Vanderbilt Law Review

Volume 28
Issue 3 *Issue 3 - April 1975*

Article 1

4-1975

Registration and Exemption from Registration of Employee Compensation Plans Under the Federal Securities Laws

Dean L. Overman

VANDERBILT LAW REVIEW

VOLUME 28 APRIL 1975 NUMBER 3

Registration and Exemption from Registration of Employee Compensation Plans Under the Federal Securities Laws

*Dean L. Overman**

I. INTRODUCTION

This article is a basic summary of the rather complex federal securities laws concerning the registration of employee compensation plans. It centers around certain provisions of the Securities Act of 1933, the Securities and Exchange Act of 1934 and the Investment Company Act of 1940. The article initially discusses the necessity of registering the following four types of employee compensation plans: (1) pension, profit-sharing, stock bonus and similar plans; (2) employee stock purchase plans; (3) stock option plans; and (4) phantom stock plans. It then considers certain exemptions for these plans and the means available to employees to effect a resale of the securities purchased under the plans. Although mentioned in passing, no detailed analysis is made of the intricate corporate and tax aspects of employee compensation plans or of "blue-sky" law requirements.[1]

II. THE SECURITIES ACT OF 1933

A. Registration

1. Pension, Profit-Sharing, Stock Bonus and Similar Plans.—The Securities and Exchange Commission's approach to employee

---

* Member of the Illinois Bar; A.B. 1965, Hope College; J.D. 1969, University of California, Berkeley.

1. Additional material concerning the federal securities aspects of employee compensation plans can be found in L. LOSS, SECURITIES REGULATION (2d ed. 1961) [hereinafter cited as LOSS]; G. WASHINGTON & V. ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE (3d ed. 1962) [hereinafter cited as WASHINGTON & ROTHSCHILD]; CCH PENSION PLAN GUIDE; P-H PENSION & PROFIT SHARING; Hyde, *Employee Stock Plans and the Securities Act of 1933*, 16 W. RES. L. REV. 75 (1964) [hereinafter cited as Hyde]; Mundheim & Henderson,

pension, profit-sharing and similar plans have been determined mainly by the degree to which the Commission perceives investor need for protection. The term "security" is defined in section 2(1) of the 1933 Act to include

> any . . . certificate of interest or participation in any profit-sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.[2]

Under this definition all pension and profit-sharing plans may be considered investment contracts because they involve the pooling of employee investments into a fund that is expected to produce profits through the efforts of someone other than the employees. The Commission has taken the position that a "security" is present whenever a plan involves an investment contract or a certificate of interest or participation in a profit-sharing agreement.[3] Any plan that provides for the contribution of funds by employees with an expectation of receiving a return involves a security. Such a plan is in essence an "investment company" with participation confined to employees. The issuer of the investment contract is frequently the trust created under the plan rather than the employer itself.[4]

Even though participating interests in a pension or profit-sharing plan may constitute securities, registration is not necessary unless the plan contemplates a "sale," an "offer to sell," an "offer for sale" or an "offer of securities."[5] The Commission has not in the past considered pension or profit-sharing plans as involving an "offer" or a "sale" so long as the employee is compelled to contribute or makes no contribution at all. When an employee has neither the right to decide whether to invest or refrain from investing in a particular security nor the obligation to make any contribution toward the investment, no "sale" occurs and thus registration under the 1933 Act is not required. If the employee has the right to select investment media, however, even compulsory and noncontributory plans must be registered.[6] The Commission also requires the regis-

---

Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans, 29 LAW & CONTEMP. PROB. 795 (1964); Comment, *Securities Aspects of Pension, Profit-Sharing, and Stock Bonus Plans,* 17 SW. L.J. 444 (1963).

2. Securities Act of 1933 § 2(1), 15 U.S.C. § 77(b)(1) (1970).
3. Opinion of Assistant General Counsel of Commission, 1 CCH FED. SEC. L. REP. ¶ 2105.53 (1941).
4. 1 Loss 506.
5. Securities Act of 1933 § 2(3), 15 U.S.C. § 77(b)(3) (1970).
6. *See* Opinion of Assistant General Counsel of Commission, 1 CCH FED. SEC. L. REP. ¶ 2105.53 (1941).

tration of pension, profit-sharing and similar plans when the plan purchases the employer's securities, but only to the extent that the investment in the securities exceeds the amount of the employer's contribution. In that case, registration is required of both the interests in the plan and the employer's underlying securities purchased by the plan, regardless of whether the securities are purchased on the open market.[7]

The 1970 amendments to section 3(a)(2) of the 1933 Act appear to codify the Commission's interpretations discussed above by making the following addition to the category of exempted securities:

> any interest or participation in a single or collective trust fund maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, or (B) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404 (a)(2) of such Code . . . .[8]

Section 3(a)(2) contains two exceptions to this exemption. The first exception disqualifies any plan (a) the contributions of which are held (i) in a single trust fund maintained by a bank, or (ii) in a separate account maintained by an insurance company for a single employer, and (b) under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust or separate account itself) issued by the employer or by any company directly controlling the employer. Accordingly, the staff has taken the position that an employee's interest in a profit-sharing plan is not an exempt security when the plan contemplates both employee and employer contributions and the plan's trust agreement allows the trustee to invest trust assets in a savings account fund, which could in turn invest in the securities of the employer.[9] The exemption also appears to be unavailable when the trustee bank acts as a mere custodian for the collective trust fund and does not "maintain" the fund by exercising substantial investment responsibility.[10]

The second exception disqualifies plans that cover self-employed individuals within the meaning of the Internal Revenue

7. Letter to CCH from Assistant Director, Division of Corporation Finance, 1 CCH FED. SEC. L. REP. ¶ 2105.51 (1953); *see* Girard Trust Bank, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,547 (SEC 1971).

8. Section 3(a)(2) of the 1933 Act was amended by the Investment Company Act Amendments of 1970, Pub. L. No. 91-547, 84 Stat. 1434.

9. Polaroid Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,204 (SEC 1973).

10. Bank of America, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,614 (SEC 1971).

Code.[11] The Commission, however, has authority to exempt these plans by rule or regulation to the extent it considers exemptions to be necessary or appropriate in the public interest and consistent with the protection of investors.[12]

Despite the 1970 amendments, the Commission has recently questioned the "no-sale" rationale discussed above. Five recent rulings indicate the Commission's present attitude:

(a) The staff has declined to give a no-action letter to a corporation that proposed contests among various independent sales representatives and distribution organizations in order to "generate more sales." The prizes would consist of various amounts of the company's common stock that would be purchased over-the-counter and registered in the name of the winner. The Commission decided that the shares should be registered, particularly in view of the "sales incentive" motive.[13]

(b) The Commission also has maintained that a noncontributory executive incentive plan that purchased the issuer's shares in the open market and ultimately distributed the shares to key employees involved a sale. The value for the disposition of the shares was considered to be the employer's benefit in retaining key employees during the duration of the plan (five years).[14]

(c) Registration was required for an award of shares of stock pursuant to a company's employee inventor awards program in which all employees of the company were obligated by contract to assign their employment-related inventions to the company.[15]

(d) The Commission has recently declined to give a no-action letter with respect to a noncontributory qualified profit-sharing plan because the employees had the election to determine whether their interests in the plan would be invested in the securities of the employer or in other investment media.[16]

(e) Registration was also required for the operation of a profit-sharing plan whereby a trust would acquire the em-

11. INT. REV. CODE OF 1954 § 401(c)(1).

12. Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970).

13. Keene Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,475 (SEC 1971).

14. Oklahoma Natural Gas Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,583 (SEC 1971).

15. Allis-Chalmers Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,803 (SEC 1972).

16. Girard Trust Bank, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,547 (SEC 1971).

ployer's shares and the employee participants could purchase the shares out of their vested interests in their respective profit-sharing trust accounts.[17]

2. Employee Stock Purchase Plans.—Employers often encourage employee ownership through employee stock purchase plans whereby the employer's stock is purchased on the open market using a payroll deduction. If the degree and type of employer's participation in such a plan is carefully limited, no "offer for sale" will exist and neither the stock offered by the plan nor the plan itself need be registered. Although some employer participation will exist in almost every employee stock purchase plan, the Commission has stated that such participation will not be considered sufficient to constitute a solicitation of an offer to buy (so that registration is required) when all communications of a soliciting character are furnished by and in the name of a broker or other agent of the employees, and the employer's functions are limited to the following:

1. The employer company or an affiliate announces the existence of the plan.
2. The employer company makes payroll deductions at the request of employees for the purpose of participating in the plan.
3. The names and addresses of employees are made available to the broker or other agent for direct communications by it to such employees regarding the plan. This may take the form of addressing the commnnication to be sent by the broker or other agent, the inclusion of the broker's communication with the announcement by the employer company, or the holding of an initial meeting of employees at the company's premises.
4. The employer company or an affiliate pays no more than its expense of payroll deductions and the reasonable fees and charges of the broker or other agent for brokerage commissions and bookkeeping and custodial expenses.[18]

Any deviations from these standards may require registration. The standards presuppose that the plan involves only minimum differences from the manner in which securities are acquired in ordinary brokerage transactions and that the broker's and employee's obligations and rights will be consistent with the ordinary broker-client relationship, which might include leaving the securities in the broker's custody. If substantial variations exist, however, a separate security may be created that must be registered under the 1933 Act, and the issuer of the security may be deemed an investment company and required to register under the Investment

17. Beacon Supply Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,625 (SEC 1972).

18. SEC Securities Act Release No. 33-4790 (July 13, 1965), 1 CCH FED. SEC. L. REP. ¶ 1132; *see* H. BLOOMENTHAL, 3 SECURITIES AND FEDERAL CORPORATE LAW § 2.06 (1974) [hereinafter cited as BLOOMENTHAL].

Company Act of 1940. Examples of substantial variations are: "[1] limitations on the right of the employee to withdraw from the plan or to withdraw securities held in custody, [2] the granting of management discretion to someone other than the employee, [3] the accumulation of sums for material periods of time before investment, [4] the payment of special fees or charges such as a front-end load, or [5] the diminution of [the employee's] rights or privileges as a shareholder."[19]

Because the distinction in employee stock purchase plans between security and no security is founded on the tenuous ground that the employee's relationship with the broker is an ordinary broker-client relationship, and because of the possible civil liabilities for violation of registration provisions, any employer contemplating an employee stock purchase plan should give careful consideration to its registration.[20]

3. Stock Option Plans.—Unless an exemption is available, the offering and sale of shares to employees pursuant to a stock option plan is subject to the registration and prospectus requirements of the 1933 Act. A stock option involves an offer of the security that is the subject of the option and will also involve the issuance of a security if and when the option is exercised. In addition, under section 2(1) of the Act, the term "security" includes warrants and rights to subscribe or purchase other securities and embraces the stock option itself.

Even though a stock option involves a security, the receipt of the option should not be considered a sale under the 1933 Act. Under most stock option plans, the employee need not pay for the option in cash. His future services are the consideration for the option and he will be required to pay cash only if he exercises the option. Because the employee does not normally render his services for an investment purpose but rather for the purpose of performing and retaining his job, the receipt of the option should not be viewed as a sale, and the Commission does not appear to require registration of the option separate and apart from the registration of the underlying securities.[21]

Since section 5(c) of the 1933 Act prohibits offers prior to the

---

19. SEC Securities Act Release No. 33-4790 (July 13, 1965), 1 CCH FED. SEC. L. REP. ¶ 1133.

20. 3 BLOOMENTHAL § 2.06.

21. Hyde at 85; WASHINGTON & ROTHSCHILD at 805; *cf.* Opinions of Assistant General Counsel of Commission, 1 CCH FED. SEC. L. REP. ¶¶ 2105.50, .53 (1941). Although the opinions concern pension and profit-sharing plans, the same principles should apply to a stock option.

filing of a registration statement, the time when a registration statement must be filed for a stock option also becomes an important issue. Although under section 2(3) the granting of a stock option or the adoption of the plan appears to constitute an "offer," the Commission raises no question if registration does not occur until the stock option is exercisable.[22] The adoption of the plan and the grant of the option are regarded as similar to preliminary negotiations with an underwriter, which are specifically excluded from the definition of "offer" in section 2(3).

When the option does become exercisable, the shares then issuable must be registered by the issuer unless an exemption is available. The issuer will normally be permitted to register all of the shares authorized for the stock option plan, even if all of the options have not been granted or are not exercisable. Advanced planning can lower the cost of registration. In a closely held corporation employee stock options should be exercisable, if possible, on or after the date of an initial public offering of other securities of the same class. Short Form S-8, rather than the more expensive Form S-1, may then be used. In addition, this type of arrangement is more attractive to the employees because, until the issuer creates a public market for the stock, they may have difficulties financing the exercise of their options.[23]

4. Phantom Stock Plans.—An increasingly popular form of compensation for key employees is the phantom stock option. In a phantom stock option the employee is credited with a certain number of units representing shares of stock of the employer corporation. In the years that dividends are declared on the outstanding stock of the employer, proportionate credits are made to the units in the employee's account. In addition, his account is credited with the increase or decrease in the value of the common stock that his units represent. At the time for payout, either after a fixed number of years of participation or at the employee's retirement, the benefits are paid in cash.

Although phantom stock may be considered a security under the 1933 Act's definition, it does not easily fall within the category of an investment contract or a certificate of interest or participation in a profit-sharing agreement. Classification as an investment contract is unlikely because the contracting parties normally consider the agreement as one for compensation rather than as one for investment purposes. The argument that a phantom stock unit is a certifi-

22. Dayton Steel Foundry Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,443 (SEC 1971).

23. *See* Dykstra and Reynolds, *Review of Form S-8*, 5 REV. OF SOC. REG. 871.

cate in a profit-sharing agreement may be refuted by the fact that these payments are measured by corporate distributions and not by total corporate earnings as in the typical profit-sharing plan. Stock appreciation increments that do not represent a share of the profits of the corporation as such are less likely to be viewed as securities.

Even if phantom stock is deemed to be a security, its issuance may not be a sale. Section 2(3) of the 1933 Act defines "sale" as every contract of sale or disposition of a security or interest in a security for value. The Commission has taken the position that value will not be attributed to employee services when the employee's participation in the stock plan is merely incidential to his employment and does not involve a cash payment by the employee. Under this position, the grant of units under noncontributory phantom stock schemes may not involve a sale.[24]

B. Exemptions

1. Insurance or Annuity Exemption for Pension and Profit-Sharing Plans.—Under section 3(a)(8) of the 1933 Act, any insurance or endowment policy or annuity contract or optional annuity contract issued by a corporation subject to the supervision of an insurance commissioner, bank commissioner or any agency performing like functions is an exempt security. The Commission will raise no question concerning the necessity of registering a voluntary contributory pension or profit-sharing plan in which the proceeds are utilized solely for the purpose of purchasing such annuities or insurance policies.[25] Certain plans, however, may contain peculiar features which necessitate registration even though the funds are used to purchase annuity contracts or insurance policies. For example, plans that purchase other securities may be required to register, even though they are primarily funded by exempt insurance policies or annuity contracts.[26]

The statutory exemption for annuity or optional annuity contracts refers to the traditional or "straight" annuity where the annuitant pays a periodic fixed premium and at a specified time the annuity company is obligated to make periodic payments in a fixed

24. *But see* text accompanying notes 13-17 *supra*. *See also* Klaus, *A Corporate Quandry: Search for an Adequate Method of Executive Compensation,* 4 TULSA L.J. 197 (1967); Note, *Phantom Stock Plans,* 76 HARV. L. REV. 619 (1963).

25. Opinion of Assistant General Counsel of Commission, 1 CCH FED. SEC. L. REP. ¶ 2105.53 (1941). In addition, pension and profit-sharing plans of normal industrial companies in continuous existence prior to July 27, 1933, may be exempted provided there has been no substantial change since that date in the nature of the security or the terms of tbe offering.

26. Opinion of Assistant General Counsel of Commission, 1 CCH FED. SEC. L. REP. ¶ 2105.50 (1941).

amount to the annuitant. A plan that authorizes the purchase of variable or flexible fund annuity contracts, however, must register unless otherwise exempted. Because such contracts provide for an annuity based upon investment performance of the securities pool in which the annuitant participates, the annuity is considered to be an investment contract, which must be registered under the 1933 Act.[27]

2. Employee Benefit Plans and the Private Offering Exemption.—The private offering exemption is frequently relied upon for omitting the registration of employee benefit plans. Section 4(2) of the 1933 Act exempts from registration "transactions by an issuer not involving any public offering." Although the term "public offering" is not defined in the Act, it is clear that the exemption is available for offerings to a limited number of persons having access to substantially the same information concerning the issuer that registration would provide and who are able to fend for themselves. Whether a transaction is one not involving any public offering is essentially a question of fact and requires a thorough consideration of all circumstances, including the number of offerees, the relationship of the offerees to the issuer and the manner of the offering.[28]

The number of offerees is a relevant, but not decisive, factor in determining whether an offering qualifies for the private offering exemption. In *SEC v. Ralston Purina Co.*,[29] the Supreme Court specifically admonished against "superimposing a quantity limit on private offerings as a matter of statutory interpretation." Over a period of four years Ralston Purina Company had sold nearly 2,000,000 dollars of its unregistered treasury stock to 1,088 of its lower-echelon employees. At that point, the Commission brought an action to enjoin the company's proposed offering to approximately 500 more employees. The offering was made pursuant to a plan adopted by a corporate resolution authorizing the sale of common stock to employees at a price equal to or lower than the current

27. SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). For a discussion of the securities aspects of variable and flexible fund annuities, see BLOOMENTHAL, *supra* note 18, § 2.08; Frankel, *Variable Life Insurance*, 4 REV. OF SEC. REG. 837 (1971); Martin, *The Status of the Variable Annuity as a Security: A Lesson in Legal Line Drawing*, 30 OHIO STATE L.J. 736 (1960); Annot., *What Annuity Contracts are Subject to Securities Act of 1933—Federal Cases*, 18 L. Ed. 2d 1557 (1968); Note, 1970 DUKE L.J. 583.

28. SEC Securities Act Release No. 5223 (Jan. 11, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487; 1 LOSS, *supra* note 1, at 653; Annot., *What Constitutes a Public Offering Within the Meaning of § 4(2) of Securities Act of 1933 (15 U.S.C. § 77d(2)), Exempting From Its Registration and Prospectus Requirements Transactions By an Issuer Not Involving 'Any Public Offering'*, 6 A.L.R. FED. 536 (1971).

29. 346 U.S. 119 (1953).

market price of the stock. The employees who responded to the offer held duties such as bakeshop foreman, clerical assistant, mill office clerk, stock clerk, credit trainee, production trainee and stenographer. Although the Supreme Court recognized that some employee offerings may fall within the private offering exemption,[30] the Court held that employees are just as much members of the investing public as any of their neighbors in the community and are entitled to the safeguards of the 1933 Act. The Court stated that the focus of inquiry should be "whether the particular class of persons affected needs the protection of the Act"[31] and this depended upon the employees' ability to fend for themselves and their access to the kind of information available in a registration statement.

Despite the *Ralston Purina* opinion, some authors have continued to recommend that a twenty-five-person rule of thumb may be relied upon for a private offering exemption.[32] Any doubt concerning the Commission's view of the twenty-five-person rule should have been dispelled by the cases of *Gilligan, Will & Co. v. SEC,*[33] in which the Second Circuit indicated that an offering to three persons constituted a public offering, and *Meadow Brook Nat'l Bank v. Levine,*[34] which held that the transfer of stock to one person is not necessarily exempt as a nonpublic offering since this person may be in need of the protection of the Act.

A further warning against reliance on the twenty-five-person rule was given in a November 1962 Commission Release which emphasized that "the number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available."[35] In this release the Commission specifically discussed offerings to employees and reaffirmed the *Ralston Purina* decision by stating that the private offering exemption does not become available simply because the offerees are furnished information concerning the issuer. An issuer cannot circumvent the registration requirements simply by offering to open its books to all offerees.[36] Finally, in a recent release discussing the changes in adopted

30. For example, an offering made only to executive employees who because of their position have access to the same kind of information available in a registration statement.

31. 346 U.S. 119, 125 (1953).

32. Orrick, *Some Observations on the Administration of the Securities Laws,* 42 MINN. L. REV. 25 (1957); Comment, *Securities Aspects of Pension, Profit-Sharing and Stock Bonus Plans,* 17 Sw. L.J. 444 (1963).

33. 267 F.2d 461 (2d Cir. 1959).

34. [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,496 (N.Y. Sup. Ct. 1965).

35. SEC Securities Act Release No. 33-4552 (Nov. 6, 1962), 1 CCH FED. SEC. L. REP. ¶ 2771, at 2919.

36. United States v. Hill, 298 F. Supp. 1221 (D. Conn. 1969); Martin Yale Indus., Inc.,

Rule 146, the Commission again referred to the *Ralston Purina* decision, and stated that the Commission "continues to be of the opinion that the question is not to be determined exclusively by the number of offerees."[37]

In addition to the number of offerees it is equally or more important to consider the relationship of the offerees to the issuer and the ability of the offerees to acquire information concerning the affairs of the issuer. An offering to the members of a class of high executive officers who should have special knowledge of the issuer is less likely to be a public offering than is an offering to subordinate employees who do not have this advantage.[38] The limitation of an offering to key employees, however, does not make the offering a private offering absent a showing that such employees have access to the kind of information which a registration statement would disclose.[39]

Because it is the ultimate purchaser who requires the protection of the 1933 Act's disclosure requirements, another important factor in determining the availability of the private offering exemption is whether the securities have come to rest in the hands of the initially informed group of employees or whether the employees are mere conduits for a wider distribution.[40] Sections 4(1) and (5) of the 1933 Act require registration of securities publicly offered by underwriters. Under section 2(11) the term "underwriter" is defined to include "any person who has purchased from an issuer with a view to . . . the distribution of any security." This broad definition makes a single employee a statutory underwriter if he purchases the corporate employer's stock with the intent to resell it to the public. In that case, it could be argued that the issuer was also directly involved in a public offering and that unless a registration statement was effective the issuer could be subject to the civil liability provisions of the 1933 Act. In order to protect against this possibility, issuers intending to rely on the private offering exemption may want to protect themselves by imposing certain requirements on the em-

[1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,673 (SEC 1971); State Bond & Mortgage Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,195 (SEC 1971).

37. SEC Securities Act Release No. 33-5487 (April 23, 1974), 1 CCH FED. SEC. L. REP. ¶ 2710 at 2907-3.

38. SEC Securities Act Release No. 33-285 (Jan. 24, 1935), 1 CCH FED. SEC. L. REP. ¶ 2740.

39. SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); J.W. Altman v. American Foods, Inc., 262 N.C. 671, 138 S.E.2d 526 (1964); BLOOMENTHAL, *supra* note 18, § 4.04(7) (discussion of *Continental Tobacco Co.*).

40. SEC Securities Act Release No. 33-4552 (Nov. 6, 1962), 1 CCH. FED. SEC. L. REP. ¶ 2770.

ployees' participation in the plan. The plan may require that (1) the securities may only be purchased for investment purposes; (2) the securities may not be purchased with the view to their distribution; (3) the employee must provide a certificate at the time he purchases the securities stating that he is purchasing for investment purposes; (4) the employee must give the employer an opportunity to purchase before he may sell his securities; (5) the employee may not sell to anyone except the employer, which must repurchase the securities at a fixed price on demand by the employee; or (6) the employee must hold the securities for a certain period of time.[41]

The issuer should also require an investment letter from the employee containing (1) a statement of his knowledge of the issuer and his intent to purchase the securities for investment purposes and not for resale to the public, and (2) an agreement by the employee not to dispose of the securities without giving the issuer satisfactory evidence that his disposal will not violate the 1933 Act. The investment letter should also contain an acknowledgment by the employee purchaser that he has been advised as to the circumstances under which he is required to take and hold the securities. Securities Act Release No. 5226, issued January 10, 1972, makes it quite clear that the Commission considers it a deceptive act for an issuer or an affiliate to sell unregistered securities in a private transaction without fully informing the purchaser of the limitations upon the resale of the securities.[42] Accordingly, the letter should acknowledge that the purchaser has been advised that (1) the securities are unregistered, (2) the securities purchased must be held indefinitely unless an exemption is available or securities are subsequently registered, (3) any routine sale of the securities made in reliance upon Rule 144 can only be made in limited amounts in accordance with the requirements of that Rule and (4) if the Rule is not available, compliance with Regulation A or some other exemption will be required.

If the seller represents to the purchaser that an attempt will be made to register the securities at a future date or that compliance with Regulation A or some other exemption will be affected, the letter should contain an acknowledgment by the employee that he has been advised of the time and the circumstances under which the attempt to register will be made or compliance with the exemption will be effected. If the issuer is not under an obligation to register the securities or to comply with an exemption, the letter should

41. See discussion in WASHINGTON & ROTHSCHILD, *supra* note 1, at 815.

42. SEC Securities Act Release No. 5226 (Jan. 10, 1972), 1 CCH FED. SEC. L. REP. ¶ 2785.

state that the purchaser has been so informed. The letter should also indicate whether the seller will furnish the purchaser with the necessary information for making routine sales of the securities under Rule 144. In addition, the Commission strongly encourages the use of restrictive legends on stock certificates and the letter should acknowledge that the purchaser has been informed, prior to any commitment to purchase, if such a legend will be placed on the certificate.

An investment letter, however, will not be of significant help if the employee finances the exercise of his stock option by means of a sale of the option shares. In this case the original investment intent is obviously lacking. Further, if an employee who owns shares of his employer's stock receives additional shares by means of a stock bonus or the exercise of a stock option and then sells some shares, he may be precluded from asserting that the sales were of the prior stock and registration may be required for the newly delivered stock. In such cases, the employer company may require that the employee's investment letter state that he is not acquiring the stock or exercising his option with a view to distributing any shares of stock previously acquired.

Employee investment letters are only precautions and are not sufficient alone to establish a private offering. The Commission has recognized the widespread use of written investment letters and has cautioned that such letters are self-serving and that "their acceptance at face value of such assurances will not provide a basis for reliance on the exemption when inquiry would suggest to a reasonable person that these assurances are formal rather than real."[43] Consequently, the issuer must consider all relevant factors to insure that the employee's intent is consistent with the requirements of the private offering exemption. Although no one factor is controlling, it has been widely recognized that the length of time between the acquisition date and the date of any proposed sale of the securities is of major significance. The longer the length of time the securities are retained, the more evidentiary support there is to prove that the shares were originally purchased with a view toward investment rather than distribution. Even though there is no specific time period during which the securities must be held to prove the original investment intent, the passage of three years will be strong evidence that the shares were originally purchased for investment purposes.[44]

43. SEC Securities Act Release No. 33-4552 (Nov. 6, 1962), 1 CCH FED. SEC. L. REP. ¶ 2777.

44. An additional problem should be noted with respect to the application of the private offering exemption to qualified employee benefit plans. Except for restricted or qualified

In addition, the offering of a small number of units indicates a probability that the offering will be completed within the confines of the private offering exemption and raises the presumption of a nonpublic offering. An offering of many units, however, indicates a probability that the units might come to rest in the hands of the general investing public and suggests that a public offering may be involved. Consideration must also be given to the question whether the offering might be regarded as a part of a larger offering that is a public offering. The Commission has listed the following factors for consideration: (1) are the offerings part of a single plan of financing; (2) do the offerings involve the issuance of securities of the same class; (3) are the offerings made at or about the same time; (4) is the same type of consideration to be received; and (5) are the offerings made for the same general purpose.[45]

On April 23, 1974, the Commission attempted to consolidate the above-mentioned factors by announcing the adoption of Rule 146 to define those transactions that do not involve a public offering. The rule operates prospectively from June 10, 1974. Although not intended to be the exclusive manner of complying with the private placement exemption, Rule 146 establishes certain conditions which, if met, mean that the offering would not be deemed a public offering. Briefly, the conditions required by the rule are as follows:

1. If there were offers or sales during the six-month periods before or after the offering pursuant to Rule 146, the integration factors set forth above must be considered.

2. The issuer may not offer the securities through any form of general advertising or solicitation, including advertisements in newspapers or magazines, radio and television broadcasts, seminar or promotional meetings, or letters, circulars and the like. Written communications and meetings with offerees and offeree representatives that meet the requirements of paragraph 3 below, however, are permitted.

3. Prior to making an offer, the issuer must reasonably believe that the offeree has such knowledge and financial and business experience to be capable of evaluating the merits and risks of the prospective investment. Equally as important, the

stock option plans, many employee benefit plans qualified under the Internal Revenue Code will not meet the requirements of this exemption. Because I.R.C. section 401 requires that certain qualified plans provide for a broad coverage of the employees and not discriminate in favor of executive employees, some plans may not be limited to employees who are sufficiently informed or who have the requisite access to information. The plans, however, may be exempt under the 1970 amendments described above.

45. SEC Securities Act Release No. 33-4552 (Nov. 6, 1962), 1 CCH. FED. SEC. L. REP. ¶ 2781.

issuer must have reason to believe prior to making an offer that the offeree is able to bear the economic risk of the investment.

4. Immediately prior to a sale, the issuer, after making a reasonable inquiry, must reasonably believe that the offeree has the requisite experience and knowledge or that the offeree and his offeree representative together have such knowledge and experience and the offeree is able to bear the economic risk of the investment.

5. During the course of the transaction, the offeree (a) must have access to the same kind of financial and other information that he would receive in a 1933 Act registration statement or (b) must be furnished with such information. The offeree or his offeree representative must also have enough access to verify the accuracy of this information.

The term "access" is used in Rule 146 to refer to the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables the offeree to secure the requisite information from the issuer.

6. No more than thirty-five persons may purchase securities of the issuer in any offering in reliance on Rule 146.

7. The issuer must exercise reasonable care to assure that the purchasers are not statutory underwriters. Such reasonable care includes:

(a) making reasonable inquiry to determine if the purchaser is purchasing for his own account;

(b) placing a restrictive legend on the stock certificates;

(c) issuing stock transfer instructions to the transfer agent or making notations in the records of the issuer; and

(d) except with respect to certain business combinations, obtaining a written agreement from the purchaser that the securities will not be sold without registration or an exemption from registration.

3. Employee Benefit Plans and the Intra-State Exemption.—Section 3(a)(11) exempts from the registration and prospectus requirements of the 1933 Act:

> Any security which is a part of an issue offered and sold only to persons resident within a single State . . . where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State . . . .

This exemption was designed to apply only to local financing that may practicably be consummated in its entirety within a single state in which the issuer is both incorporated and doing business.

The fundamental purpose of this exemption requires that all securities forming a part of the issue be offered, sold and come to rest only in the hands of residents of the appropriate state. The Commission has held repeatedly that if a single offer is made to a single nonresident, either as part of the original sale by the issuer or as a result of a resale by one of the original purchasers before completion of the distribution, the exemption is defeated for the entire issue.[46]

A basic requirement for this exemption is that the entire issue be offered and sold only to residents of the appropriate state. Thus, an employer must consider whether an offering to employees made in reliance on section 3(a)(11) might be regarded as part of another offering made or proposed to be made in the future. For example, if an employer offers and sells its stock to employees residing in more than one state under circumstances supporting a private offering exemption under section 4(2) and then six months later in reliance on section 3(a)(11) sells additional stock to employees residing in a single state, the two offerings may be viewed as a single plan of financing constituting a single (integrated) offering and the exemption may be destroyed. Whether an offering is an integrated part of a previous or proposed offering is a question of fact. In determining the question of integration, the Commission considers the same factors as mentioned above in connection with the private offering exemption.[47]

To comply with the condition that the issue be "sold only to persons resident" in the state, the securities must "come to rest" only in the hands of residents of the offering state. The securities cannot be purchased by an employee with a view to resale to nonresidents. As a practical matter, it is extremely difficult for an issuer effectively to police resales to nonresidents by the original purchaser before the original offering is completed and all the securities have come to rest in the hands of the employee-investors. It is customary to require the employee to give written assurance that his purchase is not made with a view to resale to nonresidents. In addition, the stock certificate or certificates representing the employee's interest in the plan normally contain an appropriate legend prohibiting its transfer to nonresidents of the offering state.

The residency requirement has been construed by the Commission to mean "domicile." Because the exemption will be defeated

46. SEC Securities Act Release No. 33-1459 (May 29, 1937), 1 CCH FED. SEC. L. REP. ¶ 2260. *See also* SEC v. Van Horn, 371 F.2d 181 (7th Cir. 1966); Hillsborough Investment Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960).

47. SEC Securities Act Release No. 33-4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2270. *See also* Property Investments, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,201 (SEC 1972).

by sale to mere transient employees, the employer must verify something more than mere physical presence in the state at the time the employee makes his purchase. In order to comply with the residency requirement, all advertising of the employee benefit plan should include a statement to the effect that the plan is limited to bona fide residents of the appropriate state. Any written agreement with the employee should include (1) the employee's address, (2) a representation by the employee that he is a resident of the appropriate state, (3) a provision for rescission ab initio in the event the employee is not a resident of the appropriate state and (4) a provision stating that the offering is made in reliance on the intrastate exemption, setting forth the requirements of that exemption.

Section 3(a)(11) also requires that the issuer be incorporated under the laws of the state in which the securities are sold and be doing business within that state. One of the more complex aspects of the intrastate exemption concerns the question of what constitutes doing business. It is not necessary that the issuer do business exclusively in the offering state, but the exemption contemplates substantial operational activities; the mere presence of books or records in the state of incorporation is not sufficient.

On January 7, 1974, the Commission adopted Rule 147, which attempts to provide more objective standards for reliance on the section 3(a)(11) intrastate exemption. Rule 147 is available only for transactions by an issuer and is not available for secondary transactions. The rule narrows the availability of the exemption and sets forth stringent conditions that may be unworkable for many potential intrastate issuers. The rule does not afford, however, the only method of compliance with the section 3(a)(11) exemption; issuers may elect to claim the exemption under relevant judicial and administrative interpretations in effect at the time of the offering. For those parties that do rely upon Rule 147, it basically provides that all offers and sales that are part of the same issue must meet all of the conditions of the rule. The following traditional factors are applied in determining whether offers and sales should be integrated with other offerings: (a) are the offerings part of a single plan of financing; (b) do the offerings involve the issuance of the same class of securities; (c) are the offerings made at or about the same time; (d) is the same type of consideration to be received; and (e) are the offerings made for the same general purpose.[48] Once this question is

48. As with Rule 146, these factors need not be applied to registered offerings, private offerings and offerings of exempt securities if, during the six-month periods preceding and following the Rule 147 offering, the issuer makes no offers or sales of securities of the same class as those offered or sold in the Rule 147 offering.

settled, the rule sets forth the following conditions to satisfy the intrastate exemption:

(a) The issuer must be resident and doing business within the state or territory in which the securities are offered and sold;
(b) The offerees and purchasers must be resident within the state or territory; and
(c) Resales for a period of nine months after the last sale which is part of an issue must be limited.

The residency requirement of Rule 147 may prove unduly restrictive and unworkable. A corporate issuer is deemed to be a resident of the state or territory in which it is incorporated or organized. In order to be considered doing business within a state or territory, an issuer must:

(a) derive at least eighty percent of its gross revenues from business, real property or services within the state or territory;
(b) have at least eighty percent of its assets within the state or territory;
(c) intend to use and actually use at least eighty percent of the net proceeds from the Rule 147 transaction in connection with (i) the operation of a business or of real property, (ii) the purchase of real property located in the state or territory, or (iii) the rendering of services within the state or territory; and
(d) have its principal office within the state or territory.
Rule 147 also sets forth the applicable periods of the above-mentioned revenue and assets tests and contains an exemption for gross revenues not exceeding 5,000 dollars.

As noted above, at the time of offer and sale all offerees and purchasers must be residents of the state or territory of which the issuer is a resident. A corporation, partnership, trust, or other form of business entity is considered a resident of the state or territory where it has its principal office. If the entity is organized for the specific purpose of acquiring part of an issue offered under Rule 147, all of the beneficial owners of the entity must be residents of the state or territory.

During the period in which securities are offered pursuant to Rule 147 and for nine months from the date of the last sale by the issuer of such securities, resales may be made only to residents of the state or territory. This limitation applies to covertible securities and, if conversion is made, to the underlying security. Rule 147 requires the issuer to disclose this limitation to all offerees. In addition to the disclosure of resale limitations, the issuer must (a) obtain a written representation of residency from each purchaser; (b) give stock transfer instructions to the transfer agent, or, if the issuer transfers its own securities, make a notation in its records; and (c) place a legend on the certificate representing the security, stating that the security has not been registered and setting forth the limitations on resale.

The intrastate exemption should be used with considerable caution. For example, the intrastate exemption is not generally useful for pension, profit-sharing, and stock bonus plans of large companies because such companies tend towards interstate operation and are likely to have employees in many states. Moreover, if the plan is administered by a trust, the intrastate exemption will not apply since the trust is then the issuer of the participation in the plan and the trust entity is incorporated in a state other than the one in which the company does business.[49] The consequences of losing the exemption subject the issuer to certain liability under section 12 of the Act.[50] Even if the security has appreciated in value, the Commission will generally require that an offer of rescission be made to all of the original offerees through a prospectus filed as part of a registration statement under the 1933 Act. Persons involved in an intrastate offering that loses its exemption are subject to SEC suits for injunction, civil actions, and in some instances, criminal actions.[51]

4. Regulation A Exemption.—Pursuant to section 3(b) of the 1933 Act the Commission has adopted Regulation A, which is a series of rules providing for a simplified form of registration. This exemption is available where the aggregate offering price of an issue does not exceed a certain amount during any one year. Originally the maximum amount was 300,000 dollars, but it is presently 500,000 dollars.

Regulation A consists of Rules 251 through 263.[52] Rule 255 requires the filing of a notification of the issue on Form 1-A with the Regional Office of the Commission at least ten days prior to the initial date of the offering and, for offerings exceeding 50,000 dollars, the filing of an offering circular containing the information specified in Schedule I of Form 1-A and the use of such a circular in the offering and sale of the securities.[53] The person to whom the securi-

49. *See* Continental Investors Life Ins. Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,084 (SEC 1971).

50. Suit must be brought within the statute of limitation found in § 13.

51. For a further discussion of the intrastate exemption see BLOOMENTHAL, *supra* note 1, § 4.04; 1 LOSS, *supra* note 1, at 591; Bloomenthal, *The Federal Securities Act Intra-State Exemption—Fact or Fiction?* 15 WYO. L.J. 121 (1961); Hyde, *supra* note 1, at 94.

52. 1 CCH FED. SEC. L. REP. ¶¶ 5742-54.

53. *But see* proposed Rule 257, 1 CCH FED. SEC. L. REP. ¶ 5748 (1973).

ties are expected to be sold must be furnished such a circular at least forty-eight hours prior to the mailing of the confirmation of sale to him. With respect to offerings under stock purchase, savings, stock options or similar plans for the benefit of employees, if the offering is not completed within twelve months from the date of the offering circular, Rule 256 requires a revised offering circular to be filed and used in accordance with the rules applying to the original offering circular.

The Commission has taken the position that this exemption will be available to pension, profit-sharing plans and similar plans if the aggregate employee contributions to the plan do not exceed 500,000 dollars for any one year. The availability of the exemption is not affected by the continuation of the plan over a period of years.[54] Because of the Commission's determination that a "sale" is involved only where the employee makes voluntary contributions to the plan, the 500,000 dollar limitation does not apply to contributions by the employer.

Although the Regulation A exemption may be helpful from time to time, it is of limited usefulness in connection with offerings pursuant to employee benefit plans for the following reasons:

(1) The Assistant Director's interpretation also appears to apply to other employee benefit plans involving direct investment in the employer's stock, such as stock option plans or stock purchase plans. With respect to stock option plans, it may be difficult for an employer to determine that the offering price will be limited to 500,000 dollars. For example, if three employees are given options to take down 160,000 dollars of a certain class of stock each year for five years, the employer cannot predict that the 480,000 dollars total in the third year will be the only stock in that class offered in that year. If the employer should offer stock to other purchasers in that year, the 500,000 dollar limit might be exceeded.

(2) It may be ill-advised for a corporation to commit its ability to sell 500,000 dollars of a particular class of securities per year under Regulation A to an employee benefit plan for a certain number of years, especially where a simple Form S-8 is available; the employer might be able to use Regulation A more advantageously to avoid registration of a later nonintegrated offering.

(3) The effect of Regulation A is severely limited in certain

54. *See* letter to CCH from Assistant Director, Division of Corporation Finance, 1 CCH FED. SEC. L. REP. ¶ 2105.51 (1953).

states because of the absence of comparable blue sky provisions. If a full registration statement is filed with the Commission, most states permit simplified forms of registration, which in effect permit the filing in the appropriate state office of a copy of the federal registration statement. A Regulation A filing, however, does not qualify for this simplified treatment in many states and thus a full registration statement is still required. The only practical value that Regulation A may have in these states occurs when the securities are not to be offered in that state but are to be offered in another state (such as New York), which does not require complete registration.

(4) The preparation of the notification and offering circular is nearly as complex as registering on Form S-8.[55]

C. Form S-8

The Commission has prescribed Form S-8 for the registration of (1) employer's stock offered to employees pursuant to a qualified pension, profit-sharing, stock bonus and similar plans; (2) qualified stock options and the employer's underlying stock; and (3) employer's stock offered pursuant to an employee stock purchase plan and the interests in such plans if they constitute a separate security.[56] This less expensive form may be used only by employers who

---

55. For a further discussion of Regulation A offerings, see 1 Loss, *supra* note 1, at 605; Glavin & Purcell, *Securities Offerings and Regulation A—Requirements and Risks,* 13 BUS. LAW. 303 (1958); Weiss, *Regulation A Under the Securities Act of 1933—Highways and Byways,* 8 N.Y.L.F. 1 (1962).

56. 17 C.F.R. § 239.16b (1974). The Form has an intricate set of General Instructions which must normally be followed very closely. These Instructions permit the use of the Form for the registration of the following securities:

(a) Securities of such issuer to be offered to its employees, or to employees of its subsidiaries, pursuant to a stock purchase, savings or similar plan which meets the following conditions:

(1) Periodic cash payments are made, or periodic payroll deductions are authorized, by participating employees in an amount not to exceed a specified percentage of the employee's compensation or a specified maximum annual amount;

(2) Contributions are made by the employer in cash, securities of the issuer or other substantial benefits, including the offering of securities at a discount from the market value thereof or the payment of expenses of the plan, in accordance with a specified formula or arrangement;

(3) Securities purchased with funds of the plan are acquired in amounts which, at the time of the payment of the purchase price, do not exceed the funds deposited or otherwise available for such payment: *Provided,* that such purchases are made periodically, or from time to time upon a reasonably current basis, and at prices not in excess of the current market price at the time of purchase;

(4) Prior to the time the employee becomes entitled to withdraw all funds or securities allocable to his account, he may withdraw at least that portion of

are required to file reports pursuant to section 13 or 15(d) of the 1934 Act and only for plans that purchase the securities of the employer. It cannot be used by plans designed to raise new capital. The Commission recently has proposed amendments to Form S-8 that increase the availability of the form for more types of employee plans, particularly certain option plans that may not receive special tax treatment under the Internal Revenue Code.[57]

The principal rationale for the use of Form S-8 has been the type of investment decision confronting the employee. Because an employee benefit plan usually provides the employee with a favorable investment without selling pressure from the employer, the Commission's view has been that the employee need not be completely informed about the employer's business. If an employee needs additional information, the issuer's annual report, proxy statements, and other communications distributed to stockholders generally are transmitted to him pursuant to Undertaking B of Form S-8.[58]

D. *Resale of Securities by Employees*

Under section 4(1) of the 1933 Act, only employee participants who are underwriters or affiliates of the issuers must comply with the Act's registration requirements in effecting a resale of securities purchased pursuant to an employee benefit plan. The staff often uses a ten percent rule of thumb in determining who is an underwriter, although any employee who acquires a substantial number of shares directly from an issuer may be deemed an underwriter if he purchases with a view to distribution. An employee participant is more likely to be deemed an underwriter when there is only a Form

---

the cash and securities in his account representing his contributions.

(b) Interests in the above plan, if such interests constitute securities and are required to be registered under the Act.

(c) Stock to be offered pursuant to "qualified," or "employee stock purchase plan" stock options as those terms are defined in sections 422 and 423 of the Internal Revenue Code of 1954, as amended, or "restricted stock options" as defined in section 424(b) thereof, provided, however, that for the purposes of this paragraph an option which meets all of the conditions of that section other than the date of issuance shall be deemed to be "restricted stock options."

For a discussion of the application of § 236.16(b)(4), see First Union, Inc., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,576 (SEC 1971).

57. Under the proposed amendments, the Form would be available for the following types of employee benefit plans: (1) employee security option plans meeting certain conditions without limiting reference to the Internal Revenue Code; (2) bonus, appreciation or similar plans meeting certain conditions; (3) plans involving securities other than stock securities; and (4) plans involving offers or sales to employees of a parent of an issuer.

58. For a discussion of this rationale and a criticism that it is no longer sufficient in many cases, see Dykstra & Reynolds, *A Review of Form S-8*, 5 REV. OF SEC. REG. 871 (1972).

S-8 registration statement on file or when there is no registration at all.[59]

Rule 144 sets forth certain conditions under which a purchaser in a private placement can sell the purchased securities without registration. The Rule applies to transactions in "restricted securities" acquired after April 15, 1972. Restricted securities are defined in the Rule as securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction not involving a public offering. Securities acquired pursuant to stock bonus, thrift or similar plans are included within the meaning of "restricted securities" because they have been acquired directly from the issuer.[60] Noncontrolling persons acquiring restricted securities prior to April 15, 1972, have the choice of complying with the Rule or the administrative interpretations in effect at the time of the resale. The Rule is not exclusive and securities may be sold without compliance with the Rule provided another exemption is available.

Basically, the Rule provides that any person who sells restricted securities of an issuer for his own account, or any person who sells these securities for the account of an affiliate of the issuer shall be deemed not to be engaged in the distribution of these securities and, therefore, not to be an underwriter if all of the conditions of the Rule are met. In order to comply with the Rule:

(1) adequate current information must be available to the public with respect to the issuer of the securities;

(2) the restricted securities must have been held by the person for whose account they are sold for a period of at least two years, and, if the securities were purchased, the full purchase price or other consideration must have been paid or given at least two years prior to the sale;

(3) the amount of securities sold in any six-month period may not exceed one percent of the total shares of the same class outstanding as shown in the most recent report or statement published by the issuer or, if the securities are traded on a national securities exchange, the average weekly reported value of trading on all securities exchanges during the four weeks preceding the filing of the notice on Form 144 with the Commission;

(4) the sale must be made in "brokers' transactions," and the person selling the securities may not solicit or arrange for the

---

59. *See* Gettleman, *Resale of S-8 Stock,* 6 REV. OF SEC. REG. 934 (1973).

60. E.I. duPont de Nemours & Co., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,941 (SEC 1972); [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,701 (SEC 1972).

solicitation of buy orders or make any payment in connection with the sale other than to the broker;

(5) the broker selling the securities must make reasonable inquiry to ascertain that the transaction is not part of a distribution and the seller is not an underwriter;

(6) three copies of a notice of proposed sale must be filed with the Commission on Form 144, and, if the securities are admitted to trading on any national exchange, one copy of this notice must be filed with that exchange; and

(7) the seller filing the notice of proposed sale must have a bona fide intent to sell the securities within a reasonable time after the filing of the notice.

A number of SEC rulings have recently interpreted the application of the two-year holding period to employee benefit plans. The following three examples indicate the staff's approach to this requirement:

(1) With respect to an employee's interest in a profit-sharing trust, the holding period does not relate back to the acquisition of shares by the trust, but commences only when the employee's interest is distributed to him.[61]

(2) Where shares obtained through a savings and stock bonus plan are held by a trust and do not vest until five years after they are credited to an employee's account, the employee is required to hold the shares an additional two years after delivery.[62]

(3) If shares acquired pursuant to a company's employee stock incentive plan are payment for services, the two-year holding period begins from the time all services have been rendered.[63]

Noncontrolling employees owning restricted securities who cannot satisfy the requirements of Rule 144 may be able to sell their securities pursuant to Rule 237. Generally, an exemption from registration is available under this Rule provided: (1) the seller was the beneficial owner of, and had fully paid for, the securities for five years; (2) the issuer has been a going concern for five years; (3) the sale is a negotiated transaction other than through a broker or dealer; (4) during any twelve-month period the seller's sales under this Rule do not exceed 50,000 dollars or

61. INTERNATIONAL FLAVORS & FRAGRANCES, INC., [1972-1973 TRANSFER BINDER] CCH FED. SEC. L. REP. ¶ 79,216 (SEC 1972).

62. General Elec. Savings & Stock Bonus Plan, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,239 (SEC 1972).

63. Forest Oil Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,862 (SEC 1972).

the proceeds of the sale of one percent of the securities of the class outstanding; and (5) the seller files a certain notice with the Commission at least ten days before the sale.[64]

For those securities acquired pursuant to Form S-8, Undertaking C of Form S-8 requires a new prospectus in connection with resales by any person who may be deemed an underwriter:

> That for the purpose of any public offering of any such securities (otherwise than on a national securities exchange) by any person who may be deemed an underwriter of such securities, the issuer will, prior to such public offering, file a prospectus containing, in addition to the information required by this Form, information which would be required by Items 1, 2, 7-12, 16, 17 and 20 of Form S-1 if the securities to be so offered were registered on the Form.

The undertaking does not apply, of course, when shares are resold on a national securities exchange.[65] In short, whether or not an employee participant is deemed to be an underwriter, he may resell the securities (on a national securities exchange) acquired pursuant to an employee without compliance with the requirements of Rule 144, provided an S-8 prospectus which is current under section 10(a)(3) has been delivered to the exchange pursuant to Rule 153.[66]

The staff has taken the position that if the shares are registered for resale on a national securities exchange on Form S-8 and a current prospectus is available, these shares should be sold pursuant to the current prospectus; Rule 144 would not be available for the sale of such securities even if the issuer files a post-effective amendment to deregister the securities.[67] If the Form S-8 prospectus is not available, either because it is not current or because the resales are not to be made on a national securities exchange, and the prospectus has not been amended to include the additional information

64. Noncontrolling persons may also be able to sell their securities pursuant to Regulation A. This regulation has been amended to provide a means by which an offering not to exceed $100,000 can be made by a noncontrolling person, or an aggregate of $300,000 by all such persons, during any one year without offsetting such amounts against the amount which the issuer can offer under Regulation A.

65. The Sorg Paper Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,541 (SEC 1971).

66. Capitol Indus., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,438 (SEC 1971).

67. Technical Operations, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,806 (SEC 1972).

prescribed by Undertaking C, Rule 144 may be used to effect the resale.[68]

E. *Effect of Violation of 1933 Act's Registration Requirement*

A violation of the 1933 Act's registration requirements does not appear to render void an employee benefit plan that does not cause harm to the investing public. In *A. C. Frost & Co. v. Coeur D'Alene Mines Corp.*,[69] the Supreme Court held enforceable a stock option agreement to purchase treasury stock, even though the treasury stock of the defendant corporation had never been registered. The Court emphasized that the 1933 Act's clear legislative purpose was the protection of innocent purchasers of securities and that such purchasers "are given definite remedies inconsistent with the idea that every contract having relation to sales of unregistered shares is absolutely void."

The Commission subsequently has taken the position that the contract in the *Frost* case was not intended to cause harm to the investing public, but that a contract in violation of the 1933 Act that is intended to cause such harm will not be enforceable.[70] The *Frost* case, however, does not preclude rescission by an employee investor in the event a security is sold in violation of the 1933 Act. Section 12 of the 1933 Act provides that an investor who purchases securities from one who violates section 5 of the Act may recover his consideration paid with interest, less the amount of any income received on the security. Accordingly, if an employee plan that was required to be registered was not so registered, an employee can bring an action to enforce his rights under the plan. He can also bring an action for the plan's rescission and for a return of payments made pursuant to the plan.[71]

III. THE SECURITIES EXCHANGE ACT OF 1934

The Securities Exchange Act of 1934 requires registration of securities listed on national securities exchanges and of equity securities traded in the over-the-counter market if the issuer has a million dollars in assets and a class of equity securities held by 500 or more shareholders of record. Equity security is broadly defined in the 1934 Act and includes warrants, stock options, and any certif-

---

68. *See* American-Standard; David A. DeWahl, on behalf of American Society of Corporate Secretaries, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,071 (SEC 1972).

69. 312 U.S. 38 (1941).

70. 17 SW. L.J. 445, 458 (1963).

71. 2 WASHINGTON & ROTHSCHILD, *supra* note 1, at 822.

icate of interest or participation in any profit-sharing agreement.[72]

The registration provisions of the 1934 Act have little applicability to employee benefit plans. Employee interests in such plans are not traded on exchanges. The only securities likely to be listed on a national exchange are shares of the corporate employer's stock issued pursuant to a stock option plan, stock bonus, or stock purchase plan. These securities will have been previously registered under the 1934 Act as a prerequisite to being listed on a national exchange, and their registration will not normally be made in connection with the adoption of the employee benefit plan.

As mentioned previously, section 3(a)(12) of the 1934 Act includes in the category of exempted securities any interest or participation in a collective trust fund maintained by a bank or in a separate account maintained by an insurance company issued in connection with (a) a pension, stock bonus, or profit-sharing plan qualified under I.R.C. section 401, or (b) an annuity plan meeting the requirements for the deduction of the employer's contribution under I.R.C. section 404(a)(2) except for a plan which covers participants who are employees within the meaning of I.R.C. section 401(c)(1). As exempted securities, such interests or participants are exempt from the registration provisions of the 1934 Act.

In addition, the Commission has adopted Rule 12h-2, which exempts from registration any interest in a stock bonus, stock purchase, profit-sharing, pension, retirement, incentive, thrift, savings or similar employee plan unless this interest may be transferred by the employee in situations other than death or mental incompetency. The staff of the Commission has stated that it will not object if such interest is pledged as collateral for a personal loan.[73] Rule 12h-2 also exempts from registration any interest in any common trust fund or similar fund maintained by a bank exclusively for a collective investment or reinvestment of monies contributed to the fund by the bank in its capacity as a trustee, executor, administrator, or guardian.[74]

It should be noted that an "exempted security" does not mean that it is exempt from all provisions of the 1934 Act. This type of security will only be exempt from those sections of the Act that specifically exclude exempted securities. Accordingly, counsel must examine a particular provision to determine whether an "exempted security" is in fact exempted from such provision.

72. Reg. § 240.3a11-1, 2 CCH FED. SEC. L. REP. ¶ 21, 186 (1973).

73. Hyster Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,592 (SEC 1971).

74. 2 CCH FED. SEC. L. REP. ¶ 23,343 (1965).

IV. Investment Company Act of 1940

In addition to the requirements of the 1933 and 1934 Acts, employee benefit plans may be subject to the requirements of the Investment Company Act of 1940. An investment company must register with the Commission by filing a notification of registration and then a formal registration. Section 3 of the 1940 Act defines an investment company as any issuer, which is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading of securities, or which is in the business of issuing installment type face-amount certificates, or which owns or proposes to acquire investment securities exceeding forty percent of the value of the issuer's total assets. The securities of such companies that are offered to the public must also be registered under the 1933 Act.

Section 2(a)(13) of the 1940 Act defines "employees' securities company" as follows:

> any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned (A) by the employees or persons on retainer of a single employer or of two or more employers each of which is an affiliated company of the other, (B) by former employees of such employer or employers, (C) by members of the immediate family of such employees, persons on retainer, or former employees, (D) by any two or more of the foregoing classes of persons, or (E) by such employer or employers together with any one or more of the foregoing classes of persons.

Simple stock bonus plans that provide for immediate distribution are not within the scope of this definition, but employee benefit plans that provide for the establishment of a fund may be subject to the requirements of the Act. For example, an employees' stock purchase plan that involves important departures from the ordinary broker-client relationship[75] may create a separate security which must be registered under the 1933 Act and the issuer of which may be an investment company required to register under the 1940 Act.[76]

The following situations, however, may present exceptions to these registration requirements:

1. Pension or profit-sharing plans within the scope of the above definition that are exempt from registration under the 1933 Act because they involve nothing more than the purchase

---

75. Examples of such departures are limitations on the right of the employee to withdraw from the plan or withdraw securities held in custody, the granting of management discretion to someone other than the employee, the accumulation of sums for material periods of time before investment, the payment of special fees, or the diminution of his rights as a shareholder.

76. 1 CCH Fed. Sec. L. Rep. ¶ 1,133 (1965). *See also* Kerr, *The Inadvertent Investment Company,* 12 Stan. L. Rev. 29 (1959).

of insurance policies or annuity contracts on behalf of the employees would seem by the same token not to come within the requirements of the 1940 Act. This purchase is not considered an investment in securities, because insurance policies and annuity contracts are not subject to registration under the 1933 Act. A plan involving the purchase of variable annuities or flexible fund annuities, however, should register.[77]

2. The Commission has taken the position that an investment company's arrangement that funds H.R. 10 or Keogh plans with investment company securities and life insurance contracts does not create a separate investment company nor a separate security.[78]

3. The 1970 amendment to section 3(c)(11) of the 1940 Act excludes from the definition of "investment company" (a) any employees' stock bonus, pension, or profit-sharing trust qualified under I.R.C. section 401; (b) any collective trust maintained by a bank consisting solely of assets of these trusts; or (c) any separate account the assets of which are derived from (1) contributions under pension or profit-sharing plans that meet the requirements of I.R.C. section 401 or the requirements for the deduction of the employer's contribution under I.R.C. section 404(a)(2), and (2) insurance company's advances made pursuant to the operation of such account.

4. Separate accounts used as an investment means for Keogh (H.R. 10) plans are also excepted from the definition of investment company and need not register. These accounts, however, are subject to the registration requirements of the 1933 Act and the fraud provisions of the 1933 and 1934 Acts.[79]

5. Under section 3(c)(1) of the 1940 Act an exemption is granted when the issuer's securities are beneficially owned by not more than one hundred persons and no public offering of its securities is proposed.

6. Pursuant to section 6(b) of the 1940 Act, upon application the Commission may grant an exemption to any employee's securities company if this action is consistent with the protection of investors.

Under Rule 6B-1, any employees' securities company that files an

77. *See* 1 CCH FED. SEC. L. REP. ¶ 2,105.50 (1941).

78. Investment Co. Act Release No. 5510 (Oct. 8, 1968), [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,619.

79. Sun Life Ins. Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,559 (SEC 1971).

application for an order of exemption is considered exempt, pending final determination of the application by the Commission. In determining the appropriateness of an exemption the Commission is to give weight to (1) the form or organization and the capital structure of the applicant, (2) the persons by whom the applicant's voting securities, evidence of indebtedness and other securities are owned and controlled, (3) the issuing price of the securities and their sales load, (4) the disposition of proceeds of sales, (5) the character of the securities in which the proceeds are invested, and (6) any relationship between the applicant and the issuer of any security in which such proceeds are invested. The Commission has granted several applications in connection with employee benefit plans.[80]

In addition to the question whether or not an employee benefit plan is deemed an investment company, Rule 17-d-1 must be considered when the employer is a registered investment company. The Rule requires the Commission's approval before any transaction, including any profit-sharing, pension or bonus plan, may be effected with certain insiders.

The Commission's approval is not required, however, with respect to (1) any profit-sharing, stock option, or stock purchase plan provided by any control company that is not an investment company, provided certain affiliated persons do not participate in this plan, or (2) any plan provided by a registered investment company or any control company if such plan has been qualified under I.R.C. section 401 and all contributions paid under the plan by the employer qualify as deductible under I.R.C. section 404.[81]

CONCLUSION

This article has not attempted to present a detailed analysis of the many considerations surrounding employee compensation plans and the federal security laws. Rather, it has sought to highlight the fundamental problems that these laws pose for employee compensation plans and also to point out the available alternatives to the expensive and time-consuming process of registration. In addition, the article has attempted to emphasize the pitfalls that employers might encounter in seeking to avoid registration. Particular importance has been placed on the need to set requirements on employee participation in those plans that desire a private offering exemption

80. General Elec. S & S Program Mut. Fund, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,630 (SEC 1968); Thrift Plan of Tenn. Gas & Transmission Co., 24 S.E.C. 241 (1946); *In re* H.B.N.S. Corp., Investment Co. Act Release No. 1368 [1948-1952 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,033 (SEC 1949).

81. Rule 17d-1(d)(1), 3 CCH FED. SEC. L. REP. ¶ 48,392 (1974).

and also on the difficulties of satisfying the residency requirement for employees when the employer follows the intrastate offering exemption. Other warning signals were discussed in relation to the limited usefulness of Regulation A for employee compensation plans and also the dangers inherent in the resale of restricted securities pursuant to Rule 144. Hopefully, this basic summary of the relevant provisions of the federal securities law can provide the initial guidelines for those practitioners involved in constructing employee compensation plans.