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# COMMENTS

## SECURITIES ASPECTS OF PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS

James R. Craig

### I. INTRODUCTION

At the end of the third quarter of 1962, American industry was maintaining almost 80,000 pension, profit-sharing, and stock bonus plans which met the standards of the United States Treasury Department and thus qualified for favorable income tax treatment.<sup>1</sup> Furthermore, the annual net increase in the number of qualified plans is currently in excess of 9,000, as compared with a rate of about 1,000 a decade earlier.<sup>2</sup> Although these figures undoubtedly represent the bulk of all existing pension, profit-sharing, and stock bonus plans, there are still others in operation that have not been qualified for special tax treatment. These statistics indicate that such specialized compensation plans have become or are fast becoming a very important part of doing business in this country.

The growth of pension, profit-sharing, and stock bonus plans can be attributed primarily to their tax advantages and to union pressures. Demands by unions have been especially significant since it was held in the *Inland Steel* case<sup>3</sup> in 1948 that such plans were a proper subject of collective bargaining.

This comment will discuss the securities problems surrounding the adoption and use of pension, profit-sharing, and stock bonus plans growing out of the federal securities acts and relevant state legislation.<sup>4</sup>

### II. DEFINITIONS

Pension, profit-sharing, and stock bonus plans are all arrangements by which employees may be given benefits in excess of regular salary or wage compensation.<sup>5</sup> A pension plan systematically provides for the payment of benefits to retiring employees. A profit-sharing plan is established and maintained by an employer to provide for the participation in his profits by employees or their beneficiaries.

<sup>1</sup> See Int. Rev. Code of 1954, §§ 401, 501(a).

<sup>2</sup> P-H Pen. & Profit Sharing Rep. ¶ 1511 (1961).

<sup>3</sup> *Inland Steel Co. v. NLRB*, 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949).

<sup>4</sup> Not to be presented here are securities problems peculiar to the use of the stock option, another method widely employed for the giving of employee benefits.

<sup>5</sup> See P-H Pen. & Profit Sharing Rep. ¶¶ 2091 (1955), 3014 (1962), 5043 (1962).

Payments under a profit-sharing plan normally depend upon the prosperity of the business as a whole as well as upon individual or group performance. Stock bonus plans are established by corporate employers to provide benefits similar to those of profit-sharing plans, except that benefits are distributable in stock of the company and are often less dependent upon profits. From the standpoint of securities regulation, the plans may be dealt with similarly; the discussions following are generally applicable to each.

There are certain characteristics of each of the three plans that are important in determining whether a particular plan meets the requirements of the securities laws. In *voluntary* plans, the employee is not compelled to participate; in *compulsory* plans, the employee's participation is a condition of employment. Both of the above types of plans may be either contributory or noncontributory. A *contributory* plan, commonly called a "thrift plan" because of the employee savings feature, is one to which the employee makes contributions in addition to the employer's. *Noncontributory* plans are those to which the employee makes no contribution. Also, plans may be differentiated by the way in which the funds are used. For example, some plans invest all funds in government bonds, others purchase insurance and endowment policies, and still others invest in the stock of the corporate employer. Every plan qualified for favorable tax treatment is administered by a trustee, often a bank or trust company or a corporate trustee especially incorporated for that purpose.<sup>6</sup> Furthermore, provisions may be made for either cash or non-cash distributions to beneficiaries. Finally, any of the three basic plans may be combined with either or both of the other two to meet the needs of a particular employer.

### III. REGISTRATION AND OTHER PROBLEMS UNDER FEDERAL SECURITIES ACTS

#### A. Securities Exchange Act Of 1934.

Registration under the Securities Exchange Act of 1934<sup>7</sup> is presently required for only those securities listed and registered with one of the national securities exchanges.<sup>8</sup> Therefore, the registration provisions of the 1934 statute have little or no applicability to pension, profit-sharing, and stock bonus plans. Interests of beneficiaries in such plans are held by employees or their assigns and are not traded on national securities exchanges. The only securities related to em-

<sup>6</sup> See Int. Rev. Code of 1954, § 401.

<sup>7</sup> 48 Stat. 881-909 (1934), 15 U.S.C. §§ 78a-78jj (1958).

<sup>8</sup> See 48 Stat. 881 (1934), 15 U.S.C. § 78f (1958).

ployee benefit plans that are likely to be listed with a national securities exchange, thus requiring registration by the employer under this statute, are shares of the corporate employer's stock offered to the beneficiary under a stock bonus or other plan.<sup>9</sup> Such stocks will have been registered by the company under the provisions of the 1934 statute as a condition of being listed on an exchange, and their registration will normally not be related to the adoption of a given stock bonus plan.

### B. Securities Act Of 1933.

As pointed out by the United States Supreme Court in *SEC v. Ralston Purina Co.*,<sup>10</sup> the Securities Act of 1933<sup>11</sup> is designed "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."<sup>12</sup> Whether the framers of the statute intended it to apply to the compensation arrangements with which we are concerned has been questioned by some writers.<sup>13</sup> Neither the Securities Act nor the regulations promulgated thereunder contain provisions expressly related to pension or profit-sharing plans.<sup>14</sup> Furthermore, the authority of the Securities Exchange Commission over such plans has never been delineated by the judiciary.<sup>15</sup> The Commission, however, has taken the position that the provisions of the 1933 statute do apply to certain types of pensions, profit-sharing, and stock bonus plans.

#### 1. Registration Requirements.

The registration requirements applicable to a pension, profit-sharing, or stock bonus plan should be considered from the standpoint of the assets in which the plan's funds are invested as well as from the standpoint of the plan itself. In this respect, it is clear that any plan under which the employee's funds may be invested in securities of the corporate employer involves a security and is subject to registration unless the plan is within some exception or exemption of the 1933 Act.<sup>16</sup> There are exemptions in favor of government bonds,<sup>17</sup> insurance and endowment policies, and annuity contracts.<sup>18</sup> Therefore, most plans are set up to purchase these bonds, policies,

<sup>9</sup> II Washington & Rothschild, *Compensating the Corporate Executive* 823-25 (1962).

<sup>10</sup> 346 U.S. 119 (1953).

<sup>11</sup> 48 Stat. 74-91 (1933), 15 U.S.C. §§ 77a-77aa (1958).

<sup>12</sup> *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953).

<sup>13</sup> See, e.g., Note, 96 U. Pa. L. Rev. 549 (1948).

<sup>14</sup> 1 Loss, *Securities Regulation* 506, 508 (2d ed. 1961); P-H Pen. & Profit Sharing Rep. ¶ 6225 (1959).

<sup>15</sup> P-H, *op. cit. supra* note 14, at ¶ 6225 (1959).

<sup>16</sup> See II Washington & Rothschild, *op. cit. supra* note 9, at 798.

<sup>17</sup> 48 Stat. 906 (1934), as amended, 15 U.S.C. § 77c(a)(2) (1958).

<sup>18</sup> 48 Stat. 906 (1934), as amended, 15 U.S.C. § 77c(a)(8) (1958).

and annuities and do not invest the employees' funds in corporate securities. However, if the employees' funds are invested in mutual funds or other corporate securities, the plan will involve a security and may be subject to registration. If a plan provides that contributed funds *must* be invested in exempted bonds, policies, or annuities, a security requiring registration will not be involved, and the plan need not be registered.<sup>19</sup> However, it should be noted that *variable annuities are securities* which must be registered under the Securities Act.<sup>20</sup> Furthermore, a plan confined to endowment policies or annuity contracts but authorizing the purchase of variable annuities will not be exempted by the statute's annuity exemption. In addition, certain contributory plans that confer discretion on the administrator as to the investment of the funds are not exempted even though the funds are actually invested in exempt securities.<sup>21</sup>

a. *Is There a "Security"?* — In looking to the characteristics of the plan itself, as distinguished from the underlying investments, to determine whether provisions of the 1933 Act are involved, the first question is whether a *security* is involved. If there is no security as defined by section 2(1),<sup>22</sup> registration of the plan is not required. Section 2(1) defines "security" as, *inter alia*, a "certificate of interest or participation in any profit-sharing agreement" or an "investment contract." If a plan is to be considered as involving the issuance of a "security" distinct from the underlying investment securities, it must be because an interest in the plan is an investment contract or a participation in a profit-sharing agreement.<sup>23</sup> As already pointed out, the Securities Act does not specifically mention employee pension or profit-sharing plans. The legislative history of the act contains only one isolated reference to such plans, that reference being made in connection with a proposed amendment to the act. In 1934 the Senate proposed an amendment "to exempt an offering made solely to employees of an issuer or its affiliates in connection with a bona fide plan for the payment of extra compensation or stock-

<sup>19</sup> II Washington & Rothschild, *op. cit. supra* note 9, at 798, 800. Prof. Loss comments: [I]f all employees' contributions under a plan were required to go automatically into governmental securities . . . the employer acting in substance as their agent without discretion to invest otherwise, there would still seem to be a separate, non-exempted investment contract in principle. But as a matter of administrative policy no objection is likely to be raised. 1 Loss, *op. cit. supra* note 15, at 508 n.148.

See *Hearings, infra* note 24, at 877. But see II Washington & Rothschild, *op. cit. supra* note 9, at 799.

<sup>20</sup> SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).

<sup>21</sup> II Washington & Rothschild, *op. cit. supra* note 9, at 798. See note 27 *infra* and accompanying text.

<sup>22</sup> 48 Stat. 905 (1934), 15 U.S.C. § 77b(1) (1958).

<sup>23</sup> See 1 Loss, *op. cit. supra* note 14, at 506.

investment plan for the exclusive benefit of such employees."<sup>24</sup> That amendment was eliminated in conference "on the ground that the participants in employees' stock-investment plans may be in as great need of the protection afforded by availability of information concerning the issuer for which they work as are most other members of the public."<sup>25</sup> Thus, it would appear that the senators and representatives thought the enacted definition of security was broad enough to cover at least some employee compensation plans. Moreover, the section 2 definition of "security" has been construed liberally by the judiciary to bring within the confines of the act many contracts which are not considered securities by the layman.<sup>26</sup>

The position of the Securities Exchange Commission has been that any plan providing for the contribution of funds by employees with the expectation of receiving a return involves a security under the section 2(1) definition. The issuer is considered to be either the employer or the trust entity, if the funds are placed in trust. Whether the employer makes a contribution under the plan is not controlling. Theoretically, plans of this type are "investment companies" in which participation is limited to employees.<sup>27</sup> Under this reasoning, those plans providing merely for sick benefits, hospitalization, funeral expenses, or social and cultural activities do not involve securities and are not subject to regulation by the act because they do not provide an expectation of financial return. Furthermore, no separate "security" is considered to be involved in "insured plans"; the employer or administrator simply pays the employees' contributions, usually in the form of salary deductions, to an insurance company or an exempted annuity company for individual or group policies of which the employees are beneficiaries. If a particular plan is considered to involve a security, then one must look further to determine whether the 1933 Act applies.

b. *Is There an "Offering"?* — The next consideration is whether there is an "offering." This term is one of art relating to the definitions contained in section 2(3)<sup>28</sup> of the 1933 Act. If a plan does not meet those definitions, even though it may involve a security, it will

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<sup>24</sup> Hearings on H.R. 4344, Before the House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 895 (1941).

<sup>25</sup> H.R. Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934).

<sup>26</sup> E.g., devices which purport to be sales or leases of property have been held to be "securities" within the meaning of the statute because of their "investment contract" characteristics. SEC v. W. J. Howey Co., 328 U.S. 293 (1946) (units of a citrus grove development); SEC v. Joiner Leasing Corp., 320 U.S. 344 (1943) (oil and gas leaseholds); Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953) (units of a citrus development).

<sup>27</sup> 1 Loss, *op. cit. supra* note 14, at 506-8.

<sup>28</sup> 48 Stat. 74 (1933), 15 U.S.C. § 77b(3) (1958).

not be regulated by the act. Under section 2(3) "'sale', 'sell', 'offer to sell' or 'offer for sale' shall include every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. . . ."<sup>29</sup>

It is safe to say that a noncontributory pension, profit-sharing, or stock bonus plan does not require registration.<sup>30</sup> The Commission theorizes that there has been no "sale" for "value" because of the policy determination that there is no "value" given if participation in a plan is merely an incident of employment and involves no deductions from the employees' pay.<sup>31</sup> However, the benefits that the employee receives under a noncontributory plan cannot properly be considered as having been granted without consideration simply because no financial contribution was made by such employee.<sup>32</sup> An interesting question is whether the Commission would continue to take the same position if faced with a plan in which the promised future benefits were so great that the employee could be considered to have rendered his services primarily to obtain those benefits rather than for his normal compensation. Furthermore, the Commission's reasoning might not apply to a noncontributory plan under which, e.g., the employee could elect to take his benefits in either cash or his employer's stock or other securities.

Contributory plans, on the other hand, may be designed for either voluntary or involuntary employee contributions. The involuntary plan normally requires contributions through automatic payroll deductions. This plan, like the noncontributory plan, has been considered by the Securities Exchange Commission as not involving a "sale."<sup>33</sup> Chairman Purcell of the Commission explained that:

Compulsory plans do not require registration. If a plan is so set up that participation in it is a condition of employment, the Commission

<sup>29</sup> *Ibid.*

<sup>30</sup> *Hearings*, *supra* note 24, at 896; 1 Loss, *op. cit. supra* note 14, at 507; P-H Pen. & Profit Sharing Rep. ¶ 6226 (1959).

<sup>31</sup> 1 Loss, *op. cit. supra* note 14, at 508. See Op. SEC Ass't Gen. Counsel, 1941, 1 CCH Fed. Sec. L. Rep. ¶ 2231.21 (1959):

[I]t is because of the language of Section 2(3) that we have taken the position in the past that no 'offer' or 'sale' is involved in the case of a non-contributory plan, where the employees are not requested to make any contributions, or in the case of a compulsory plan, where there is no element of volition on the part of employees whether or not to participate and make contributions. *Id.* at 1172-73.

<sup>32</sup> In actions brought by employees to enforce the provisions of noncontributory compensation plans, most courts find adequate consideration in the fact of continued employment and do not require a showing that the employee would have remained at his job in the absence of the plan. See Note, 70 Harv. L. Rev. 490, 494 (1957).

<sup>33</sup> 1 Loss, *op. cit. supra* note 14, at 507; II Washington & Rothschild, *op. cit. supra* note 9, at 806; P-H Pen. & Profit Sharing Rep. ¶ 6226 (1959). See Op. SEC Ass't Gen. Counsel, *supra* note 31.

has taken the position that, as in the case of a noncontributory or bonus plan, there is no sale involved. The purpose of the registration provisions of the Securities Act is to disclose to prospective investors the essential facts about securities which they are asked to buy, and if the employees are given no choice as to whether to buy or to refuse to buy there hardly seems any point in the registration process.<sup>34</sup>

The major securities problems concern plans that are both voluntary and contributory. The Commission has taken the position that such plans are technically offers to sell securities and are, in the absence of exemptions, subject to registration.<sup>35</sup> However, there has never been a formal ruling by the Commission or the courts on the status of any of these plans under the Securities Act.<sup>36</sup> Furthermore, a proposal by the Commission in 1941 that the Securities Act be amended to exempt certain plans was opposed by employers' representatives who were not willing to concede that any of the plans were covered by the enacted statute.<sup>37</sup>

Significantly, although the Commission has indicated that all voluntary contributory plans are subject to registration, it has not put its determination into practical effect by requiring broad scale registration. For a number of years, registration was waived on the grounds that suitable forms were not available.<sup>38</sup> Then, in 1953 the Commission adopted a special registration form, S-8. That form required registration only for contributory plans under which investment was authorized in securities of the employer,<sup>39</sup> and then only if the purchase of the employer's securities might be in excess of the employer's contributions under the plan.<sup>40</sup> Form S-8, after revision in 1962, may be used only by those issuers required to file current reports with the Commissioner by virtue of their having issued securities listed on a national securities exchange or because the aggregate value of their outstanding securities equals or exceeds 2,000,000 dollars.<sup>41</sup> With the exception of the plans covered by this registration form, the Securities Commission still takes the informal

<sup>34</sup> *Hearings*, *supra* note 24, at 896-97.

<sup>35</sup> P-H Pen. & Profit Sharing Rep. ¶ 6226 (1959); Op. SEC Ass't Gen. Counsel, 1941, 1 CCH Fed. Sec. L. Rep. ¶ 2231.21 (1959). See Commissioner Purcell's definition of an investment contract as any plan under which employees are given the opportunity to place their earnings in a fund to be invested for their benefit and later returned to them. *Hearings*, *supra* note 24, at 899.

<sup>36</sup> 1 Loss, *op. cit. supra* note 14, at 508.

<sup>37</sup> See II Washington & Rothschild, *op. cit. supra* note 9, at 807 n.48.

<sup>38</sup> See Note, 96 U. Pa. L. Rev. 549, 550 (1948).

<sup>39</sup> SEC Securities Act Release No. 3480, —, 1953. There it was made clear that form S-8 did not apply to "an offering of interests in a plan which does not involve an offering of securities of an employer." *Id.* at 1.

<sup>40</sup> II Washington & Rothschild, *op. cit. supra* note 9, at 807.

<sup>41</sup> See 17 C.F.R. § 239.16b (Supp. 1963). See also 48 Stat. 894-95 (1934), 15 U.S.C. §§ 78m, 78o(d) (1958) for delineation of those issuers required to file annual reports.



position that "no question will be raised with respect to the registration of participations in a voluntary contributory pension, profit-sharing, or similar plan that does not invest in the securities of the employer company in an amount exceeding the company's contributions."<sup>42</sup> Still, it has been wisely said that "the law in this respect is not sufficiently clear . . . for safety's sake the SEC's opinion should be sought regarding the need for registering a particular plan."<sup>43</sup>

c. *The Private Offering Exemption.* — If a given plan is found to involve a security offered for sale, it is still possible that it is exempt from registration, if it is one of those plans to which the S-8 registration form applies. The Securities Act specifically exempts "transactions by an issuer not involving any public offering."<sup>44</sup> Although it might appear that an offering of securities to employees would not be an offering to the "public," in the normal sense of that word, such a conclusion is unsound in the context of the 1933 Act. The term "public" as it is used in the act has been given a very broad meaning, and it is unlikely that many plans will be able to satisfy the requirements of this exemption. An example of this expansive interpretation may be found in *SEC v. Ralston Purina Co.*<sup>45</sup> In that case, the Securities Exchange Commission brought an action to enjoin the offering and sale of unregistered company stock by Ralston Purina Co. to certain "key employees." The company relied upon the section 4(1) "private offering exemption." The Court, in reversing a dismissal of the Commission's suit, held that "to be public an offer need not be open to the whole world."<sup>46</sup> It indicated that the proper way to interpret the act's "private offering exemption" was to view it in the light of the statute's purpose "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."<sup>47</sup> The Court stated that only "an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'."<sup>48</sup> Moreover, the court indicated that corporate employees, as a class,

<sup>42</sup> Letter From G. J. O'Leary, Assistant Director, Division of Corporation Finance, SEC, to Prentice Hall, 1953, P-H Pen. & Profit Sharing Rep. ¶ 11941 (1962); Letter From Chas. E. Shreve, Chief Counsel, Division of Corporation Finance, SEC, to Prentice Hall, 1962: "The position stated in the letter of . . . 1953 is still pursued by this Division." P-H Pen. & Profit Sharing Rep. ¶ 11941 (1962). See also 1 Loss, *op. cit. supra* note 14, at 511; P-H Pen. & Profit Sharing Rep. ¶ 6228 (1957).

<sup>43</sup> P-H Pen. & Profit Sharing Rep. ¶ 6225 (1959).

<sup>44</sup> 48 Stat. 906 (1934), 15 U.S.C. § 77d(1) (1958).

<sup>45</sup> 346 U.S. 119 (1953). The Court's interpretation must suffice because the term "public offering" is not defined in the act itself.

<sup>46</sup> *Id.* at 123.

<sup>47</sup> *Id.* at 124.

<sup>48</sup> *Id.* at 125.

should not be deprived of the safeguards of the act and that "employees are just as much members of the investing 'public' as any of their neighbors in the community"<sup>49</sup> absent a showing of special circumstances which would give them access to the kind of information available through registration under the act.

Thus, theoretically, a public offering exemption is not determined by the number of offerees, but rather by the degree of their knowledge of the business affairs of the company. However, the Commission has long used its "rule of twenty-five" in such cases.<sup>50</sup> Mr. Andrew Orrick, then a member of the Commission, explained in 1957 that "as a rule of thumb, the Commission has considered that an offering made to not more than 25 or 30 persons . . . is generally a private transaction not requiring registration."<sup>51</sup> This "rule of thumb" is clearly not binding under the act, and the Supreme Court made clear that there is "no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation."<sup>52</sup> The Court conceded, however, that nothing prevented the Commission, "in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims."<sup>53</sup> As a practical matter, therefore, it is fairly safe to rely on this "rule of twenty-five." However, with an offering to more than twenty-five employees, the Commission will not give a "no action" letter "unless there is a showing that the offering is limited to executive or management personnel who are acquainted with and have access to the business and financial information concerning the issuer."<sup>54</sup>

Most plans do not qualify for the private offering exemption for two reasons. The first is that more than twenty-five persons are normally covered in a given plan, and the second is that most plans include employees who do not qualify as sufficiently informed. Significantly, to obtain favorable tax treatment under the Internal

<sup>49</sup> *Id.* at 126.

<sup>50</sup> See Op. SEC Gen. Counsel, 1935, 1 CCH Fed. Sec. L. Rep. ¶ 2266.17 (1962).

<sup>51</sup> Orrick, *Some Observations on the Administration of the Securities Laws*, 42 Minn. L. Rev. 25, 33 (1957).

<sup>52</sup> SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

<sup>53</sup> *Ibid.*

<sup>54</sup> Orrick, *supra* note 51, at 33. For these reasons, interests in a pension, profit-sharing, or stock bonus plan otherwise covered may be exempted from registration as part of a private offering only where the number of participants in the plan is less than twenty-five, as a practical matter, or where the participants, if more than twenty-five, are all key employees "all of whom are fully familiar with the business affairs of the company." II Washington & Rothschild, *op. cit. supra* note 9, at 814. Only in very rare cases has the Commission ruled an offering to employees to be exempt when more than one hundred were eligible to participate. *Ibid.* It should be clear that only those fairly high on the executive ladder can qualify as being sufficiently informed as not to need the protective benefits of the act. See generally Israels, *Some Commercial Overtones of Private Placement*, 45 Va. L. Rev. 851, 852-53 (1959).

Revenue Code of 1954, plans must provide benefits to employees below the executive level and cannot discriminate in favor of supervisory employees.<sup>55</sup>

Another problem is that under a plan providing for the distribution of stock of the corporate employer, registration of the stock is required even if there is only one beneficiary so long as he purchases with the intent to resell to the public. This conclusion is based upon the provision of the act requiring registration of securities publicly offered by underwriters as well as by issuers,<sup>56</sup> and an underwriter, as defined by section 2(11), includes "any person who has purchased from an issuer with a view to . . . the distribution of any security."<sup>57</sup> Such definition is broad enough to make the single beneficiary a statutory underwriter if he purchases with an intent to resell to the public.<sup>58</sup> This problem will arise more often with a stock option plan than with pension, profit-sharing, and stock bonus plans because a stock option plan most often distributes corporate stocks to employees. The problems of the statutory underwriter and secondary distribution will be considered in more detail.<sup>59</sup>

d. *The "Intrastate" Exemption.* — Another exemption found in the Securities Act is that for purely intrastate transactions. Section 3(11) exempts from the provisions of the act "any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a . . . corporation, incorporated by and doing business within, such State or Territory."<sup>60</sup> This exemption is applicable to interests in pension, profit-sharing, and stock bonus plans<sup>61</sup> and can be very useful to the relatively small company with no out-of-state employees. However, care should be taken to ascertain that no interests in the given plan are to go to out-of-state residents, for one such "sale" would destroy the exemption for the entire plan.<sup>62</sup> The intrastate exemption is not generally helpful to the larger companies in which pension, profit-sharing, and stock bonus plans are now most commonly found, for those companies tend to interstate operations and are likely to have employees in more than one state. Furthermore, if the plan is administered by a trust so that the trust is the issuer of the participa-

<sup>55</sup> See Int. Rev. Code of 1954, § 401(a).

<sup>56</sup> See 48 Stat. 906 (1934), 15 U.S.C. § 77d(1) (1958).

<sup>57</sup> 48 Stat. 905 (1934), 15 U.S.C. § 77b(11) (1958).

<sup>58</sup> See *Israels*, *supra* note 54, at 852.

<sup>59</sup> See text accompanying note 77 *infra*.

<sup>60</sup> 48 Stat. 906 (1934), 15 U.S.C. § 77e(11) (1958).

<sup>61</sup> See *II Washington & Rothschild*, *op. cit. supra* note 9, at 817-18; *Op. SEC Ass't Gen. Counsel*, 1941, 1 CCH Fed. Sec. L. Rep. ¶ 2231.21 (1959).

<sup>62</sup> See generally 1 *Loss*, *op. cit. supra* note 14, at 591-605.

tions in the plan and the trust entity is incorporated in a state other than the one in which the company does business, the intrastate exemption will not apply even for the small intrastate company.

e. *The "Small Issue" Exemption.* — There are no other exemptions under the Securities Act that are of any practical use in connection with new pension, profit-sharing, and stock bonus plans,<sup>63</sup> with the exception of the exemption from normal registration requirements provided by Regulation A of the Securities Exchange Commission for offerings of securities aggregating less than 300,000 dollars annually. This exemption differs from those above in that it does not exempt the security from coverage by the act, but merely provides a simpler registration process for small issues which would otherwise be required to be registered through normal channels, *viz.*, form S-8.<sup>64</sup>

The Regulation A exemption, often called the "small issue exemption," is not automatic, but exists only after certain prescribed conditions are met. The essential conditions are: (1) that notification of the issue be filed in the office of the Commission for the region in which the corporation's principal business operations are conducted at least ten days before the offering begins and (2) that for offerings aggregating over 50,000 dollars, an offering circular giving basic information about the issuer and the securities be filed and used in contacts with offerees.<sup>65</sup> The exemption is available if aggregate offering prices of the securities during a one year period do not exceed 300,000 dollars. The Commission's current view is that Regulation A is applicable to the "securities" of a voluntary contributory pension, profit-sharing, or similar plan "if the employees' contributions to the plan are not more than 300,000 dollars for any one year period."<sup>66</sup>

<sup>63</sup> However, theoretically there are additional grounds for exemption that may be available in a particular case.

For example, the plan may not involve any offering in interstate commerce or require the use of the mails. However, such a possibility is rare and this will usually be a risky exemption on which to rely. To bring the transaction within the Act it is not necessary that a prospectus or security be mailed; any use of the mails or of interstate communication is sufficient. II Washington & Rothschild, *op. cit. supra* note 9, at 817.

Furthermore, it has been pointed out that an exemption exists under "Section 3(a)(1) in the case of plans which have been continuously in existence since some date prior to July 27, 1933, and under which there has been no substantial change since that date in the nature of the security or of the terms of the offering." Op. SEC Ass't Gen. Counsel, 1941, 1 CCH Fed. Sec. L. Rep. ¶ 2231.21 (1959). The Commission has also adopted three exemptions from registration in addition to Regulation A. Regulation F exempts certain issues of assessable mining stock of less than \$100,000; Regulation B exempts various kinds of fractional undivided interests in oil or gas rights up to \$100,000 in total amount, and Regulation B-T exempts certain certificates of interest in trusts or unincorporated associations whose assets consist substantially of fractional oil or gas leasehold interests.

<sup>64</sup> See generally 1 Loss, *op. cit. supra* note 14, at 605-634.

<sup>65</sup> See 17 C.F.R. §§ 230.251-262 (Supp. 1963).

<sup>66</sup> P-H Pen. & Profit Sharing Rep. ¶ 6228 (1963). See 1 Loss, *op. cit. supra* note 14,

Note that the 300,000 dollar limitation is not applied to the amounts contributed by the employer. This view, of course, follows from the Commission's determination that a "sale" is involved only where the employee makes voluntary contributions under a given plan.<sup>67</sup> Under Regulation A, the corporation or trust administering the plan, considered to be the issuer of the interests therein, would be required to file anew each year for the contributions to be made in that year.

*f. Registration Form S-8.* — If a given pension, profit-sharing, or stock bonus plan is of the voluntary contributory type with employees' contributions allowed to be invested in securities of the corporate employer, and there are no applicable exemptions from the coverage of the act, and, further, if the employee contributions thereto will exceed 300,000 dollars annually so that Regulation A is inapplicable, the registration on form S-8 is required.<sup>68</sup> This form was adopted as of June 6, 1953.<sup>69</sup> At that time, the Commission explained that "most employees' stock purchase plans provide an opportunity for the accumulation by employees of securities of the employer upon favorable terms."<sup>70</sup> Therefore, "the investment decision required to be made by the employee is of a substantially different character than is involved where securities offered for the purpose of raising capital are sold upon the best obtainable terms."<sup>71</sup> Because of this difference, the form "is not intended for the registration of securities offered primarily for the purpose of raising capital."<sup>72</sup>

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at 615; Letter From G. J. O'Leary, Assistant Director, Division of Corporation Finance, SEC, to Prentice Hall, 1953, P-H Pen. & Profit Sharing Rep. ¶ 11941 (1962). This is a relaxation of the Commission's earlier view that the \$300,000 limitation to the amount of employee contributions applied to the total amount contributed throughout the life of the plan. Op. SEC Gen. Counsel, 1945, 1 CCH Fed. Sec. L. Rep. ¶ 2231.22 (1959).

<sup>67</sup> See note 35 *supra* and accompanying text.

<sup>68</sup> See note 39 *supra* and accompanying text. Interestingly, even before the adoption of form S-8, and during the time that the Commission informally took the position that full registration would not be required of the voluntary contributory plans which were considered to entail offers of securities, a few full registrations were filed. 1 Loss, *op. cit. supra* note 14, at 509. For example, each year statements were filed by Sears Roebuck & Co. and by the separate trust company administering the Sears pension and profit-sharing plan. The Sears plan requires that the fund be invested in company stock so far as is practicable and advisable. At the end of 1958, the plan owned in excess of twenty-six per cent of Sear's outstanding stock and was the company's single largest stockholder. The plan at that time had assets in excess of 1,061,000,000 dollars, with seventy-four per cent of them invested in Sears stock. N.Y. Times, Jan. 26, 1959, p. 38, col. 2. For those who used this form of full registration, the Commission adopted a rule permitting the use of an abbreviated prospectus for stock in which the plan's funds were to be invested. 1 Loss, *op. cit. supra* note 14, at 509.

<sup>69</sup> SEC Securities Act Release No. 3438, \_\_\_\_\_, 1953. The form and its accompanying instructions are set out at P-H Pen. & Profit sharing Rep. ¶¶ 8821-22 (1959).

<sup>70</sup> SEC Securities Act Release No. 3480, \_\_\_\_\_, 1953.

<sup>71</sup> *Ibid.*

<sup>72</sup> *Ibid.*

To register a plan by form S-8, one must file an abbreviated prospectus which includes a brief description of the plan, the employer's securities offered thereunder, and the employer's certified financial statement. The most recent annual certified reports to stockholders will suffice, so that there is no need to have financial statements prepared solely for the purpose of registration.<sup>73</sup> The employer must furnish to participating employees copies of all material distributed to stockholders, and the company must likewise periodically file such materials with the Commission for information purposes.<sup>74</sup> Possibly the most notable attribute of the form is that it eliminates the necessity for separate registration of the participations in the plan and the securities offered thereunder.<sup>75</sup> Also, it makes the cost of registration much less than the cost of a full registration.<sup>76</sup>

## 2. Statutory Underwriter and Secondary Distribution Problems.

Some significant problems arise under the 1933 Act because of the inter-relationship of sections 2(11), 4(1), and 5. Section 2(11) defines "underwriter" as "any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security . . . . [T]he term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."<sup>77</sup> Section 4(1) exempts from registration "transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering . . . ."<sup>78</sup> Section 5 is the act's basic registration requirement.<sup>79</sup> Because the term "underwriter" is defined in section 2(11) to include a person who contracts with either the issuer or any person in a control relationship with the issuer, a "secondary distribution" of outstanding securities must be registered if the person for whose account the distribution is made is in a control relationship with the issuer of the security. Furthermore, the definition of "control" under the Securities Act is not limited to ownership of a majority of the

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<sup>73</sup> See 17 C.F.R. § 239.16b (Supp. 1963).

<sup>74</sup> *Ibid.*

<sup>75</sup> See II Washington & Rothschild, *op. cit. supra* note 9, at 808.

<sup>76</sup> This savings is particularly good from the standpoint of a trustee plan, considered to be the issuer of its participation, for the cost of registration of its participations comes from the plan's funds, *Hearings on H.R. 4344 Before the House Committee on Interstate and Foreign Commerce*, 77th Cong., 1st Sess. 1020 (1942), and that cost is now much less than it might have been with a requirement of full registration and the necessity to compile, print, and distribute a major prospectus. *Ibid.*

<sup>77</sup> 48 Stat. 905 (1934), 15 U.S.C. § 77b(11) (1958).

<sup>78</sup> 48 Stat. 906 (1934), 15 U.S.C. § 77d(1) (1958).

<sup>79</sup> See 48 Stat. 906 (1934), 15 U.S.C. § 77c (1958).

stock of the controlled company.<sup>80</sup> If an officer or director is found to be one with substantial influence on company policies, he is considered a "controlling person."<sup>81</sup> Likewise, a stockholder with far less than majority ownership may be considered a controlling person.<sup>82</sup>

These statutory underwriter and secondary distribution provisions do not apply to pension, profit-sharing, or stock bonus plans unless the particular plan invests funds in the corporate employer's securities or unless it is non-funded and distributes employer's stock directly to the employees. Without a purchase from the issuer of his stock, there can be no resale and distribution problems. However, problems arise if either the plan as an entity or the beneficiaries can be considered to have purchased the employer's securities.

If the purchaser, either the plan itself or the beneficiary thereunder, obtains the employer's stock with a view to distribution and then makes a public offer of the stock, such purchaser is within the definition of statutory underwriter in section 2(11), and the transaction must be registered.<sup>83</sup> Registration may be carried out by either the issuer or the purchaser, but the issuer will be liable for a violation of the act's registration provisions if it sells unregistered and non-exempt securities to the purchaser for distribution.

As noted above, the private offering exemption is unavailable if the buyer intends to redistribute the securities. However, if the purchaser purchases only for investment, the issuer may not be required to register because of the private offering exemption. Whether a particular purchase is one for "investment" is often a matter of intent which must be proven. There are ways to attempt to insure an investment intent, such as the taking of an investment letter from the purchaser or placing restrictions on the resale of the stock.<sup>84</sup> Often the purchaser may subsequently decide to sell even though he had a bona fide investment intent when he originally purchased it. He may then do so without registration if he is not a "controlling person," and there will be no violation of the act. He does not meet the statutory definition of underwriter because he did not purchase originally with a view to distribution.

However, if the purchaser is a "controlling person," when he resells or deals in his stock he will be considered an issuer under section

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<sup>80</sup> 2 Loss, Securities Regulation 770 (1961).

<sup>81</sup> *Id.* at 781.

<sup>82</sup> *Id.* at 776. It has been said that whether a secondary distribution by a given stockholder requires registration depends upon whether that person has enough influence with the issuer's management to be able to obtain the issuer's signature on a registration statement. *Id.* at 780-81.

<sup>83</sup> See II Washington & Rothschild, *op. cit. supra* note 9, at 818-21.

<sup>84</sup> *Ibid.*

2(11), and the transaction must be registered unless otherwise exempted. Moreover, any one purchasing from the controlling person with a view to distribution is considered an underwriter under section 2(11) and will also need registration of his transaction if it is not otherwise exempted. Of course, both these transactions are exempted if the private offering exemption in the second clause of section 4(1) is met.

The "control" problem is particularly acute in the area of these compensatory arrangements. The purchaser-beneficiary may be an influential officer in the company. It may be that the plan is an independent entity, but that its administrators are the officers of the company as well. In which case, there is common control and the section 2(11) definition has been met. Finally, the plan may obtain such a percentage of the company's outstanding stock that it actually becomes a "controlling" stockholder. Consider the case of the Sears Roebuck & Co. pension plan; the plan owns twenty-six per cent of the company's stock and is the largest single stockholder.<sup>85</sup> There is little doubt that the Sears plan is a "controlling person" within the definition of section 2(11).

### 3. *Effects of Violation of the Registration Provisions.*

If a transaction or security is not exempt from registration under the act and registration is not made, the penalties of the act apply.<sup>86</sup> Should the plan itself be voided by non-registration? In *A. C. Frost & Co. v. Coeur D'Alene Mines Corp.*,<sup>87</sup> the Supreme Court held enforceable a stock option contract which the defendant company argued was unenforceable because the underlying shares had not been registered as required by the Securities Act. The Court noted that "the clear legislative purpose [of the 1933 Act] was protection of innocent purchasers of securities. They are given definite remedies inconsistent with the idea that every contract having relation to sales of unregistered shares is absolutely void."<sup>88</sup> The Commission has subsequently taken the view that the contract in the *Frost* case was not intended to harm the investing public, but that a contract in violation of the Securities Act calculated to cause such harm should not be enforceable.<sup>89</sup> Of course, since the plaintiff in the *Frost* case was attempting to enforce his contract, rescission is still a possibility. Under section 12 of the Securities Act, an investor who buys from

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<sup>85</sup> See note 68 *supra*.

<sup>86</sup> See 48 Stat. 82-84 (1933), 15 U.S.C. §§ 77k, 77L (1958).

<sup>87</sup> 312 U.S. 38 (1941).

<sup>88</sup> *Id.* at 43.

<sup>89</sup> II Washington & Rothschild, *op. cit. supra* note 9, at 822.



one who violates section 5, by failure to register or otherwise, may recover the consideration paid on tender of the securities, or he may recover damages if he no longer owns the security. In *Deckert v. Independence Shares Corp.*,<sup>90</sup> the Supreme Court upheld an action for rescission based on defendant's violation of the Securities Act. Therefore, although an employee can enforce his rights under a pension, profit-sharing, or stock bonus plan, he may also recover his contributions by a rescission action if the plan should have been registered, but was not. In addition, the regular civil liabilities under sections 11 and 12, which allow damages or rescission, apparently would apply against an employee benefit plan just as against any other issuer if misleading statements or omissions were found in registration statements and prospectuses.<sup>91</sup>

#### IV. REGISTRATION UNDER STATE BLUE SKY LAWS

Pension, profit-sharing, and stock bonus plans must be considered in the light of the state "blue sky" laws as well as from the standpoint of the relevant federal regulation. Most states have adopted laws aimed at the prevention of fraudulent practices in the sale of securities. Definitions of "security" under most of the state laws are broad enough so that participations in employee benefit plans may be subject to regulation.<sup>92</sup> Many of those states, however, exempt qualified plans from their "blue sky" laws by explicit statutory provision.<sup>93</sup> In some states, the "blue sky" laws have not yet been interpreted with respect to employee benefit plans;<sup>94</sup> in other states, the statutes have been determined to have no applicability to such plans.<sup>95</sup> A few states consider the "blue sky" laws to be regulative of employee benefit plans and enforce registration requirements.<sup>96</sup> Because there is so little unanimity among the states and the rules in most of the states are poorly articulated, it would appear wise to contact the state securities administrator when the question arises whether or not the state "blue sky" law applies to a given plan.

In Texas, the present securities act defines a security as, among other things, "a certificate in or under a profit sharing or participation agreement."<sup>97</sup> There is no statutory exemption in Texas for

<sup>90</sup> 311 U.S. 282 (1940).

<sup>91</sup> See testimony of Commissioner Purcell, *Hearings on H.R. 4344 Before the House Committee on Interstate and Foreign Commerce*, 77th Cong., 1st Sess. 1021 (1942).

<sup>92</sup> P-H Pen. & Profit Sharing Rep. ¶ 6231 (1959).

<sup>93</sup> *Ibid.*

<sup>94</sup> *Ibid.*

<sup>95</sup> *Ibid.*

<sup>96</sup> *Ibid.*

<sup>97</sup> Tex. Rev. Civ. Stat. Ann. art. 581-4(A) (Supp. 1962).

pension, profit-sharing, or stock bonus plans, but under the prior securities act, which defined "security" as does the present act,<sup>98</sup> the Attorney General ruled the act inapplicable to the voluntary and contributory pension trust of Safeway Stores, Inc.<sup>99</sup> Because the Safeway plan was held not to involve the issuance of a "security," there is some indication that the present Texas "blue sky" law will not be considered applicable to employee benefit plans. However, the authority is far too slim for reliance, and the State Securities Commissioner should be contacted about any proposed plan.

#### V. CONCLUSION

There are far more securities problems, both federal and state, connected with the use of pension, profit-sharing, and stock bonus plans than most persons realize. Still, it appears questionable whether employee benefit plans should be matters for securities regulation, at least under the federal "disclosure" theory. The concerns of an employee when faced with the choice of whether to participate in a voluntary benefit program are very much different from those of the independent investor in the securities market. The Securities Exchange Commission has recognized this difference by adopting the simplified registration procedure of form S-8 for some plans and by not requiring registration for others that it considers covered by the securities acts. Yet, until it is finally determined whether the securities acts do properly apply to interests in these plans, great care should be taken to ascertain the applicability of the securities laws as they are presently interpreted to the facts of each plan. It is far better to stand the expense of registration than to run the risk of serious civil liabilities for nonregistration.

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<sup>98</sup> Tex. Rev. Civ. Stat. Ann. art. 600a(2)(a) (1953).

<sup>99</sup> 165 OPS. ATT'Y GEN. — (1947).