* Appellant's Proof Br. at 28-32, *Iowa ex rel. Miller v. Pace,* No. 02-1726 (Iowa) (filed Jan. 21, 2003). The appeal is pending.

In *Garvin v. Secretary of State,* No. OSAH-SECSTATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hgs Aug. 28, 2002) (Order on Reconsideration), an administrative law judge with the Georgia Office of Administrative Hearings ruled that the ETS pay phone investment was a security, issued a cease and desist order against further offerings of the investment, and imposed a fine against the respondent for selling unregistered securities. The respondent has filed a petition for review in state court, relying in part on the Eleventh Circuit's opinion in this case. *See* Aff. of Charles R.T. O'Kelley, attached as Ex. B to Pet'r Br. in Support of Pet. for Judicial Review, at 7-8, *Garvin v. Sec'y of State,* No. 2002 CV 6027 (Ga. Super. Ct., Fulton County, Dec. 16, 2002). The petition for review is pending.

The appellate court's decision is also being cited in defense of investments other than pay phone sale and leaseback programs. In *In re Yucatan Resorts*, No. 2002-10-33, 2002 WL 31971658, at *1-2 (Pa. Sec. Comm'n Oct. 22, 2002) (Summary Order to Cease and Desist), the respondents were named in a cease and desist order for selling unregistered securities in the form of a vacation resort leasing program. The program offered an annual return of 9%-11%, and featured the services of a third-party agent to handle leasing of the resort units for investors. *Id*. at *1. On January 22, 2003, the respondents filed a request to vacate the order, and a motion for summary judgment in the alternative, relying in part on the appellate court's ruling. *See* Resp't Req. to Vacate Cease and Desist Order or in the Alternative, Mot. for Summ. J. and Br. in Support Thereof, at 11-14, *In re Yucatan Resorts*, No. 2002-10-33 (Pa. Sec. Comm'n) (filed Jan. 13, 2003). That request is pending.

The influence of the Eleventh Circuit's decision is not confined to courts and administrative agencies. Evidently as a direct result of the court's ruling, a bill has appeared in the Colorado legislature that would amend the definition of a security in that state to exclude leaseback arrangements "in exchange for a contractually fixed and guaranteed rate of return." *See* House Bill 1311, 1st Sess. (Colo. 2003).[6] Colorado is among the states where both state and federal regulators have taken aggressive enforcement action against pay phone promoters. *See Joseph v. Geier*, No. 01 CV 1151 (Colo. D. Ct., Denver County, Jan. 30, 2003) (order on motions for summary judgment) (Phoenix Telecom pay phone program held to be illegal investment contract); *SEC v. Quarter Call, Inc.*, No. 94Z-1227 (D.Colo.), 1996 WL 635380 (SEC Release No. 15145, Nov. 4, 1996) (action against now bankrupt pay phone company QCI, finding that

[6] *Available at* http://www.leg.state.co.us/2003a/inetcbill.nsf/fsbillcont/1777905CD8404C8187256CC50077A764?Open&file=1311_01.pdf

defendants obtained over $9 million from 520 investors in fraudulent sales of pay phone investments). The bill introduced in the state legislature is an apparent attempt to curtail securities regulation in Colorado, using the appellate court's decision as a justification.

These examples illustrate the potentially far-reaching impact that the appellate court's decision may have on securities regulation and ultimately, on public investors. To stem this tide and restore the SEC's regulatory jurisdiction to full strength, this Court should grant the SEC's Petition, and upon a review on the merits, reverse the decision of the appellate court.

II. THE APPELLATE COURT'S DECISION CONFLICTS WITH THE DECISIONS OF THIS COURT, THREE FEDERAL CIRCUIT COURTS, AND NUMEROUS STATE COURTS

The appellate court held that because the returns promised by ETS were at a fixed rate, they could not be classified as a participation in earnings, and therefore could not be considered profits for purposes of defining an "investment contract" under *Howey* and *Forman*. *See SEC v. ETS Payphones, Inc.,* 300 F.3d at 1284-85. As an alternative basis for its decision, the court also held that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *Id.* at 1285. The appellate court's decision conflicts with the precedents of this Court, three federal circuit courts, and numerous state courts. The appellate court's decision also conflicts with traditional statutory analysis, the policies underlying the securities laws, and the interpretations of the federal and state administrative agencies responsible for securities regulation.

A. The Appellate Court's Narrow Interpretation of Profits

1. Conflict with Federal and State Court Decisions

Under *Howey* and a venerable line of Supreme Court cases, courts are to interpret the definition of "investment contract" broadly and must seek to effectuate the remedial purpose of federal securities law, which is investor protection. *See Howey*, 328 U.S. at 299, 301; s*ee also Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The appellate court's decision conflicts with these fundamental principles. The court seized upon a restrictive interpretation of *Forman* and adopted a "limited meaning" of the word "profits." *See* 300 F.3d at 1284. The court furthermore dismissed an enforcement action against an illegal enterprise that defrauded thousands of investors, a result at odds with the remedial purpose of the federal securities laws.

The appellate court's decision also conflicts with this Court's specific formulations of the "profits" test. In *Howey,* the Court chose a variety of terms to describe an investor's expectations under an investment contract, including "income," "profit," and "financial returns." *See Howey,* 328 U.S. at 298, 300. All of these words encompass fixed as well as variable returns. The Court confirmed the broad meaning of these terms by relying on state cases involving investment contracts with fixed returns. *See People v. White*, 12 P.2d 1078, 1079, 1081 (Cal. Dist. Ct. App. 1932) (investment contract found where promoter offered a $7500 return on $5000 invested in enterprise trading trust deeds, bankrupt stocks, and foreclosure instruments); *Stevens v. Liberty Packing Corp.*, 161 A. 193, 194, 195 (N.J. Ch. 1932) (investment contract found where promoter offered $1 per offspring in breeding scheme involving sale and leaseback of rabbits). Removing any doubt on this issue, the Court in *Howey* declared: "It is immaterial whether the enterprise is speculative or non-speculative . . . . The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *See Howey*, 328 U.S. at 301.

The *Forman* case is not to the contrary. Once again, the Court's choice of words belies the appellate court's narrow interpretation. In *Forman,* the Court repeatedly used terminology that is consistent with fixed as well as variable returns: "income," "profits," and "financial returns." *See United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851-53 (1975). The Court's reference to "participation in earnings" was not an attempt to graft technical distinctions—such as fixed versus variable rates—onto investment contract analysis, but to differentiate the expectations of an investor from those of someone seeking to use or consume a commodity. *See Forman,* 421 U.S. at 852-53. The holding in *Forman* rested squarely on this point, not on notions of fixed or variable returns: "What distinguishes a security transaction—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use." *Id.* at 858. On this basis, the Court held that stock in a non-profit housing cooperative was not an investment contract. *Id.* at 853. By contrast, of course, investors in the ETS program were motivated by the lure of profits, not by a desire to acquire telephones.[7]

[7] Even if "participation in earnings" were the litmus test for investment contracts, the appellate court's decision would still be incorrect because receiving fixed returns does not preclude one from participating in earnings. To the extent ETS investors actually received fixed monthly yields from pay phone operations, they would have been *participating* in earnings because their returns would have been *paid* from earnings. The appellate court conceded as much: "Of course, the funds generated by the pay phones helped ETS meet its obligations." 300 F.3d at 1285.

The court's decision also conflicts with Supreme Court cases holding that the nature of an investment offering may be determined by the representations that promoters have used to sell it to the public. *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 352-53 (1943) (oil leases combined with test drilling services). Until the appellate court issued its decision in this case, the Eleventh Circuit followed this approach. *See SEC v. Unique Financial Concepts*, 196 F.3d 1195 (11th Cir. 1999) (sham investment in foreign currency options evaluated under *Howey* in terms of the promoter's representations). Respondent Edwards quite clearly used the lure of "profits" to sell his pay phone investments. *See* Ex. 14, at 1, 2; Ex. 15. at 5, 7, 8, 9; Ex. 17, at 4, 5, 8, 9, 10, 11; Ex. 22, at 1, 5.

The appellate court's interpretation of profits also conflicts with decisions issued in at least three other federal circuits. In *SEC v. Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), *cert. denied*, 532 U.S. 905 (2001), the promoters of an investment trust argued that shares in their program were not investment contracts because they featured a fixed rate of return rather than a rate dependent upon the success of the investments. The Third Circuit flatly rejected this defense, holding that "the definition of a security does not turn on whether the investor receives a variable or fixed rate of return." *Id.* at 189.

In *SEC v. SG Ltd.*, 265 F.3d 42 (1st Cir. 2001), the First Circuit had no difficulty finding an "expectation of profits" where a promoter of "virtual companies" on the internet "flatly guaranteed that investments in the shares of the privileged company would be profitable, yielding monthly returns of 10% . . . ." *Id.* at 54; s*ee also United States v. Carman,* 577 F.2d 556, 563 (9th Cir. 1978) (fixed interest guaranteed by federal government was nevertheless derived from efforts of others due to investors' passive role and continuing dependence upon promoter's sound management and solvency).

The appellate court's decision also conflicts with decisions issued by two state supreme courts.[8] In *Payable Accounting Corp. v. McKinley*, 667 P.2d 15 (Utah 1983), investors contributed cash and other assets to fund a payroll management business, for which the company promised to pay fixed monthly interest. *Id.* at 16-17. The Supreme Court of Utah held that the arrangement was an investment contract under *Howey* notwithstanding the fixed rate of return:

> The crucial factor is not whether the rate of return is fixed, but whether the "investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise". . . . That the investors receive a fixed rate of return does not make this scheme any less an investment contract. The money to pay off the investors is still generated by PAC, and the risk of loss still depends on PAC's managerial skills.

Id. at 19, 21 (quoting *LTV Fed. Credit Union v. UMIC Gov't Sec., Inc.*, 523 F. Supp. 819, 829 n.5 (N.D. Tex. 1981), *aff'd*, 704 F.2d 199 (5th Cir. 1983), *cert. denied*, 464 U.S. 852 (1983)).

---

[8] As a threshold matter, state court decisions are relevant in this case for two reasons. The term "investment contract" originated in state blue sky laws during the early 1900's, and it was interpreted extensively by state courts before Congress enacted the federal securities laws. *See Howey,* 328 U.S. at 298. For this reason, the Court in *Howey* expressly adopted state judicial interpretations of the term "investment contract" as a guide to its meaning under federal law. *Id.* Today, virtually every state securities law in the country includes a definition of the term "security" that closely parallels the federal definition and that specifically includes "investment contracts." Therefore, modern state court decisions, as well as the early state cases that helped establish the investment contract definition, continue to serve as a guide to the meaning of the term.

In *Suave v. K.C. Inc.*, 591 P.2d 1207 (Wash. 1979), the plaintiff invested in a retail appliance leasing business in return for 12% fixed interest payable monthly. *Id.* at 1208. The Supreme Court of Washington held that the arrangement was an investment contract under *Howey,* because even though the investor's profit may have been constant, she was still subject to the risk of loss of her entire investment if the management failed to keep the company profitable. *Id.* at 1210.

The appellate court's opinion conflicts with other state cases. Two of the state precedents that the Court relied upon in *Howey* for defining investment contracts involved fixed returns. *See People v. White*, 12 P.2d 1078; *Stevens v. Liberty Packing Corp.*, 161 A. 193, cited *supra.* More recently, trial courts in Colorado and Iowa have held that pay phone sale and leaseback investments, including the ETS contract and a similar version offered by Phoenix Telecom, were investment contracts. *See Joseph v. Geier*, No. 01 CV 1151, at 2 (Colo. D. Ct., Denver County, Jan. 30, 2003) (order on motions for summary judgment) (a fixed rate of return does not take an investment contract out of the definition of a security); *Iowa ex rel. Miller v. Pace*, Equity No. LA26445, at 17 (Iowa D. Ct., Warren County, Sept. 4, 2002), *appeal docketed*, No. 02-1726 (Iowa Oct. 28, 2002) (irrelevant that inducements leading an investor to risk his initial investment are founded on promises of fixed returns rather than a share of profits.)[9]

---

[9] Since 1939, a minority line of cases has emerged holding that payment of a fixed fee such as interest does not meet the profits test. *See* 12 Joseph C. Long, Blue Sky Law § 2.58 (2002) and cases cited therein. However, these decisions have been viewed as "defective" for two reasons. First, the distinction between dividends and interest is often arbitrary and subject to the control of the promoter. Second, the real focus of the *Howey* profits test is on the motivation of the investor, not the specific nature of the profits or losses of the enterprise. *Id.*

These conflicts between the Eleventh Circuit's decision and the decisions of this Court, the federal circuits, and the state courts provide a compelling basis, within the meaning of Rule 10, Sup. Ct. R. 10, for granting the Petition.

2. Other Considerations

A plain meaning analysis of the term "investment contract" provides further evidence that the appellate court's opinion is incorrect and should be reviewed by this Court. The words "investment contract" actually encompass, rather than exclude, fixed rate investments. The dictionary definition of the term "investment"—in 1934 as well as today—includes the core concept of investing money for "income or profit." *See Websters New International Dictionary* 1306 (1934); *Websters Third New International Dictionary* 1190 (1993). "Income," in turn, refers to a gain or recurrent benefit usually measured in terms of money, and it clearly encompasses regular and fixed payments, as well as variable amounts. *See Websters New International Dictionary, supra,* at 1258; *Websters Third New International Dictionary, supra,* at 1143. The appellate court's restrictive interpretation of the term "profits" is inconsistent with the plain meaning of the terminology chosen by Congress.

Legislative intent supports the point. This Court has repeatedly observed that Congress intended to define the term "security" broadly in order to eliminate serious abuses in the securities market. *See, e.g. Reves v. Ernst & Young,* 494 U.S. 56, 60 (1990); *United Hous. Found., Inc. v. Forman,* 421 U.S. 837, 847-48 (1975). Congress added the term "investment contract" as a catchall provision to ensure that the statute would cover not just the items specifically listed, such as stocks and bonds, but "virtually any instrument that might be sold as an investment." *See Reves,* 494 U.S. at 61; *SEC v. C. M. Joiner Leasing Corp.,* 320 U.S. 344, 351 (1943). Of course, many of the instruments enumerated in the definition of a security involve fixed returns, promises, and even guarantees. *See* 15 U.S.C. §§ 77b(a)(1), 78c(a)(10). As a catchall term, the reference to "investment contract" deserves an interpretation broad enough to include these traditional characteristics of securities, along with features outside the mainstream. *See C. M. Joiner Leasing,* 320 U.S. at 351 ("We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included in any of these definitions, as a matter of law, if on their face they answer to the name or description").

The appellate court's decision also conflicts with the interpretation of securities law that both federal and state securities regulators have applied for years. Under the principle of deference to administrative interpretation, "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *See Chevron, U.S.A, Inc. v. Natural Res. Def. Council*, 104 S. Ct. 2778, 2782 (1984). The SEC's position that investment contracts include fixed and guaranteed returns is reflected in the enforcement actions described above, *supra* at Part I.A, and in the authorities cited by the Solicitor General, *see* Petition at 23-26.

State securities regulators also have brought innumerable enforcement actions against ETS, their sales agents, and other companies offering similar sale and leaseback programs. *See* actions discussed *supra* at Part I.A. So far, state administrative law judges and commissions have rejected arguments that fixed or guaranteed returns put an investment beyond the reach of *Howey. See, e.g., Stigall v. Sec'y of State*, No. EN-18727, at 7-8 (Ga. Comm'r of Sec. Sept. 6, 2002); *Garvin v. Sec'y of State,* No. OSAH-SECSTATE-SECUR-0231234-33-PJ, at 1 (Ga. Off. of Admin. Hgs Aug. 28, 2002) (Order on Reconsideration) ("An offeror may not avoid registration of a security in Georgia merely by establishing a fixed rate of return on the investment"). *But cf. In re Rahaim*, No. E-2000-22, at 5 (Sec'y of the Commonw. of Mass., Sec. Div., July 11, 2000) (Memorandum and Order).[10] These interpretations of the securities laws by the regulatory authorities tasked with administering them support review of the appellate court's decision.

B. The Appellate Court's Unique Interpretation of the Efforts of Others

As an alternative basis for its decision, the appellate court ruled that because investors' returns were contractually guaranteed, those returns were not derived from the efforts of others. *See* 300 F.3d at 1285. This decision cannot be reconciled with decisions from the federal circuit courts or the policies underlying the securities laws.

1. Conflict With Federal Court Decisions

Decisions from other federal circuits have established that the appropriate focus of the third *Howey* element is not on whether returns are contractually guaranteed, but on "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *See, e.g., SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).

Prior to this case, the Eleventh Circuit followed this approach. In *Albanese v. Florida National Bank of Orlando*, 823 F.2d 408 (11th Cir. 1987), a case involving an ice machine sale and leaseback scheme, the court found that the promoters retained managerial control over the ice machines and on this basis held that the "efforts of others" test was

---

[10] The *Rahaim* decision held that the ETS pay phone contract was not an investment contract, on commonality grounds. The case did not rest on the "profits" or "efforts of others" elements of *Howey*. *See Rahaim,* at 4, 9.

satisfied. *Id.* at 410-412. With respect to the third prong of *Howey,* the court stated that "Under the precedent of this circuit, the crucial inquiry is the amount of control that the investors retain under their written agreements." *Id.* at 410.

The appellate court's decision also conflicts directly with the Ninth Circuit's decision in *United States v. Carman,* 577 F.2d 556, 563 (9th Cir. 1978). There the defendants sold fixed rate, federally guaranteed packages of student loans, along with service contracts. *Id.* at 560, 563-64. Against charges of securities fraud, the defendants argued that their offerings were not securities because returns were in the form of guaranteed fixed interest, which did not depend upon the promoters' efforts. *Id.* at 563. The Ninth Circuit rejected this argument, observing that the investors had a passive role and were in fact dependent upon the "sound management and continued solvency" of the promoter to maintain the guarantee in place and absorb potential refund liability under the notes. *Id.* Similarly in this case, ETS investors were passive, and they relied upon ETS's continuing efforts to manage the pay phones—or entice additional investors—to provide the returns.

2. Other Considerations

The rationale underlying these cases is clear. The securities laws were intended to provide investors with certain safeguards because they put their funds at risk. The economic reality is that promises and guarantees of returns—even from a legitimate business enterprise—do not eliminate investor risk. Promises can be broken and companies can go bankrupt, as ETS did in this case. Very often, in fact, assurances of guaranteed returns are part of a promoter's sales pitch, not a genuine risk-reducing feature of the investment. Accordingly, investors need the protections of the securities laws whether or not their investments are nominally "guaranteed" or promised to them as the benefit of their bargain, just as they require those same protections whether or not their returns are fixed. *Cf. Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (in the analysis of investment contracts, "form is to be disregarded over substance" and the emphasis should be on "economic reality").

CONCLUSION

For the reasons set forth above, the SEC's petition for a writ of certiorari should be granted.

Respectfully submitted,

MARK J. DAVIS *
Associate Counsel
ROYCE O. GRIFFIN
General Counsel
JOHN R. VEATOR
Deputy General Counsel
STEPHEN W. HALL
Associate Counsel
NORTH AMERICAN SECURITIES
ADMINISTRATORS ASSOCIATION, INC.
10 G Street, N.E., Suite 710
Washington, D.C. 20002
(202) 737-0900

* Counsel of Record

March 17, 2003