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## Racing Syndicates as Securities

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# Racing Syndicates as Securities\*

BY RUTHEFORD B CAMPBELL, JR.\*\*

## INTRODUCTION

It is not difficult to understand why horses like Devil's Bag, Chief's Crown and Spend A Buck are syndicated during their racing careers. The owners of such horses find themselves with an asset worth millions of dollars, but the asset has the potential to decrease significantly in value if the racing fortunes of the horse change. That creates pressure for owners to disinvest, at least partially, and spread the risk of loss. Investors, on the other hand, are often just as anxious to invest. Not only is there the chance of earnings and appreciation if the horse continues to win, but perhaps more importantly, the syndicate may provide a once-in-a-lifetime chance to own a Kentucky Derby winner or even a Triple Crown winner.

These same fundamental pressures are present in less expensive racing syndicates. Owners of less expensive horses also want to spread risk; investors similarly want to share in earnings, appreciation and excitement of owning a successful racehorse.

Whatever the horse's value, the formation of racing syndicates invariably involves significant and complicated issues under federal securities laws. This Article addresses these problems, shares certain observations and criticisms on these matters and provides advice on how to structure racing syndicates in ways that minimize the burden of federal securities laws.

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\* This Article should be considered in connection with the author's previous piece, Campbell, *Stallion Syndicates as Securities*, 70 Ky. L.J. 1131 (1981-82). Each article provides analyses and information relevant to the other.

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## I. TERMS OF RACING SYNDICATES

Racing syndicates are basically similar to breeding syndicates.<sup>1</sup> Each involves the joint ownership of a horse pursuant to a contract, the syndicate agreement, that governs the rights and obligations of the joint owners ("co-owners"). The co-owners of the interests in a racing syndicate ("fractional interests"), however, are not, at least initially, concerned about breeding the horse. Instead, the purpose of a racing syndicate is to race the animal, and that necessarily requires terms different from breeding syndicates.

In a racing syndicate, therefore, provisions must be made for handling the expenses and income generated by racing the horse. Typically, the expenses are divided equally among the co-owners according to their ownership interest in the horse. Although provisions may vary, the winnings are also usually shared equally by the co-owners, perhaps after deducting each owner's share of the unpaid syndicate expenses.<sup>2</sup>

In addition, arrangements must be made regarding the control and supervision of the horse's racing career. For practical reasons, it is difficult to involve all of the co-owners in the day-to-day decisions of a racing career. Decisions concerning jockeys, racing schedules and veterinary care, for examples, must be made expeditiously and, as a result, the syndicate agreement usually

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<sup>1</sup> For a discussion of breeding syndicates, see Campbell, *Stallion Syndicates as Securities*, 70 Ky. L.J. 1131 (1981-82).

<sup>2</sup> The following language appeared in one major racing syndicate:

From and after the date of this Agreement, the Co-owners shall share the expenses and earnings of the Colt in proportion to their ownership interests. Such expenses shall include all costs and expenses incurred in connection with the care, training and racing of the Colt including, but not limited to, boarding, training, veterinary, and racing fees and expenses, the cost of liability insurance hereinafter provided for, and for any other fees and expenses actually and reasonably incurred by the Owners in actively training and racing the Colt. To the extent earnings are available to offset expenses, they shall be so used. The Owners shall account to the Co-owners on at least an annual basis for all items of income and expense. The Owners shall bill each Co-owner for his share of expenses on such basis as the Owners may deem appropriate, but not more frequently than monthly. The expenses so billed shall be payable by each Co-owner within ten (10) days of the date of billing. All racing trophies or other objects of value (except monies received) awarded on account of the performances of the Colt shall be the sole and absolute and permanent property of [the Owners].

delegates responsibility for the care of the horse and the supervision of the racing career to the syndicate manager or to some other person or small group. The delegation is typically broad, usually giving the syndicate manager essentially unfettered control over the racing career of the horse.<sup>3</sup>

Even though racing is the most immediate purpose for the formation of a racing syndicate, the major value component of many syndicated animals is derived from the animal's breeding potential. As a result, racing syndicates often include all of the terms of a breeding syndicate. Such provisions, which become

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<sup>3</sup> The following language from two racing syndicates concerns the allocation of responsibilities to the syndicate manager:

[1] [The Colt] is now in active training and racing under the management and supervision of [X]. The Colt shall continue in active training and racing under the principal supervision and control of [X] . . . , which supervision and control shall be with the advice and consent of [Y]. In the event any conflict should arise in said supervision and control, [X] shall have final and ultimate decision-making authority.

\* \* \*

[2] The owner designates the Syndicate Manager to have the sole and exclusive possession of the Colt and the sole and exclusive discretionary right, power and authority, subject to the further provisions of this paragraph, to manage and supervise the boarding, training, development and racing of the Colt, including, but not limited to: (a) selection of where the Colt shall be boarded, trained and raced, and under whose direct supervision such activities will occur; (b) selection of the trainer of the Colt and determination of the conditions, including compensation, under which the Colt shall be trained; (c) selection of the races to which the Colt will be nominated and the races in which he shall actually start; (d) selection, employment and compensation of jockeys, farriers, veterinarians and other like support personnel; (e) determination of when and under what conditions the Colt shall be retired from racing . . . ; (f) the selection of accountants and attorneys and their compensation; (g) the procurement of a policy of public liability insurance in the amount of not less than [\$X] . . . insuring the Co-owners, the Syndicate Manager, and the agents, servants, employees of the Syndicate Manager against loss or liability to any person whomsoever by reason of the negligence of any of the said persons in the boarding, training, racing, and other use of the Colt (provided that the Syndicate Manager shall be obligated to procure such insurance); and (h) in general, the Colt's racing career. *Notwithstanding the above provisions*, the Syndicate Manager shall consult with Owner from time to time with respect to decisions affecting the Colt's racing career, and it is agreed that [A] shall be the trainer of the Colt and that he shall select the races to which the Colt will be nominated and the races in which he shall actually start, unless Owner and Syndicate Manager unanimously determine otherwise.

effective upon the horse's retirement from the track, permit a smooth transition from racing to breeding and minimize the chances of surprises for the co-owners.

There are, of course, other matters that must be treated in a racing syndicate agreement or related documents. Examples include provisions regarding the sales price and terms of payment for the fractional interest, insurance and warranties and representations of health and fertility. The scope of this Article, however, does not necessitate any detailed consideration of these latter provisions.

## II. THE CASES AND THE COMMISSION

### A. *The Cases*

When structuring a racing syndicate, one must consider whether interests in such a syndicate constitute securities under federal law. In *SEC v. W.J. Howey Co.*,<sup>4</sup> the most important case in that regard, the United States Supreme Court laid down its now classic four-part test<sup>5</sup> for a security, stating that a security involves (1) an investment (2) in a common enterprise (3) with an expectation of profits (4) derived solely from the efforts of the promoter or some third party.<sup>6</sup>

*SEC v. Koscot Interplanetary, Inc.*<sup>7</sup> is representative of a series of cases<sup>8</sup> involving an important theoretical development in the *Howey* test. In *Koscot*, the court concluded that the

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<sup>4</sup> 328 U.S. 293 (1946).

<sup>5</sup> Commentators and courts sometimes separate the *Howey* test into only three elements. See, e.g., FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 900 (1979-80); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 477 (5th Cir. 1974). A recent case in the Eastern District of Kentucky, *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp 6 (E.D. Ky. 1985), recognized that there are four elements to the *Howey* test. *Id.* at 8.

<sup>6</sup> 328 U.S. at 298-99.

<sup>7</sup> 497 F.2d 473 (5th Cir. 1974).

<sup>8</sup> Other cases using the same standard as *Koscot* include: *Union Planters Nat'l Banks v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1181 (6th Cir.), *cert. denied* 454 U.S. 1124 (1981); *Noa v. Key Futures, Inc.*, 638 F.2d 77, 79 (9th Cir. 1980); *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 193, *modified on other grounds*, 611 F.2d 105 (5th Cir. 1980); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976); *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973); *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

language in *Howey*'s fourth element, which requires that the investor rely "solely" on the efforts of the promoter or third party, should not be read literally. Instead, the court held that the requirement would be met if the efforts of the promoter or third party were "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."<sup>9</sup>

Although a number of earlier cases are relevant to the determination of whether interests in a racing syndicate are securities,<sup>10</sup> *Howey* and *Koscot* generally provide the basis for any analysis.<sup>11</sup> There is, however, a recent district court case, *Kefalas v. Bonnie Brae Farms, Inc.*,<sup>12</sup> that deserves mention, because it is the first time that a federal court directly faced the question of whether a horse syndicate involves a security under federal law.<sup>13</sup>

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<sup>9</sup> 497 F.2d at 483 (quoting 474 F.2d at 482).

<sup>10</sup> For a discussion of these cases, see Campbell, *supra* note 1, at 1135-46.

<sup>11</sup> In a recent decision, *Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297 (1985), the United States Supreme Court rejected the sale of business doctrine and thus held that the federal securities laws apply to the sale of 100% of a closely held corporation's stock. *Id.* at 2306-08. In its opinion, the Court attempted to limit, preserve and explain the applicability of the *Howey* analysis, which the Court had thoroughly confused in its prior decision, *Marine Bank v. Weaver*, 455 U.S. 551 (1982). In *Landreth Timber*, the Court indicated that the *Howey* analysis should be used in instances involving "unusual instruments not easily characterized as 'securities.'" 105 S. Ct. at 2304. It seems clear, then, that *Howey* is the analysis that generally should be applied to racing syndicates.

The same day the Supreme Court decided *Landreth Timber*, it also handed down its decision in *Gould v. Rufenacht*, 105 S. Ct. 2308, 2310-11 (1985), also rejecting the sale of business doctrine.

Prior to *Landreth Timber*, there was a split among the circuits regarding the sale of business doctrine. Compare *Sutter v. Groen*, 687 F.2d 197 (7th Cir. 1982) (reaffirming the position of the Seventh Circuit that the sale of a business does not constitute the sale of a security) with *Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983) and *Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982) (both cases rejecting the sale of business doctrine). For articles discussing the sale of business doctrine prior to *Landreth Timber*, see Easley, *Recent Developments in the Sale of Business Doctrine: Toward a Transactional Context-Based Analysis for Federal Securities Jurisdiction*, 39 BUS. LAW. 929 (1983-84); Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine Under the Federal Securities Laws*, 37 BUS. LAW. 637 (1981-82); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Security Transaction*, 57 N.Y.U.L. REV. 225 (1982); Thomas, *A New Look at 10b-5: The Sale of Business Doctrine*, 33 SYRACUSE L. REV. 999 (1982).

<sup>12</sup> 630 F. Supp. 6 (E.D. Ky. 1985).

<sup>13</sup> There have been state decisions, however, on the question of whether interests

The plaintiffs in *Kefalas* purchased fractional interests in three thoroughbred stallions syndicated pursuant to breeding syndicate agreements containing fairly standard terms. Specifically, each co-owner was entitled to one breeding right ("nomination") to the stallion each year. The nominations could, in the discretion of the co-owner, either be sold or utilized in the co-owner's own breeding program. As is typical in such syndicates, the co-owners agreed to share pro rata the expenses associated with each stallion.<sup>14</sup>

The *Kefalas* court granted the defendants' motion for summary judgment, concluding that two elements of the *Howey* test were not met and that, accordingly, the fractional interests did not constitute securities under federal and state laws. The court found that the *Howey* "common enterprise" (or, as the court called it, "common venture") requirement was not satisfied, because there was no "horizontal commonality" among the co-owners.<sup>15</sup> That test, according to the court, requires that "the fortunes of the individual investor . . . [be] tied to the success of the venture as a whole."<sup>16</sup> Although the court found that an increase in the stallion's reputation would benefit all co-owners, the court concluded that the co-owners' greatest expectation of profit came from "the value of the offspring—a value dependent in large part on the quality of the mare, the work of the trainer, and the fortunes of the foal's racing season."<sup>17</sup> These were factors that the court considered to be independent of the "success of the venture as a whole." The court ended its analysis metaphorically, stating that "[a] rising tide, in this case an

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in horses are securities under state blue sky laws. See *Brown v. Rairigh*, 363 So. 2d 590 (Fla. 1978) (not a security because no common enterprise if only one investor); *Marshall v. Harris*, 555 P.2d 756 (Or. 1976) (interest in race horses and their earnings constitute a security because it is an investment contract under *Howey*).

<sup>14</sup> See 630 F. Supp. at 7.

<sup>15</sup> *Id.* at 8. The Sixth Circuit has required horizontal commonality. See *Curran v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 622 F.2d 216, 221-24 (6th Cir. 1980), *aff'd*, 456 U.S. 353 (1982); *Union Planters Nat'l Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1183 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981).

<sup>16</sup> 630 F. Supp. at 8 (citing 651 F.2d 1174).

<sup>17</sup> *Id.*



increase in the value of the nomination, will not lift all boats to the same height.”<sup>18</sup>

The court also found that the efforts of the promoters and syndicate managers were not sufficiently significant to meet the fourth element of the *Howey* test. Although the bare terms of the syndicate agreement clearly support such a conclusion, there were allegations that the plaintiffs “owned no mare of their own and expected the defendants to sell their nominations”<sup>19</sup> and that the defendants represented to the plaintiffs that they (i.e., the defendants) “would sell the plaintiffs’ nominations to other breeders.”<sup>20</sup> These allegations, however, were not sufficient to defeat the defendants’ motion for summary judgment. In that regard, the court relied heavily on the syndicate agreement, which the court described as providing:

that the syndicate manager would do no more than furnish a list of breeders who had inquired as to the availability of nominations. Selling these nominations would be the job of the owner, and any profits derived would necessarily depend on the skills and efforts of the owners rather than those of the syndicate manager.<sup>21</sup>

Although *Kefalas* represents no major conceptual development in the definition of a security, it is a significant application of traditional *Howey* concepts, especially in light of the procedural setting of the case. The court’s willingness to grant a defendant’s motion for summary judgment, even in the face of plaintiffs’ allegations concerning the syndicate manager’s additional undertakings, indicates that one may be able to assign the syndicate manager duties and responsibilities beyond those presently sanctioned by the no-action letters of the Securities and Exchange Commission (“Commission”).<sup>22</sup> More specifically, the case reflects at least one court’s opinion that promises by a syndicate manager to sell nominations on behalf of the co-

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<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 7.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 8 (citations omitted).

<sup>22</sup> For a discussion of the Commission’s position, see the text accompanying notes 23-38, *infra*.

owners will not necessarily create a security. All of this should provide some comfort to persons who wish to expand the traditional responsibilities of the syndicate manager.

### *B. The Commission*

The Commission continues to take a hard line on the definition of a security,<sup>23</sup> especially when applying that definition to

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<sup>23</sup> The Commission has issued more than 60 no-action letters dealing with the question of whether interests in horses are securities. Interco Syndicate, SEC No-Action Letter (available Aug. 8, 1985); Top Ten Syndicate, SEC No-Action Letter (available July 29, 1985); Cals Neat Star Syndicate, SEC No-Action Letter (available July 17, 1985); Rhaladdinn Syndication, SEC No-Action Letter (available Mar. 28, 1985); Turn of the Moon Syndication, SEC No-Action Letter (available Mar. 28, 1985); Threat's Supreme A and Super Stock Syndication, SEC No-Action Letter (available Feb. 11, 1985); IBN Shamus Syndication, SEC No-Action Letter (available Jan. 9, 1985); Silver Ring Syndication, SEC No-Action Letter (available Jan. 28, 1985); Syndication of Daniri, SEC No-Action Letter (available Nov. 26, 1984); \*ETIW Syndication, SEC No-Action Letter (available Nov. 2, 1984); Bay Hilal Syndication, SEC No-Action Letter (available Oct. 15, 1984) (SEC refused to take no-action position because stallion could be sold and profits shared among investors); Bakkarat Syndication Agreement, SEC No-Action Letter (available Jan. 9, 1984); El Jefe Gitano Syndicate, SEC No-Action Letter (available Mar. 26, 1984); Arn-Ett Perlanet Syndication, SEC No-Action Letter (available Oct. 27, 1983); Elkanada Syndicate, SEC No-Action Letter (available Oct. 8, 1983); Baske-To Syndicate, SEC No-Action Letter (available Sept. 30, 1983); Gai Robert Syndication, SEC No-Action Letter (available Aug. 7, 1983); El Rim Syndication, SEC No-Action Letter (available June 10, 1983); Jack's Doc Frost Syndication, SEC No-Action Letter (available June 6, 1983); Especial Effects Syndication, SEC No-Action Letter (available May 20, 1983) (SEC refused to issue no-action letter); El Repaso Syndicate, SEC No-Action Letter (available May 6, 1983); Bay Dubonnet Syndicate, SEC No-Action Letter (available Sept. 30, 1983) (no action after amendments, confirmed original no-action letter of Apr. 29, 1983); Shorty Lena Syndicate Agreement, SEC No-Action Letter (available Mar. 24, 1983); GDANSK Syndication, SEC No-Action Letter (available Mar. 4, 1983); Huckleberry Bey Syndicate Agreement, SEC No-Action Letter (available Jan. 1, 1983); Forbis, Donald L. and Judith E., and Zichy-Thysson Investment Corp., SEC No-Action Letter (available Dec. 30, 1982); Red Dee Hobby Venture, SEC No-Action Letter (available Nov. 29, 1982); Majestic Arabians, Inc., SEC No-Action Letter (available Oct. 13, 1982); Dave Parker Quarterhorses, SEC No-Action Letter (available July 8, 1982); Gin & Peppy Horse Syndication, SEC No-Action Letter (available June 25, 1982); Eskimos Stallion Syndication, SEC No-Action Letter (available Apr. 15, 1982); Secret Passage Syndication Agreement, SEC No-Action Letter (available Feb. 22, 1982); Himito Dancer Syndicate Agreement, SEC No-Action Letter (available Feb. 5, 1982); Dale Ross Lloyd & Lake, SEC No-Action Letter (available Dec. 14, 1981); Blaze Drift Syndicate, SEC No-Action Letter (available Oct. 29, 1981); B.F. Phillips, Jr., SEC No-Action Letter (available Oct. 21, 1981); Markegard, Roy L., SEC No-Action Letter (available June 11, 1981); New Frontier Investments, Inc., SEC No-Action Letter (available June 4, 1981); Owens, Marjorie, SEC No-Action Letter (avail-

horse syndications.<sup>24</sup> For example, there is no indication that the Commission has backed off its reflexive aversion to all syndicates containing provisions for income pooling.<sup>25</sup> As a result, the staff

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able Feb. 27, 1981); Carrico, Norman T. and Paula, SEC No-Action Letter (available Dec. 12, 1980); Winger, Richard, SEC No-Action Letter (available Nov. 21, 1980); Roosevelt, Franklin D., Jr., SEC No-Action Letter (available Oct. 8, 1980); Ariston Syndication Agreement, SEC No-Action Letter (available June 23, 1980); Downing, Cathy and Marianne, SEC No-Action Letter (available June 23, 1980); Ostrer Brothers, SEC No-Action Letter (available June 23, 1980); Murphy, Gregory J., SEC No-Action Letter (available May 5, 1980); Khemosabi Syndication, SEC No-Action Letter (available Feb. 19, 1980); J.E. Garrett, SEC No-Action Letter (available Sept. 20, 1979); Darrell Keener, SEC No-Action Letter (available Apr. 23, 1979); B.F. Phillips, Jr., SEC No-Action Letter (available Apr. 9, 1979); Reese Evans Howard, SEC No-Action Letter (available Feb. 23, 1979); Schenck, Ralph E., Jr. and Diana, SEC No-Action Letter (available Nov. 20, 1978); Stallions Unlimited, Inc., SEC No-Action Letter (available Nov. 13, 1978); Kennaugh, Robert Q., SEC No-Action Letter (available Oct. 12, 1978); Rheusdasile, Jerry, SEC No-Action Letter (available Oct. 11, 1978); B.F. Phillips, Jr., SEC No-Action Letter (available Sept. 21, 1978); B.F. Phillips, Jr., SEC No-Action Letter (available Mar. 23, 1978); B.F. Phillips, Jr., SEC No-Action Letter (available Feb. 16, 1978); Crumpler, Paul, SEC No-Action Letter (available Nov. 3, 1977); John R. Gaines, SEC No-Action Letter (available Aug. 18, 1977); Pink Lady Farms, SEC No-Action Letter (available July 18, 1977); J.D.A. Farms, Inc., SEC No-Action Letter (available Dec. 29, 1976).

<sup>24</sup> There is one area, however, in which the Commission may have softened its position. In my previous article, I reported the Commission's unwillingness to issue a no-action letter if the syndicate manager agreed to sell unused nominations on behalf of individual syndicate members. See Campbell, *supra* note 1, at 1151-54. Since that article, the SEC has issued no-action letters in situations in which the syndicate manager (or some other related party) agreed to "assist" the members in selling nominations. Rhal-addinn Syndication, SEC No-Action Letter (available Mar. 28, 1985); Turn of the Moon Syndication, SEC No-Action Letter (available Mar. 28, 1985); GDANSK Syndication, SEC No-Action Letter (available Mar. 4, 1985). It appears, however, that this activity must be quite limited to satisfy the staff. For example, in El Repaso Syndicate, SEC No-Action Letter (available May 6, 1983), the original request letter indicated that one of the original owners "will agree to act as agent for owners wishing to sell unused breedings." Letter from Robert R. Estes to Norman Schou, Securities and Exchange Commission (Dec. 7, 1982) (requesting no-action letter) (letter appended to El Repaso Syndicate, SEC No-Action Letter (available May 6, 1983)). In a subsequent communication with the staff, however, the attorney stated that the original owner "will not be involved in any selling activities of promotional efforts on behalf of the owners of the shares." Letter from Robert R. Estes to Ms. Charlene Bell, Securities and Exchange Commission (Mar. 7, 1983) (letter appended to El Repaso Syndicate, SEC No-Action letter (available May 6, 1983)). Obviously this change was pursuant to negotiations with the staff.

<sup>25</sup> Requests for no-action letters continue to recite the absence of pooling. See, e.g., GDANSK Syndication, SEC No-Action Letter (available Mar. 4, 1983). In Top Ten Syndicate, SEC No-Action Letter (available July 29, 1985), the staff specifically made inquiries regarding pooling. See Letter from Robert W. Hedquist to Don Bobbitt,

will not issue a no-action letter regarding a breeding syndicate if, for example, the syndicate agreement provides for the sale of seasons and the pro rata distribution to co-owners of the sale proceeds.<sup>26</sup>

This is of obvious importance to racing syndicates, in which winnings are normally pooled and distributed pro rata to the co-owners. It seems, therefore, that for this reason alone the Commission will refuse to assume a no-action posture toward a racing syndicate.

The staff also apparently has concluded that any syndicate agreement containing provisions for a futurity fund involves a security.<sup>27</sup> Futurity funds, most prevalent in show horse breeding syndicates, are funded by required annual contributions from the co-owners. The fund then supplements the awards made to progeny of the syndicated stallion in the event that the progeny win certain designated events.

The conclusion that futurity funds cause syndicates to involve securities is, in this writer's view, inconsistent with the United States Supreme Court's decision in *International Brotherhood of Teamsters v. Daniel*.<sup>28</sup> There the Court held that participation in a compulsory, non-contributory pension plan did not involve the purchase of a security. One reason for this conclusion was that the participant's expectation of payment from the plan did not depend sufficiently on the fund managers' efforts. Although the Court conceded that benefits to participants depended "to some extent on earnings from [the fund's] assets"<sup>29</sup> (actually, the fund managers' investments had generated seventeen percent

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Securities and Exchange Commission (June 11, 1985) (letter appended to Top Ten Syndicate, SEC No-Action Letter (available July 29, 1985)).

<sup>26</sup> See Campbell, *supra* note 1, at 1154-58. The staff has, however, issued no-action letters when the syndicate agreement provides for the sale of one nomination to generate the cash necessary to pay for Breeders Cup fees (i.e., to pay the fees necessary for the stallion's participation in the Breeders Cup program). Syndication of Daniri, SEC No-Action Letter (available Nov. 26, 1984).

<sup>27</sup> Letter from Myra R. Harris to Securities and Exchange Commission (June 2, 1983) (letter appended to Gai Robert Syndicate, SEC No-Action Letter (available Aug. 7, 1983)); El Jefe Gitano Syndicate, SEC No-Action Letter (available Dec. 12, 1983) (original syndication agreement provided for futurity trust, which was eliminated after SEC refused to issue no-action letter).

<sup>28</sup> 439 U.S. 551 (1979).

<sup>29</sup> *Id.* at 561-62.

or \$31 million of the fund), the Court found that "a far larger portion of . . . [the benefits for the plan participants] comes from employer contributions, a source in no way dependent on the efforts of the Fund's managers."<sup>30</sup> The Court bolstered its conclusion that the fourth element of the *Howey* test was missing by finding that any "profit would depend primarily on the employee's efforts to meet the vesting requirements, rather than the fund's investment success."<sup>31</sup>

This appears analogous to the futurity funds, in which the co-owner's expectation of profits depends principally on a fund generated by contributions from other co-owners (as opposed to income from the fund itself) and on the co-owner's ability to breed, raise and show a champion horse. Because these factors are entirely outside the syndicate manager's control, it is improper to conclude that the efforts of the syndicate manager or the futurity fund manager are the undeniably significant ones. As a result, the fourth element of *Howey* is not satisfied.

It is interesting to note that securities administrators in at least two states have concluded that futurity funds do not cause syndicate shares to fall into the definition of a security. Texas reached that decision in what appears to be a traditional breeding syndicate.<sup>32</sup> The Kentucky Division of Securities reached a similar conclusion in a less traditional setting.<sup>33</sup>

The Commission also refuses to take a no-action position with regard to any syndicate agreement containing a sales clause.<sup>34</sup> These provisions, which may occur in either breeding or racing syndicate agreements, authorize the sale of the syndicated animal upon the vote of a certain percentage of the co-owners.

Although it is difficult to understand the Commission's reasoning on this matter, it apparently is based on the idea that the syndicate manager may arrange a sale of the horse and thereby

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<sup>30</sup> *Id.* at 562.

<sup>31</sup> *Id.*

<sup>32</sup> 3 BLUE SKY L. REP. (CCH) ¶ 55,802 (Dec. 9, 1982).

<sup>33</sup> Select Seven Syndicate, No-Action Letter from Kentucky Department of Banking and Securities, 2 BLUE SKY L. REP. (CCH) ¶ 27,561 (Oct. 20, 1982).

<sup>34</sup> Threat's Supreme A and Super Stock Syndication, SEC No-Action Letter (available Feb. 11, 1985); Syndication of Daniri, SEC No-Action Letter (available Nov. 26, 1984); Bay Hilal Syndication, SEC No-Action Letter (available Oct. 15, 1984); El Jefe Gitano Syndicate, SEC No-Action Letter (available Dec. 23, 1983).

raise the significance of his role sufficiently to meet the fourth element of the *Howey* test.<sup>35</sup> This position, however, not only reflects a complete misunderstanding of the realities of syndicates, but also is inconsistent with the very essence of the *Howey* test.

Sales provisions, especially in breeding syndicates, are rarely used to sell the horse and are, therefore, generally insignificant to the syndicates.<sup>36</sup> More importantly, the Commission's position is actually antithetical to the *Howey* doctrine. The whole purpose of the *Howey* standard is to include in the definition of a security arrangements in which investors are primarily passive, dependent upon someone else for their expected profit. A corollary is that an investor controlling his own destiny and making his own managerial decisions does not need the protection of the securities acts.<sup>37</sup> Sales provisions permit sale upon vote of the co-owners and do not delegate that decision to the syndicate manager. The provisions, therefore, actually increase the co-owners' control by involving them in the decision to sell and should reduce the possibility that such syndicates involve securities.

The Commission, however, seems intent on clinging to its position on sales clauses. Recently, this writer sought a no-action letter regarding a syndicate with a sales clause. In the request letter and in telephone conversations with the staff, arguments were made that the sales provision should not cause the syndicate to constitute a security. Although one staff member was sympathetic, the Commission refused to budge from its position, indicating that it felt bound by *stare decisis*.<sup>38</sup>

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<sup>35</sup> In one response the staff stated that "there appears to be a potential investment aspect involved by virtue of the fact that the stallion may be sold and the profits divided under certain circumstances." El Jefe Gitano Syndicate, SEC No-Action Letter (available Dec. 23, 1983).

<sup>36</sup> Recently this writer was involved in the amendment of a major breeding syndicate to remove a sales provision from the syndicate agreement. This was done to obtain a no-action letter from the Commission regarding the resales of the fractional interests. The amendment was effected easily, and it was apparent that the syndicate members either were not aware of the provision or considered it completely unimportant.

<sup>37</sup> Of course, courts recognize that allocation of control to investors lessens the need for the protection of the securities acts. *See, e.g., Williamson v. Tucker*, 645 F.2d 404, 423-24 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 915 (8th Cir. 1976).

<sup>38</sup> For a description of other positions taken by the Commission regarding horse syndications, see Campbell, *supra* note 1, 1146-58.

### III. SHARES IN RACING SYNDICATES AS SECURITIES

#### A. Generally

The Commission's positions regarding pooling,<sup>39</sup> futurity funds<sup>40</sup> and sales clauses<sup>41</sup> indicate that any variation from the traditional breeding syndicate is unlikely to pass muster with the staff. As a result, it seems certain that the Commission will conclude that an interest in a racing syndicate is a security, if the syndicate manager is delegated the breadth of responsibility described in Section I of this Article (these racing syndicates in which broad management power is delegated to the syndicate manager are hereinafter referred to as "broad delegation racing syndicates").<sup>42</sup>

The more difficult and interesting question, however, is whether existing case law justifies such a conclusion. Although it is obviously difficult to generalize, there are arguments against including a broad delegation racing syndicate in the definition of a security, especially if the broad delegation racing syndicate is the prelude to a stallion breeding syndicate.

*Howey* provides the primary analysis here, and the critical component of the *Howey* test is the fourth element.<sup>43</sup> That element, as explained in *Koscot*, requires that the investor's expectation of profits depend on the efforts of the promoter or third party (in this case, the syndicate manager) and that those efforts be the "undeniably significant ones, those essential managerial efforts which affect the failure or success of the enter-

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<sup>39</sup> See note 19 *supra*.

<sup>40</sup> See note 27 *supra*.

<sup>41</sup> See note 34 *supra*.

<sup>42</sup> It is interesting that no one has ever requested a no-action letter from the Commission for a traditional racing syndicate of the type described in section one of this Article. There was one request, however, in a situation in which the syndicate was structured like a general partnership. See Especial Effects Syndication, SEC No-Action Letter (available May 20, 1983). There were also requests in which the racing syndicates were preludes to a stallion breeding syndicate, with all expenses and prizes of racing paid by and to the original owner. See, e.g., Cals Neat Star Syndicate, SEC No-Action Letter (available July 17, 1985).

<sup>43</sup> But see *Kefalas v. Bonnie Brae Farms, Inc.*, 630 F. Supp 6 (E.D. Ky. 1985) (finding no common enterprise in a breeding syndicate).

prise."<sup>44</sup> It is not clear that the syndicate manager's function in a broad delegation racing syndicate always reaches that level of importance.

There are normally three bases for an investor's expectation of profits. First, profits may be derived from the efforts of the promoter (or syndicate manager, in the case of a racing syndicate); second, profits may be derived from the investor's own efforts or activities; and, finally, profits may come from other sources or forces, such as inflation or appreciation in the value of property.<sup>45</sup> An investor's expectation of profits from a racing syndicate may well depend on all three of these sources, and as a result, it may be difficult to conclude that the syndicate manager's efforts are sufficiently significant to meet the *Koscot* standard.<sup>46</sup>

Undoubtedly, a co-owner's expectation of profits from a broad delegation racing syndicate depends to some extent on the syndicate manager's efforts. The syndicate manager, it is assumed, exercises control over the horse's racing career, and a successful racing career can generate profits for the co-owners in the form of purses and can increase the value of the horse as a breeding animal.

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<sup>44</sup> SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974) (quoting Securities & Exchange Commission v. Glenn W. Turner Ent., Inc., 474 F.2d 476, 482 (9th Cir. 1973)).

<sup>45</sup> There is authority indicating that an expectation of profits solely from appreciation in the value of assets is not sufficient to qualify the investment as a security. See *Gordon v. Terry*, 684 F.2d 736, 740 n.4 (11th Cir. 1982), cert. denied, 459 U.S. 1203 (1983) (limited partnership interest not a security because investor had equal vote in partnership decision to sell property and investor was not dependent on entrepreneurial abilities of others); *McConnell v. Frank Howard Allen & Co.*, 574 F. Supp. 781, 784-85 (N.D. Calif. 1983) (investor's claim that interest in apartment complex was a security was neither insubstantial nor frivolous).

<sup>46</sup> This is the analysis that was used by the Supreme Court in *International Bhd. of Teamsters v. Daniels*, 439 U.S. 551 (1979). There the Court found that a pension fund participant's expectation of payments depended on the income generated by the fund manager, contributions by the employer and the participant's ability to meet the vesting requirements of the plan. After evaluating these three factors, however, the Court concluded that the fourth element of the *Howey* test was not met, since "a far larger portion of . . . [the participant's benefits] comes from employer contributions, a source in no way dependent on the efforts of the Fund's manager . . . [and] profit would depend primarily on the employee's efforts to meet the vesting requirements, rather than the Fund's investment success." *Id.* at 561-62.



Recognizing this still does not resolve the question of whether the efforts of the syndicate manager are the "undeniably significant" ones, because the other two sources of profits, as described above, can also be significant in broad delegation racing syndicates. For example, if a racing syndicate is a prelude to a stallion breeding syndicate, investors invariably anticipate that exercising their breeding rights under the syndicate agreement will generate their principal source of revenue, and the co-owners will depend substantially on their own efforts at that point. Similarly, other forces outside the control of a syndicate manager are significant, including, most obviously, the syndicated horse's speed, health, durability, virility and natural appreciation (if any) in value. Although some of these factors may depend to some extent on the syndicate manager's care, they are largely beyond anyone's control.

Evaluating the relative importance of these profit components in any particular situation will necessarily require careful analysis. The point, however, is that broad delegation racing syndicates do not always fall clearly into the definition of a security, especially when the racing of a colt is the prelude to a stallion breeding syndicate. In that instance, the syndicate manager's efforts may not be the undeniably significant ones, because the importance of other factors, including the co-owners' participation at the breeding stage, may be sufficient to remove the transaction from the definition of a security.<sup>47</sup>

While one can muster these arguments, there is considerable ambiguity in even the best situations and considerable risk in proceeding under an assumption that a broad delegation racing

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<sup>47</sup> *Marine Bank v. Weaver*, 455 U.S. 551 (1982), also provides a basis to argue that an interest in a racing syndicate is not a security, although, admittedly, the lack of judicial craftsmanship and the confusion in the case should cause one to be wary. In that case, the plaintiffs had pledged a certificate of deposit to the bank in exchange for an agreement to pay the plaintiffs 50% of the net profits from a corporation. In holding that the plaintiffs had not purchased a security, the Court arguably limited the definition of a security in situations involving "unusual instruments" to situations in which the instruments had "equivalent values to most persons and could have been traded publicly." *Id.* at 559-60.

Typically, racing syndicates are attractive only to people actively engaged in the horse business, especially when the residual breeding component is the real value in such syndicates. As a result, investments in racing syndicates normally do not have equivalent values to investors.

syndicate is not a security. Thus, the better course is either to make adjustments in the syndicate agreement, in order to reduce the risk that the syndicate constitutes a security, or to treat the syndicate as a security and qualify for an exemption from the registration provisions of the Securities Act of 1933 ("1933 Act").<sup>48</sup>

*B. Adjustments to Avoid Inclusion in the Definition of a Security*

There are at least two adjustments that can be made in a broad delegation racing syndicate to reduce the risk that interests in the syndicate will be considered securities.

The first technique is for the syndicate agreement to provide that earnings from races (or shows, if the horse is a performance animal) are not shared with the co-owners but are, instead, retained by the original owners of the horse.<sup>49</sup> This technique has been used in racing syndicates when the horse's retirement and breeding are anticipated in the foreseeable future. Racing, therefore, is clearly a prelude to a breeding syndicate, which becomes effective upon the retirement of the horse.<sup>50</sup>

This technique is simple and straightforward and has the imprimatur of the Commission.<sup>51</sup> Unfortunately, it also may eviscerate a racing syndicate, because investors are substantially eliminated from financial and emotional participation in the horse's racing career. This technique changes the essence of a racing syndicate into a deferred breeding syndicate and is, as a result, often unacceptable.

A second way to reduce the risk that a racing syndicate constitutes a security is to limit the syndicate manager's responsibilities and increase the co-owner's involvement in the horse's

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<sup>48</sup> The Securities Act of 1933, c. 38, Title I, § 1, 48 Stat. 74 (codified at 15 U.S.C. § 77a) [hereinafter referred to as "1933 Act"].

<sup>49</sup> See Cals Neat Star Syndicate, SEC No-Action Letter (available July 17, 1985); Shorty Lena Syndicate Agreement, SEC No-Action Letter (available Mar. 24, 1983); Himito Dancer Syndicate Agreement, SEC No-Action Letter (available Feb. 5, 1982); Blaze Drift Syndicate Agreement, SEC No-Action Letter (available Oct. 29, 1981).

<sup>50</sup> Of course, the terms of the breeding syndicate must otherwise meet the Commission's requirements for the issuance of a no-action letter.

<sup>51</sup> See note 49 *supra*.

management. This is an attempt to negate the existence of the fourth element of *Howey* by reducing the importance of the syndicate manager's responsibilities below the *Koscot* standard.

Although the cases supporting such a strategy involve an eclectic group of entities and transactions, a broad rule seems to emerge from the decisions. Courts generally are unwilling to find a security in instances in which partners, joint venturers or property owners delegate considerable managerial authority to third parties, provided that the partners, joint venturers or property owners retain effective ultimate control. While the courts insist that the owners be capable of actually exercising control over the person to whom power is delegated, delegations of considerable breadth and importance have been upheld.<sup>52</sup> Some examples are instructive.

In *Mr. Steak, Inc. v. River City Steak, Inc.*,<sup>53</sup> a franchisee purchased a restaurant franchise from Mr. Steak. Mr. Steak retained a substantial amount of control over the franchise operation and, it appears, actually ran the restaurant. Nonetheless, the Tenth Circuit affirmed the lower court's dismissal of a securities claim, emphasizing that "the franchise agreement and the restaurant manager's agreement contemplated that River City Steak [the franchisee] would play an active, if severely circumscribed, role in the conduct of the restaurant."<sup>54</sup> Thus, although the franchisee delegated effective day-to-day control to Mr. Steak, the franchisor, the court did not find a security present.

In *Fargo Partners v. Dain Corp.*,<sup>55</sup> the Eighth Circuit affirmed a dismissal of a securities claim in a real estate transaction. Fargo Partners purchased an apartment complex from Candletree, a partnership that retained complete management control over the operation of the complex. The court concluded

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<sup>52</sup> In addition to the cases described in notes 53-65 *infra* and accompanying text, see also *Schultz v. Dain Corp.*, 568 F.2d 612 (8th Cir. 1978) (transaction whereby purchaser of apartment complex contracted management agreement denying purchaser the unilateral right to cancel the management contract with vendors within its three year term, held not to be an "investment contract" where purchaser, who had considerable business expertise, retained ultimate control over the apartment complex).

<sup>53</sup> 460 F.2d 666 (10th Cir. 1972).

<sup>54</sup> *Id.* at 669 (quoting *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 645 (D.C. Co. 1970)).

<sup>55</sup> 540 F.2d 912 (8th Cir. 1976).

that the deal did not involve a security, because "Fargo's role was a significant one despite the management contract."<sup>56</sup> The reservation by Fargo of the right to fire Candletree as manager on thirty days notice was important to that conclusion. The court stated that "[w]hether [Fargo] . . . chose to exercise that right or was content to give Candletree a free hand is irrelevant; the power to control the business was in Fargo's hands."<sup>57</sup> Again, the retention of effective<sup>58</sup> ultimate control was sufficient to avoid inclusion in the definition of a security, even though there was delegation of substantial operational functions.<sup>59</sup>

Finally, in *Williamson v. Tucker*,<sup>60</sup> a Fifth Circuit decision that must be considered one of the leading cases in this area, three joint venturers each purchased a one-third undivided interest in certain real estate. The purpose of the joint venture was to hold the land for subsequent development or resale. Godwin Investments, which arranged all of the transactions and sold the interest in the land to one of the joint venturers, represented that it would perform all management functions with regard to the property, attempt to have the land rezoned and pursue the sale or development of the property. The joint venture agreements, however, reserved certain powers for the joint venturers, including most importantly the power to approve any plan of development and the power to remove Godwin as manager.

In remanding the case, the court discussed extensively the substantive issues involved. The court concluded that in the absence of certain "limited circumstances . . . meaningful powers possessed by joint venturers under a joint venture agreement do indeed preclude a finding that joint venture interests are securities."<sup>61</sup> Those limited circumstances exist when:

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<sup>56</sup> *Id.* at 915.

<sup>57</sup> *Id.*

<sup>58</sup> Fargo's sophistication also impressed the court. "Fargo's investment in this enterprise was over three million dollars, and it had made other investments in the past. This is not a case where a small investor is helplessly reliant on the promotor's efforts because of a lack of business knowledge, finances or control over the operation." *Id.*

<sup>59</sup> In a subsequent case, the Eighth Circuit described *Fargo Partners* in the following terms: ". . . the investor demonstrated his ultimate control over the complex by reserving the right to manage the business. It was irrelevant whether he chose to exercise the right or not." *Schultz v. Dain Corp.*, 568 F.2d 612, 615 (8th Cir. 1978).

<sup>60</sup> 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

<sup>61</sup> *Id.* at 425.

(1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in the business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.<sup>62</sup>

The court found none of these factors present.<sup>63</sup> Again, it seems that the power reserved for the joint venturers gave them effective ultimate control, even though there were substantial managerial responsibilities allocated to Godwin.

These cases provide a basis for an effective strategy to reduce the risk that a racing syndicate involves a security. Implementation of such a strategy necessitates adjustments in the terms of a broad delegation syndicate agreement, and in that regard, provisions for the following should be made in the syndicate agreement. First, the co-owners should be permitted to replace the syndicate manager by a majority vote. Second, the co-owners should retain the power to amend the syndicate agreement by a majority vote. This would include, of course, the authority to amend the delegation of authority to the syndicate manager. Third, major decisions, such as retirement of the horse from the track, the sale of the horse and the selection of the trainer, should require majority approval of the co-owners. Fourth, the syndicate manager should be obligated to provide material information about the horse to the co-owners on a reasonably prompt basis. Finally, the fractional interests should not be sold to persons that are so inexperienced or unknowledgeable that they are incapable of exercising the syndicate powers.

While the writer is convinced that the foregoing strategy is sound and can be adapted to many situations, it is not, unfortunately, a panacea. Certain clients, for example, will not tolerate sharing such control over the syndicated animal's racing

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<sup>62</sup> *Id.* at 424.

<sup>63</sup> *Id.*

career. They, as the horse's original owners, may believe, often with good reasons, that they know most about the horse and may insist on an essentially unfettered right to direct the horse's racing career.

One must also understand that the strategy outlined above does not eliminate all vestiges of risk.<sup>64</sup> Obviously the determination of whether the co-owners retain sufficient control to avoid inclusion in the definition of a security is an exceedingly factual judgment. Thus, the possibility always exists that a court may conclude that the particular racing syndicate constitutes a security,<sup>65</sup> especially if the court's philosophical predilections regarding the coverage of the securities laws differ, for example, from those of the court in *Williamson*.

Notwithstanding such limitations, racing syndicates drafted pursuant to the foregoing suggestions should not be considered securities. As a policy matter, investors in such racing syndicates have the power, information and sophistication to control their

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<sup>64</sup> The Commission, for example, is unwilling to issue a no-action letter for such a racing syndicate.

In one request to the Commission for a no-action letter regarding a racing syndicate formed for a quarter horse, it was represented that the syndicate agreement spread all management control among the 50 proposed co-owners. The request letter stated that:

The Members of the Syndicate totally control all aspects of the business of the Syndicate, including, without limitation, the election of the Syndicate Manager or Managers and all decisions regarding the board, care, management, maintenance, breeding, training, racing and location of the horse. The day-to-day management of the Syndicate shall be delegated to a Syndicate Manager elected by the Members. The Syndicate Manager shall at all times be subject to the control of the Members and may be removed by the Members at any time with or without cause.

The letter also represented that the Members would have "special and extensive knowledge and experience in the horse industry and in the business of breeding horses." See Letter from Alan R. Miller to the Securities and Exchange Commission (Mar. 17, 1983) (letter appended to Especial Effects Syndication, SEC No-Action Letter (available May 20, 1983)). Notwithstanding these representations, the staff refused to take any position on the matter. Especial Effects Syndication, SEC No-Action Letter (available May 20, 1983).

<sup>65</sup> There are also cases in which courts have found a security, even though inventors retained some control or participated in the operation of the business. See, e.g., *Cameron v. Outdoor Resorts of America*, 608 F.2d 187 (5th Cir. 1979) (exclusive right of condominium campsite vendor to rent campsite in owner's absence required that campsite be considered a security); *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979) (agreement to repurchase offspring of earthworms sold to investor was an investment contract subject to securities laws).

own destinies and do not need the special protections of the disclosure and fraud provisions of the securities laws. Delegation to the syndicate manager of day-to-day responsibilities regarding the horse's racing career should not change this analysis. The modifications suggested herein indicate that effective ultimate control is in the hands of the co-owners and should avoid any of the "limited circumstances" described in *Williamson* as a basis for concluding that such a venture is a security.

### CONCLUSION

While this writer is convinced that functional racing syndicates can be designed to fall outside the definition of a security, he is equally convinced that one should not, merely to achieve such a result, tolerate unnecessary levels of risk under the securities laws or accede to unacceptable or troublesome terms. One has the option to treat the interests in the racing syndicates as securities and comply with the provisions of the 1933 Act and the Securities Exchange Act of 1934.<sup>66</sup>

The registration requirements of the 1933 Act,<sup>67</sup> which normally present the most burdensome problem in such instances,<sup>68</sup> can be met by compliance with any one of a number of exemp-

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<sup>66</sup> The Securities & Exchange Act of 1934, c. 404, Title I, § 1, 48 Stat. 881 (codified at 15 U.S.C. § 78a) [hereinafter referred to as "1934 Act"].

<sup>67</sup> The registration provisions of the 1933 Act provide that one offering or selling securities must file a registration statement with the Commission and comply with the prospectus delivery requirements, unless an exemption is available from the registration and prospectus delivery requirements. The general registration provision in the 1933 Act is found at 15 U.S.C. § 77(e) (1982). The statutory exemptions from registration are found in 15 U.S.C. §§ 77(c) and (d).

The time and expense associated with a registration statement typically make that alternative impractical. Thus, persons structuring racing syndicates generally need to qualify such deals for an exemption from registration. For information regarding the process of registration, see H. BLOOMENTHAL, C. HARVEY & S. WING, 1984 GOING PUBLIC HANDBOOK §§ 6.01-13 (1984). For a somewhat dated but still excellent discussion of the registration process, see I. L. LOSS, SECURITIES REGULATION 159-351 (2d ed. 1961).

<sup>68</sup> One must, of course, also comply with the antifraud provisions of the 1933 Act and the 1934 Act. Rule 10b-5 under the 1934 Act, 17 C.F.R. § 240.10b-5 (1984), and § 12(2) of the 1933 Act, 15 U.S.C. § 77(2) are the most significant of such antifraud provisions. These provisions, however, are substantially less burdensome than the registration provisions because the antifraud requirements are satisfied if the issuer refrains from making material misstatements and discloses all material facts. See *id.*

tions,<sup>69</sup> the most significant of which are the exemptions provided by Regulation D.<sup>70</sup> Although Regulation D is not without its fair share of problems,<sup>71</sup> it typically provides an attractive exemption from the registration requirements of the 1933 Act and normally works reasonably well for the sale of interests in racing syndicates. Experience teaches that problems of disclosure,<sup>72</sup> timing<sup>73</sup> and

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<sup>69</sup> In addition to Regulation D (see note 70 *infra* for a discussion of Regulation D) exemptions with broad applicability include rule 147, 17 C.F.R. § 230.147 (1985), (the interstate exemption); § 4(2), 15 U.S.C. § 77d(2) (the statutory exemption for non-public offers and sales); and § 4(6), *id.* § 77d(6) (offerings limited only to accredited investors). The requirements of these exemptions, however, generally make them either unavailable or unattractive for structuring racing syndicates, and as a result, Regulation D is the principal exemption used.

<sup>70</sup> Regulation D, 17 C.F.R. § 230.501-.506, actually contains three separate but related exemptions from registration. All three exemptions require essentially private offers and sales and, accordingly, prohibit any general advertising in connection with the offering, restrict the resale of securities and require the issuer to take certain steps to insure that the securities are not resold publicly. In addition, each rule has its own requirements, which become more onerous as the deals become larger.

Rule 504, *id.* § 230.504, allows sales up to \$500,000.00 with no limitation on the number of purchases, no disclosure requirements and no purchaser qualification requirements. Rule 505, *id.* § 230.505, permits sales up to \$5 million, limits the number of unaccredited purchasers to 35, normally requires that the issuer deliver to the investor the same information that would be contained in a Form S-18 but contains no purchaser qualification requirements.

Rule 506, *id.* § 230.506, is available for offerings in excess of \$5 million, normally requires disclosures that are more extensive than the Rule 505 disclosures, imposes purchaser qualification requirements and also limits the number of unaccredited purchasers to 35.

For a discussion of Regulation D, see J. HICKS, 1985 LIMITED OFFERING EXEMPTIONS: REGULATION D (1985); Wertheimer, *Small Issuers: Updated on Regulation D*, 15 INST. ON SEC. REG. 377-441 (1983).

<sup>71</sup> See generally, Campbell, *The Plight of Small Issuers (and Others) Under Regulation D*, 74 Ky. L.J. 127 (1985-86).

<sup>72</sup> Disclosure is a prerequisite to the availability of a Regulation D exemption, unless the deal is either less than \$500,000 or is sold only to "accredited investors." 17 C.F.R. § 230.502(b). Even in instances in which Regulation D does not require disclosure, however, issuers typically use a somewhat abbreviated offering circular to protect against a violation of the federal antifraud provisions. See Campbell, *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553, 559-62 (1985). Meeting the disclosure requirements of Regulation D or of the antifraud provisions adds time and expense to any deal. Although these added burdens are not always insignificant, neither are they necessarily insurmountable to the formation of a racing syndicate. For a discussion of these matters, see notes 73-74 *infra*.

<sup>73</sup> Timing is often critical in the formation of a racing syndicate, and compliance with disclosure requirements is considered one of the principal obstacles to expediency.



expenses,<sup>74</sup> all of which appear burdensome in Regulation D offerings, are manageable in most instances. Finally, the problems of restrictions on resales of securities purchased under Regulation D,<sup>75</sup> which can cause significant impediments to the use of the Regulation D exemptions,<sup>76</sup> now appear less burdensome. A recent no-action letter from the Commission accepted a theory that allows resales substantially sooner than the normal holding period otherwise applicable to restricted securities.<sup>77</sup>

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If disclosure is required as a prerequisite to the availability of Regulation D, see 17 C.F.R. § 230.502(b) and note 71 *supra*, a competent firm operating under reasonable conditions should be able to complete a racing syndicate in about four weeks. In situations in which disclosure is not required by the terms of Regulation D but is instead provided only to meet the antifraud provisions, see 17 C.F.R. § 230.502(b) and note 71 *supra*, even less time is required to effect disclosure, because the offering circular utilized to satisfy the antifraud provisions is substantially less extensive than the offering circular required by Regulation D. Finally, it is not necessary to have disclosure documents completed at the time the selling effort is commenced. Regulation D allows offers to be made prior to any disclosure, so long as disclosure is completed before sale. 17 C.F.R. § 230.502(b). This technique, therefore, allows the issuer to start the selling campaign almost instantaneously, with disclosure documents to be supplied prior to the completion of the sale. Most deals can tolerate these limitations.

<sup>74</sup> As with the problem of timing, the expenses in structuring a racing syndicate within the requirements of Regulation D depend in large part on the amount of disclosure that is required. In today's dollars, the securities work on a Regulation D deal not involving mandated disclosure (i.e., an offering in which disclosure is not a prerequisite to the availability of Regulation D) may be \$10,000.00. This assumes no unusual problems with the deal, a cooperative client and that an abbreviated offering circular is utilized to avoid problems under antifraud provisions. If Regulation D requires disclosure, the cost of the securities work could easily double, or it could even be more.

Although these are not insignificant costs, they may seem less burdensome in the contexts of particular deals. For example, \$10,000.00 is only 2% of a \$500,000.00 deal and 1% of a \$1 million deal. Many racing syndicates are able to endure these fees.

<sup>75</sup> Securities purchased under Regulation D "shall have the status of securities acquired in a transaction under Section 4(2) . . . and cannot be resold without registration under the [1933] Act or an exemption therefrom." 17 C.F.R. § 230.502(d).

<sup>76</sup> For a critical discussion of the resale restrictions applicable to Regulation D offerings, see Campbell, *supra* note 71, at 147-61.

<sup>77</sup> Counsel for the Devil's Bag Syndicate requested a no-action letter for the resale of fractional interests in the Devil's Bag Syndicate. The syndicate was originally formed as a broad delegation racing syndicate, with provisions for a breeding syndicate to become effective following the colt's retirement from the track. The fractional interests were purchased pursuant to Regulation D and held for approximately one year. During that time, however, Devil's Bag had been retired from racing and was therefore governed under the terms of the syndicate agreement covering the breeding of the stallion.

Counsel argued that the shares should no longer be considered securities because the syndicate agreement was then a typical breeding syndicate, which under the Com-

One fashioning a racing syndicate, therefore, has various alternatives in meeting the requirements of federal securities laws. By adjusting the provisions of the broad delegation racing syndicates or by meeting the requirements of Regulation D, one normally can construct a racing syndicate that provides an acceptable level of protection, retains the essential elements of the syndicate and meets the clients' cost and timing requirements.

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mission's own determination did not involve a security. Thus, counsel essentially was arguing that the security disappeared when the horse was retired, because at that point the efforts of the syndicate manager were no longer the undeniably significant ones under the *Howey-Koscot* test.

After a certain amount of negotiation over peripheral matters, the Commission accepted this argument and issued its no-action letter. See *Devil's Bay Syndicate*, SEC No-Action Letter (available Mar. 4, 1985).

The practical impact of this is significant, because it may, in many instances, dramatically reduce the holding period for interests in racing syndicates originally purchased under Regulation D. Persons investing in racing syndicates in Regulation D offerings should now feel comfortable selling their fractional interests as soon as the horse is retired from the track. In many instances, that will occur reasonably quickly, as was the case, for example, with *Devil's Bag and Spend A Buck*.

In addition, investors who can meet the applicable criteria can resell in three years under Rule 144, 17 C.F.R. § 240.144, or at any time under the so called "Section 4(1 1/2)" exemption. For a discussion of the "Section 4(1 1/2)" criteria, see Campbell, *supra* note 71, at 147-51.