

Memorandum

To:

From: The Q Companies

Date: 10-14-2025

Re: Classification of Promissory Note With Variable Return as a Security

I. Issue

Whether a promissory note that provides variable or “upside” potential based on performance, rather than a fixed rate of return, should be classified as a *security* under the Securities Act of 1933 and relevant judicial interpretations.

II. Summary of Conclusion

Based on statutory language, judicial precedent, and interpretive guidance, a promissory note that exposes the holder to **investment risk**—through variable returns or participation in enterprise performance—constitutes a **security**.

Under the *Reves v. Ernst & Young*, 494 U.S. 56 (1990) “**family-resemblance**” **test**, and supporting authorities such as *Camp Wolters Enterprises*, 22 T.C. 737 (1954), and *D’Angelo Associates*, 70 T.C. 121 (1978), the proposed note embodies characteristics of an investment security because repayment and profit depend on business outcomes rather than a fixed obligation.

Accordingly, securities law compliance or exemption analysis (e.g., Regulation D or Rule 144A) should be applied.

III. Applicable Law

A. Statutory Definition

Section 2(a)(1) of the Securities Act of 1933 defines *security* to include “any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement...” (15 U.S.C. § 77b(a)(1)).

Although the statute includes “any note,” the Supreme Court has limited this broad language through the **family-resemblance test** in *Reves* to distinguish investment instruments from ordinary commercial or consumer notes.

B. *Reves v. Ernst & Young* (1990) – The Family Resemblance Test

As summarized in *Compliance Building, “Is a Note a Security?”* (2012)

3a Is a Note a Security_ – 2012...

The Court presumes that **every note is a security**, subject to rebuttal if it bears a strong resemblance to one of several recognized categories of non-securities (e.g., consumer finance, short-term commercial paper, home mortgage loans).

The test applies four factors:

1. **Motivation of the Parties.**

If the issuer seeks to raise capital for general business or investment purposes and the buyer seeks to earn a profit, the note is a *security*.

Here, the issuer’s use of proceeds for enterprise funding and the investor’s expectation of *variable returns* align squarely with investment motivation.

2. **Plan of Distribution.**

Notes broadly offered or marketed as investment opportunities resemble securities. Even limited offerings to accredited investors can

trigger this factor when the marketing emphasizes *growth* or *performance participation*.

3. **Reasonable Expectations of the Public.**

When investors perceive the instrument as an investment—particularly when returns are *contingent or performance-linked*—courts classify it as a security. (*Reves*, 494 U.S. at 66.)

4. **Presence of Alternative Regulatory Schemes.**

The absence of banking or ERISA-type protections weighs in favor of securities regulation.

Because a note with upside potential functions economically as an investment, all four *Reves* factors support classification as a security.

IV. Analysis

A. Judicial Authorities Supporting Security Status

1. Long-Term and Enterprise-Risk Participation

- **Helvering v. Watts**, 296 U.S. 387 (1935) — Bonds payable in installments over seven years held to be securities; duration and investment nature deemed decisive
- **Burnham v. Commissioner**, 86 F.2d 776 (7th Cir. 1936) — Ten-year notes exchanged for stock qualified as securities, reflecting long-term capital investment.
- **Camp Wolters Enterprises**, 22 T.C. 737 (1954), aff'd 230 F.2d 555 (5th Cir. 1956) — Non-negotiable notes treated as securities because holders bore *substantial risk of the corporation's enterprise*; repayment contingent on business success

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The Tax Court emphasized that classification depends on “an overall

evaluation of the nature of the debt, degree of participation and continuing interest in the business, and the purpose of the advances.”

2. Contingent or Variable Payment Structures

- **D’Angelo Associates**, 70 T.C. 121 (1978) — A demand note was deemed a security where repayment depended on rental income and eventual property sale, illustrating that even short-term notes become securities when *repayment is contingent on enterprise performance*.
- **Mills v. Commissioner**, 399 F.2d 944 (5th Cir. 1968) — One-year notes were securities because the stated maturity was unrealistic and repayment was indefinitely extended.

These cases align directly with a note providing variable or performance-based returns, where repayment and gain depend on economic results.

B. Distinguishing Non-Security Cases

By contrast, **short-term, collateralized, or purely commercial notes**—such as the 45- to 105-day notes in *Pinellas Ice & Cold Storage Co.*, 287 U.S. 462 (1933)—are treated as cash equivalents, not securities

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Similarly, *Sisto Financial Corp.*, 139 F.2d 253 (2d Cir. 1943), excluded six-month notes used for routine financing.

These precedents underscore that **liquidity and absence of investment risk** negate security status—conditions opposite those present here.

C. Equitable and Policy Considerations

As summarized by *HG.org*, “*When Is a Promissory Note a Security?*”

3b When Is a Promissory Note a ...

Courts also weigh fairness and investor protection.

When an issuer markets a note with **upside potential or speculative profit**, the court liberally applies securities law to prevent fraud and ensure disclosure.

Because no alternative regulatory framework governs such instruments, classification as a security promotes transparency consistent with the Securities Act's remedial purpose.

V. Application to Subject Note

The proposed note contains the following pertinent features:

- **Variable or contingent return** based on business performance or external benchmarks.
- **Long-term or indefinite maturity** is aligned with project completion or enterprise success.
- **Subordination** to senior obligations exposes investors to business risk.
- **Investment-style marketing** emphasizing potential upside.

These attributes satisfy each *Reves* factor and mirror the instruments in *Camp Wolters* and *D'Angelo Associates* that were held to be securities.

The note's economics demonstrate **equity-like participation** rather than fixed-income lending, thus falling squarely within the federal definition of a *security*.

VI. Conclusion

Given the variable return structure, dependency on enterprise performance, and absence of alternative regulatory protection, the subject promissory note should be **classified as a security** under federal law.

Accordingly, the issuer should either (1) register the offering under the

Securities Act of 1933, or (2) rely on an available exemption such as **Regulation D** (Rule 506(b)/(c)) or **Rule 144A** for qualified institutional buyers.

This classification ensures compliance with antifraud and disclosure provisions and aligns with judicial precedent recognizing investment-risk notes as securities.

Key Authorities Cited

- *Reves v. Ernst & Young*, 494 U.S. 56 (1990)
- *Helvering v. Watts*, 296 U.S. 387 (1935)
- *Burnham v. Commissioner*, 86 F.2d 776 (7th Cir. 1936)
- *Camp Wolters Enterprises*, 22 T.C. 737 (1954), *aff'd* 230 F.2d 555 (5th Cir. 1956)
- *D'Angelo Associates*, 70 T.C. 121 (1978)
- *Pinellas Ice & Cold Storage Co.*, 287 U.S. 462 (1933)
- *The Tax Adviser*, "Security Call: Determining Whether Debt Is a Security" (2021)
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- *Compliance Building*, "Is a Note a Security?" (2012)
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- *HG.org*, "When Is a Promissory Note a Security?"
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