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Employee Stock Plans and the Securities Act of 1933

Alan L. Hyde*

A regular reader of the Securities and Exchange Commission's reports¹ of filings of registration statements under the Securities Act of 1933, as amended,² cannot fail to observe the substantial and increasing number of such registration statements which relate to proposed offerings of securities to corporate employees pursuant to stock option, stock purchase, savings and thrift, and similar plans. During the Commission's most recent fiscal year, ended June 30, 1964, 280, or 25 per cent,³ of the

1,121 registration statements which became effective under the Securities Act, were on Form S-8, which may be used only for the registration of securities to be offered pursuant

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to such plans.⁴

The popularity of employee stock plans is also borne out by other statistics. According to the New York Stock Exchange's 1962 census of shareowners, one in six of the nation's then 17 million shareholders first acquired stock through a company-sponsored plan.⁵ As of 1960,

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1. These reports appear in the Securities and Exchange Commission *News Digest*, which is issued daily by the Commission and contains a resume of each filing with, as well as a summary of each order, decision, or rule issued by, or other action of, the Commission. The *News Digest* is distributed to the press and is also available for subscription from the U.S. Government Printing Office at a price of \$15 per year.

2. 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77a-aa (1958), as amended, Pub. L. No. 88-467, 88th Cong., 2d Sess. (Aug. 20, 1964) [hereinafter referred to as Securities Act or act].

3. These figures are based upon unpublished information furnished by the Commission's staff. According to the same source, comparable statistics for the fiscal years ended June 30, 1960 to 1963, inclusive, are as follows:

Year Ended June 30	Total Securities Act Registration Statements Effective	Effective Registration Statements On Form S-8
1960	1,426	127
1961	1,550	123
1962	2,307	143
1963	1,159	209

4. Described at pp. 98-101 *infra*.

5. NEW YORK STOCK EXCHANGE, THE 17 MILLION, 1962 CENSUS OF SHAREOWNERS IN AMERICA 17 (1962).

233 of the 1,130 corporations with shares listed on the New York Stock Exchange had a total of 248 stock acquisition plans for general employees⁶ in effect, including 114 stock purchase plans, 80 savings and thrift plans, and 39 profit-sharing plans involving investment in the shares of the employer corporation.⁷

While the application of the Securities Act to the issuance and sale of securities pursuant to employee stock plans is in many respects not essentially different from its application to other types of securities offerings, an analysis of the application of the Securities Act to offerings under employee stock plans would appear worthwhile in light of the popularity of such plans.

There are several reasons for the popularity of employee stock plans. First and foremost is the favorable federal income tax treatment accorded to employer and employee participants in many of these plans. With respect to employee stock option plans providing for the grant of "restricted stock options,"⁸ in the case of options granted prior to January 1, 1964, and "qualified stock options"⁹ or "employee stock purchase plan options,"¹⁰ in the case of options granted after December 31, 1963, as a general rule the employee realizes no income upon the grant or exercise of his option;¹¹ any amount received by him upon sale of his option shares in excess of his cost basis for them, assuming that he has held them for the required length of time, is treated as a long-term capital gain.¹² The employer corporation is entitled to no deduction for federal income tax purposes, either in connection with the granting of the option or the issuance of shares upon exercise of the option.¹³

The employee participating in pension, profit-sharing, and savings and thrift plans which have "qualified" under section 401(a) of the Internal Revenue Code of 1954¹⁴ is not subject to federal income tax when amounts are contributed by the employer and credited to his account, nor is he taxable currently when income is earned by the trust

6. Defined to include salaried workers, supervisory personnel, company officials, and sometimes hourly-paid employees. Under this definition, the totals presumably do not include stock option plans.

7. NEW YORK STOCK EXCHANGE, STOCK PLANS FOR EMPLOYEES.

8. As defined in INT. REV. CODE OF 1954, § 424(b) [hereinafter cited as CODE §].

9. As defined in CODE § 422(b).

10. As defined in CODE § 423(b).

11. CODE § 421(a)(1). *But see* the special rule provided by CODE § 422(c)(1).

12. CODE §§ 1221, 1001, 1002, and 1222. *But see* the special rule for "85% options" provided by CODE §§ 423(c) and 424(c)(1).

13. CODE § 421(a)(2).

14. The intent of the requirements of CODE § 401(a) for qualification, which are rather elaborately worded, is to preclude qualified plans from discriminating as to participation or benefits in favor of executives or highly compensated employees and to prevent the use of funds set aside for purposes of the plan and the income thereon for purposes other than the exclusive benefit of employees.

either on the employer's contributions for his account or on his own contributions.¹⁵ The trust holding the investments of the plan is exempt from federal income tax.¹⁶ When the funds are finally distributed to the employee, or his beneficiary, they constitute taxable income to him to the extent they exceed his own contributions;¹⁷ but if the employee is retired when the funds are distributed, he may receive them in low tax brackets, or may pay no tax on them at all due to reduced income and increased personal exemptions. The distribution, if made in a lump sum, may qualify for long-term capital gain treatment under certain circumstances.¹⁸ If all or part of the distribution is made in stock of the employer, the amount subject to tax can be reduced by any unrealized appreciation on such stock.¹⁹ Employer contributions pursuant to such plans are deductible as a business expense in the year the contribution is made.²⁰

The principal non-tax benefit of employee stock plans to employers is generally stated to be the greater interest and incentive in the success of the employer generated in the employee by having a proprietary interest in the corporation. Many employers believe that such plans better enable them to attract more desirable employees, as well as to hold key employees against outside job offers, and that, to the extent that such plans provide or supplement other retirement benefits, they facilitate the retirement of older employees and thereby permit an organization to remain young and able to meet vigorously the challenge of outside competition. In addition, these plans provide a means by which additional compensation may be provided to employees without cash cost to the employer to the extent that authorized but unissued shares are used for them.

Another factor to be considered is that the corporation laws of a number of states diminish or eliminate the pre-emptive rights of shareholders in situations where shares are issued and sold to employees pursuant to one or more types of employee stock plans.²¹ In more than one

15. CODE § 402.

16. CODE § 501(a).

17. CODE § 402(a)(1).

18. CODE § 402(a)(2).

19. CODE § 402(a)(1).

20. CODE § 404.

21. The following state corporation laws provide for a waiver of pre-emptive rights where the issuance and sale of shares to employees pursuant to employee stock option, stock purchase, or savings and thrift plans is approved by the holders of two-thirds of the voting shares:

D.C. CODE, § 29-908j(b) (1961); ILL. REV. STAT. ch. 32, § 157.24 (Supp. 1963);

MD. ANN. CODE art. 23, § 30(b)(7) (1957); N. D. CENT. CODE, § 10-19-24

(1960); ORE. REV. STAT. § 57.136(3) (1961); TEX. BUS. CORP. ACT art.

2.22(D) (1956); WYO. STAT. ANN. § 17-36.23 (Supp. 1963).

Approval by the holders of two-thirds of the shares entitled to pre-emptive rights is required in California to waive such pre-emptive rights with respect to shares issued and sold

instance, the ability to issue and sell additional shares and place them in the presumably friendly hands of employees or employee trusts without pre-emptive rights problems has been a useful management device in seeking to ward off the efforts of outsiders to gain control of the corporation.²²

The chief non-tax benefit of employee stock plans to the employee is generally stated to be the provision of a means by which the employee can accumulate a nest egg for the future. In the case of profit-sharing and savings and thrift plans, such accumulation is on a regular, systematic, and automatic basis. Where investments in the stock of the employer or in other equity securities are made on a regular periodic basis, the advantages of the "dollar-averaging" principle of investment are provided. When the fund is administered by a corporate trustee, professional investment advice and management is provided without cost to the employee.

to or for the benefit of employees pursuant to employee stock plans generally. See CAL. CORP. CODE § 1108 (1961).

The following state corporation laws provide that approval by the holders of a majority of the voting shares is required to waive pre-emptive rights upon the issuance and sale of shares to or for the benefit of employees pursuant to employee stock plans as specified:

COLO. REV. STAT. ANN. § 31-2-19 (1953) (stock option, stock purchase, savings and thrift, pension, profit-sharing, and stock bonus plans); CONN. GEN. STAT. ANN. §§ 33-343(b), -344(b) (Supp. 1963) (stock option plan) (approved by the shareholders); IOWA CODE ANN. § 496A.19 (Supp. 1964) (stock option plan); N.C. GEN. STAT. §§ 55-45, -56(c)(4) (1960) (stock option, stock purchase, savings and thrift, pension, profit-sharing, and stock bonus plans); and VA. CODE ANN. § 13.1-23 (1950) (stock option plan) (approved by the stockholders).

The following state corporation laws provide that approval of the issuance and sale of shares to or for the benefit of employees pursuant to employee stock plans generally by the holders of a majority of the shares entitled to pre-emptive rights also constitutes a waiver of such pre-emptive rights:

IDAHO CODE ANN. §§ 30-120(6), (7) (1947); LA. REV. STAT. ANN. §§ 12:28 B. (3), (4) (1950); N. Y. BUS. CORP. LAW §§ 505(d), 622(e)(2); OHIO REV. CODE § 1701.15(H); PA. STAT. ANN. tit. 15, § 2852-612 (Supp. 1963).

The corporation law provisions cited above diminish the pre-emptive rights of shareholders, in that the respective corporation laws either make no provision for the release of pre-emptive rights by shareholder action except with respect to shares issued pursuant to employee stock plans or permit such release by the vote of the holders of a lesser percentage of shares if the shares are to be issued pursuant to employee stock plans.

Nebraska and Utah provide a complete waiver of pre-emptive rights with respect to shares issued to employees pursuant to stock option, stock purchase, and savings and thrift plans. NEB. REV. STAT. § 21.2025 (Supp. 1963); UTAH CODE ANN. § 16-10-24 (1962).

On the other hand, New Jersey not only provides the same pre-emptive rights with respect to shares offered pursuant to employee stock plans as with respect to shares offered generally but also makes the dissenters' appraisal remedy applicable to the issuance of shares pursuant to such plans. N. J. STAT. ANN. § 14:9-3 (Supp. 1963).

22. See *McPhail v. L. S. Starrett Co.*, 257 F.2d 388, 394-96 (1st Cir. 1958); *Yasik v. Wachtel*, 25 Del. Ch. 247, 17 A.2d 309 (1941). But see *Anderson v. Albert & J. M. Anderson Mfg. Co.*, 325 Mass. 343, 346-47, 90 N.E.2d 541, 543-44 (1950); *Cheff v. Mathes*, 199 A.2d 548, 555 (Sup. Ct. Del. 1964). See generally ARANOW & EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL* 7, 24 (1957).

TYPES OF EMPLOYEE STOCK PLANS

The principal types²³ of plans involving the issuance and sale of securities to employees are stock option plans, deferred profit-sharing plans, stock bonus plans, stock purchase plans, and savings and thrift plans.²⁴ The essential characteristics of each of these types of plans are briefly described below. It is believed that the overwhelming majority of employee stock plans are designed to provide the federal income tax benefits described previously.²⁵ The discussion which follows will refer to such "qualified plans" except where the contrary is indicated.²⁶

Stock Option Plans

A stock option plan is customarily embodied in a resolution, or in a separate instrument entitled a "plan," adopted by the board of directors of the corporation, providing for the granting of options to purchase up to a specified number of shares of the corporation, set aside and reserved for that purpose to a designated class of employees, commonly denominated "key employees," within a stated period of time and upon stated terms and conditions, including the method of determination of the option price. The action of the board of directors may, however, in some cases consist only of the authorization of the grant of individual options. The plan may or may not be adopted subject to approval by the shareholders, as determined by applicable Internal Revenue Code, state corpo-

23. There are many other types of employee stock plans, human inventiveness being the only limitation on the variety thereof. Space limitations, however, will confine consideration in this article to the principal types.

24. An additional type of employee benefit plan, which is not, however, an employee stock plan, is a pension plan, which may bring into play the registration and prospectus requirements of the Securities Act in certain circumstances if the investments of the pension fund include securities of the employer corporation, as more fully discussed in a subsequent section of this article. A pension plan is a plan established and maintained by an employer to provide systematically for the payment of definitely determinable benefits to its employees (or beneficiaries of deceased employees) over a period of years, usually for life, after retirement. Treas. Reg. § 1.401-1(b)(1)(i) (1956), as amended, T.D. 6722, 1964 INT. REV. BULL. No. 22, at 8 [hereinafter cited as Reg. §]. The plan must be a definite written program and is customarily embodied in a formal document denominated a "plan" adopted by the board of directors, with the essential provisions thereof subsequently communicated to the eligible employees. The plan may or may not be adopted subject to shareholder approval. The obligations assumed by the employer may or may not be funded as they accrue, the most common funding arrangement being the purchase of individual or group annuity contracts from, or deposit administration plans with, an insurance company or the deposit of funds with a corporate trustee for investment.

25. See pp. 76-77 *supra*.

26. It must be recognized, of course, that many non-qualified plans exist in particular situations where benefits which cannot be provided by qualified plans may outweigh the tax benefits of qualified plans. Non-qualified plans, however, frequently apply to such a limited class of employees that one of the exemptions from registration under the Securities Act described at pp. 89-97 *infra* can be availed of.

ration law, and stock exchange requirements, as well as by corporate policy considerations.²⁷ An individual option granted under the plan may be evidenced by nothing more than a simple notice of the option award by the corporation and an acknowledgment by the employee, or it may be evidenced by a rather formal and detailed option agreement spelling out many of the provisions which would otherwise be set forth in the plan.

In addition to the qualified or restricted stock option plans referred to in the preceding paragraph, "employee stock purchase plans," as defined in section 423 of the Internal Revenue Code, also fall into the general classification of stock option plans. Employee stock purchase plans are stock option plans, rather than "stock purchase plans." They provide federal income tax benefits which are in some respects broader than those accorded qualified or restricted stock options. In order to meet the requirements of section 423, however, a plan must provide for options to a broad class of employees, rather than to a limited class of "key" employees. In addition, all optionees must receive the same benefits, except that the respective numbers of shares optioned to employees may bear a uniform relationship to their compensation with an over-all limitation on the number of shares any optionee may purchase under the plan.

Deferred Profit-Sharing Plans

A deferred profit-sharing plan is a plan established and maintained by an employer to provide for participation in its profits by its employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating contributions made to the plan among the participants, and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.²⁸ The employer does not undertake to provide future fixed benefits, but rather benefits determined by profits

27. Under § 422(b)(1) of the CODE, as amended by the Revenue Act of 1964, and § 221(e)(3) of said act, for an option granted after December 31, 1964, to qualify as a "qualified stock option" such option must be granted pursuant to a plan which is approved by the shareholders of the granting corporation within 12 months before or after the date such plan is adopted. Similarly, under CODE § 423(b)(2), for a plan to qualify as an "employee stock purchase plan" it must be approved by the shareholders within 12 months before or after the date such plan is adopted.

Action by shareholders may be required to release pre-emptive rights with respect to shares set aside and reserved for issuance pursuant to the plan. See note 21 *supra* for information concerning state corporation law provisions diminishing or eliminating pre-emptive rights with respect to shares issued and sold pursuant to various types of employee stock plans.

See, e.g., THE NEW YORK STOCK EXCHANGE COMPANY MANUAL A-118-20, for a statement of stock exchange requirements relating to shareholder approval of employee stock plans.

28. See Reg. § 1.401-1(b)(1)(ii) (1956).

of the employer, investment experience on funds set aside under the plan, and forfeitures by employee participants whose interest in the plan is terminated prior to full vesting. Benefits are generally funded through payments into a trust for investment. Employees are credited with "units" of the fund. Deferred profit-sharing plans may be contributory, with the employee making contributions which are held and invested with those of the employer. The plan must be a definite written program and is customarily embodied in a formal document denominated a "plan" and adopted by the board of directors with the essential provisions thereof subsequently communicated to the eligible employees. The plan may or may not be adopted subject to shareholder approval.²⁹

Stock Bonus Plans

A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a deferred profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon current profits and the benefits are distributable in stock of the employer company.³⁰ A stock bonus plan is often contributory, in which event it is more frequently called a "savings" or "thrift" plan. To be distinguished from the qualified stock bonus plan is the type of non-qualified stock bonus plan which is purely an incentive arrangement provided for executives and a few other key employees, which the amount of stock awarded to each employee is dependent upon individual performance as determined by or pursuant to authority conferred by the board of directors or a committee of the board.

Stock Purchase Plans

A stock purchase plan is an arrangement, not providing any special federal income tax benefits, pursuant to which an employer corporation facilitates the systematic purchase of its shares by its employees through authorized payroll deductions, within maximum permitted dollar and percentage of compensation limits. Funds are accumulated and periodically invested in the corporation's shares. The shares purchased by the employees may be unissued shares, but are more frequently treasury shares or shares purchased in the open market.³¹ The employer absorbs the administrative cost, commission charges, and other fees of the plan, but generally does not contribute directly toward the purchase price of the

29. See notes 21 and 27 *supra* as to the necessity of shareholder action.

30. See Reg. § 1.401-1(b)(1)(iii) (1956).

31. NEW YORK STOCK EXCHANGE, *op. cit. supra* note 7, indicates that, of the 111 corporations with shares listed on the New York Stock Exchange having such plans in effect as of 1961, 65 provided for the use of treasury shares or shares purchased in the open market, while 46 relied on authorized but unissued shares.

shares, although some employers make shares available at a small discount from market value. The plan is customarily embodied in an instrument entitled a "plan" adopted by the board of directors, which may or may not be submitted to shareholders for approval.³²

Savings and Thrift Plans

A savings and thrift plan, often called simply a "savings plan" or "thrift plan," is an arrangement pursuant to which an employee authorizes his employer to deduct a percentage of his base compensation, within fixed limits, and to invest it in one or a combination of several types of securities provided for in the plan, such as government bonds, Series E savings bonds, mutual fund shares, and common and preferred stocks, including those of the employer. To limit the employee's risk, the plan generally limits the percentage of an employee's contribution which may be invested in the employer's shares to approximately fifty per cent. For every dollar the employee contributes, the employer contributes a matching amount, typically fifty cents,³³ which is generally invested in shares of the employer, which may be unissued shares, but are more frequently treasury shares or shares purchased in the open market.³⁴ Like most other plans, a savings and thrift plan is embodied in an instrument adopted by the board of directors, with or without shareholder approval.³⁵

THE STATUTORY FRAMEWORK

The registration and prospectus requirements are found in section 5 of the Securities Act. Other directly related provisions are found in sections 2 through 8 and in section 10.³⁶ The other important sections³⁷

32. See notes 21 and 27 *supra*.

33. BANKERS TRUST COMPANY, 1963 STUDY OF SAVINGS AND THRIFT PLANS, PROFIT SHARING PLANS, AND STOCK PLANS. This excellent study contains a detailed survey of provisions found in qualified plans and digests of specific plans and finds that the employer contribution equals one-half of the employee contribution in two-thirds of the plans studied.

34. NEW YORK STOCK EXCHANGE, *op. cit. supra* note 7; Koester, *Modern Employees Savings Plans*, 73 PUB. UTIL. FORT. 19 (1964).

35. See notes 21 and 27 *supra*.

36. Section 2 defines certain terms used in the Securities Act. 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b (1958). Section 3 exempts certain classes of securities from the provisions of the Securities Act. 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77c (1958). Section 4 exempts certain transactions from the provisions of section 5. 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77d (1958), as amended, Pub. L. No. 88-467, 88th Cong., 2d Sess. (Aug. 20, 1964). Section 6 relates to the signing and filing of registration statements with the Commission. 48 Stat. 78 (1933), 15 U.S.C. § 77f (1958). Section 7 specifies the information to be set forth in the registration statement. 48 Stat. 78 (1933), 15 U.S.C. § 77g (1958). Section 8 relates to the taking effect of the registration statement and amendments. 48 Stat. 79 (1933), as amended, 15 U.S.C. § 77h (1958). Section 10 specifies the information to be included in a prospectus. 48 Stat. 81 (1933), as amended, 15 U.S.C. § 77j (1958).

37. Section 11 of the Securities Act makes certain specified persons liable for damages if a registration statement contains an untrue statement of a material fact, or omits to state a mate-

of the Securities Act not directly related to the registration and prospectus requirements cannot be considered here in detail.

The Registration and Prospectus Requirements

Reduced to the essentials, the subsections of section 5 of the Securities Act provide as follows: (1) section 5(c) prohibits *offers* to sell and *offers* to buy a security until a registration statement *has been filed* under the Securities Act; (2) section 5(a) prohibits *sales* and *deliveries after sale* of securities until the registration statement *has become effective*; and (3) section 5(b) prohibits *deliveries after sale* of a security *unless accompanied or preceded by a prospectus* meeting the requirements of the Securities Act, and requires any prospectus relating to a security with respect to which a registration statement has been filed to meet the requirements of the act.

Definitions Relating to Registration and Prospectus Requirements

Three terms which are of particular importance in determining the applicability of the registration and prospectus requirements of the Securities Act to various types of employee stock plans are defined in section 2 of the act. These terms and their statutory definitions are as follows:

Security.—The term "security" is defined in section 2(1) as

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, 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.

Sale.—The terms "sale" or "sell" are defined in section 2(3) to include

rial fact. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k (1958). Section 12 makes any person who offers or sells a security in violation of section 5 or by means of a prospectus or oral communication including an untrue statement of a material fact or omitting to state a material fact liable to the purchaser in an action for rescission, or for damages if the purchaser no longer owns the security. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77l (1958). Section 15 extends the liabilities imposed by sections 11 and 12 to persons controlling the persons liable under those sections. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77o (1958). Section 17 is a general anti-fraud provision. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77q (1958). Section 20 confers investigative powers and powers to seek injunctive relief and the institution of criminal proceedings on the Commission. 48 Stat. 86 (1933), as amended, 15 U.S.C. § 77t (1958). Section 24 provides criminal penalties for willful violations of the Securities Act. 48 Stat. 87 (1933), 15 U.S.C. § 77x (1958).

every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell," "offer for sale," or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The terms defined in this paragraph and the term "offer to buy" as used in subsection (c) of section 5 shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer).

Issuer.—Section 2(4) defines the term "issuer" as

every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued, except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity.

APPLICATION OF REGISTRATION AND PROSPECTUS REQUIREMENTS TO PARTICULAR TYPES OF PLANS

Stock Option Plans

The offering and sale of shares to employees pursuant to a stock option plan is subject to the registration and prospectus requirements of the Securities Act, absent an available exemption in the particular circumstances. There are, however, several interesting problems in connection with the application of the requirements of section 5 to such plans.

First is the question of the securities to be registered. The term "security" clearly includes shares of the employer corporation for which the option is exercisable. The question is, however, whether the option itself is also a "security." Under the statutory definition of "security,"³⁸ which includes a warrant or a right to subscribe or purchase, the option itself is undoubtedly a security, and the Commission has so held.³⁹ However, registration of the option is seldom necessary.

38. Securities Act § 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(1) (1958).

39. *Middle South Utilities, Inc.*, 40 S.E.C. 509 (1961), SEC Holding Co. Act Release No. 14367 (Feb. 7, 1961) (Opinion of Gadsby, Chairman).

Under the typical stock option plan, no cash payment is required for the grant of the option itself, the option being granted in consideration of future services to be rendered prior to the exercise of the option,⁴⁰ or for some other non-monetary consideration. A financial contribution by the optionee is required only when and if he exercises the option and purchases the shares. In these circumstances, the argument has been advanced that there is no "sale" of the option, on the theory that the employee does not render the services which provide the consideration for the option for the purpose of enabling him to make an investment, but rather to enable him to keep his job and his salary.⁴¹ In any event, at the present time the Commission does not appear to require registration of the option separate and apart from the underlying shares.

A second question concerns the time when the filing of a registration statement is required. It has been noted previously that section 5(c) prohibits *offers* until a registration statement has been filed.⁴² The grant

40. A problem frequently presented is whether the grant of an option is supported by sufficient consideration. See generally Comment, *Employee Stock Option Plans: The Clydesdale Rule*, 52 COLUM. L. REV. 1003 (1952). Absent an employment agreement or other circumstances assuring that the corporation will receive the benefits of the employee's services, it is generally considered necessary that there be a waiting period between the date of grant of the option and the date of exercise sufficient to constitute legal consideration for such grant. It has been held that an option to purchase shares exercisable immediately upon grant under certain circumstances is vulnerable to attack in a shareholder's derivative suit on the theory that such option is not supported by legally sufficient consideration, and therefore constitutes an unauthorized gift of corporate assets. *Kerbs v. California Eastern Airways, Inc.*, 33 Del. Ch. 69, 90 A.2d 652 (1952) (no waiting period); *Holthusen v. Edward G. Budd Mfg. Co.*, 52 F. Supp. 125 (E.D. Pa. 1943) (no waiting period); *Frankel v. Donovan*, 35 Del. Ch. 433, 120 A.2d 311 (1956) (no waiting period); *Rosenthal v. Burry Biscuit Corp.*, 30 Del. Ch. 299, 60 A.2d 106 (1948) (six months waiting period); *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 82, 90 A.2d 660 (1952) (nine months waiting period). The inducement to remain an employee contained in the provisions of the federal income tax laws governing employee stock options has not been regarded as constituting, in and of itself, legally sufficient consideration. See *Frankel v. Donovan*, *supra*, and *Kerbs v. California Eastern Airways, Inc.*, *supra*. Nor has job satisfaction or increased incentive resulting from giving an employee a proprietary interest in the corporation been regarded as legally sufficient consideration. See *Frankel v. Donovan*, *supra*, and *Rosenthal v. Burry Biscuit Corp.*, *supra*.

On the other hand, stock option plans requiring a waiting period of one year or more between date of grant and date of exercise have been sustained. *Eliasberg v. Standard Oil Co.*, 23 N.J. Super. 431, 92 A.2d 862 (1952) (one year waiting period); *Holthusen v. Edward G. Budd Mfg. Co.*, 53 F. Supp. 488 (E.D. Pa. 1943) (one year waiting period); *McQuillen v. National Cash Register Co.*, 27 F. Supp. 639 (D. Md. 1939) (option exercisable in installments over five years); *Gruber v. Chesapeake & Ohio Ry.*, 158 F. Supp. 593 (N.D. Ohio 1957) (option exercisable in installments over five years).

The determinative question in these cases appears to be whether the terms of the stock option plan or the surrounding circumstances are such as to assure that the contemplated consideration — the employee's services — will, in fact, be received by the corporation.

41. See opinions of the Assistant General Counsel of the Commission, Sept., 1941, CCH FED. SEC. L. REP. ¶¶ 2105.50, 2105.53, CCH FED. SEC. L. REP. ¶ 75,195 (Transfer Binder 1941-44). The opinions dealt specifically with pension and profit-sharing plans, but the same principles would appear to apply to a stock option. See WASHINGTON & ROTHCHILD, *COMPENSATING THE CORPORATE EXECUTIVE* 809 (3d ed. 1962).

42. See page 83 *supra*.

of an option would certainly appear to constitute an "offer" under the broad language of the second sentence of section 2(3),⁴³ and it has even been suggested that an offer to all eligible employees is involved in the earlier adoption of the plan.⁴⁴ However, where the option is not immediately exercisable, the adoption of the plan or the grant of the option may be viewed as akin to preliminary negotiations with an underwriter, which are specifically excluded from the definition of "offer" contained in section 2(3). As a practical matter, the Commissioner's staff raises no question if the registration statement is not filed and made effective until the time when the option by its terms becomes exercisable.

Pension, Profit-Sharing, Stock Bonus, and Savings and Thrift Plans

Application of the registration and prospectus requirements of the Securities Act to pension, deferred profit-sharing, stock bonus, and savings and thrift plans will be considered together since the same pattern of analysis is involved.

The first question to be asked in the case of each plan is whether an "offer" or "sale" is involved. This question must in turn be answered in light of two factual determinations: (1) Whether the plan is contributory; and (2) if it is, whether the plan is also compulsory. It seems clear that where the plan is non-contributory, there is no attempt to dispose of a security *for value*, and accordingly there is no "sale" bringing the provisions of section 5 into play. This has long been the view of the Commission's staff.⁴⁵

In the past, it has also been the position of the staff that even if the plan is contributory, no "sale" is involved if the plan is truly compulsory and the employee has no choice other than employment or non-employment as to participation. This position has been based on the theory that volition on the part of the employee as to whether to contribute is a necessary element of a "sale."⁴⁶ There appears to be some question as to whether the Commission's staff takes the same view today.

What should perhaps logically be the first question — whether a "security" is involved — is of only secondary importance, since the answer is nearly always in the affirmative. The Securities Act's definition of

43. See pp. 83-84 *supra*.

44. See WASHINGTON & ROTHCHILD, *op. cit. supra* note 41, at 796.

45. See opinions of Assistant General Counsel of the Commission, *supra* note 41; *Hearings Before the House Committee on Interstate and Foreign Commerce on Proposed Amendments to the Securities Act of 1933, and the Securities Exchange Act of 1934*, 77th Cong., 1st Sess. 896 (1941).

46. Opinion of Assistant General Counsel of the Commission, *supra* note 41. The theory is essentially the same as the "no sale" theory underlying the exemption from the registration requirements of the Securities Act for securities issued pursuant to consolidations, mergers, and certain types of corporate reorganizations afforded by Rule 133, 17 C.F.R. § 230.133 (rev. ed. 1964).

"security"⁴⁷ expressly includes a "certificate of interest or participation in any profit sharing agreement" and an "investment contract," the latter term having been ascribed a very broad meaning by court and Commission decisions.⁴⁸

The more pertinent question is what securities are involved in the plan. There are frequently two: the interest or participation in the plan itself, and any investment, other than cash, made by the plan or any trust thereunder. In most cases, however, the sale of this second security to the plan participant will be exempt from the registration and prospectus requirements of the Securities Act, unless the second security is one issued by the employer corporation. If the second security is not issued by the employer corporation, it may be one of the types of exempt securities described in section 3 of the Securities Act, such as a government or municipal bond or a bank stock, all of which are exempt under section 3(a)(2), or, in the case of a pension plan, an insurance or endowment policy or an annuity contract, all of which are exempt under section 3(a)(8). It is also possible that the second security may be considered to be offered and sold to the employee in a transaction exempt under section 4(1), which exempts from the provisions of section 5 "transactions by any person other than an issuer, underwriter, or dealer," unless the second security is acquired directly from the issuer thereof, or from an underwriter or a person in a control relationship with the issuer.⁴⁹

Another question to be considered is that of the identity of the "issuer" of the security. A plan which invests in a security of the employer corporation will frequently involve two issuers: (1) the plan or trust thereunder, which is the issuer of interests or participations in the plan,

47. See p. 83 *supra*.

48. See, e.g., *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946), where the Supreme Court, in holding units of a citrus grove development a "security" within the meaning of section 2(1) of the Securities Act, stated:

In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

See also *SEC v. Chinchilla, Inc.*, 1952-56 CCH FED. SEC. L. REP. ¶ 90,618 (N.D.N.Y. 1953); *Hollywood State Bank v. Wilde*, 70 Cal. App. 2d 103, 160 P.2d 846 (1945) (an interest in mated pairs of chinchillas); *SEC v. Bailey*, 41 F. Supp. 647 (S.D. Fla. 1941); *SEC v. Tung Corp. of America*, 32 F. Supp. 371 (N.D. Ill. 1940) (shares in Tung trees); *SEC v. Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940) (an interest in silver foxes); *SEC v. Cultivated Oyster Farms Corp.*, 1 SEC Jud. Dec. 672 (S.D. Fla. 1939) (cultivated oyster half shells); *State v. Agey*, 171 Minn. 191, 213 N.W. 904 (1927) (shares in fig orchard). See generally, 1 LOSS, *SECURITIES REGULATION*, 483-511 (2d ed. 1961).

49. If the employer corporation or the plan or trust thereunder acquired the second security directly from the issuer, it might itself be an "underwriter," within the meaning of section 2(11) of the Securities Act, with the result that the exemption would not be available. See discussion on "Resale by Plan Participants" at pp. 105-109 *infra*.

and (2) the employer corporation, which is the issuer of its own securities.

One overall consideration as to the necessity of registering securities offered pursuant to pension, profit-sharing, stock bonus, and savings and thrift plans is the administrative position of the Commission's staff 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."⁵⁰ This interpretation will eliminate most pension plans from consideration of the need of compliance with the registration and prospectus requirements of the Securities Act with respect to plan participations, although not necessarily with respect to securities of the employer corporation.⁵¹ Such an interpretation will similarly eliminate qualified stock bonus plans, which have been defined previously as being non-contributory, except where they are called savings and thrift plans,⁵² and savings and thrift plans which do not include securities of the employer corporation among the investment options for employee contributions.⁵³

Stock Purchase Plans

Employee stock purchase plans in the usual form as described above present both the elements of a "security" and a "sale" so as to bring them within the registration and prospectus requirements of the Securities Act. There is, however, at least one type of plan where, absent the availability of one of the exemptions described in a subsequent section of this article, the Commission's staff has in the past been willing to issue a "no action" letter, stating that the staff would not recommend any action to the Commission should the employer corporation put the plan into effect without registration of the shares under the Securities Act. This type of plan is sponsored by a securities dealer, and the employer corporation's function is limited to informing its employees of the availability of the plan without any recommendation that they participate therein, withholding designated amounts from payrolls and maintaining records of the withholdings, and periodically instructing the dealer to purchase shares

50. Letter from General Counsel to the Commission, May 12, 1953, P-H PENSION & PROFIT-SHARING SERV. ¶ 9921.

51. According to the annual survey made public by the Commission, of the \$46,554,000,000 of book value of total assets of private uninsured pension funds at December 31, 1963, \$38,390,000,000 was invested in corporate securities, of which amount only \$2,228,000,000 was invested in securities of the employer corporation. U. S. SECURITIES AND EXCHANGE COMMISSION, STATISTICAL BULLETIN 30, Table 1 (June, 1964).

52. See pp. 86-88 *supra*.

53. Of the 74 savings and thrift plans reviewed in BANKERS TRUST COMPANY, *op. cit. supra* note 33, only 17 excluded employer stock from the available investment media for employee contributions.

for the individual accounts of the participants with the funds withheld. The employer corporation bears the costs of establishing the withholding procedure and record keeping, and in some cases the brokerage commission. The theory apparently has been that such transactions are exempt under section 4(1) of the Securities Act, which exempts from the registration and prospectus requirements transactions by any person other than an issuer, underwriter, or dealer, and section 4(3), which exempts transactions by a dealer in certain circumstances. However, it is understood that the staff is not entirely satisfied with this approach, and it may be reconsidered by the Commission.

THREE PRINCIPAL TYPES OF EXEMPTIONS

There are three types of transactions, one of which may frequently be involved in connection with the issuance and sale of securities pursuant to an employee stock plan, which are exempt from the registration and prospectus requirements of the Securities Act. These are the so-called private offering, intrastate offering, and small offering exemptions.⁵⁴

Private Offering Exemption

Section 4(2) of the Securities Act exempts "transactions by an issuer not involving any public offering" from the provisions of section 5. What constitutes a public offering, however, is not defined in the act. The interpretation of the Commission's staff was first announced in an opinion of the Commission's General Counsel published in 1935.⁵⁵ This opinion took the position that what constitutes a public offering is a question of fact in which all of the surrounding circumstances are of moment. The principal factors to be considered were viewed to be the following: (1) the number of offerees (*not* ultimate purchasers) and their relationship to each other and to the issuer, *i.e.*, whether selected from the public at large or from a particular class of persons, and whether they have some relationship to the issuer giving them special knowledge of the issuer, such as that of employees; (2) the number of units offered; (3) the size

54. The legislative history of the intrastate and small offering exemptions makes it clear that, contrary to the terms and present statutory arrangement, such exemptions technically involve exempt transactions, rather than exempt securities. The significance of this fact is apparent. If sections 3(a)(11) and 3(b) of the Securities Act were to provide a permanent exemption for the securities themselves, a distribution of treasury shares by the issuer, or a secondary distribution of securities by a controlling person, previously issued under one of the exemptions, would likewise be exempt. The Commission has adopted the contrary view. See SEC Securities Act Release No. 4434 (Dec. 6, 1961), 17 C.F.R. § 231.4434 (rev. ed. 1964); *cf.* SEC Securities Act Release No. 646 (Feb. 3, 1936), 17 C.F.R. § 231.646 (rev. ed. 1964); Thompson Ross Securities Co., 6 S.E.C. 1111, 1117-18 (1940). See generally 1 LOSS, *op. cit. supra* note 48, at 708-10.

55. See opinion of General Counsel, SEC Securities Act Release No. 285 (Jan. 24, 1935), 17 C.F.R. § 231.285 (rev. ed. 1964).

of the offering; and (4) the manner of the offering, *i.e.*, whether by direct negotiation or through the channels of public distribution. The General Counsel also recognized that his office had expressed the opinion that under ordinary circumstances an offering to not more than twenty-five persons does not involve a public offering.

The United States Supreme Court, in *Securities & Exchange Comm'n. v. Ralston Purina Co.*,⁵⁶ specifically rejected the adoption of any numerical test in determining the applicability of the private offering exemption. The case involved the Ralston Purina employee stock plan, pursuant to which stock was made available each year for purchase by "key employees" who, without any solicitation by the company, inquired as to how they might purchase company stock. The company interpreted "key employees" to include individuals eligible for promotion, who especially influence or advise others, to whom employees look in some special way, who carry some special responsibility, who are sympathetic to management and ambitious, and who management feels are likely to be promoted to greater responsibility. Pursuant to this policy, the company sold nearly two million dollars worth of stock to employees between 1947 and 1951, to as many as 414 employees in 1950, and to employees with duties such as chow-loading foreman, stock clerk, production trainee, and stenographer, with annual salary rates as low as \$2435.

The Supreme Court, in reversing the decisions of both lower courts against the Commission in its action to enjoin Ralston Purina's unregistered sales, took the position that the private offering exemption must be interpreted in light of the statutory purpose of protecting investors by promoting full disclosure of information thought necessary to informed investment decisions. In other words, the Court held the applicability of the exemption should turn on whether the particular class of persons affected needs the protection of the Securities Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."

With respect to the application of a numerical test, the Court stated:

[N]othing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation.⁵⁷

Dealing expressly with the application of the exemption to offerings to employees, the Court stated:

The exemption, as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some

56. 346 U.S. 119 (1953).

57. *Id.* at 125.

employee offerings may come within § 4(1) [now § 4(2)] e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement. Absent such a showing of special circumstances, employees are just as much members of the investing "public" as any of their neighbors in the community. Although we do not rely on it, the rejection in 1934 of an amendment which would have specifically exempted employee stock offerings supports this conclusion. The House Managers, commenting on the Conference Report, said 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. . . ." ⁵⁸

In November 1962, the Commission issued a release⁵⁹ setting forth its analysis of the private offering exemption. This release represents the present administrative interpretation. After reiterating the 1935 view of its General Counsel⁶⁰ that whether a transaction is one not involving any public offering is essentially a question of fact necessitating a consideration of all surrounding circumstances and singling out essentially the same factors as those mentioned by the General Counsel as being of importance, the Commission, in discussing such factors, dealt first with the significance of the number of offerees. After reviewing the Supreme Court's comments on the application of a numerical test in the *Ralston Purina* decision,⁶¹ the Commission emphasized that the number of offerees is relevant only to the question of whether they have the requisite association with, and knowledge of, the issuer to make the exemption available.

In discussing the factor of the identity of the offerees, the Commission dealt specifically with offerings to employees. The Commission again referred to the *Ralston Purina* decision, and added a further gloss to the Court's holding that the availability of the exemption turned upon the need of the offerees for the protection afforded by registration, to the effect that the exemption does not become available simply because offerees are voluntarily furnished information about the issuer, reasoning that such a construction would give each issuer the choice of registering or making its own voluntary disclosures without regard to the standards and sanctions of the Securities Act.

The Commission also discussed an additional important consideration which has not been previously discussed in our examination of the private offering exemption, *i.e.*, the necessity that the purchasers acquire the securities for investment and not with a view to distribution where the exemption is to be relied upon. Whether a transaction is one not involving

58. *Ibid.* (Citations omitted.)

59. SEC Securities Act Release No. 4552 (Nov. 6, 1962), 17 C.F.R. § 231.4552 (rev. ed. 1964).

60. See note 55 *supra*.

61. 346 U.S. 119 (1953).

any public offering is determined as of the time the securities "come to rest" in the hands of the ultimate purchasers; hence the necessity of the investment intention. The Commission recognized the existence of the widespread practice by issuers of obtaining written "investment letters" at the time of sale, and cautioned that mere acceptance at face value of such assurances would not provide a basis for reliance upon the exemption when inquiry would suggest to a reasonable person that these assurances were more formal than real. The Commission pointed out that the purchase for investment requirement is not satisfied by the passage of any particular period of time, recognizing, however, that the longer the period of retention the more persuasive would be the argument that the resale is not at variance with an original investment intent. The period of retention, however, is but one evidentiary fact to be considered.

The Commission also discussed what would constitute a "change of circumstances" justifying a sale consistent with an original investment intent. It is generally agreed that the change must be an unforeseen change in the personal circumstances of the purchaser, and not a change in the market price of the security or in the issuer's prospects. The Commission specifically pointed out that possible inability of the purchaser to pay off loans incurred in connection with the purchase of stock would ordinarily not be deemed an unforeseeable change of circumstances.

The body of law relating to the private offering exemption has been discussed at some length because such exemption is the one most frequently relied upon to justify omitting to register under the Securities Act. A few general observations are in order as to the application of the exemption to offerings pursuant to employee stock plans.

First, insofar as plans which qualify for special federal income tax benefits are concerned,⁶² the exemption will, except perhaps in the case of very small corporations, ordinarily be available only for restricted or qualified stock option plans, since they are the only types of qualified plans which may be provided only for executive or highly-compensated personnel. Second, even in the case of restricted or qualified stock option plans, and where the optionees meet the *Ralston Purina* standards of knowledge of the issuer, the purchase for investment requirement can present a real problem. Many executives finance the exercise of their options with the expectation of selling the option shares to repay the loan, or exercise the option in installments with the expectation of selling shares purchased through a partial exercise of the option to provide funds for a further exercise. In these circumstances, it is doubtful

62. See pp. 76-77 *supra*.

that an original investment intent is present.⁶³ Assuming, however, that these problems are surmounted, the "twenty-five-offerees rule-of-thumb" adopted by the Commission in the thirties would appear to continue to be a safe one to follow. It is understood that the Commission's staff will issue no-action letters without approval of the Commission in appropriate circumstances where up to 100 optionees are involved. It is considered, however, that the options involve a continuing offering, and, therefore, the number of persons to whom unexercised options have been granted over a period of years must be added together.

Intrastate Offering Exemption

Section 3(a)(11) exempts from the registration and prospectus requirements of the Securities Act, "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, 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 or Territory."⁶⁴ While the meaning and application of this exemption has been the subject of a number of court opinions and earlier Commission releases,⁶⁵ the principles so expressed are well restated in a 1961 Commission release,⁶⁶ which will serve as the basis for the following examination of the exemption.

The legislative history of the Securities Act indicates that the exemption was designed to apply only to local financing which may practically be consummated in its entirety within the state or territory in which the issuer is both incorporated and doing business. A basic condition of the exemption is that the *entire issue* of securities be offered and sold exclusively to residents of the state in question. Whether an offering is "a part of an issue," *i.e.*, an integrated part of an offering previously made or proposed to be made, is a question of fact, and depends essentially upon whether the offerings are a related part of a plan or program. Any one or more of the following factors may be determinative of the question of integration: (1) whether the offerings are part of a single plan of financing; (2) whether the offerings involve the issuance of the same class of security; (3) whether the offerings are made at or about the same time; (4) whether the same type of consideration is to be re-

63. These practices are made more difficult by the new three year holding requirement for long-term capital gain federal income tax treatment introduced by the Revenue Act of 1964. CODE § 422(a)(1). Presumably, an intention to hold for this three year period would not be considered a purchase for investment.

64. See note 54 *supra*.

65. SEC Securities Act Release No. 1459 (May 29, 1937), 17 C.F.R. § 231.1459 (rev. ed. 1964); SEC Securities Act Release No. 4386 (July 12, 1961), CCH FED. SEC. L. REP. ¶ 76,774 (Transfer Binder 1957-61).

66. SEC Securities Act Release No. 4434 (Dec. 6, 1961), 17 C.F.R. § 231.4434 (rev. ed. 1964).

ceived; and (5) whether the offerings are made for the same general purpose.

To meet the requirement that the issue be "sold only to persons resident" in the state, it is necessary that the issue "come to rest" only in the hands of residents within the state. This seems to require that purchasers of the issue have a subjective intent, analogous to the purchase for investment intent discussed in connection with the private offering exemption, that the purchase is not made with a view to resale to non-residents. In this respect, it is customary to obtain written assurances of such intention from the purchasers at the time of sale. The same caveat is appropriate as to reliance upon such assurances as to reliance upon investment letters — where given and accepted as mere formalities, they may be valueless. The passage of time prior to resale to a non-resident is of evidentiary value in determining whether the original purchase was made without a view to resale to non-residents, but no particular period establishes a conclusive presumption.⁶⁷ The whole question is of extreme importance, since one offer or sale to a non-resident renders the exemption unavailable, not only for the securities so offered and sold, but for all securities forming a part of the issue, including those sold to residents.

The requirement that the issuer be doing business in the state seems to contemplate substantial operational activities. It seems obvious that keeping the books or stock records in the state of incorporation is insufficient. Whether the "residence" requirement for offerees and purchasers means "domicile," as the Commission has suggested, is a question which has never been litigated. It is clear, however, that more than mere presence in the state at the time of the offer or sale is required.

While the intrastate offering exemption is extremely narrow and is perilously relied upon where truly public financing is involved, it would seem to be of value in the case of an offering to employees of an issuer conducting a truly local business. The tests for determining its applica-

67. See *Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147 (1935). This case involved \$8,000,000 principal amount of bonds issued to four New York banking firms. Within four months from the date the underwriters' bids were accepted, all of the bonds had been resold (a major portion to the public) with approximately 15% in the hands of non-residents of New York. On these facts, the Commission had little difficulty concluding that the intrastate offering exemption was unavailable. Although finding it unnecessary to decide the question, the Commission suggested a one-year period as a rule of thumb in determining when the distribution is completed and the securities have come to rest in the hands of resident investors.

As already noted, the Securities Act incorporated in Section 4(1) [now § 4(3)] a presumption that sales by dealers within a period of one year from the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter are a part of the distribution of the issue. That presumption which Congress adopted should be applied here, not, however, as a conclusive presumption of law, as in the third clause of Section 4(1) of the Act [now § 4(3)], but as a presumption of fact subject to refutation upon a showing of fact that distribution was completed within less than one year. *Id.* at 162-63.

bility are certainly more precise than those laid down in the *Ralston Purina*⁶⁸ case for determining the applicability of the private offering exemption, and, where the exemption would appear to be otherwise available, there is no limitation upon the number of employees who may be included in the plan.

Small Offering Exemption

Section 3(b) of the Securities Act provides that the Commission may from time to time by rule or regulation add any class of securities to the securities exempted under section 3, if it finds that the enforcement of the Securities Act with respect to such securities is not necessary to the public interest and the protection of investors. However, no issue of securities can be exempted under this section where the aggregate amount at which such issue is offered to the public exceeds \$300,000.⁶⁹ The Commission has adopted a number of regulations⁷⁰ under section 3(b), Regulation A being the general exemption and the one which, in appropriate circumstances, will apply to offerings pursuant to employee stock plans.

Regulation A is embodied in Rules 251 to 263, inclusive, of the General Rules and Regulations under the Securities Act.⁷¹ It does not provide an automatic exemption, but rather conditions the exemption upon the filing with a regional office of the Commission of a notification containing the information prescribed by Form 1-A. If the aggregate offering price exceeds \$50,000, the filing and use of an offering circular containing the information specified in Schedule I to Form 1-A is also required. The preparation of a notification and offering circular is a considerable task,⁷² and may involve the preparation of as much material as would be required to register under the Securities Act on Form S-8, if that form is available.⁷³

The aggregate amount of securities of the issuer, its predecessors, and certain affiliates which may be sold under Regulation A is a maximum of \$300,000 within any period of one year.⁷⁴ The Commission's staff has taken the position that Regulation A is applicable to participations in vol-

68. 346 U.S. 119 (1953).

69. 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77c(b) (1958).

70. In addition to Regulation A, the Commission has adopted Regulation B, relating to fractional undivided interests in oil or gas rights. 17 C.F.R. §§ 230.300-356 (rev. ed. 1964). Regulation E relates to securities of small business investment companies. 17 C.F.R. §§ 230.601-610 (rev. ed. 1964). Regulation F relates to assessments on assessable stock and for assessable stock offered or sold to realize the amount of assessment thereon. 17 C.F.R. §§ 230.651-656 (rev. ed. 1964).

71. 17 C.F.R. §§ 230.251-263 (rev. ed. 1964).

72. Filing with a regional office of the Commission pursuant to Regulation A is frequently referred to as a "short-form registration," and those who have been through the procedure have been known to question just how "short-form" it is.

73. See pp. 98-101 *infra* for a discussion of Form S-8.

74. Rule 254, 17 C.F.R. § 230.254 (rev. ed. 1964).

untary contributory pension, profit-sharing, and similar plans so long as employee contributions do not exceed \$300,000 per year.⁷⁵ This seems to indicate that the integration doctrine⁷⁶ will not be employed so as to apply the \$300,000 limitation to the entire amount which employees may contribute throughout the life of the plan. This interpretation would presumably also apply to other plans involving direct investment in the corporation's stock, such as a stock option plan or a stock purchase plan. It might be questionable, however, whether a corporation would wish to commit its ability to sell \$300,000 of securities per year under Regulation A to an employee plan for a number of future years, especially where the relatively simple Form S-8⁷⁷ is available for registration for purposes of the plan and Regulation A might be more advantageously used to avoid a more complicated registration of another non-integrated offering which could be made pursuant thereto.

The conclusion must be that the small offering exemption is generally of limited usefulness in connection with offerings pursuant to employee stock plans.

Considerations Applicable to All Three Exemptions

Two further considerations which are common to the private, intrastate, and small offering exemptions should be mentioned. First, it is well settled that the terms of an exemption are to be strictly construed against the claimant, who also has the burden of proving its availability.⁷⁸ The second consideration is the application of the integration doctrine, which has been discussed previously in conjunction with the intrastate offering exemption.⁷⁹ The doctrine is equally applicable to the private offering and small offering exemptions. It is clear that it is not possible to claim different exemptions with respect to various parts of an issue where a single exemption would not be available for the entire issue. Where a corporation has only one employee stock plan in effect, the application of the doctrine to the plan will ordinarily not be difficult to determine. However, where the corporation has two or more employee stock plans contemporaneously available for its employees, and the plans taken together would not involve an exempt offering under a single exemption,

75. Letter from General Counsel to the Commission, May 12, 1953, P-H PENSION & PROFIT-SHARING SERV. § 9921.

76. See pp. 93, 94 *supra*.

77. See pp. 98-101 *infra*.

78. SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959); SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699 (9th Cir. 1938); SEC Securities Act Release No. 4552 (Nov. 6, 1962), 17 C.F.R. § 231.4434 (rev. ed. 1964).

79. See pp. 93-95 *supra*.

the various tests to be utilized to determine the applicability of the integration doctrine can be quite difficult to apply.

THE REGISTRATION PROCESS

The first step in registering securities under the Securities Act is the preparation of a registration statement, including a form of prospectus, on the appropriate form.

Selection of the Appropriate Form

The Commission has prescribed a total of seventeen different forms for use in registering various types of securities under the Securities Act.⁸⁰ One of two of these is generally appropriate: Form S-1 is the general form; Form S-8 may be used when securities are to be offered to employees pursuant to certain plans.⁸¹ Before proceeding to a discussion of these particular forms, it will be helpful to understand the use of registration forms in general.

Registration Forms in General.—It should be noted first that the various forms are “guide” forms or instruction books, rather than “fill-in” forms. They specify, under the appropriate items or captions, the information to be included in considerable detail in the registration statement. The draftsman prepares the registration statement to include all material information which is responsive to the applicable items of the appropriate form; the items of the form and other instructions are not reproduced in the registration statement.⁸² The registration statement ordinarily consists of two parts. Part I is the prospectus, containing the essential information to be furnished to the prospective investor. Part II contains certain additional information which is to be made available to the Commission, but not to the prospective investor (unless he chooses to visit the offices of the Commission and examine the full registration statement), a list of the exhibits required to be filed with the registration statement, the undertakings required by the appropriate form, and the required signatures. The registration statement is frequently printed, but it may be lithographed, mimeographed, typewritten, or prepared by

80. For a discussion and the official text of all of the forms for registration statements the reader is referred to CCH FED. SEC. L. REP. §§ 6001-552 (1964).

81. Form S-2, for commercial and industrial companies in the developmental stage, may in certain circumstances be the appropriate form, but a detailed discussion of it has been omitted upon the supposition that relatively few companies in the developmental stage have employee stock plans in effect under circumstances in which one of the exemptions from registration discussed in an earlier section of this article will not be available and for the further reason that Forms S-1 and S-2 are fairly similar except as to the required financial statements.

82. Rule 404(a), 17 C.F.R. § 230.404(a) (rev. ed. 1964).

any similar process which, in the opinion of the Commission, produces copies suitable for a permanent record.⁸³

Form S-8.—Form S-8 was adopted by the Commission as of June 6, 1953, for use in registering securities which are to be offered pursuant to certain stock purchase, savings, or similar plans, and for registering the interests in such plans where registration is required.⁸⁴ Although Form S-8 was neither expressly applicable to nor appropriate for stock option plans, the Commission did, for a number of years, permit its use for registration of shares offered pursuant to restricted stock option plans if the prospectus included the information called for by parts of three items of Form S-1⁸⁵ as well as that called for by Form S-8. In 1962, Form S-8 was revised to essentially its present form. Among other things, the 1962 revision made Form S-8 expressly available for registering shares to be offered pursuant to restricted stock options as defined in section 421(d) of the Internal Revenue Code of 1954.⁸⁶ In 1964, Form S-8 was further amended to conform to the changes made by the Revenue Act of 1964 in the provisions of the Internal Revenue Code relating to stock options eligible for special tax treatment.⁸⁷

The use of Form S-8 when it is available is optional, for the registrant always has the choice of using the more complicated Form S-1. The general instructions to Form S-8 contain the following rule concerning the use of the form:

Any issuer which at the time of filing a registration statement on this form is required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934⁸⁸ may use this form for registration under the Securities Act of 1933 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 period payroll deductions

83. Rule 403(b), 17 C.F.R. § 230.403(b) (rev. ed. 1964).

84. SEC Securities Act Release Nos. 3469-X (1953) (proposed), 3480 (June 6, 1953) (adopted).

85. *Ibid.* The summary of earnings prescribed by Item 6, the data relative to the remuneration of directors and officers prescribed by Item 17, and the information regarding options to purchase securities prescribed by Item 18.

86. SEC Securities Act Release No's 4440 (1962) (proposed), 4533 (Sept. 17, 1962) (adopted).

87. SEC Securities Act Release No's 4686 (April 21, 1964) (proposed), 4718 (Aug. 27, 1964) (adopted); SEC Securities Act Release No. 4733 (Nov. 20, 1964).

88. 48 Stat. 881 (1934), as amended, 15 U.S.C. §§ 78a-jj (1958). The issuers subject to these reporting requirements are those which have securities registered and listed on a national securities exchange, those which have previously undertaken to comply with the reporting requirements in connection with the registration of securities under the Securities Act, and, under the Securities Acts Amendments of 1964, Pub. L. No. 88-467, 88th Cong., 2d Sess. (Aug. 20, 1964), those with securities traded in the over-the-counter market which, by reason of meeting certain tests as to total assets and number of shareholders of record, are required to register under section 12 of the Securities Exchange Act of 1934.

are authorized, by participating employees in an amount not to exceed a specified percentage of the employee's compensations 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 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."

The information required to be set forth in the prospectus falls into two general classifications: (1) information regarding the plan, and (2) information regarding the issuer and its securities, including those being registered under the Securities Act. In the case of a stock purchase, savings, or similar plan, the information regarding the plan to be included in the prospectus is that prescribed in Items 1 to 11, inclusive, of Form S-8. In general terms, this information consists of descriptions of the purposes of the plan, who may participate, the basis of employer and employee contributions, the conditions under which an employee may withdraw from or assign his interest under the plan, defaults and the effect thereof, the administration of the plan, investment policies and the extent to which the employees may direct the same, any liens which may be created on any assets of the plan, provisions for termination and extension of the plan, the charges or deductions which may be made against the plan assets, and, if interests in the plan are being registered, certified financial statements of the plan as of the end of and for its last fiscal year. The last item need not be again supplied if financial statements substantially meeting the Form S-8 requirements have been previously furnished to all employees receiving the prospectus, in which case such financial statements may be incorporated by reference in the prospectus. In the case of a stock option plan, the information regarding the plan to be in-

cluded in the prospectus is that prescribed in Items 12 to 18, inclusive. This consists essentially of descriptions of the general nature and purpose of the plan, its duration, the federal income tax treatment both to employees and to the issuer, the securities subject to the options, antidilution provisions, eligibility requirements, the terms upon which options may be exercised, provisions for exercise of options after death or termination of employment and as to the assignability of options, and information concerning outstanding options.

The information regarding the issuer and its securities to be furnished is that prescribed by Items 19 to 25, inclusive, which call for a tabular summary of earnings for at least the last five fiscal years of the issuer, certified for at least the last three fiscal years, market price information with respect to the securities being registered, a brief description of certain significant business developments within the past five years, a description of the terms and provisions of the securities being registered, information regarding the principal holders of equity securities of the issuer, and the certified financial statements (excluding schedules) which the issuer filed or is required to file as a part of its Form 10-K annual report to the Commission pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 for its last fiscal year. If the issuer's annual report to shareholders for its last fiscal year includes certified financial statements substantially meeting the Form 10-K requirements, they may be incorporated by reference in the prospectus in lieu of furnishing the financial statements otherwise required.

Part II of the registration statement must include (1) undertakings by the employer, the issuer, and the plan to file with the Commission the periodic information, documents, and reports prescribed by rules or regulations adopted by the Commission pursuant to section 15(d) of the Securities Exchange Act of 1934; (2) an undertaking by the issuer to deliver to all plan participants a copy of its annual report to shareholders for its last fiscal year with each copy of the prospectus other than copies delivered to participants who already received the annual report as shareholders; (3) an undertaking by the issuer to furnish to all plan participants who do not otherwise receive such material as shareholders, at the time and in the manner such material is sent to shareholders, copies of all reports, proxy statements, and other communications distributed to shareholders generally; and (4) in the case of stock option plans, an undertaking by the issuer that, prior to any public offering, otherwise than on a national securities exchange, of any of the securities being registered by a person who may be deemed an "underwriter" of such securities, it will file with the Commission as part of a post-effective amendment to the registration statement a prospectus containing, in addition to the information prescribed by Form S-8, the information required

by certain items of Form S-1,⁸⁹ and that the prospectus will not be used until the post-effective amendment has become effective.

Part II must also include the consent of the accountants who certified the financial statements included or incorporated by reference in the prospectus to the inclusion or incorporation by reference therein of their certificate. Also to be included are the signatures of the issuer, the employer(s), and, where there is created under the plan an unincorporated association, a trust, committee, or other legal entity, of such association, trust, committee, or other legal entity, their respective principal executive officers, principal financial officers, controllers or principal accounting officers, and of at least a majority of their respective boards of directors or persons performing similar functions.

Subject to the rules relating to incorporation by reference,⁹⁰ the exhibits required to be filed with the registration statement consist of (1) copies of the plan; (2) any other constituent instruments defining the rights of participants; (3) certain material contracts relating to the plan; (4) an opinion of counsel as to the legality of the securities being registered; (5) the issuer's annual report to shareholders for its last fiscal year with the accountants' certificate manually signed if the financial statements therein are incorporated by reference in the prospectus; (6) all summaries of the plan and other communications relating to the offering of the securities being registered; and (7) provisions for the indemnification of directors and officers.

While the foregoing requirements may appear imposing, the prospectus frequently need not consist of more than ten pages of printed or typed material when financial statements appearing in an annual report may be incorporated by reference, and the entire registration statement can be confined to fifteen pages or less.

Form S-1.—Where Form S-8 is not available, Form S-1 is ordinarily the appropriate form. Since counsel with even slight securities registration experience will be familiar with Form S-1, it will not be reviewed in detail. The respects in which Form S-1 requirements are more stringent or more extensive than the Form S-8 requirements will, however, be noted.⁹¹

The principal items of information required to be set forth in a Form S-1 prospectus which are not required in a Form S-8 prospectus

89. Items 1, 2, 7, 8, 9, 10, 11, 12, 17, and 20.

90. Rule 447, 17 C.F.R. § 230.447 (rev. ed. 1964).

91. Where securities to be offered and sold pursuant to an employee stock plan are registered on Form S-1 the Commission will require the prospectus to set forth, in addition to the information required by Items 1 to 21 of Form S-1, a brief description of the plan, which may, but need not necessarily, contain the information required by Items 1 to 11 or 12 to 18 of Form S-8, whichever would be applicable if the registration statement were filed on Form S-8.

are (1) a reasonably complete description of the business and properties of the issuer, as contrasted with a description of only the significant developments within the past five years; (2) information concerning the directors and officers of the issuer and their compensation and retirement benefits; and (3) information regarding the interest in certain material transactions to which the issuer was or is to be a party of directors, officers, ten percent shareholders, and their respective "associates."⁹² The Form S-1 prospectus must include, and may not incorporate by reference, a balance sheet as of a date within 90 days prior to the date of filing the registration statement,⁹³ which need not be certified if a certified balance sheet as of a date within one year prior to the date of filing is also furnished,⁹⁴ together with profit and loss statements for the last three fiscal years and the interim period, if any, ended on the date of the latest balance sheet filed, which must be certified up to the date of the latest certified balance sheet filed.⁹⁵

Form S-1 also requires (1) certain financial schedules, which in most cases will appear in Part II of the registration statement; (2) nine items of additional information; and (3) the filing of exhibits which, in addition to those required by Form S-8, will include copies of the charter and by-laws, specimens or copies of all securities being registered and copies of constituent instruments defining the rights of holders of long-term debt, copies of pension, retirement, or other deferred compensation plans, contracts, or arrangements, and copies of material contracts not made in the ordinary course of business made within two years prior to filing or to be performed in whole or in part in the future. If Form S-8 were available, the issuer would have previously filed this material with the Commission as part of a previous registration statement filed under the Securities Act, a registration statement filed under the Securities Exchange Act of 1934, or reports on Forms 8-K and 10-K.

*Filing and Effectiveness of the Registration Statement;
Delivery of Prospectus*

Upon filing of the registration statement with the Commission,⁹⁶ it is assigned for review to one of the Division of Corporation Finance's

⁹². As defined in Rule 405, 17 C.F.R. § 230.405 (rev. ed. 1964).

⁹³. Under certain conditions specified in the Instructions as to Financial Statements to Form S-1, the balance sheet may be as of a date within six months prior to the date of filing.

⁹⁴. If the fiscal year of the registrant has ended within 90 days prior to the date of filing, the certified balance sheet may be as of the end of the preceding fiscal year.

⁹⁵. Parts B and C of the Instructions as to Financial Statements to Form S-1 set forth the requirements for consolidated financial statements and financial statements for unconsolidated subsidiaries and other persons.

⁹⁶. The formal requirements for the preparation and filing of the registration statement, including such matters as the numbers of required filing copies and the computation and pay-

fifteen branches of Corporate Analysis and Examination. This review is under the direction of the Branch Chief, who is assisted by a team of lawyers, accountants, and analysts, and is for the purpose of determining whether the registration statement meets the disclosure requirements of the Securities Act and the form on which it was prepared. In due course,⁹⁷ the issuer receives a letter of comment, or as it is commonly called, a "deficiency letter," over the signature of an Assistant Director of the Division of Corporation Finance, or, if the comments are few and of a minor nature, a collect telephone call from the Branch Chief or a member of his team, informing the issuer as to the respects in which the Commission's staff believes changes in the registration statement or additional disclosures are required to comply with the Securities Act. If counsel is unable to persuade the staff that the suggested changes or additions are not necessary, the issuer must incorporate them in one or more amendments to the registration statement filed with the Commission,⁹⁸ each of which must contain a revised form of prospectus. When the staff is satisfied that the registration statement as amended meets the requirements of the Securities Act, and upon the filing by the issuer of a request for acceleration,⁹⁹ the staff will recommend to the Commission that it issue an order declaring the registration statement effective.¹⁰⁰ The agent for service of the issuer named in the registration statement¹⁰¹ normally receives a telegram from the secretary of the Commission shortly after the registration statement has become effective. This is followed within a few days by a copy of the Commission's formal order pursuant to section 8(a) of the Securities Act.

After the registration statement has become effective, the issuer will wish to deliver copies of the final prospectus to each participant in the plan prior to the time of sale to the participant of any security registered. If the registration statement was filed on Form S-8, the issuer will also need to comply with its undertaking contained in the registration state-

ment of the registration fee, are covered by the Commission's Regulation C under the Securities Act, and will not be examined here. A number of detailed descriptions of the registration process have been written, one of which is found in THOMAS, *FEDERAL SECURITIES ACT HANDBOOK*, published by the Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association.

97. For the fiscal year of the Commission ended June 30, 1964, the number of calendar days which elapsed from the date of the original filing of the registration statement to the date of issuance of the letter of comment with respect to the median registration statement was 16.

98. The formal requirements relating to the preparation and filing of amendments to the registration statement are found in Rules 470 to 472, inclusive, of SEC Reg. C, 17 C.F.R. §§ 230.470-472 (rev. ed. 1964).

99. See Rules 460 and 461, 17 C.F.R. §§ 230.460, 230.461 (rev. ed. 1964).

100. For the fiscal year of the Commission ended June 30, 1964, the number of calendar days which elapsed from the date of original filing of the registration statement to the effective date for the median registration statement was 36.

101. Rule 100(a)(5), 17 C.F.R. § 230.100(a)(5) (rev. ed. 1964).

ment to deliver a copy of its annual report to shareholders for its last fiscal year with each copy of the prospectus, other than copies delivered to participants who received the annual report as shareholders. In addition, it is necessary to make arrangements to ensure compliance with the issuer's undertaking to furnish to all participants who do not otherwise receive such material as shareholders copies of reports, proxy statements, and other communications distributed to shareholders generally.¹⁰² The issuer must also file twenty-five copies of the final prospectus with the Commission within five days after the effective date of the registration statement, or the commencement of the offering, whichever occurs later.¹⁰³

Updating the Prospectus

Most employee stock plans involve offers and sales of securities continuing over a period of time. The issuer in such instances must be concerned with the requirement of section 10(a)(3) of the Securities Act that when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use, so far as such information is known to the user of such prospectus, or can be furnished by such user without unreasonable effort or expense.¹⁰⁴ This requirement may necessitate a periodic updating of the prospectus, which is accomplished by means of the preparation and filing with the Commission of one or more post-effective amendments to the registration statement, each of which must contain a revised prospectus.

The preparation of a post-effective amendment and a revised prospectus is ordinarily not a formidable task, particularly where the registration statement was filed on Form S-8. In most cases, there are no changes in the plan requiring revision of its description in the prospectus, and consequently the prospectus material to be revised is limited to that relating to the issuer, including the financial statements. If the preparation of the post-effective amendment is performed concurrently with the annual audit by the issuer's independent accountants, the required updated financial statements can be prepared by the accountants simultaneously with the preparation of their audit report with minimal additional effort and expense. If the post-effective amendment is filed shortly after the updated financial statements and, in the case of a Form S-8 registration statement, the latest annual report to shareholders is available, the revised prospectus will be available for use for the maximum period of

102. See p. 100 *supra*.

103. Rule 424(b), 17 C.F.R. § 230.424(b) (rev. ed. 1964).

104. See also Rule 427, 17 C.F.R. § 230.427 (rev. ed. 1964).

time before it must once again be updated to meet the requirements of section 10(a)(3) of the Securities Act.

The formal requirements for the preparation and filing of post-effective amendments with the Commission and the procedures for their review by the Commission's staff are not essentially different from those discussed previously with respect to the original registration statement and amendments filed prior to the effective date.¹⁰⁵

RESALES BY PLAN PARTICIPANTS

Section 4(1) of the Securities Act exempts "transactions by any person other than an issuer, underwriter, or dealer" from its registration and prospectus requirements. On its face, this language would seem to exempt resales by plan participants of securities previously registered under the Securities Act acquired pursuant to employee stock plans, in that a participant would not appear to be an issuer, underwriter, or dealer. An examination of the statutory definition of the term "underwriter" will indicate, however, that this is not necessarily the case.

Section 2(11) of the Securities Act defines the term "underwriter" as

any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. *As used in this paragraph the term "issuer" shall include, in addition to an issuer,^[106] any person directly or indirectly controlling or controlled by the issuer, or under direct or indirect common control with the issuer.*¹⁰⁷

This definition goes well beyond the ordinary concept of an underwriter as being a securities firm which specializes in the public distribution of large blocks of securities. It includes any person who has purchased any security from the issuer, or from a person directly or indirectly controlling, controlled by, or under direct or indirect common control with the issuer,¹⁰⁸ with a view to distribution, as well as any person who participates in any such undertaking.

This definition of underwriter may apply so as to prevent a resale of a security acquired pursuant to an employee stock plan from being an

105. See pp. 97-102 *supra*. No request for acceleration is necessary, however.

106. See p. 84 *supra* for the definition of "issuer" contained in Securities Act, § 2(4). 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(4) (1958) (Emphasis added.)

107. Securities Act § 2(11), 48 Stat. 75 (1933), as amended, 15 U.S.C. § 776 (1958). (Emphasis added.)

108. Such a person will hereinafter be referred to as a control person.

exempt transaction under section 4(1) of the Securities Act in either one of two situations. First, if the participant acquired the security from the issuer with a view to distribution, he would himself be an underwriter, and his resale would not be an exempt transaction under section 4(1). Second, even if the participant acquired the security from the issuer otherwise than with a view to distribution, if he is a control person¹⁰⁹ and in fact makes a distribution, any person participating therein, such as the participant's broker, would be an underwriter and the sale transaction would not be exempt under section 4(1).

In the first situation, the question arises as to when a plan participant may be considered to have purchased a security pursuant thereto "with a view to distribution." The term "distribution" as used in the Securities Act is treated as synonymous with "public offering."¹¹⁰ It also seems clear that the language "with a view to" is concerned with the participant's subjective intent at the time he purchased the security. This analysis would lead to the conclusion that the participant must acquire the security from the issuer for purposes of investment, or at least for purposes other than distribution or public offering¹¹¹ — even though the sale to him was made pursuant to registration and not in reliance upon the private offering exemption. Otherwise he will not be in a position to resell the security without compliance with the registration and prospectus requirements of the Securities Act, unless one of the exemptions from registration other than the one afforded by section 4(1)¹¹² is available. This view finds support in the facts that where purchasers were not taking for investment, the Commission formerly would not permit the registration of shares to be offered pursuant to a stock option plan on Form S-8, but required it to be on Form S-1,¹¹³ and that, as mentioned previously,¹¹⁴ the 1962 revision of Form S-8 contains a required undertaking by the issuer, in the case of stock option plans, that prior to any public offering, otherwise than on a national securities exchange, of any of the securities being registered by a person who may be deemed an

109. See note 116 *infra* and accompanying text.

110. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U. S. 896 (1959); See H. R. REP. NO. 1838, 73d Cong., 2d Sess. 41 (1934); 1 LOSS, *op. cit. supra* note 48, at 551-53.

111. There are, at least theoretically, several differences. First, the participant might acquire the security with a view to subsequent disposition in a private offering, although it is probably unrealistic to assume that he is sufficiently conversant with the Securities Act to grasp this subtlety, or that in most circumstances he could assume that a disposition in a private offering would be feasible. Second, the participant might acquire so few shares or units that it would be difficult to consider a "distribution" to be involved under any circumstances of disposition. In this connection, consider the discussion of the selling shareholder's exemption in a broker's transaction at pp. 107-109 *infra*.

112. See the discussion of the private offering, intrastate offering, and small offering exemptions at pp. 89-96 *supra*.

113. See Raytheon Mfg. Co. Plan, Commission file No. 2-11885 (1955).

114. See p. 98 *supra*.

"underwriter," the issuer will, through the filing of a post-effective amendment, make available what is essentially a Form S-1 prospectus. Avoidance of the necessity of compliance with this undertaking provides a strong motivation to an issuer registering on Form S-8 to require plan participants to purchase for investment, to secure the appropriate investment representations, and to take appropriate measures to ensure compliance with such representations.¹¹⁵

Turning to the second situation, consideration must be given to the question of who is a control person.¹¹⁶ The term "control" is not defined in the Securities Act, but rule 405 defines the term, including the terms "controlling," "controlled by," and "under common control with," as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." The existence of control in any particular situation is a question of fact. A control person can consist of more than one person. The officers and directors of the issuer as a group may frequently constitute a control person. Although the fact that a person is an officer or director does not create any presumption of control, it is nevertheless a sort of red light.¹¹⁷

Consideration must also be given to the question of whether the plan participant, assuming that he is a control person, is engaged in a "distribution." Some guidance may be found in rule 154.

Section 4(4) of the Securities Act exempts from the provisions of section 5 brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market, but not the solicitation of such orders. In rule 154, the Commission has defined "brokers' transactions" as used in section 4(4) to include transactions by a broker acting as agent for the account of a control person in which the broker performs no more than the customary broker's function; does no more than execute sell orders and receives no more than the usual broker's commission and his principal, to his knowledge, makes no payment in connection with the execution of the transaction to any other person; neither he, nor to his knowledge his principal, solicits or arranges for the solicitation of orders to buy; and he is not aware of circumstances indicating that his principal is an underwriter or is engaged in a distribution. The

115. For a discussion of various devices for policing compliance with investment representations, such as the endorsement on the stock certificates of a legend to the effect that the shares may not be transferred without registration under the Securities Act or receipt of an opinion of counsel satisfactory to the issuer and its transfer agent to the effect that registration is not necessary under the circumstances of the proposed transfer, see 1 LOSS, *op. cit. supra* note 48, at 672-73 & n. 94.

116. See note 108 *infra* and accompanying text.

117. See 1 LOSS, *op. cit. supra* note 48, at 781. See generally 1 LOSS, *op. cit. supra* note 48, at ch. 5.

term "distribution" is defined in rule 154 as not applying to transactions involving an amount of securities not substantial in relation to the number of shares or units outstanding or the volume of trading, including, without limitation, a sale or series of sales which, together with all other sales of securities of the same class by or on behalf of the same person¹¹⁸ within the preceding six months, do not exceed: (1) in the case of unlisted securities, approximately 1% of the shares or units outstanding at the time of receipt by the broker of the sale order; or (2) in the case of listed securities, the lesser of (a) such one percent, or (b) the largest aggregate reported volume of trading on securities exchanges during any one week within the four calendar weeks preceding the receipt of such order.

The brokers' transaction exemption contained in section 4(4) and rule 154 exempts only the broker's part in the transaction, and the Commission takes the position that the selling shareholder is left to find his own exemption.¹¹⁹ It is generally considered, however, that whenever the broker's side of the transaction is within rule 154, the selling shareholder's side of such transaction is also exempt under section 4(1), being a transaction not involving an issuer, underwriter, or dealer.¹²⁰

It should be pointed out that the ability to make limited sales under the brokers' transaction exemption is not necessarily available to the plan participant who has acquired securities for purposes of investment. Such a purchaser would be free to sell consistent with his investment intent only in the event of a change of circumstances.¹²¹ However, where there is a change of circumstances, and if the participant is a control person, the brokers' transaction exemption may provide a means of effecting limited sales which otherwise could not be made without the consequences of the broker's being an "underwriter."

The conclusion to be drawn from this analysis of rather complicated resale problems is that the fact that securities sold to employees pursuant to employee stock plans are registered under the Securities Act does not always mean that the employees are free to resell significant amounts of the securities without further compliance with the registration requirements of the Securities Act. In the case of a stock option plan where the

118. A "person," for such purposes, may consist of more than one. See SEC Securities Act Release No. 4669 (Feb. 17, 1964); PRACTICING LAW INSTITUTE, SEC PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 67 (Israel's ed. 1962); 1 LOSS, *op. cit. supra* note 48, at 705-06.

119. See SEC Securities Act Release No. 4669 (Feb. 17, 1964); SEC Securities Act Release No. 131 (March 13, 1934), 17 C.F.R. § 230.131 (rev. ed. 1964).

120. See SEC Securities Act Release No. 4669 (Feb. 17, 1964); 1 LOSS, *op. cit. supra* note 48, at 700-01, 705 n.178; PRACTICING LAW INSTITUTE, *op. cit. supra* note 118, at 49.

121. See p. 108 *supra*.

issuer wishes to register on Form S-8, the issuer will generally wish to require the optionees to purchase for investment, so that it will not be required at a later date to make good on its undertaking to furnish an essentially Form S-1 prospectus in the event that an optionee wishes to resell, other than on a national securities exchange, under circumstances which would constitute him an "underwriter." Furthermore, the plan participant himself must always be concerned with the possibility that his subsequent resale activities may constitute him or his broker an "underwriter."

CONCLUSION

Employee stock plans are achieving ever increasing popularity, if the number of registration statements filed under the Securities Act for securities to be offered pursuant to such plans is any indication. This is a result of the special federal income tax benefits accorded to both employer and employee participants in such plans and other more intangible benefits which are believed to flow from such plans.

Counsel participating in the institution of such plans by corporate employers must be aware of the fact that the registration and prospectus requirements of the Securities Act may apply to offerings to corporate employees pursuant to such plans. He must undertake much the same pattern of analysis in determining whether the registration and prospectus requirements in fact do apply in any particular situation as he would if a financing transaction were involved.

In many cases, a conclusion from such analysis that registration is required will not mean that a burdensome task is in store, due to the availability to issuers filing reports with the Commission under the Securities Exchange Act of 1934 or the rather simple Form S-8 for a number of the more popular types of plans. The relative simplicity of Form S-8 stems from the facts that many of the disclosure requirements of the Securities Act are satisfied by the delivery of an annual report and other shareholder material to the participants, and that much of the material which would otherwise be required to be included in the registration statement is furnished to the Commission pursuant to its reporting requirements.

Counsel's duty does not end when the securities to be offered pursuant to the plan have been registered under the Securities Act. In addition to seeing that the prospectus is kept up-to-date if the offering is a continuing one, he has the further responsibility of insuring that plan participants are acquainted with the circumstances under which resales by them of securities acquired pursuant to the plan may require further compliance with the registration and prospectus requirements of the Securities Act.