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Employee Incentives and the Federal Securities Laws

ROBERT ANDERSON IV*

I. INTRODUCTION

Stock-based compensation is no longer the exclusive privilege of corporate executives. A recent survey indicated that sixty percent of publicly traded technology companies offered stock options during the past three years to *all* their employees.[1] A separate survey cited by the Securities and Exchange Commission (the "Commission") indicated that the percentage of major companies with stock option plans in which at least half of their employees could participate increased from seventeen percent in 1993 to 39.4 percent in 1999.[2] Even the less dazzling results of a survey conducted by the Bureau of Labor Statistics revealed that five percent of *non*-executive employees in publicly traded firms received option grants in 1999.[3] In absolute numbers, estimates indicate that nearly ten million American employees received stock options in 1999, compared with only one million in 1992.[4]

The proliferation of broad-based employee incentives, however, has created a crisis for many privately held companies under an otherwise unremarkable provision of the federal securities laws. The Commission has taken the position that the over-the-counter registration requirements of the Securities Exchange Act of 1934[5] (the "Exchange Act") can cause a privately held company to actually "go public" by

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1. *See* Am. Elecs. Ass'n, *AeA Study Finds 84% of High-Tech Workers Receive Stock Options* (Aug. 14, 2002), *at* http://www.aeanet.org/PressRoom/prtl_081402_StockOptionsSurvey.asp (last visited Sept. 30, 2002).

2. *See* Disclosure of Equity Compensation Plan Information, Exchange Act Release No. 34-43892 (Jan. 26, 2001).

3. *See* BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, PILOT SURVEY ON THE INCIDENCE OF STOCK OPTIONS IN PRIVATE INDUSTRY IN 1999, at 2 (Oct. 11, 2000). The Bureau's survey covered only stock options actually granted during the 1999 calendar year. *Id.* at 1. Because stock options normally remain outstanding for several years, the actual incidence of outstanding stock option ownership in any particular year is likely considerably larger than the number of options granted in that year. The survey defined "publicly held" as "[a] company whose stock is traded on an exchange and who meets certain requirements under the law to report its financial position to the Securities and Exchange Commission." *Id.* By way of comparison, similar data from 1993-1994 revealed that less than one-half of one percent of all full-time workers (executive and non-executive) were even eligible to receive stock option grants. *See id.*

4. Pallavi Gogol, *When Good Options Go Bad*, BUS. WK., Dec. 11, 2000, at 96.

5. 15 U.S.C. § 78a (2002). The Exchange Act, which regulates transactions on securities

granting stock options to too many employees. The Commission asserts that a company with five hundred or more holders of employee stock options, like a company with five hundred or more holders of common stock, must register under Section 12(g) of the Exchange Act.[6] Section 12(g) registration would mean the private company would have essentially the same reporting burdens as a company that had completed an initial public offering.[7]

The prospect of inadvertently "going public" under the Exchange Act by virtue of employee stock options is at best highly impractical.[8] Fortunately, when Congress enacted Section 12(g), it built in explicit and expansive exemptive authority from the requirements of that Section to be exercised by the Commission.[9] Moreover, the Commission has, to

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exchanges and the over-the-counter markets, contains registration and reporting requirements for companies meeting certain securities distribution criteria.

6. Section 12(g) of the Exchange Act provides, in part:

> Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall . . . within one hundred and twenty days after the last day of its first fiscal year . . . on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more . . . persons, register such security by filing with the Commission a registration statement.

15 U.S.C. § 78l(g) (2002). Commission Rule 12g-1 under Section 12(g) of the Exchange Act increases the required registration threshold from $1 million to $10 million. 17 C.F.R. § 240.12g-1 (2003) (exempting issuers form Section 12(g) "if on the last day of [such issuer's] most recent fiscal year the issuer had total assets not exceeding $10 million").

7. Note that the number, amount, or value of the outstanding "equity securities" are not relevant to the requirement of registration under Section 12(g). The only relevant criteria are the number of "holders of record," the size of the issuer's assets, and the use of the so-called "jurisdictional means." *See* 15 U.S.C. § 78l(g) (2002).

8. *See* HERBERT KRAUS, EXECUTIVE STOCK OPTIONS AND STOCK APPRECIATION RIGHTS 6-4 (2001).

> Federal registration and its consequences are too expensive an complex to be practical for the institution of a stock option plan by a privately owned company . . . . [O]f all the consequences of federal registration, the one most unacceptable to a privately owned company would be its introduction into the system of periodic reporting under the Exchange Act. Even a privately owned company which intends to go public ultimately and accept those consequences is not usually prepared to do so prematurely in connection with an employee benefit program.

Id. Undertaking an initial public offering ordinarily entails months of preparation, corporate housekeeping, and consultation with financial advisors and attorneys, not to mention the expenditure of considerable amounts of money. *See, e.g.*, HAROLD S. BLOOMENTHAL, GOING PUBLIC AND THE PUBLIC CORPORATION 1-9 to 1-11 (1986) (estimating the cash cost of a Securities Act IPO at $250,000 to $1,000,000). While Exchange Act registration would normally cost less than Securities Act registration in the context of a traditional initial public offering, Exchange Act registration is an ongoing requirement, whereas Securities Act registration is a transaction-specific regulatory hurdle.

9. Congress provided the Commission with exemptive authority pursuant to Section 12(h) of the Exchange Act, which provides that:

> The Commission may . . . exempt in whole or in part any issuer or class of issuers

a limited extent, exercised this authority with respect to employee stock options on the application of affected issuers.[10] The problem is that the Commission's relief is so riddled with conditions that the exemption is, in many ways, as onerous as the registration from which the issuer is ostensibly exempted.[11] In effect, the Commission has, by the device of this exemptive relief, imposed the disclosure obligations of publicly traded companies on issuers of instruments that cannot even be traded.[12]

The awkwardness of applying the securities laws to employee incentives is not, moreover, limited to the over-the-counter registration provisions of the Exchange Act. In fact, the Commission itself has acknowledged, even in the context of the centerpiece of the securities laws—registration under the Securities Act of 1933 (the "Securities Act")—that the imposition of the full securities law apparatus on compensatory arrangements is both unnecessary and unreasonably burdensome.[13] Accordingly, the Commission has gradually chipped away at the literal requirements of that securities law apparatus for employee incentives, nearly to the point of eliminating the Securities Act regulation of compensatory transactions altogether.[14] The obvious question, therefore, is whether the Securities Act and the Exchange Act (collectively, the "Acts") should apply to employee incentives at all.

The answer to this question lies in the core concept defining the scope of the securities laws—the definition of a "security"—and is sig-

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> from the provisions of subsection [12(g)] . . . upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors.

15 U.S.C. § 78l(h) (2002). The Commission also has a general exemptive authority with respect to the Exchange Act as a whole pursuant to Section 36 thereof. *Id.* § 78ff.

10. Issuers who have, or are likely to have, over 500 holders of employee stock options may petition the Commission for relief from the requirement of Section 12(g) registration. *See* DIV. OF CORP. FIN., SEC, CURRENT ISSUES AND RULEMAKING PROJECTS QUARTERLY UPDATE (Mar. 31, 2001) [hereinafter CURRENT ISSUES].

11. The Commission's exemption is conditioned on, among other things, the issuer providing option holders with "essentially the same Exchange Act registration statement, annual report and quarterly report information they would have received had the company registered the class of securities under Section 12, including audited annual financial statements and unaudited quarterly financial information, each prepared in accordance with [Generally Accepted Accounting Principles]." *Id.* The process of preparing the disclosure documents mandated by the Commission, like registration under the Exchange Act, involves substantial cash costs, including those of independent public auditors, attorneys, and other professionals, as well as considerable diversion of internal attention. Further, these are not one-time expenditures; the reporting obligations of a registrant under the Exchange Act are ongoing and continual.

12. *See infra* note 223 and accompanying text.

13. *See infra* notes 345-48 and accompanying text.

14. *See infra* Part IV.C.2.

nificant not only in its disposition of the employee incentive issue specifically, but in implications for the scope of the securities laws generally. The Supreme Court's definition-of-security cases reveal that employee stock options, while the supposedly paradigmatic employee incentive "security" instrument, may actually fall outside the category of "security" under the principles articulated in the Supreme Court case of *Reves v. Ernst & Young*.[15] The *Reves* case, which was criticized for its vagueness and generality as a specific test for instruments called "notes,"[16] performs slightly more acceptably in the inevitably murky and abstract task of delimiting the outer boundaries of the term "security." Reading *Reves* as a case delimiting the scope of the securities laws generally, as opposed to "notes" specifically, combines a long and disparate line of Supreme Court cases into a unified (but not entirely satisfying) approach to the definition of a security.

In that spirit, this article develops a synthesis of the Court's decisions defining a security that, inexplicably, has eluded courts and commentators in an estimated 792 decisions and 300-plus law review articles on the subject.[17] Part II of this article proceeds by introducing the term "security" from a statutory and jurisprudential standpoint, and by illustrating that many of the broad-based employee incentives presently regarded as investment contract "securities" actually fail the Supreme Court's investment contract criteria. Part III develops the synthesis of the Supreme Court's cases to reveal a consistent theoretical framework for the definition of a security. This approach reveals that, under the criteria set forth in the *Reves* decision, non-security treatment is appropriate not only for equity incentives classified as "investment contracts" but also for some types of broad-based employee stock options. Part IV discusses the policy implications of treating employee stock options as non-securities and demonstrates that, in fact, non-security treatment would not entirely remove such stock options from securities law regulatory coverage. Part V outlines the alternatives available to companies

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15. 494 U.S. 56 (1990).

16. *See infra* notes 183-84 and accompanying text.

17. *See* Theresa A. Gabaldon, *A Sense of Security: An Empirical Study*, 25 J. CORP. L. 307, 308 (2000). Commentators are nearly unanimous on one point: the outer boundaries of the term "security" have "remained muddy in an area otherwise distinguished for its maturity and precision—muddy to the point that . . . many financial arrangements that are basic to commerce and industry remain in the zone of doubt." Scott FitzGibbon, *What is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 893, 895 (1980). Commentators often blame this "doubt" on ambiguity or mistakes the Supreme Court's decisions. *See, e.g.*, Marc I. Steinberg & William E. Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 490 (1987). For a veritable bibliography of articles lamenting the "elusiveness" of the definition of the term "security," see LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 925 n.5 (3d ed. 1999).

faced with the Section 12(g) exemptive ultimatum. Part VI concludes by offering some illuminating historical context on the relationship among stock options, promissory notes, and functional securities regulation under the Acts.

II. Employee Incentives or "Investment Contracts"?

A. *Orientation to the Definition of a Security*

As might be suspected, the starting point in ascertaining the applicability of the federal securities laws is the definition of the term "security." The Securities Act, which sets forth the registration and prospectus delivery requirements of the securities laws, provides that "unless the context otherwise requires," a "security" means:

> any note, stock, treasury stock, security future, 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, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.[18]

The Exchange Act, which sets forth the registration, reporting, exchange, trading, and major antifraud provisions of the securities laws, contains its own definition of a security. That Act provides that "unless the context otherwise requires," a "security" means:

> any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for,

18. 15 U.S.C. § 77b(a)(1) (2002).

> receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.[19]

The two definitional lists suggest some basic observations about the Congressional approach to defining a security. The first observation is that despite certain minor differences between them, the two definitions are very nearly identical.[20] Indeed, the legislative history of the Exchange Act reveals that Congress intended the definitions to be substantially the same,[21] and the Supreme Court has confirmed that the two lists may be construed identically.[22] The second observation is that each definition defines the term security not conceptually, but by simple enumeration. The Supreme Court has observed that "[i]n providing this definition Congress did not attempt to articulate the relevant economic criteria for distinguishing 'securities' from 'non-securities.'"[23] Instead, Congress provided the names of instruments that constitute securities for the purposes of the Acts, without interpretive guidance as to the meanings of those names.

The courts have added to these observations a rule of construction—that the terms contained in the definitions should be read expansively. As the Supreme Court has noted, "[e]ven a casual reading" of the definitions "reveals that Congress did not intend to adopt a narrow or restrictive concept of security."[24] Instead, Congress "painted with a

19. *Id.* § 78c(a)(10).

20. For an overview of the differences between the two sections, see generally, Lewis D. Lowenfels & Alan R. Bromberg, *What Is a Security Under the Federal Securities Laws?*, 56 ALB. L. REV. 473, 479-83 (1993). This article focuses on the definitions contained in the Securities Act and the Exchange Act, but excludes consideration of the Investment Company Act of 1940 (15 U.S.C. § 80a (2002)), the Investment Advisors Act of 1940 (15 U.S.C. § 80b (2002)), the Public Utility Holding Company Act of 1935 (15 U.S.C. § 79a (2002)), and the Trust Indenture Act of 1939 (15 U.S.C. § 77aaa (2002)), each of which uses the same or similar definition of a security as the Securities Acts, although some such definitions, such as that of the Investment Company Act (15 U.S.C. § 80a-2(a)(36) (2002)), have been interpreted differently than those of the Securities Acts.

21. The Senate Report on the Exchange Act indicates that the Exchange Act definition of "security" was intended to be "substantially the same" as that of the Securities Act. S. Rep. No. 73-792, at 14 (1934), *reprinted in* 1 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 65 (J. Ellenberger & E. Mahar eds., 1973) [hereinafter LEGISLATIVE HISTORY].

22. The Supreme Court has construed these two definitional sections identically, calling the two definitions "virtually identical," Tcherepnin v. Knight, 389 U.S. 332, 336 (1967), and repeatedly indicating that for most purposes the two definitions may be construed identically. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985); Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975).

23. *Forman*, 421 U.S. at 847.

24. *Tcherepnin*, 389 U.S. at 338.

broad brush,"[25] enacting "a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment."[26] Accordingly, the definitional lists include not only the "obvious and commonplace"[27] instruments that most people would recognize as securities, such as stocks, bonds, and notes, but also other, more "[n]ovel, uncommon, or irregular devices."[28] The definitions, in fact, are not only expansive, but also self-evidently *over*-inclusive, leaving to the courts and the Commission the task of distinguishing from ordinary non-security arrangements "the many types of instruments that in our commercial world fall within the ordinary concept of a security."[29]

The Supreme Court, to ensure coverage of "any instrument that might be sold as an investment," has extended the concept of a security beyond the rigid terms of the statutory list by emphasizing the "economic reality" of the instrument under consideration,[30] not merely on the nominal correspondence of name attached to the instrument under consideration with a label on the definitional list. Accordingly, even instruments not specifically included in the list can still constitute securities if the economic reality of those instruments dictates securities treatment.[31] In order to fit "uncommon, irregular devices" into the statutory definitions, two of the listed items, the "investment contract" and the "interest or instrument commonly known as a security" have served as the catch-all categories. The courts use these two enumerated items (primarily the "investment contract") to bring instruments that are not enumerated in the definitions within the scope of the Securities Acts.[32]

The controversial issue in the definition of a security generally has not been the use of economic reality to *include* instruments *not* literally included in the statutory lists, but the use of economic reality to *exclude* instruments that *are* literally enumerated in the statutory lists.[33] The tex-

25. Reves v. Ernst & Young, 494 U.S. 56, 60 (1990).

26. *Id.* at 61.

27. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).

28. *Id.* at 351.

29. H. Rep. No. 73-85, at 11 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 21, at 11.

30. *See* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

31. *See, e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

32. Note that the Securities Act contains the category "interest or instrument commonly known as a 'security,'" while the Exchange Act contains the slightly abbreviated formulation "instrument commonly known as a 'security.'" *Compare* 15 U.S.C. § 77b(a)(1) (2002), *with* 15 U.S.C. § 78c(a)(10) (2002). The Court has not attached any importance to the omission of "interest or" in the Exchange Act definition.

33. The notion of using economic reality to include instruments nominally falling outside of the statutory terms has long been accepted under the investment contact rubric. Nevertheless, the notion of using economic reality to exclude instruments from the Securities Acts that are nominally included in the statutory terms has never been explicitly adopted by the Supreme Court.

tual support for the notion that economic reality should work both ways is the fact that the statutory definitions are preceded by the phrase "unless the context otherwise requires." This innocent-sounding phrase, whether rightly or wrongly, has become the exclusionary counterweight to the investment contract catchall category, suggesting that even instruments whose labels are specifically enumerated in the definitional list are not necessarily securities.[34] Thus, under this reading of the definition-of-security cases, courts should look beyond the mere label of an instrument[35] to determine whether, despite the instrument's nominal inclusion within the definition of a security, the overall "context otherwise requires."

B. *Employee Incentives and Investment Contracts*

In the employee incentive arena, the principle of "economic reality" is stretched almost to its limit in squeezing the various and sundry forms of incentives into the statutory definitions. Modern employers motivate their employees with a variety of devices that may or may not fit into the enumerated categories of the definitional lists. While some instruments, such as restricted stock and employee stock options, correspond to enumerated categories or may be readily analogized to one or more categories, others, such as stock appreciation rights, phantom stock, performance units, or interests in employee stock ownership or pension plans, are not readily identified with any enumerated category of security. Accordingly, if these instruments are to be classified as securities, they must satisfy the criteria for one of the residual security categories, such as the "investment contract" or the "instrument commonly known as a security."

1. THE *HOWEY-DANIEL* TEST APPLIED TO EMPLOYEE INCENTIVES

In a modest triumph for jurisprudential economy, the Supreme Court has opined that the same test applies to determine whether an instrument falls within either of these residual categories of security.[36] That test was first articulated in the now classic securities law case of

34. One recent student casenote observed that *Howey* and the context clause have come to represent the tension at either end of the securities law spectrum that keeps the literal language of the statutory lists from under- or over-inclusiveness, respectively. *See* Kyle M. Globerman, Note, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271, 293-94 (1999).

35. *See, e.g.*, Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).

36. *See Landreth*, 471 U.S. at 691 n.5; United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852 n.12 (1975). The Court has also suggested that the "certificate of interest . . . in any profit-sharing agreement" should also be treated as coextensive with the term "investment contract." *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 n.11 (1979).

SEC v. W.J. Howey Co.[37] In *Howey*, the issuers of the purported securities were two affiliated companies that owned large tracts of citrus groves in Florida.[38] These companies offered to purchasers, many of whom were tourist patrons of a local resort hotel, land plots in Florida citrus groves.[39] Considered in isolation, the interests might have been regarded as simple land sales contracts, and therefore outside the definition of a security.[40] Yet, the promoters were offering "something more than fee simple interests in land;"[41] they marketed the land sales contracts together with contracts for cultivating and marketing the fruit and remitting the net proceeds to the investors. The issue before the Court was whether the land sales contract, combined with the service contract for harvesting and selling the fruit, constituted an "investment contract" and therefore a security for the purposes of the Securities Act.[42]

The Court approached the definitional question by looking to the meaning of an investment contract under state securities laws. It observed that although the term "investment contract" was undefined in the Acts, the meaning of the term had been "crystallized" by "prior judicial interpretation" under the state "blue sky" laws from which the term was adapted.[43] The Court drew upon judicial interpretations under those blue sky laws to formulate a four-prong test for an investment contract. That four-prong test defined an investment contract as any "contract, transaction or scheme" whereby a person makes: (1) an investment of money; (2) in a common enterprise; (3) and is led to expect profits; (4) solely from the efforts of the promoter or a third party.[44] Applying its new test, the Court concluded the interests sold by the *Howey* companies were, in fact, investment contracts, and thereby established a test that would dominate the federal definition-of-security jurisprudence to the present day.[45]

In the decades since the *Howey* decision, the lower federal courts

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37. 328 U.S. 293 (1946). The test was, in large measure, adapted from the "investment contract" test that had been formulated in state courts prior to enactment of the Securities Acts. *See, e.g.*, State v. Gopher Tire & Rubber Co., 177 N.W. 937, 938 (Minn. 1920).

38. *W.J. Howey Co.*, 328 U.S. at 294-95.

39. *Id.* at 296.

40. *Id.* at 297-98.

41. *Id.* at 299.

42. *Id.* at 294-97.

43. *Id.* at 298. The term "blue sky laws" refers to a system of state regulation of securities that every state except Nevada had adopted prior to the adoption of the Securities Act in 1933, and is still (to a lesser extent) important to securities practitioners today. *See generally* LOSS & SELIGMAN, *supra* note 17, at 31-43.

44. *Howey*, 328 U.S. at 298-99.

45. *See generally* Gabaldon, *supra* note 17, at 308 (noting that of the 792 securities law cases collected, 461 dealt with investment contracts).

have elaborated on all four prongs of the investment contract test[46] and the Supreme Court has provided significant guidance on all but the "common enterprise" element.[47] Among the unsettled questions, however, is the uneasy status of employee incentive and compensation devices under the *Howey* test. Lower courts have provided little meaningful guidance on the question of equity incentives as securities, and many courts themselves seem confused about the proper scope of their approach to the question.[48] The dearth of meaningful analysis of employee incentives under the *Howey* test, in fact, has compelled the Commission for decades to fudge its analysis to obtain jurisdiction over certain types of transactions in supposed employee "securities."[49]

The general failure to meaningfully address the *Howey* test in the context of employee incentives must, at least in part, be attributed to the fact that lower courts, even outside the context of employee incentives, have not sufficiently focused on the first *Howey* prong, the requirement of an "investment of money." This prong is particularly important in the context of employee incentive schemes because in many cases employees do not invest "money" in incentive instruments, and often the decision to "invest" is primarily an employment decision, not an investment decision. Accordingly, two critical questions arise: (1) whether an employee's "investment" of labor in exchange for a compensation package including an equity incentive instrument constitutes the "investment of money" required to find a security under the *Howey* test; and (2) if so, whether an "investment decision" is required to find an "investment."

The only Supreme Court case to explicitly analyze the "investment" component of the *Howey* test was *International Brotherhood of*

46. *See generally* Loss & Seligman, *supra* note 17, at 987-1010.

47. In *Daniel*, the Court construed the "investment of money" prong. *See infra* notes 65-87 and accompanying text. In *Forman*, the Court elaborated on the "expectation of profits" prong. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852-58 (1975). *Forman* also hinted at its resolution of the troublesome "solely" language in the "solely from the efforts of the promoter or a third party" prong of *Howey*, restating the test as "a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *Id.* at 852. There is also an argument that the Court implicitly adopted the so-called "horizontal commonality" approach in the *Marine Bank* case, but the better view is that *Marine Bank* said nothing about the common enterprise prong.

48. In a recent insider trading case, *Clay v. Riverwood Int'l Corp.*, 157 F.3d 1259 (11th Cir. 1998), the Eleventh Circuit leaped to the conclusion that stock appreciation rights (SARs) were not "securities, puts, calls, straddles, options or privileges with respect to securities." *Id.* at 1269. The court, over the objection of concurring Judge Carnes, astonishingly reached that holding without considering the investment contract analysis. The court, however, subsequently vacated these portions of the opinion on consideration of the petition for rehearing, leaving only the unremarkable conclusion that the SARs were not the same class of security as the Riverwood common stock. *See id.* at 1269-71.

49. The most blatant example in this regard is the Commission's treatment of stock appreciation rights. *See infra* notes 319-22 and accompanying text.

Teamsters v. Daniel.[50] In that case, the Court was called upon to decide whether interests in a noncontributory, compulsory pension plan constituted a security within the meaning of the Securities Acts.[51] The pension plan at issue was the result of multi-employer collective bargaining that took place in 1954 between a labor union and various Chicago trucking firms.[52] When the respondent Daniel retired in 1973, the plan's administrator determined that he was ineligible for a pension because of a brief break in his service.[53] Daniel brought suit in federal court against the union, its local branch, and a trustee of the pension trust fund alleging, *inter alia*, violations of the antifraud provisions of the Securities Acts.[54]

The defendants moved to dismiss the securities counts of the complaints on the basis that Mr. Daniel's complaint stated no cause of action under the Securities Acts.[55] The district court denied the motion, finding that Daniel's interest in the pension fund constituted a security within the meaning of the Securities Acts, and further finding that there had been a "sale" of that "security" interest within the meaning of the Acts.[56] The order denying the motion was certified for appeal and the Court of Appeals for the Seventh Circuit affirmed.[57] The Supreme Court granted certiorari and reversed the Court of Appeals, holding that Daniel's interest in the noncontributory, compulsory pension plan was not a security within the meaning of the Securities Acts.[58]

The fact that interests in pension funds are not enumerated as a category of security in the statutory definitions meant that the Court would have to find the pension interests were an "investment contract" (or other residual category) to treat them as "securities." Justice Powell, writing for the Court, found that Daniel, who made no contributions to the fund and had no choice about whether to participate, had not made the "investment" required by the first prong of the *Howey* investment contract test.[59] The Court went on to observe that the argument that Daniel's pension benefits were a security was also undermined by the relative insignificance of the asset earnings of the fund versus the

50. 439 U.S. 551 (1979).
51. *Id.* at 553.
52. *Id.*
53. *Id.* at 554-55.
54. Daniel alleged that the defendants violated Section 10(b) of the Exchange Act (15 U.S.C. § 78j(b) (2002)), Rule 10b-5 (17 C.F.R. § 240.10b-5 (2002)), and Section 17(a) of the Securities Act (15 U.S.C. § 77q (2002)). *See id.* at 555.
55. *Id.* at 556.
56. *Id.*
57. *Id.* at 557.
58. *Id.* at 570.
59. *Id.* at 560.

employer's contributions to the fund.[60] In other words, Daniel did not have a sufficient "expectation of profit" for his interest in the fund to constitute a security.[61] Finally, the Court added as an afterthought the additional observation that the security afforded the pension plan by its regulation under the Employee Retirement Income Security Act of 1974 (ERISA)[62] militated against the finding of a security.[63]

The *Daniel* case has been generally interpreted as a clarification of the treatment of pension plans or, more broadly, of employee benefit plans in general.[64] In reality, however, the reasoning of the *Daniel* case is both broader and narrower than the common interpretation would suggest. The case is narrower than is commonly thought in the sense that it does not govern the disposition of all pension plans, and certainly not all employee benefit plans. The case is also broader than is commonly thought in the sense that it addresses the meaning of the "investment" prong for *all* purported investment contracts, not just "plans."

The real contribution of *Daniel* was its resolution of two important issues with respect to the *Howey* investment prong. First, the Court made it clear that *Howey*'s "investment of money" prong does not necessarily require an investment of "cash"—that is, "goods and services" may suffice as an "investment."[65] Second, the Court emphasized that a determination with respect to the investment prong of the *Howey* test requires an analysis of the "entire transaction" involving the purported security, not merely the characteristics of the purported security instrument itself.[66]

The first clarification, that goods and services can constitute an investment, is reasonably straightforward and uncontroversial. While "money" may be the usual consideration for securities, there is no reason why goods, services, or other securities may not also constitute an investment. The Court's second clarification, that the "entire transaction" must be analyzed to determine the presence of an investment, has proved less palatable to courts and commentators.[67] In the Court's view, the *Howey* test should be used "[t]o determine whether a particular

60. *Id.* at 561-62.

61. *Id.*

62. Employer Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

63. *Daniel*, 439 U.S. at 569-70.

64. Employer Benefit Plans, Exchange Act Release No. 33-6188, Fed. Sec. L. Rep. (CCH) ¶ 1051, at 2073-3 (Feb. 1, 1980) [hereinafter Release 6188].

65. *Daniel*, 439 U.S. at 560 n.12. Courts had held that other instruments or securities, such as promissory notes, could constitute an "investment" even before *Daniel*. *See, e.g.*, Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976).

66. *Daniel*, 439 U.S. at 559.

67. *See infra* Part III.C.

financial relationship constitutes an investment contract,"[68] as opposed to whether an instrument itself constitutes such a contract. The Court explained that "[i]n order to determine whether respondent *invested* in the Fund by *accepting and remaining* in covered employment, it is necessary to look at the *entire transaction* through which he obtained a chance to receive pension benefits."[69] Thus, the relevant considerations are not limited to whether the purported investment contract itself has investment characteristics, but must also encompass the motivation of the "purchaser" in surrendering his "investment."[70]

The "entire transaction" approach means that the mere fact that a particular "financial relationship" may involve some investment elements is not sufficient to establish the existence of an "investment." The *Daniel* analysis broke up the concept of an "investment" into two components: a consideration component and an investment decision component.[71] To determine whether a person was an "investor," the *Daniel* Court required that such person "chose to give up a specific consideration in return for . . . a security."[72] Where a person has not surrendered a "specific consideration," he has not made an "investment" under *Daniel.* Likewise, even where a person does give up a specific consideration, if that person does not *choose* to surrender that consideration, he has not made an investment decision or an investment.

The *Daniel* Court did not stop, however, with the abstract observation that the "entire transaction" or "financial relationship" should be examined to determine whether a person has made an investment. *Daniel* grappled with the troublesome issue of whether the "entire transaction" of an employment relationship demands that an employee "give up a specific consideration" or make an investment decision with respect to his compensation.[73] The Court observed that in the pension plan at issue "the purported investment [was] a relatively insignificant part of an employee's total and indivisible compensation package."[74] While the pension benefits may theoretically have influenced Daniel's employ-

68. *Id.* at 558 (emphasis added).

69. *Id.* at 559 (emphasis added).

70. *See infra* Part III.B.2.a.

71. The Tenth Circuit Court of Appeals has read *Daniel* as concluding that the "plan's noncontributory structure precluded the plaintiff from making the requisite investment at the same time that its involuntary component prevented him from making an affirmative investment decision 'to give up a specific consideration in return for a separable financial interest with the characteristics of a security.'" Uselton v. Commercial Lovelace Motor Freight, 940 F.2d 564, 573 (10th Cir. 1991); *see also In re* Cendant Corp. Sec. Litig., 81 F. Supp. 2d 550, 557 (D.N.J. 2000) ("A hallmark of a 'voluntary' plan is the ability of the employee to make an 'investment decision' to acquire the stock options.").

72. *Daniel*, 439 U.S. at 559.

73. *Id.* at 559-60.

74. *Id.* at 560.

ment decision, as a practical matter the Court observed that the "decision to accept and retain covered employment may have only an attenuated relationship, if any, to perceived investment possibilities."[75] Such an "attenuated relationship," the Court determined, did not constitute a "choice" to surrender "specific consideration" and therefore failed the investment prong.[76]

The "attenuated relationship" to investment possibilities in *Daniel* applies with equal force to many compensatory instruments other than pensions. Equity incentives for rank-and-file employees, when available, are frequently part of an incentive and compensation "package" and are accompanied by salary, pension, and other benefits. For rank-and-file employees, that "package" is often indivisible and not subject to individual negotiation. In such cases, the *Daniel* Court's reasoning applies; the employee, like Mr. Daniel, "surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security."[77] That is, for rank-and-file employees, any security component of their compensation is often part of an indivisible package in which the non-security components predominate.

The *Daniel* Court's conclusion was not, as might be presumed, that personal services cannot suffice as a specific consideration.[78] The Court's point was that the employee, in order to be an "investor," must be in a position to make an individual investment decision about exchanging "specific consideration" for a "separable financial interest with the characteristics of a security."[79] This observation responded to the court of appeals opinion which asserted, in the context of pension plans, that "the employment fringe benefit aspect of a pension can be separated from its security aspects."[80]

Moreover, the rule in *Daniel* is not that the "investment" component of an employment relationship is irrelevant merely because that investment component is coupled with a non-investment employment decision. As the Seventh Circuit has observed, "[t]he securities acts apply to investment decisions, even those made indirectly or bound up with other decisions, such as employment."[81] Instead, the *Daniel* rule is

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75. *Id.*

76. *Id.* at 559-60.

77. *Id.*

78. Some courts have, unfortunately, read *Daniel* as supporting the proposition that labor is not sufficient consideration, a reading that has brought disrepute on the *Daniel* decision as a whole. *See, e.g.*, Bauman v. Bish, 571 F. Supp. 1054, 1064 (D.C.W. Va. 1983).

79. *Daniel*, 439 U.S. at 559.

80. Daniel v. Int'l Bhd. of Teamsters, 561 F.2d 1223, 1237 (7th Cir. 1977).

81. Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 437 (7th Cir. 1987).

that an insignificant "investment" component of a larger, indivisible employment relationship will not transform the entire relationship into a securities transaction. There is no investment unless, as one district court put it, "the compensation package as a whole exhibit[s] 'the characteristics of a security.'"[82] Thus, where the employee is not in a position to choose to surrender a specific consideration, then, in the Supreme Court's phraseology, "[o]nly in the most abstract sense may it be said that an employee 'exchanges' some portion of his labor in return for these possible benefits."[83] This approach is simply another formulation of the "entire transaction" analysis.

The crucial lesson of the *Daniel* case, therefore, is that where there is no decision to invest made by the employee nor any exchange of specific consideration on her behalf, there is no investment, and accordingly no investment contract. Expressed differently, where a plan is involuntary or compulsory, in the sense that any purported investment elements are the automatic accompaniments of the employment relationship, the employee simply has no separable investment decision to make. And where a plan based on an employee contribution has only an "abstract" or "attenuated" relationship to the purported security, the purported investment is, as a practical matter, a noncontributory benefit. Thus, in applying *Daniel*'s learning about noncontributory, compulsory employee compensation outside the pension context, the key is ascertaining which types of equity incentives, other than pension plans, are "noncontributory" and "compulsory" within the meaning of the *Daniel* case.

From the perspective of rank-and-file employees, it turns out that many equity incentives, when properly analyzed, would fail the *Daniel* "investment" analysis within the meaning of the investment contract rubric.[84] The equity incentives of non-executive employees are often structured as an automatic incident of the employment relationship—as a take-or-leave-it employment proposition. The employee, therefore, "surrenders his labor as a whole," often for an incentive instrument that, in the words of *Daniel*, is "a relatively insignificant part of [the] employee's total and indivisible compensation package."[85] The employee, like the respondent in *Daniel*, "is selling his labor primarily

82. Foltz v. U.S. News & World Report, 627 F. Supp. 1143, 1158 (D.D.C. 1986).

83. *Daniel*, 439 U.S. at 560.

84. Surprisingly, only a few cases have applied the *Daniel* analysis outside the context of pension plans. *But see, e.g.*, Bauman v. Bish, 571 F. Supp. 1054, 1064 (D.C.W. Va. 1983). (applying the Daniel approach to an employee stock ownership plan to determine that no "investment" of labor occurred satisfying the "value" requirement of the Securities Act).

85. *Daniel*, 439 U.S. at 560.

to obtain a livelihood, not making an investment."[86] Thus, as one commentator notes, "[a]fter *Daniel* . . . serious doubts about the presence of a security must arise when, under the circumstances of the purchase, it is impossible to find a divisible portion of the consideration that is attributable to the acquisition of the instrument."[87]

The *Daniel* argument for non-security treatment, at least in its strict form, applies only to equity incentives that do not correspond to any of the enumerated categories of security. As discussed above, the more unusual instruments not specifically identified in the statutory lists can only come within the regulatory purview of the Acts if they qualify as "investment contracts" or as another residual category of security. Unenumerated equity incentives, when regarded through the lens of *Daniel*, could therefore fail the "investment" prong of the *Howey* test and not constitute securities. Thus, while stock, a specifically enumerated category of security, would still be a security even when given as an incentive or bonus to employees, broad-based stock appreciation rights, phantom stock, or performance units should not constitute securities when granted in the context of non-negotiated broad-based employee incentive programs.

2. "INVESTMENT" VERSUS "SALE" AND THE DEMISE OF *DANIEL*

The distinct analytical contribution *Daniel* made to the "investment of money" prong of the investment contract test has been largely lost, however, in subsequent case law and commentary. The slide of *Daniel* into relative obscurity may be attributed to three principal factors. First, the *Daniel* "investment" test was simply too easy to gloss over in most non-plan employee incentive cases; courts have assumed *Daniel* was met whenever an employee received some type of "separable financial interest," without consideration of the other components of the *Daniel* "investment" test.[88] Second, courts have rarely ever applied the *Daniel* "investment" test to securities generally, regarding *Daniel* as a "pension plan" case, or slightly more broadly as a "plan" case, but not an "investment contract" or an "investment" case generally. Finally, the *Daniel* analysis of an "investment" has lost its separate identity because of its similarity to the concept of a "sale" under the Securities Act; the separate "investment" analysis effectively merged into the virtually identical concept of a "sale."

86. *Id.*

87. FitzGibbon, *supra* note 17, at 905.

88. *See infra* Part II.B.2.b.

a. Separating the "Separable Financial Interest" Component

The first reason for the slide into obscurity of *Daniel's* "investment" test outside the context of employee benefit plan interests is that it is simply easier to treat as determinative the superficial parts of the *Daniel* test than to give effect to the whole test set forth by the Court. The *Daniel* analysis of what constitutes an investment should be regarded as a four-part test. Specifically, *Daniel* noted that in every Supreme Court case where a "security" was found, "the person found to have been an investor (1) chose (2) to give up a specific consideration (3) in return for a separable financial interest (4) with the characteristics of a security."[89] Each of these components is necessary to establish the presence of an "investment" under *Daniel,* but only the third and fourth factors of the test are commonly taken into account.

The problem is that when the incentive instrument received by an employee happens to be a stock option or other tangible written instrument, courts are tempted to regard that instrument as a "separable financial interest with the characteristics of a security" simply because the courts can see, touch, and construe the "separate" written document. This approach elevates the mere separable *form* over the inseparable *substance* of the instrument. The fact is, such instruments are not "separable" from the employment in almost any meaningful sense. Such instruments are so closely tied to the employment relationship that they do not even have value apart from the employment relationship. For example, employee stock options and stock appreciation rights customarily terminate ninety days after termination of employment,[90] even when those interests have "vested" under the relevant plan. Thus, those instruments are, in a very real sense, inseparable from the larger employment relationship.

The second crucial issue that is ignored by the separability analysis is that even if the instrument were considered separable from the employment relationship, other than in the context of stock purchase plans, it would be uncommon to find a broad-based employee plan that allowed employees to "choose" to contribute a separate consideration in exchange for the purported security. Under such plans, employees receive grants of equity interests at the discretion of an administrating committee designated by the board of directors. Employees have no contractual expectation of benefits, and are not entitled to "choose" to

89. *Daniel,* 439 U.S. at 559.

90. This characteristic appears generally in many stock option plans, whether the options qualify as "incentive stock options" under the Internal Revenue Code or not, even though the requirement of this provision is only a legal requirement for incentive stock options. *See, e.g.*, KRAUS, *supra* note 8, § 8.02[2].

receive equity interests under the plans. The only decision the employee makes is that employee's "decision to accept and retain covered employment," and as we have seen in the context of rank-and-file employees, that decision has "only an attenuated relationship, if any, to perceived investment possibilities."[91]

b. Relegating *Daniel* to Plan Interests

The second reason for the untimely demise of *Daniel* is another species of focus on the less important aspects of *Daniel* to the detriment of the more important ones. Specifically, despite the conceptually sweeping implications of the case, in the twenty years since the decision few federal cases have extended its reasoning beyond the immediate pension plan context, and virtually none have extended it beyond the context of employee benefit plans in general.[92] Courts appear to have focused exclusively on the fact that *Daniel* involved pension plan interests, ignoring the real issue in the case—the meaning of an investment contract and, as we shall see, of securities generally.[93]

This misreading is the result of the focus of courts on the "expectation of profits" discussion in *Daniel* to the detriment of the "investment of money" discussion. There is little serious dispute that the core holding in *Daniel* was predicated on the noncontributory, compulsory nature of the plan, not on the presence of employer contributions, the plan's defined benefit nature, or the plan's regulation under ERISA.[94] Even the Commission recognized shortly after the *Daniel* case that the key holding in that case was on the noncontributory, compulsory nature of the pension plan at issue.[95] Some courts have so thoroughly missed *Daniel*

91. *Daniel*, 439 U.S. at 560.

92. The farthest extension generally ventured is to employee stock ownership plans. *See, e.g.*, Uselton v. Commercial Lovelace Motor Freight, 940 F.2d 564 (10th Cir. 1991). Some cases have used *Daniel*'s "investment" prong to defeat security treatment for plan interests that are, in fact, incentive plans. *See, e.g.*, Simon v. Fribourg, 650 F. Supp. 319 (D. Minn. 1986). Nevertheless, such decisions were still rendered in the context of plan interests.

93. The irony is that this very failure to focus on the most important elements of the instrument itself was the basis of the *Daniel* Court's reversal of the lower court. *See Daniel*, 439 U.S. at 561 ("As in other parts of its analysis, the court below found an expectation of profit in the pension plan only by focusing on one of its less important aspects to the exclusion of its more significant elements.").

94. The Court specifically stated its holding as "[w]e hold that the Securities Acts do not apply to a noncontributory compulsory pension plan," *id.* at 570, making no reference to ERISA, to the defined benefit nature of the plan, or to the relative importance of employer contributions over plan investment return.

95. The Commission stated that:

> The Supreme Court's opinion in [the *Daniel*] case, however, did not rest on the fact that the plan was a defined benefit one. Instead, the Court based its decision on the involuntary nature of the plan (unlike all prior cases of the Court involving securities, the employees did not have a choice whether to participate) and the fact

as to read the case as supporting a categorical rule that "a pension plan does not constitute a security,"[96] without even considering the plan's voluntary or contributory nature. Even those courts that have understood that the "noncontributory, compulsory" nature of the *Daniel* interests were the key to the holding in that case have implied that that holding is limited to the context of "plans."[97]

This process was starkly illustrated in *Black v. Payne*,[98] decided shortly after *Daniel*. There, the court held that an employee's interest in the California Public Employees Retirement System pension plan was not a security under the Securities Acts.[99] The pension plan was a compulsory but contributory one, and therefore not directly addressed by *Daniel*. The court, probably to avoid facing the tougher issue of whether an "investment" exists in a compulsory but contributory plan, predicated its holding on the absence of an "expectation of profits."[100] The troubling observation, however, was the court's statement that "[b]oth this court and the Supreme Court have noted that while the *Howey* test has two components—the 'investment of money' and an expectation of 'profits to come solely from the efforts of others'—the latter is the more critical factor."[101] In fact, the Supreme Court has never said any such thing; the *Howey* prongs are not "factors" in some indeterminate balancing test, but individual requirements that must each be met to find an investment contract.

Thus, the distinctiveness of the *Daniel* analysis disappeared in large part because courts were more comfortable disposing of cases on plan-specific grounds, rather than investment-specific grounds. Some courts, for example, have relied on the "defined benefit" nature of *Daniel* and regulation under ERISA as authority for finding even a voluntary, partially contributory plan to constitute a non-security,[102] and other courts have relied on the "expectation of profits" aspect of *Daniel* to hold such

> that the plan did not provide for direct, identifiable contributions by employees (the employees' labor could be considered a contribution 'only in the most abstract sense').

Release 6188, *supra* note 64, at 2073-7 to 2073-8. Further, the Commission also indicated that "the ERISA requirements would not be a barrier to finding an investment contract present," *id.* at 2073-11, thus reinforcing the importance of the "investment" element.

96. Manchester Bank v. Conn. Bank & Trust, 497 F. Supp. 1304, 1312 (D.N.H. 1980).

97. *See Uselton*, 940 F.2d at 586.

98. 591 F.2d 83 (9th Cir. 1979).

99. *Id.* at 88.

100. *Id.* at 87-88. In fact, the court specifically stated that it did not need to reach the "investment" issue. *See id.* at 88 n.4.

101. *See id.* at 87.

102. *See* Tanuggi v. Grolier Inc., 471 F. Supp. 1209, 1214-16 (S.D.N.Y. 1979); *see also* O'Neil v. Marriott Corp., 538 F. Supp. 1026, 1031 (D. Md. 1982) (finding no "expectation of profit solely from the efforts of others" in a voluntary, contributory plan).

pension plans non-securities.[103] Thus, while the Commission made it clear that the dispositive holding in *Daniel* was the fact that the plan at issue was not voluntary or contributory, relatively few courts have reached the right determination by regarding those characteristics as dispositive.[104] That failure may help to explain why the "investment" prong of *Daniel* has slid into obscurity.

c. Investment versus Sale Distinction

The third and most important consideration in the demise of *Daniel's* separate analytical significance is the similarity of the concept of an "investment" under *Daniel* to that of a "sale" under Section 2(a)(3) of the Securities Act. The *Daniel* investment prong intuitively resembles the securities law idea of a sale, and in fact traces its lineage to the Commission's articulation of a "sale."[105] The problem from the perspective of preserving the independent analytical significance of an investment is that, like a finding of no security, a finding of no sale is dispositive as to most Securities Act claims. Where a court can dispose of a Securities Act claim on the narrower basis of "no sale," that court is unlikely to risk taking the additional step of finding "no security," even though (for an investment contract case) that latter finding would be implied by a finding of "no sale." As a consequence, the independent significance of the "no investment" construct was effectively eclipsed by its analytical similarity to the more easily judicially comprehensible and seemingly narrower holding of "no sale."

The Securities Act concept of a "sale" has evolved in an *ad hoc* manner under the pertinent case law. Section 2(a)(3), which defines the term "sale" for the purposes of the Securities Act, provides that "[t]he term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value."[106] In comparing the term

103. *See* Coward v. Colgate-Palmolive Co., 686 F.2d 1230, 1237 (7th Cir. 1982); *see also* Cunha v. Ward Foods, 545 F. Supp. 94, 99-101 (D. Haw. 1982) (holding that a voluntary, contributory plan was not a security). Note that these decisions do not necessarily conflict with *Daniel*, as *Daniel* merely held that an interest in a compulsory, noncontributory plan *was not* a security, not the converse proposition that an interest in a voluntary, contributory plan necessarily *was* a security. The chief vice of these cases is that they imply that *Daniel* supported an exclusion from the term "security" for pension plans generally, as opposed to pension plans not involving an "investment."

104. Some courts have, however, interpreted *Daniel* correctly. *See, e.g.*, Salazar v. Sandia Corp., 656 F.2d 578, 582 (10th Cir. 1981) ("[I]f not both voluntary and contributory the plan cannot be a security."); Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 573-74 (10th Cir. 1991). ("[A]n employee benefit plan that is either noncontributory or compulsory is not an investment contract because it does not allow a participant to make the 'investment' required by the first prong of the *Howey* test.").

105. *See infra* notes 111-15 and accompanying text.

106. 15 U.S.C. § 78b(a)(3) (2002).

"investment" to the term "sale," the key words in this definition are "for value." In the courts' view, whether "value" is present in a purported "sale" is a context-specific undertaking; while there may be no general definition, "it is pretty well understood that certain types of disposition are regarded as made for 'value' and others are not."[107] The best that can be said as a general rule, as Professor Loss has observed, is that the Commission "has not attempted any metaphysical distinction between 'value' and 'consideration.'"[108]

The concept of an investment for the purposes of the investment contract analysis, as articulated by *Daniel*, looks to the "contributory" and "voluntary" nature of the purported "investment." In order to have an "investment," there must be a "specific consideration" and a "choice," or investment decision, to find a voluntary, contributory plan and therefore an "investment." These two components are similar to the concept of a "sale" under the Securities Act, which requires "value" and arguably an "investment decision."[109] The apparent similarity of the "investment" prong to the concept of "value" under Section 2(a)(3) has led many courts to read *Daniel* as authority for construing the contours of the "value" requirement.[110] The *Daniel* concept of "consideration" seems identical to the notion of "value," and in the absence of any specialized securities law definition of value, the *Daniel* concept of a "separate consideration" has become a reliable surrogate for value, particularly in the employee benefit context.

The conceptual crossover between "investment" and "value" has, from its inception, persuaded the Commission as well. The Commission has applied identical tests for the two concepts and cited one concept as authority for the other. For example, in the Commission's Securities Act Release Number 6281, the Commission explained that, "[a]s noted in Release 6188 . . . a plan may also be deemed to be *voluntary and contributory* and therefore to involve a sale of a security in those instances where participating employees individually bargain to contrib-

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107. LOSS & SELIGMAN, *supra* note 17, at 1138.20-.21.

108. *Id.* at 1138.20.

109. The courts have not been entirely clear about whether the concept of an "investment decision" is a requirement for finding a "sale," or whether the investment decision is relevant to some other dispositive element of a claim under the various antifraud provisions of the securities laws. Some courts have read "investment decision" out of the sale concept entirely, even in the context of employee benefit plans. *See, e.g.*, Daniel v. Int'l Bhd. of Teamsters, 561 F.2d 1223, 1243 (7th Cir. 1977) ("The definitions of 'sale' in the 1933 and 1934 Acts do not require volition."); other courts have retained the notion of an "investment decision" but have presented it as a question of reliance, *see, e.g.*, Isquith by Isquith v. Caremark Int'l, Inc., 136 F.3d 531, 534 (7th Cir. 1998) (explaining that a person who makes "no investment decision" is not "induced by" and has not "relied on" a purported misrepresentation), or as a matter of "duty" or "causation." *See, e.g.*, Jordan v. Duff & Phelps, 815 F.2d 429, 437-38 (7th Cir. 1987).

110. *See, e.g.*, Bauman v. Bish, 571 F. Supp. 1054 (D.C.W. Va. 1983).

ute their services in exchange for interests in the plan."[111] The "voluntary" versus "compulsory" and "contributory" versus "non-contributory" distinction, as the reader will recall, is the same distinction employed by *Daniel* to determine whether there is an investment within the meaning of the *Howey* test.[112] Further, the Commission, as authority for this statement, cited the "separately bargained consideration" language that is surprisingly similar to the "specific consideration" required for an investment under *Daniel*.[113]

The kinship between the concept of a "sale" under Section 2(a)(3) and the concept of an "investment" developed in the *Daniel* case is not only not purely coincidental, but may actually be intentional. There is at least some evidence that the Court deliberately fused the two concepts in that decision. In a portion of the opinion rebutting the Commission's assertion that a noncontributory plan could constitute a security, the Court explained that the Commission, "[i]n an attempt to reconcile [past] interpretations of the Securities Acts with its present stand," argued that there could be a "security" "even where a 'sale' is not involved."[114] The Court noted that "none of the SEC opinions, reports, or testimony cited to us address the question,"[115] implying that the Court was at least skeptical that a security could exist without a sale. The Court then proceeded to copy the Commission's phraseology for a "sale" to create its new definitional concept of an "investment."[116] Given the fact that the *Daniel* case drew its "investment" analysis from the Commission's "sale" analysis, and the Commission subsequently restated that "investment" analysis in its "sale" analysis, it seems safe to say that both camps regard the two concepts as functionally identical.

3. THE SIGNIFICANCE OF *DANIEL*

The *Daniel* case suggested, and the foregoing discussion further reveals, the somewhat unconventional notion that a security, at least in

111. Plan Subject to the Act, Exchange Act Release No. 33-6281, Fed. Sec. L. Rep. (CCH) ¶ 1052, at 2073-31 n.6 (Jan. 15, 1981) (emphasis added) [hereinafter Release 6281].

112. *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979).

113. *See* Release 6281, *supra* note 111.

114. *Daniel*, 439 U.S. at 567 (1979).

115. *Id.*

116. The Commission articulated the contributory/compulsory distinction in the plan context almost from the inception of the Acts. *See* Opinion of the Assistant General Counsel of Commission, [1941-1944 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 75,195 (1941).

> [I]t is because of the language of Section 2(3) that no "offer" or "sale" occurs in the case of a non-contributory plan, where employees are not requested to make any contributions, or in the case of a compulsory plan, where there is no element of volition on the part of employees whether or not to participate and make contributions.

Id.

the form of an investment contract, does not exist in the absence of a "sale" of that instrument. The Commission has indicated that when instruments are awarded to employees pursuant to certain types of incentive plans, there is no sale unless employees "individually bargain to contribute cash or other tangible or definable consideration to such plans."[117] Since the concept of a "sale" is functionally equivalent to the concept of an "investment" under *Howey*, employee incentives that do not fall within an enumerated category of security must be the subject of a sale if they are to be regarded as securities. Thus, the real uncertainty associated with the *Daniel* decision is not connected with its impact on unenumerated instruments as discussed above, but with the much more troublesome case of employee stock options, which arguably *are* an enumerated category of security.

III. Employee Stock Options and the Securities Acts

The analysis of employee stock options differs from that of the other categories described above because stock options arguably fall within one or more enumerated categories of security specifically enumerated in the definitions. There is little doubt that ordinary options to purchase stock outside the employment context constitute securities for purposes of the Securities Acts. Not only does the definition of "security" in both Acts expressly include "any put, call, straddle, option, or privilege on any security" and any "warrant or right to subscribe to or purchase, any [security],"[118] but the courts have regularly confirmed that options are securities.[119] This is where the security analysis of employee stock options has ended for virtually all courts and commentators—"options" are included in the definition, so employee stock options are *per se* securities.

The problem for the simplistic "facial interpretation" approach is that in spite of the literal terms of the statutory language, the Supreme Court has held that the term "any note" in the definitional lists does not literally mean "any note" for the purposes of the Securities Acts.[120] The

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117. Release 6188, *supra* note 64, at 2073-15.

118. 15 U.S.C. § 78c(a)(10) (2000). Not only are such options themselves securities, but they also embody the right to purchase other securities. A put represents the right to sell an underlying security at a fixed exercise price. A call represents the right to purchase an underlying security at a fixed exercise price. Thus, as Professor Loss observed, options have a "dual personality. They are themselves 'securities' at the same time that they represent offers to sell other securities." Louis Loss, Securities Regulation 467 (2d ed. 1961).

119. *See, e.g.*, Mansbach v. Prescott, Ball, & Turben, 598 F.2d 1017, 1026 n.40 (6th Cir. 1979); LTV Fed. Credit Union v. UMIC Gov't Sec., Inc., 523 F. Supp. 819, 832 (N.D. Tex. 1981); *see also* Wharf (Holdings) Ltd. v. United Int'l Holdings, 532 U.S. 588 (2001) (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 750-51 (1975)).

120. *See* Reves v. Ernst & Young, 494 U.S. 56, 63 (1990).

Court has even held that stock is not always "stock" for the purposes of the Acts.[121] In fact, as this Part will describe, the Supreme Court has applied a contextual, fact-specific test to determine whether an instrument nominally included in the definitional list is, in fact, a "security" within the meaning of the Securities Acts. This Part will address the question of whether the fact that the definitional lists nominally include any "warrant," "right," "call," or "option" means that *any* employee stock option is *necessarily* a security for the purposes of the Securities Acts.

A. *The Rise and Fall of the* Howey *Test*

There has been little serious scholarly or judicial consideration of whether employee stock options constitute securities for the purposes of the Securities Acts. Most courts and practitioners have simply assumed, often without analysis, that security treatment is compelled by the literal terms of the statutory definitions.[122] In order to understand the reluctance of lower courts and commentators to look beyond the superficial literal terms of the definitions, it is instructive to consider the effect of *Howey*'s subsequent history and reputation on the credibility of Supreme Court dicta in this area.

In 1975, roughly four years before *Daniel*, the Supreme Court decided the groundbreaking case of *United Housing Foundation v. Forman*.[123] In that case, the Court concluded that shares of stock in a New York City housing cooperative were not securities within the meaning of the Securities Acts.[124] The Court relied on the fact that the so-called stock involved in that case bore none of the characteristics "traditionally associated with stock."[125] The purchasers of that stock, tenants in the cooperative, parted with their money to acquire low-cost subsidized living space for personal use, not investment securities.[126] Having concluded that the instruments denominated "stock" were not in fact "stock," the Court addressed the argument that the shares were investment contracts.[127] This segment of Justice Powell's analysis spawned a significant detour in the evolution of the definition of a security.

In the *Forman* opinion, Justice Powell appeared to set forth a universal test for the definition of a security. Admiring the apparent versa-

121. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 848 (1975).
122. *See, e.g.*, Fenoglio v. Augat, 50 F. Supp. 46 (D. Mass. 1999).
123. 421 U.S. 837 (1975).
124. *Id.* at 847.
125. *Id.* at 851.
126. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 687 (1985) (explaining *Forman*'s holding).
127. *Id.* at 689.

tility of the *Howey* test, Justice Powell observed that that test, "in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security."[128] Some commentators reasonably concluded that *Howey* would thenceforth constitute a restraining force on the expansion of regulatory coverage of all categories of securities, not merely of investment contracts.[129] Similarly, many federal courts adopted *Howey* as the universal archetype of a "security."[130] One court went so far as to laud the *Howey* test as "a kind of sacred measure of the existence of a security."[131] That "sacred measure" of a "security" appeared to be destined for posterity when Justice Powell reaffirmed the same statement in footnote eleven of his opinion in the *Daniel* case only a few years later.[132]

The Court, however, repudiated this interpretation of the *Howey* test when Justice Powell wrote his next definition-of-security opinion a decade later in *Landreth Timber v. Landreth.*[133] In that case, Justice Powell slipped in another footnote that called his previous footnote a "bit of dicta"[134]—one of the most vicious epithets the Supreme Court can apply to anything it regrets having said. A backtracking Justice Powell explained that what he meant was that there was no distinction "'*for* [then] *present purposes*'" between the test for "'investment contracts'" and that for another "general category" of security, the "instrument commonly known as a 'security.'"[135] Further, Justice Powell explicitly stated that "the *Howey* economic reality test was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples listed in the statutory definition of 'security.'"[136] Justice Powell was even confident enough

128. *Forman*, 421 U.S. at 852. In Professor McGinty's terms, the Court, beholding the test of its own creation, chose to "look with pride at the *Howey* test and say, 'That's my child.'" *See* Park McGinty, *What is a Security?*, 1993 WIS. L. REV. 1033, 1081.

129. *See, e.g.*, John Deacon & James D. Prendergast, *Defining a "Security" After the* Forman *Decision*, 11 PAC. L.J. 213, 217-18 (1980).

130. *See, e.g.*, Baurer v. Planning Group, 669 F.2d 770, 778-79 (D.C. Cir. 1981) (applying the *Howey* investment contract test to promissory notes); LTV v. UMIC Gov't Sec., Inc., 523 F. Supp. 819, 828 (N.D. Tex. 1981) (noting that the statements in *Forman* and *Daniel* "naturally enough, has led to speculation that the elements of an 'investment contract' are generic to all securities"); Hackford v. First Sec. Bank of Utah, 521 F. Supp. 541, 555 (D. Utah 1981) ("[I]t should generally be of non moment which of the forms listed in § 3(a)(10) a transaction most closely resembles. The *Howey* test capably exposes the economic reality necessary to determine whether any form of transaction falls within the Act's definition of a 'security.'").

131. Braniff Airways v. LTV Corp., 479 F. Supp. 1279, 1284 (N.D. Tex. 1979).

132. *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 558 n.11 (1979); *see also Braniff Airways*, 479 F. Supp. at 1287.

133. 471 U.S. 681 (1985).

134. *Id.* at 691 n.5.

135. *Id.* at 691-92 n.5.

136. *Id.* at 691. In Professor McGinty's terms, the Court, beholding the test, "rightly viewed it

to follow that conclusion with the dubious proposition that "[o]ur cases are consistent with that view."[137]

Justice Powell's explanation of the *Daniel* footnote in *Landreth* was, at best, a creative reinterpretation of what the *Forman* and *Daniel* cases actually said.[138] Enough courts and commentators were burned by this palinode that they would never again take any universal-sounding Supreme Court test at face value. But this once-bitten mentality of courts and commentators has distorted both the *Howey* test and the subsequent definition-of-security cases. With respect to the *Howey* case, it is true that the *Landreth* Court forcefully repudiated *Daniel*'s assertion that the *Howey* test applied to all categories of security, but nowhere did the *Landreth* Court repudiate *Daniel*'s lengthy discussion of the "investment" requirement. This failure is significant because the Court in *Daniel* specifically made a *separate* "universal" statement regarding the "investment" prong of the *Howey* test. Specifically, Justice Powell stated that "[i]n every decision of this Court recognizing the presence of a 'security' under the Securities Acts, the person found to have been an investor chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security."[139]

It is possible, of course, that Justice Powell simply overlooked his second universal proclamation about the nature of securities. It is also possible that Justice Powell found it unnecessary to repudiate this second statement because it was not briefed by the parties.[140] The fact is, however, that the Court *did* explicitly declare that "every decision" finding the presence of a security had involved transactions satisfying the "investment" prong of the *Howey* test. While *Landreth* justifiably spooked the securities law community from taking any universal Supreme Court statement in this area at face value, it is difficult to perceive any principled reason why an "investment contract" should require an "investment" while a stock, bond, option, or note should require no "investment" at all.[141] In fact, one commentator has, independently of the Court's statement in *Daniel*, taken the position that the legislative purpose of the Acts supports the proposition that "[w]here there is no

with horror; wrongly said 'That's not my child!' and euthanized it." McGinty, *supra* note 128, at 1081.

137. *Landreth*, 471 U.S. at 691 (1985).

138. Justice Powell delivered the Court's opinion in *Forman*, *Daniel*, and *Landreth*.

139. Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979).

140. For example, in *Landreth*, Justice Powell refuted the footnote 11 assertion in response to the respondents' "contention that the Court has mandated use of the *Howey* test whenever it determines whether an instrument is a 'security.'" *Landreth*, 471 U.S. at 691 n.5.

141. It is possible that the *Landreth* Court did not, in fact, intend to imply that an investment was not necessary for finding that a stock is a security within the meaning of the Acts, but only that the *Howey* test as a unified whole did not apply outside the context of investment contracts.

investment, the securities laws are not involved."[142] This position is supported by Justice Marshall's observation in *Reves*, that "Congress' purpose in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called."[143] In the absence of some persuasive reason not to apply the "investment" requirement generally, it makes sense to take Justice Powell at his word.

The aversion to extending any portion of *Howey* outside the investment contract context is understandable, but also may be seen to be unnecessary with respect to the "investment" prong by examining the experience with the test in the wake of *Forman* and *Daniel*. The repudiation of a universal application of the *Howey* test was inevitable, not because the Court did not clearly extend *Howey*, but because the investment contract test was unworkable as a universal test for debt instruments in general and notes in particular.[144] Although the extension of *Howey* caused courts and commentators considerable heartburn about the test, the widespread outrage was not focused on the horrors of applying the "investment" prong of *Howey*, but on the "common enterprise" and the "expectation of profits" prongs,[145] with a lesser emphasis on the "efforts of others" prong.[146] Thus, the more plausible explanation is not that the *Landreth* Court found it necessary to repudiate the "investment" prong, but rather that it sought to avoid the problems associated with the "sale-of-business" doctrine (a *Howey* derivative),[147] and from applying the *Howey* test to notes. This was, in fact, the concern that arose after the *Forman* case, intensified after the *Daniel* case,[148] and was finally

142. McGinty, *supra* note 128, at 1087.

143. Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).

144. Interestingly, commentators differed in their assessment about what effect *Howey* would have on treatment of "notes." *Compare* Edward Sonnenschein, Jr., *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW 1567, 1594-95 (1980) (arguing that the *Howey* test, if universally applicable to all "securities," could make it very difficult to classify notes and other debt instruments as "securities" under the Acts), *with* FitzGibbon, *supra* note 17, at 900-01 ("The [*Howey*] test provides no way to avoid the conclusion that virtually all loans involve securities.") and McGinty, *supra* note 128, at 1072 (arguing that "[i]f the interest counted as profits, notes would always be securities; if interest did not count as profits, notes would never be securities").

145. *See, e.g.*, McGinty, *supra* note 128, at 1072.

146. *See, e.g.*, Sonnenschein, Jr., *supra* note 144, at 1595 (describing the "profits" and "efforts of others" prongs as "problematic" in the context of note transactions). Another commentator observed that because "profits derived from notes are always 'based on the managerial efforts of others,'" the fourth *Howey* factor is superfluous. *See* Janet Kerr & Karen M. Eisenhauer, Reves *Revisited*, 19 PEPP. L. REV. 1123, 1126 (1992).

147. *See* Williamson B.C. Chang, *Meaning, Reference, and Reification in the Definition of a Security*, 19 U.C. DAVIS L. REV. 403, 408 n.17 (1986).

148. The more prescient courts, however, recognized that despite the expansive language in *Forman* and *Daniel*, the Supreme Court could not possibly have intended to apply the *Howey* test to notes. *See, e.g.*, Meason v. Bank of Miami, 652 F.2d 542, 550 n.17 (5th Cir. 1981) (noting that the *Howey* test is "of dubious value in [the note] context"); Exch. Nat'l Bank of Chicago v.

resolved in *Reves*.[149]

After the dust settled from *Landreth*, it was at least clear that the *Howey* investment contract test no longer applied as a whole to stock, with a strong implication that the test did not apply to the other enumerated security categories. It is much less clear, however, that the inapplicability of *Howey* implied a literal "security" treatment for the other enumerated categories. This is particularly the case in the context of employee stock options. There, the so-called "plain terms" approach—that is, that the plain terms of the definition include any "put," "call," or "option," as well as any "warrant or right to subscribe to or purchase" any security, is simply too tempting in an analysis of an instrument denominated an "option."[150] The fact that employee stock options have the label "options," combined with the fact that they share some characteristics of ordinary stock options, probably contributes to the lack of scholarly dissent on the "security" status of employee stock options.

This literalist approach, although seductive to courts, commentators, and practitioners, is belied by the Supreme Court's approach to the definitional provisions. In *Forman*, for example, the Court plainly considered and rejected what the Court itself called the "'literal approach' to defining a security,"[151] and that rejection occurred in the context of an instrument called "stock"—the "paradigm" of a security. The Court in that case invoked the venerable aphorism: "[a] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."[152] Even *Landreth*, which may be regarded as the Supreme Court's best example of literalism in this area, expressly left "until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.'"[153] In fact, the

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Touche Ross & Co., 544 F.2d 1126, 1136 (2d Cir. 1976); Briggs v. Sterner, 529 F. Supp. 1155, 1168 (S.D. Iowa 1981) ("[I]t would be difficult if not impossible to fit any note, debenture or even preferred stock within that framework.").

149. *See infra* Part III.B.

150. The superficiality of this approach is particularly stark when the reader considers that in fact employee stock options would more plausibly qualify as "warrants" or "rights" than as "options." In the financial community, the instruments commonly called "employee stock options" are really "warrants." *See, e.g.*, SIMON Z. BENNINGA & ODED SARIG, CORPORATE FINANCE: A VALUATION APPROACH 374 (1996) ("When an option is written by an investor, it is simply called an *option*. When the firm whose stock is the underlying asset writes the option, we call the option a *warrant*."). The exercise of a warrant causes the number of shares of a firm outstanding to increase, while the exercise of an option only effects a transfer of already outstanding shares. *See id.*

151. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 (1975).

152. *Id.* at 849 (quoting Church of the Holy Trinity v. United States, 143 U.S. 457, 459 (1892)).

153. Landreth Timber Co. v. Landreth, 471 U.S. 681, 694 (1985). With respect to "notes," the

Court there expressly cautioned that "'stock' may be viewed as being in a category by itself,"[154] and "may be distinguishable from *most if not all* of the other categories listed in the Acts' definition."[155] That statement by the Court, although largely neglected, is crucial; the Court straightforwardly stated that the notion that a security may be found "by proving the document itself" is *not* applicable to "most if not all" of the other statutory categories.

Once satisfied that the plain terms approach is not controlling as to the general definition of a security, but is controlling for stock, the second possible approach would be to treat stock options as securities on the rationale that stock options are somehow analytically identical to stock. The rationale would be that since stock has special status as the "paradigm" of a security, a stock option—that is, a contract to acquire stock—ought to have a special securities law status too. This was roughly the approach taken in *One-O-One Enterprises v. Caruso.*[156] In that case, then-Circuit Judge Ginsburg invoked the traditional/non-traditional dichotomy of *Landreth,* concluding that "[t]he option to purchase stock, it seems to us, is such a traditional securities instrument that its existence may be shown 'by proving the document itself.'"[157] Judge Ginsburg then proceeded to the conclusion that the right to purchase stock should "be subject to the same test for application of the securities laws as [stock] itself."[158]

Court subsequently answered this question in the negative—i.e., that "notes" could not be shown by proving "the document itself." *See* Reves v. Ernst & Young, 494 U.S. 56, 62-63 (1990).

154. *Landreth,* 471 U.S. at 694.

155. *Id.* at 693.

156. 848 F.2d 1283 (D.C. Cir. 1988).

157. *Id.* at 1288.

158. As support for this proposition, the court cited the statement of *Blue Chip Stamps* that "[a] contract to purchase or sell securities is expressly defined by § 3(a) of the 1934 Act, 15 U.S.C. § 78c(a), as a purchase or sale of securities for the purpose of that Act." *Id.* (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 750-51 (1975)). But that statement in *Blue Chip Stamps* only observed that a contract to purchase or sell, including a put, call, or other option, constitutes a "purchase or sale" of the underlying security, not that such a put, call, or other option is itself a security, and certainly not that a contract to purchase a security is subject to the same test for security status as the underlying security itself. Justice Ginsburg's observation is particularly unfortunate not only because it has been cited as authority for treating stock options as stock, but also because Justice Ginsburg explicitly acknowledged that the security question "[did] not affect the outcome of this appeal." *See id.* at 1284. Nevertheless, Justice Ginsburg is not the first to have misread the *Blue Chip Stamps* case as determining whether a security was involved, as opposed to whether a "purchase" or "sale" was involved. One particularly troubling district court opinion actually *replaced* the *Blue Chip Stamps* language that "the holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for the purposes of Rule 10b-5" with the inaccurate paraphrase, "puts, calls, options, and other contractual rights to purchase or sell securities have been recognized as [securities under the federal securities laws]." Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1235 (S.D.N.Y. 1981).

The problem with the *One-O-One Enterprises* approach is that employee stock options are not stock, but only contractual rights to acquire stock. In fact, for this reason the argument made by the *One-O-One Enterprises* court actually cuts both ways. That is, the court argued that stock options should be *per se* securities because they are rights to acquire stock and stock is "in a category by itself."[159] But, we might just as easily point out that stock options are *not* stock and stock is "in a category by itself." Even in the context of instruments that were actually called shares of "stock," the court stated that "the fact that instruments bear the label 'stock' is not of itself sufficient to invoke the coverage of the Acts. [W]e must also determine whether those instruments possess 'some of the significant characteristics typically associated with' stock."[160] After all, if we are to invoke the special status of stock to establish the security character of employee stock options, those options should at least meet the same test we would apply to stock.

The *One-O-One Enterprises* analysis, however, fails on its own terms in this regard, as employee stock options have virtually none of the characteristics of stock. The Supreme Court itself identified the characteristics of "traditional stock" as: (1) the right to receive dividends contingent upon an apportionment of profits; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the conferring of voting rights in proportion to the number of shares owned; and (5) the capacity to appreciate in value.[161] Stock options, like the "stock" in *Forman*, "lack what the Court in *Tcherepnin* deemed the most common feature of stock: the right to receive 'dividends contingent upon an apportionment of profits.'"[162] Employee stock options also are not negotiable and normally may not be pledged or hypothecated.[163] Further, employee stock options have no voting rights, leaving only the capacity to appreciate in value as their common characteristic with traditional stock.

Lest the reader be tempted to take a "one out of five ain't bad" approach to the "traditional stock" analysis, it is important to consider the ramifications of letting the other four factors slide. If we allowed the capacity to appreciate in value alone to convince us that something is "traditional stock," then virtually every conceivable piece of personal or real property could constitute "traditional stock."[164] The realist in the

159. *One-O-One Enterprises*, 848 F.2d at 1288.

160. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).

161. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975).

162. *Id.* (citation omitted).

163. *See* David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 460 (2000) ("Option plans usually prevent executives from pledging their grants. [T]he option is not usable collateral.").

164. In fact, such property also generally has the characteristic of the "ability to be pledged or

audience might exclaim that such other pieces of property are not even called "stock." The fact is, though, that neither are employee stock options. While this argument does not, by itself, dispel the argument that "warrants," "rights," and "options" are expressly included in the definition of "security," it does dispel the argument that they should be included in the special *per se* security category of "traditional stock."

B. Reves v. Ernst & Young *and the Second-Level Context Clause Test*

1. REREADING *REVES*

The question remained after *Forman*, *Daniel*, and *Landreth* whether any elements of the *Howey* test survived outside the context of investment contracts. The *Landreth* Court, after all, clearly cautioned that the *Howey* test, at least as an integral whole, should not apply to other enumerated categories of securities. But the Court's indication that *all* of the *Howey* factors would not be relevant to *all* of the other enumerated instruments did not necessarily imply that *none* of the *Howey* factors would be relevant to *any* of the other instruments. Specifically, the Court did not clarify whether the absence of an "investment" could remove an instrument not only from the "investment contract" rubric, but also from the other enumerated categories, such as "bonds," "options," or "notes." Nor did the Court resolve the broader question of whether *any* contextual inquiry, whether related to *Howey* or not, could suffice to remove an instrument falling within an enumerated category of security from the scope of the term "security."

The answer to both questions depended on the Court's resolution of the interpretive dispute over the prefatory language, "unless the context otherwise requires," that qualifies the definitional provisions in the Securities Acts. At issue is whether this so-called "context clause" refers only to the textual context of the Acts themselves or more broadly to the underlying factual context of the transaction at issue.[165] If the context clause language refers "only to the statutory context," as many commentators have contended,[166] then that clause would not support

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hypothecated," and accordingly would have two of the five characteristics, compared with stock options' one of five.

165. This issue was discussed in detail in Ruefenacht v. O'Halloran, 737 F.2d 320 (3d Cir. 1984), *aff'd sub nom.*, Gould v. Ruefenacht, 471 U.S. 701 (1985), in which the Court of Appeals opted for the narrower, "textual" interpretation of the context clause with respect to "stock."

166. Professor Rosin is one of several commentators who have argued for the narrower, "textual" interpretation of the context clause. *See generally* Gary S. Rosin, *Functional Exclusions from the Definition of a Security*, 28 S. TEX. L. REV. 333 (1986) [hereinafter Rosin, *Functional Exclusions*]. In contrast, Professor Loss argues that there is "support in the legislative history of the Securities Act for the view that 'context' refers more broadly to the surrounding factual

"judicial exclusions of securities from the scope of the Act when the 'factual circumstances' seem to warrant it."[167] If, on the other hand, the context clause language refers more broadly to the underlying factual circumstances of the transaction at issue, that clause would provide at least a plausible statutory basis for so-called "functional" exclusions from securities law coverage.

The Supreme Court resolved the context clause issue without even mentioning the clause in *Reves v. Ernst & Young*.[168] In that case, the Court was called upon to decide whether certain promissory notes issued by a farmers' cooperative constituted securities within the meaning of the Exchange Act.[169] Justice Marshall, assuming Justice Powell's role as the Court's definition-of-security expositor, considered the top three tests established in the circuit courts to ascertain whether "notes" are securities. These tests included: (1) the *Howey* investment contract test, which some circuits had adopted from the "investment contract" context; (2) the "family resemblance" test, which compared a particular note to a "judicially-crafted list of exceptions" from the definition of a security; and (3) the "investment versus commercial" test, which distinguished notes issued in an investment context from notes issued in a commercial or consumer context.[170] The Court officially opted for the "family resemblance" test, although it regarded the "investment versus commercial" test as embodying the "same general approach."[171]

The *Reves* Court sorted through the ambiguous language in *Landreth* and resolved the context clause dispute in favor of the functionalist and "contextualist" approach and against the literalist or "textualist" interpretation. Justice Marshall, writing for the Court, explained that it is the presence of an "investment" that is "the fundamental essence of a 'security.'"[172] In Justice Marshall's view, "Congress' purpose in enacting the securities laws was to regulate *investments*," and in determining whether a particular transaction involves an investment, courts are not

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circumstances of a transaction alleged to involve a security." LOSS & SELIGMAN, *supra* note 17, at 928. Professor Loss bases this interpretation in part on the fact that "[e]arly versions of the 1933 bills said: 'unless the text otherwise indicates.'" *Id.* at 928 n.14. Professor Rosin's article retorts that "[t]he adoption in the 1933 and 1934 Acts of the phrase 'unless the context otherwise requires' reflects nothing more than differences in choice of drafting sources," meaning the choice of the English Companies Act definition section over that drafted by Huston Thompson. *See* Rosin, *Functional Exclusions*, *supra*, at 580-82, 597. While this interpretive matter of legislative history may continue to occupy commentators, its ultimate resolution is moot as the Supreme Court has opted for the "factual context" approach. *See infra* Part III.C.

167. Ruefenacht v. O'Halloran, 737 F.2d 320, 331 (3d Cir. 1984).

168. 494 U.S. 56 (1989).

169. *Id.* at 58.

170. *Id.* at 63-65.

171. *Id.* at 64-65.

172. *Id.* at 68-69.

"bound by legal formalisms, but instead take account of the economics of the transaction under investigation."[173] Distinguishing the literalist and anti-contextualist approach of *Landreth*, the Court made it perfectly clear that the only reason the instruments in *Landreth* were not subject to "case-by-case analysis" on the basis of economic reality was precisely because those instruments were "by their nature *investments*."[174] In the Court's view, "stock is, as a practical matter, *always an investment* if it has the economic characteristics traditionally associated with stock."[175] The *Reves* Court, therefore, expressly confirmed what the *Daniel* Court had suggested—that the "fundamental essence" of a security is an investment.

The next component of the *Reves* Court's opinion, though, has generated more controversy than the widely overlooked "investment" requirement. Justice Marshall did not merely name the "family resemblance" notes that did not constitute "securities" under the adopted Second Circuit test, he further explained "what it is about [the family resemblance] instruments that makes *them* non-'securities.'"[176] Here, Justice Marshall articulated a four-factor test to distinguish non-securities from securities, requiring courts to:

> [1] examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." . . .
> [2] . . . examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment."
> [3] . . . examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.
> [4] . . . examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument,

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173. *Id.* at 61.
174. *Id.* at 62.
175. *Id.* (emphasis added).
176. *Id.* at 65-66.

thereby rendering application of the Securities Acts unnecessary.[177]

This generic four-factor test has been nearly unanimously regarded by courts and commentators as a specialized test for determining whether notes and other debt instruments constitute securities.[178] There is a strong argument, however, on the basis of the language and reasoning of the *Reves* case, that the four-factor test should serve to determine whether *any* enumerated instrument is a security, not merely whether a "note" is a security. Yet, no federal court has seriously discussed the possibility that the *Reves* test might be applied to securities generally,[179] and the corpus of scholarly commentary fares only slightly better in this regard. While a handful of commentators have suggested that the *Reves* test may be applied to securities generally, none have systematically analyzed the *Reves* case to ascertain whether that reading is correct.[180] In spite of the scant attention this aspect of the *Reves* case has received, this pretermitted issue regarding the scope of the *Reves* test could provide the universal test for the presence of a "security" that commentators and courts have struggled to reach for over a half century.

The first incongruity that casts suspicion on the interpretation of *Reves* as a specialized test for notes is obvious from the face of the four-factor test itself. None of the factors articulated by the *Reves* Court seems to have any particular relevance to notes, as opposed to investment contracts, stock, or any other enumerated instrument. The test contains none of the debt-specific components of the "risk capital" test, such as the time to maturity, the degree of collateralization, or the amount borrowed.[181] One could, in fact, envision the four-factor test applying

177. *Id.* at 66-67 (citations omitted).

178. *See* McGinty, *supra* note 128, at 1075 (arguing that *Reves* presented the four factor test "as the 'real' way to separate notes that were securities from those that were not"). *But see* Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105, 1121 (1992) (applying *Reves* to LLC interests).

179. The farthest the federal courts have ventured in extending the *Reves* test is to apply the test to unusual debt-like instruments like post-dated checks. *See* Guidry v. Bank of LaPlace, 954 F.2d 278, 284-85 (5th Cir. 1992).

180. Donald C. Langevoort, Schoenbaum *Revisited: Limiting the Scope of the Antifraud Protection in an Internationalized Securities Marketplace*, 55 LAW & CONTEMP. PROBS. 241, 255 (1992); Marc I. Steinberg, *Notes as Securities:* Reves *and its Implications*, 51 OHIO ST. L.J. 675, 679 (1990) ("If any applicable standard has widespread application in the definition of 'security' setting, it is the 'family resemblance' test.").

181. *See, e.g.*, Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1257-58 (9th Cir. 1976). The similarity to *Kotz*'s specialized note test is particularly stark in light of the fact that that case described "time" as the "most important factor." *Id.* "Time" or "maturity" are factors normally only relevant to debt-like securities, which ordinarily are finite-life instruments. While options also have a finite life, in the sense that they ultimately expire, the "time to maturity" analysis is completely inapposite because the time to "maturity" of an option benefits the holder of the option, not the issuer. Although the *Reves* Court did mention the debt-specific issue of collateralization in connection with the "risk-reducing" factor, it did so not in its general

equally well to bonds, stocks, or even the ultra-generic category of investment contracts. The general and unspecific nature of the *Reves* test stands in stark contrast to the *Forman* test for "stock," which contained some factors that could *only* apply to stock.[182]

The scholarly commentary, sensing this incongruity, has expressed a generalized dissatisfaction with the four-factor test. Leading commentators have called the test "troublesome"[183] and have lambasted the *Reves* Court for articulating factors that seem "arbitrarily plucked" from the Court's precedents.[184] This dissatisfaction with the four-factor test results, at least in large part, from the failure to apprehend and answer one simple rhetorical question: if the *Reves* four-factor test is so poorly adapted to notes, has no particular relevance to debt securities generally, and would apply arbitrarily well to any other enumerated category of security, then what makes us believe that the *Reves* test should be regarded as a specialized test for notes?

The answer is, of course, that the instrument at issue in the case was denominated a "note," and the Court's decision was made in the context of an inter-circuit split over the securities law treatment of notes. The Court also made statements that sealed the test to notes, such as prescribing that, "in determining whether an instrument denominated a 'note' is a 'security,' courts are to apply the version of the 'family resemblance' test that we have articulated here."[185] Furthermore, the Court's own statement of the holding emphasized the connection of the test to notes: "[w]e therefore hold that the notes at issue here are within the term 'note' in [Section] 3(a)(10)."[186] Despite these note-specific statements, however, the language, structure, and context of the *Reves* opinion as a whole reveal that the four-factor test has a broader application than the narrow "note" context of *Reves*.

The language used throughout by the *Reves* court reveals that the test was regarded neither as a novel test nor as a note-specific test. The *Reves* opinion introduced the four factors by describing them as those (supposedly) applied by the Second Circuit in formulating the family resemblance list. More importantly, though, the Court described those factors as "the *same factors* that this Court has held apply in deciding

exposition of the four-factor test, but as a particular application of the fourth factor to the instruments at issue in the case—i.e., notes. *See Reves*, 494 U.S. at 69.

182. These include the first factor ("the right to receive dividends") and the third factor ("voting rights in proportion to the number of shares owned"). *See supra* note 161 and accompanying text.

183. *See* Loss & Seligman, *supra* note 17, at 951.

184. McGinty, *supra* note 128, at 1075.

185. *Reves*, 494 U.S. at 67.

186. *Id.* at 70. Note that the Court actually stated the holding differently at the end of the case.

whether a transaction involves a *'security.'*"[187] Significantly, the Court did not say that those factors were the same factors it had applied in deciding whether a transaction involves a "note," nor could it. That is because the Court cited precedent for each of the four factors, and *none* of the cases cited as precedent were cases construing the term "notes."[188] The cases from which the four factors were drawn used those factors in the course of construing other categories of enumerated instruments, including stock, investment contracts, and the other catchall category known as "any other instrument commonly known as a security," which underlies the allegation that the Court "arbitrarily plucked" the factors from prior case law. In fact, the Court did not even mention the term "note" in the main text of the four-factor test itself, but only in the illustrative portion of one of the factors of the test, explaining the proper application of the factor to the notes at issue in the case.[189]

On these bases alone, an argument could be made that the *Reves* test sets forth the characteristics common to securities generally, not merely to notes. It would defy credulity for the Court to select four factors from prior cases unrelated to notes, present those four factors together as a unified test, and then contend that those factors were actually a specialized test for notes, inapplicable to the instruments that spawned them.[190] This conclusion is bolstered by the fact that the *Reves* analysis was not the result of the peculiar analysis of a single Justice, or even of a majority of the Justices. This portion of the opinion was *unanimous*—joined even by the four Justices who dissented from the Court's actual holding. If the Court had not, in fact, intended to apply the *Reves*

187. *Id.* at 66 (emphasis added).

188. For the first factor, the Court cited *Forman*, which involved the construction of the terms "stock" and "investment contract." *See id.* at 66. For the second factor, the Court cited *Joiner*, which involved the construction of the terms "investment contracts" and "any interest or instrument commonly known as a 'security.'" *See id.* For the third factor, the Court cited *Landreth*, which involved the construction of the terms "stock" and "investment contract." *See id.* at 66-67. For the final factor, the Court cited *Marine Bank v. Weaver*, 455 U.S. 551 (1982), which construed the term "instrument commonly known as a 'security.'" *See id.* at 67. *See also* Adena Exploration, Inc. v. Sylvan, 860 F.2d 1242, 1250 (5th Cir. 1988).

189. The Court does mention the word "note" three times in connection with the first factor, though not in the textual description first factor itself, but rather in the two explanatory sentences that follow the factor. Throughout the test, the Court used the term "instrument," the Court's generic term for any purported security. In total, the word "note" appears only three times and "instrument" appears six times.

190. Despite the fact that the court abstracted the four-part test entirely from non-note cases, courts and commentators appear to have universally limited the *Reves* test to notes and similar instruments, and have not even considered it as the test for a "security" generally. *See, e.g.*, Loss & SELIGMAN, *supra* note 17, at 925 ("There is no universal or generic test of the term [security]."). Despite the scholarly emphasis on the distinctiveness of the analysis for the individual enumerated categories, some commentators have observed that the *Reves* factors, among others, have common elements that underlie most of the Court's decisions on the definition of a "security." *See generally* Lowenfels & Bromberg, *supra* note 20.

test outside the context of "notes," then it would be difficult to imagine that not a single Justice in this splintered decision would have registered an objection to the majority's expansive language.

The most compelling piece of evidence supporting the principle that *Reves* applies outside the narrow context of notes depends on an issue not expressly discussed in the *Reves* case itself. That issue is whether an instrument that fails the *Reves* test implies only that the instrument is not a "note," or whether failing the *Reves* test implies that the instrument is not a "security." If failing the *Reves* test means only that an instrument is not a "note," then because almost any instrument failing the test would have a possibility of still qualifying as an "investment contract,"[191] a second-stage investment contract analysis would be necessary to determine whether the instrument was nevertheless a security by virtue of being an investment contract.[192] But if failing the *Reves* test means not only that an instrument is not a "note," but also that an instrument is not a "security," then there would be no need to examine whether the instrument qualified as any other enumerated category, such as an "investment contract."[193] Therefore, if the *Reves* test is sufficient to remove a particular note from the definition of a "security" as opposed to merely removing an instrument from the definition of a note, then that test must also be sufficient to determine that the instrument is not a security by virtue of any other enumerated category as well, without recourse to any second-stage investment contract analysis.

While the Court in *Reves* did not explicitly discuss the possibility of a second-stage inquiry, there is limited support from subsequent jurisprudence and commentary that a second-stage inquiry would be appropriate. The lower federal courts have not, at least in an explicit manner, explored the question of whether a second-stage analysis is necessary when an instrument fails the *Reves* test. Nevertheless, some courts, while not making the conceptual distinction between a finding of a "non-note" and a finding of a "non-security," have treated *Howey* and *Reves* as alternative bases for finding the existence of a security,[194] implying that a second-stage approach would be appropriate. A few

191. This would be particularly true in those circuits that do not require so-called "horizontal commonality" to find an investment contract. The requirement of horizontal commonality would stymie security treatment for the large population of notes that are negotiated individually between the buyer and the seller, independent of any other similar notes.

192. This approach was illustrated in the *Forman* case where "[t]he Court first held that the 'shares' did not fall within the category stock .... Second, the Court held that the shares did not fall within the investment contracts category." Chang, *supra* note 147, at 441.

193. In *Marine Bank*, for example, the Court held that the "context otherwise required" with respect to the instruments at issue and accordingly did not examine the instruments under the *Howey* test. *See* Marine Bank v. Weaver, 455 U.S. 551, 558-59 (1982).

194. *See, e.g.*, Reeder v. Succession of Palmer, 736 F. Supp. 128, 130-32 (E.D. La. 1990). As

courts, evidently relying on the stated holding in *Reves*,[195] have concluded that the *Reves* test is a "method for determining whether an instrument called a note was a note."[196] Furthermore, one commentator's article actually considered whether a second-stage investment contract analysis was necessary and concluded that *Reves* supported such a second-stage inquiry.[197] When taken with the *Reves* Court's stated holding that "the notes at issue here are within the term 'note,'"[198] one could conclude that an instrument that failed the "family resemblance" test could still qualify as a security under second-stage investment contract analysis.

The evidence taken as a whole, however, refutes the proposition that an instrument failing the *Reves* test would require the application of a second-stage *Howey* analysis. The reason is that the family resemblance test was presented as a test for determining whether an instrument, including a note, is a "security," not whether a purported note was in fact a "note." In spite of the confusing "holding" of *Reves*, the explicit language throughout the opinion,[199] from the first sentence[200] to the antepenultimate sentence,[201] was cast in terms of whether an ostensibly enumerated instrument was, in fact, a security. This is further supported by the Second Circuit's list of "family resemblance" instruments, which was introduced as "instruments commonly denominated 'notes'

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noted above, treating *Reves* and *Howey* as alternative bases for finding a security presupposes that the four-factor test does not remove an instrument from the scope of the term security.

195. *See supra* note 186 and accompanying text.

196. *In re* Tucker Freight Lines, Inc., 789 F. Supp. 884, 888 (W.D. Mich. 1991); *see also* Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808, 812 (2d Cir. 1994) (using *Reves* to hold that particular instruments were "'notes' within the meaning of the securities acts").

197. *See* Dennis S. Corgill, *Securities as Investments at Risk*, 67 TUL. L. REV. 861, 896-903 (1993). Professor Corgill acknowledged, as I have, that the *Reves* Court "did not indicate whether further analysis would be appropriate if the notes failed the family resemblance test." *Id.* at 898. Analogizing to *Forman*, however, Professor Corgill concluded that the *Reves* Court would have applied a second-stage *Howey* test as the *Forman* Court did. This analysis, however, conflicts with the language and structure of the *Reves* opinion. *See infra* notes 199-210 and accompanying text.

198. Reves v. Ernst & Young, 494 U.S. 56, 70 (1990).

199. *See, e.g.*, *id.* at 60 ("This case requires us to decide whether the note issued by the Co-Op is a 'security.'"); *id.* at 65 ("We agree that the items identified by the Second Circuit are not properly viewed as 'securities.'"); *id.* at 67 ("[I]n determining whether an instrument denominated a 'note' is a 'security,' courts are to apply the version of the 'family resemblance' test that we have articulated here."); *id.* ("[A] note is presumed to be a 'security,' and that presumption may be rebutted."); *id.* ("[W]e have little difficulty in concluding that the notes at issue here are 'securities.'").

200. *See id.* at 58 ("This case presents the question whether certain demand notes . . . are 'securities' within the meaning of § 3(a)(10) of the Securities Exchange Act of 1934.").

201. *See id.* at 73 ("[W]e conclude that the demand notes at issue here fall under the 'note' category of instruments that are 'securities' under the 1933 and 1934 Acts.").

that nonetheless fall without the 'security' category,"[202] not as "instruments denominated 'notes' that nonetheless fall without the 'note' category." In addition, the Court agreed with the Second Circuit "that the items identified by the Second Circuit are not properly viewed as 'securities.'"[203] This judicial language demonstrates that the Court set forth a test that would distinguish notes that were securities from those that were not.[204]

The Second Circuit jurisprudence from which *Reves* copied its "family resemblance test" answers definitively both the effect and the statutory basis of the test. In *Chemical Bank v. Arthur Andersen & Co.*,[205] one of the cases from which *Reves* drew its test, the Second Circuit appeals court *did* have occasion to determine whether a second-stage *Howey* inquiry was necessary. There, the court found that the notes at issue were not securities because the "context otherwise require[d]."[206] The court did not proceed to an investment contract analysis,[207] as it would have if it had held merely that the notes were not "notes," as opposed to holding the notes were not "securities." The Second Circuit's explicit statutory basis for that conclusion was the context clause.[208] The approach of *Reves*, like that taken in the Second Circuit, has overwhelmingly been regarded as a test for whether a "note" constitutes a "security,"[209] not whether a note constitutes a "note." And while

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202. *Id.* at 65.

203. *Id.*

204. In this regard, the *Reves* approach is a different type of analysis from that in *Forman*. Although the *Forman* Court did not explicitly say that it was holding that the stock there was not "stock" within the meaning of the definition, the *Landreth* Court subsequently so characterized the *Forman* holding. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 691 n.5 (1985) (explaining that "once the label 'stock' did not hold true" in *Forman*, the Court applied the *Howey* test to the security catchall categories).

205. 726 F.2d 930 (2d Cir. 1984).

206. *Id.* at 937.

207. *Id.* at 939.

208. *Id.* at 936-37.

209. *See, e.g.*, Chaim J. Fortgang & Thomas M. Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 733, 751 (1993) (noting that the *Reves* factors "determine whether a debt instrument constitutes a security"); Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 59 (1992) (noting that the *Reves* Court "articulated standards for determining when 'notes' were not securities"); Henry T.C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L.J. 2319, 2350 (1996) ("[T]ests adopted under *Reves* to determine whether or not a 'note' would constitute a "security.'"); Anupam Chandler, *Diaspora Bonds*, 76 N.Y.U. L. REV. 1005, 1076 (2001) ("*Reves* Court decided "whether an instrument bearing the name 'note' is a security."); C. Steven Bradford, *Expanding the Investment Company Act: The SEC's Manipulation of the Definition of Security*, 60 OHIO ST. L.J. 995, 1020 n.152 (noting that *Reves* determines "whether a note is a security"); Kerr & Eisenhauer, *supra* note 146, at 1129 (discussing how *Reves* "set down a uniform test for determining which notes are securities").

the majority opinion in *Reves* never mentioned the context clause, it is likely that the *Reves* Court, like the Second Circuit, was applying a context clause analysis in deciding whether a "note" was a "security."[210]

The four-factor "family resemblance" analysis in *Reves*, therefore, is a test for determining whether the "context . . . requires" that an enumerated instrument be treated as a non-security. As indicated above, the fact that the "context" can remove an instrument from the definition of a security by virtue of that instrument being a "note" means that the same context necessarily must be able to remove the instrument from the definition of a security by virtue of that instrument qualifying as a "bond," a "debenture," or an "investment contract." That fact, taken in conjunction with the *Reves* Court's sweeping statements about the test it articulated, counsels the conclusion that the *Reves* test, like the context clause on which that test is predicated, qualifies each of the enumerated categories of "security," not merely the category of "notes."

2. *REVES* AND OPTIONS: DOES THE CONTEXT OTHERWISE REQUIRE?

The securities law status of broad-based employee stock options, while seemingly settled in the minds of many securities practitioners, is not at all free from doubt after *Reves*. The status of broad-based employee stock options has not been authoritatively decided by the courts,[211] and the legislative history of the Acts provides little useful guidance.[212] The analysis of the *Reves* Court, however, does provide

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210. *See* McGinty, *supra* note 128, at 1085 n.216.

> The context clause was the only plausible mechanism for reconciling *Reves*' multifactored test with the Acts' statutory language. The context clause was omitted from *Reves* presumably because its credibility had been severely damaged by criticisms of its misuse in *Weaver* and by its association with the sale of business doctrine and with overreaching judicial exclusions generally.

Id.; *see also* Larry D. Soderquist, *A Paradigm from Securities Law of Uninformed Supreme Court Decisionmaking*, 57 WASH. & LEE L. REV. 497, 502 (2000) (describing *Reves* as a case "in which the Court did decide a 'what is a security' issue by reference to the 'unless the context otherwise requires' proviso").

211. Only a few federal cases appear to have squarely faced the question of whether employee stock options are securities for the purposes of the Securities Acts. *See* Collins v. Rukin, 342 F. Supp. 1282 (D. Mass. 1972) (holding that executive stock options were securities); Fenoglio v. Augat, Inc., 50 F. Supp. 2d. 46, 58 (D. Mass. 1999) (holding stock options were securities, relying, without analysis, on *Collins*); Globus, Inc. v. Jaroff, 271 F. Supp. 378, 380 (S.D.N.Y. 1967) ("It is axiomatic that . . . an option agreement is a security under the 1934 Act."). The *Collins* case has unfortunately been relied on as authority that stock options are securities, even though that case did no more than decline to hold, as a matter of law, that the employment context there described "require[d] that the explicit inclusion of stock options in the definitional sections of the 1933 and 1934 Acts be disregarded." *Collins*, 342 F. Supp. at 1288. In the *Globus* case, the purported security was an option granted to executive officers, not part of a broad-based option plan. *See Globus*, 271 F. Supp. at 379 (granting options to president and chief executive officer of company).

212. One piece of legislative history could be interpreted as supporting the contrary

useful guidance. The *Reves* Court based its family resemblance exclusionary analysis on the fact that notes "are used in a variety of settings, not all of which involve investments."[213] The enumerated categories of "options," "rights," and "warrants" are equally broad in terms of the variety of transactions they encompass. They range from options instruments traded on organized exchanges, to complicated instruments negotiated among financial institutions, to the employee stock options that are an increasingly common component of employee compensation. The motivation underlying the creation of options, warrants, and rights is different in each of these contexts. The four factors of *Reves*, when applied to the context of broad-based, non-transferable employee stock options, suggest that many such options are not "securities" for purposes of the federal securities laws.

a. Motivations of Reasonable Seller and Buyer

The analysis of these instruments begins with the first *Reves* factor, which requires an examination of the motivations of "reasonable seller and buyer" in entering into the transaction. According to the Court, the crucial inquiry is what motivation, in the particular factual setting of employee stock options, "would prompt a reasonable seller and buyer to enter into" an employment relationship in which an employee surrenders his or her labor for a compensation package that includes stock options. That inquiry, viewed through the lens of the "entire transaction" approach, compels the conclusion that the motivations underlying grants of broad-based employee stock options are those of incentive and com-

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proposition. This blurb was described in the *Daniel* case as "the rejection by Congress in 1934 of an amendment to the Securities Act that would have exempted employee stock investment and stock option plans from the Act's registration requirements." Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 563 (1979). The amendment would have added to Section 4(1) of the Securities Act the language:

> As used in this paragraph, the term 'public offering shall not be deemed to include an offering made solely to employees by an issuer or by its affiliates in connection with a bona fide plan for the payment of extra compensation or stock investment plan for the exclusive benefit of such employees.

78 CONG. REC. 8708 (1934). The implication, of course, is that Congress would have had no need to exempt a "bona fide plan for the payment of extra compensation or stock investment plan" if such plans did not constitute "securities." The *Daniel* Court, however, determined that "[t]he legislative history of the defeated proposal indicates it was intended to cover plans under which employees contributed their own funds to a segregated investment account on which a return was realized." *Daniel*, 439 U.S. at 563-64. Regardless of whether the Court's interpretation of legislative history is correct, this proposed amendment has no bearing on the analysis of this argument. The amendment would have exempted such plans from the registration provisions of the Securities Act, which require "value" for a sale. Under circumstances where "value" exists, the analysis of this article agrees that there would normally be an "investment."

213. Reves v. Ernst & Young, 494 U.S. 56, 62 (1990).

pensation, not of capital-raising and investment.[214]

The mere language of "seller and buyer" in the *Reves* test is awkward enough in the context of employee stock options as to suggest their non-security character.[215] From the perspective of the employer "seller," the purpose of stock options is not to "raise money for the general use of a business or to finance substantial investments," but to provide performance incentives and foster loyalty among employees. After all, the grant of stock options raises no capital for the company,[216] and even the exercise of options results in a capital inflow less than (or possibly equal to) the fair market value of the stock.[217] In fact, the seller's non-capital-raising motivation in the compensatory context is so plain that even the Commission itself has acknowledged that "[i]n a bona fide compensatory arrangement, the issuer is concerned primarily with compensating the employee-investor rather than maximizing its proceeds from the sale."[218]

One could, of course, argue that options are an alternative to paying cash compensation, thereby indirectly freeing up capital. If that were the test, though, even the non-security "notes" for which the test was designed would fail. After all, even when a "note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties," examples of non-securities under *Reves*, those transactions are ordinarily undertaken with the specific purpose of freeing up liquidity for other uses. In any event, any capital "freed up" by the employee stock option would be for the specific purpose of compensation, not for the "general use of a business."

The motivations of the employee "buyer" similarly militate against security treatment. The reasonable rank-and-file employee cannot be

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214. Even the Commission acknowledges the distinction between sales for "compensatory and incentive purposes" and sales for "capital-raising" purposes. *See, e.g.*, Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act Release No. 33-7645, Fed. Sec. L. Rep. (CCH) ¶ 86,115, at 81,777 (Feb. 25, 1999) [hereinafter Release 7645].

215. Some might argue that the awkwardness of the language militates against the application of the *Reves* test rather than against the classification of options as securities under the test. The *Reves* language about a "reasonable seller and buyer," however, is equally awkward in the context of a note delivered in the context of consumer purchase on credit. Yet such transactions are exactly the type of "family resemblance" notes that the *Reves* test was designed to identify as non-securities. *See Reves*, 494 U.S. at 65.

216. It is true that the exercise of stock options may result (depending on mode of exercise) in a capital inflow to the company. This inflow, however, is more properly associated with the exercise of the options than their grant. The exercise is separately subject to the Securities Acts, regardless of whether the options themselves constitute "securities."

217. This is because a rational employee would only exercise stock options if the value of the stock underlying the options is greater than or equal to the exercise price the employee is required to pay.

218. *See* Release 7645, *supra* note 214, at 81,780.

said to have surrendered his labor "primarily" for "the profit the [option] is likely to generate," but rather to earn a day-to-day livelihood, which is to come primarily from salary or wages. The Court calls upon us to "examine the transaction," not merely the instrument itself, to assess the motivations of "a reasonable buyer and seller to enter into it." The only separable "transaction" at issue in employee stock option cases is the employment relationship. The temptation should be resisted to look only at the option grant itself, as that is not a "transaction" that the employer and employee "enter into," but rather it is the exchange of labor for a compensation package that may only incidentally include a stock option.

As *Daniel* observed, such an employee is "selling his labor primarily to obtain a livelihood, not making an investment."[219] This factor bears more than a passing similarity to the first factor of the *Howey* test; both question whether the acquisition of the purported "security" is primarily stimulated by an "investment" motive. This fact has not gone unnoticed by commentators.[220] In fact, the *Reves* requirement is so similar to the first prong of *Howey* that some commentators have described the *Reves* factors as a "reformulation" of the *Howey* test.[221] And as is the case in the context of the first prong of the *Howey* test, it would be difficult to classify employees' labor as an "investment" in most broad-based employee stock options.

b. Plan of Distribution

The second *Reves* factor requires the court to "examine the 'plan of distribution' of the instrument to determine whether it is an instrument in which there is 'common trading for speculation or investment.'"[222] In the context of employee stock options, which are nearly universally non-transferable,[223] there cannot be "trading" at all, much less "common trading for speculation or investment." Although it is arguably possible

219. Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979).

220. *See* Steinberg, *supra* note 180, at 679 (noting that "in order for a security to exist . . . there must be investment, as compared to commercial, motives underlying the transaction"). According to Professor Steinberg, this fact "goes to the first prong of the 'family resemblance' test and the first and third parts of *Howey*." *Id.* at n.31.

221. *See* James D. Gordon III, *Interplanetary Intelligence About Promissory Notes as Securities*, 69 TEX. L. REV. 383, 403 (1990). Like Professor Steinberg, Professor Gordon identified the *Reves* first factor with the *Howey* "investment of money" prong. *See id.*

222. Reves v. Ernst & Young, 494 U.S. 56, 66 (1990) (citations omitted).

223. *See, e.g.*, KRAUS, *supra* note 8, § 6.03[3] ("Executive stock options are almost always non-transferable except at death to the optionee's estate or heirs."). As is the case with the requirement that options terminate no later than ninety days after termination of employment, this characteristic is common in both "incentive stock options" and "non-qualified" stock options, although technically only required to preserve the tax treatment of incentive stock options. The notion of a transferable employee stock option, however, would raise numerous problems in

to characterize a person's choice of employment as "speculation" or "investment," it would be far-fetched to describe that choice as "trading." Thus this prong would generally not be met by employee stock options. Even some of those literalists who advocate looking to the "instrument" itself, rather than the "transactional" setting of the purported security, would find instruments to be non-securities on the basis of their non-transferable nature.[224]

The *Reves* Court, it is true, did not create a particularly tough standard for this factor, noting that "all we have held to be necessary to establish the requisite 'common trading' in an instrument" is that the instrument was "offered and sold to a broad segment of the public."[225] A plausible argument could be made, at least in the context of some companies, that the company's employees would constitute a "broad segment of the public."[226] This argument suffers from two principal weaknesses. First, as discussed above, employee stock options are nearly always non-transferable. The courts have held non-transferability in a secondary market to mitigate an instrument's "plan of distribution."[227] Similarly, courts have regarded the presence or absence of secondary trading as an important factor.[228] Second, as noted earlier, without a "specific consideration" and an investment decision, there is no "value" and therefore no "offer" or "sale" of stock options within the meaning of the Securities Act.[229] With no "offers" and no "sales," an instrument obviously cannot be "*offered and sold* to a broad segment of

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addition to tax treatment, including securities law issues under both state and federal securities regulations. *See id.*

224. *See* FitzGibbon, *supra* note 17, at 926 (arguing that an instrument "is not a security if it is not 'eligible' to be bought and sold in open or public markets"). For this reason, Professor FitzGibbon described as "notable exclusions from the category of 'securities,'" those "employee benefit plans when . . . the instruments (the interests in the benefit funds) must be acquired largely in exchange for labor for a particular employer." *See id.* at 930-31.

225. *Reves*, 494 U.S. at 68.

226. This is supported by the Supreme Court's decision in *SEC v. Ralston Purina*, where the Court observed that absent "special circumstances, employees are just as much members of the investing 'public' as any of their neighbors in the community." SEC v. Ralston Purina, 346 U.S. 119, 126 (1953).

227. *See, e.g.*, Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51, 55 (2d Cir. 1992) (holding that the absence of a secondary market "worked to prevent the loan participations from being sold to the general public, thus limiting eligible buyers to those with the capacity to acquire information about the debtor").

228. *See* Stoiber v. SEC, 161 F.3d 745, 750-51 (D.C. Cir. 1998).

229. *See supra* Part II.B.2.c. The Exchange Act has a similar definition of "sale" that does not contain a "value" requirement. *See* 15 U.S.C. § 78c(a)(14) (2000). The Supreme Court expressly reserved in *Daniel* the question of "whether the meaning of 'sale' under the Securities Exchange Act is any different from its meaning under the Securities Act." Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 556-57 n.8 (1979). It seems likely, however, that the Court used the terms "offered and sold" as such terms are used in the Securities Act, since the Exchange Act's definitional section contains no mention of "offer" or "offer to sell."

the public." Consequently, the "plan of distribution" factor militates against characterization of employee options as securities under either approach.

c. Reasonable Expectations of the Investing Public

The third *Reves* factor, the "reasonable expectations of the investing public," allows a court to find a security "on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not 'securities' as used in that transaction."[230] This factor emphasizes that "the fundamental essence of a 'security'" is "its character as an 'investment.'" Nonetheless, the Court has not left us without guidance as to the meaning of an "investment." As discussed above, the *Daniel* case was decided on the basis of the meaning of an "investment" within the meaning of the *Howey* test. Although the *Reves* Court inquiry is not necessarily controlled by the *Howey* definition of an investment, *Daniel* is the only Supreme Court definition-of-security case that has construed the term "investment," and accordingly it is the most intuitive starting point in construing this third *Reves* factor.[231]

The use of the *Daniel* concept of an "investment" to construe the "fundamental essence" of a security is actually bolstered by the reasoning that *Reves* applied in repudiating the use of the *Howey* test as a universal test for finding a security. The Court refused to apply the *Howey* test because "[t]o hold that a 'note' is not a 'security' unless it meets a test designed for an entirely different variety of instrument 'would make the Acts' enumeration of many types of instruments superfluous'" and "would be inconsistent with Congress' intent to regulate the entire body of instruments sold as investments."[232]

This reasoning, however, provides no support for the rejection of applying the first prong of the *Howey* test as the universal definition of the "investment" that is the "fundamental essence" of a security. First, requiring all instruments to meet the "investment" prong of *Howey* would not make the enumeration of other instruments superfluous because the investment contract test requires satisfaction of three other separate prongs.[233] Second, it would be difficult to contend that it would

230. *Reves*, 494 U.S. at 66.

231. Professor McGinty looked to the presence of "value" in determining whether his version of an "investment" was present. *See* McGinty, *supra* note 128, at 1088. As noted above, *see supra* Part II.B.2.c. and accompanying text, the concept of "value" may be treated as identical to that of an "investment."

232. *Reves*, 494 U.S. at 64 (quoting Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985)).

233. That is, unlike the situation where all instruments were required to satisfy the *Howey* test

violate "Congress' intent to regulate the entire body of instruments sold as investments" to impose a requirement that a security involve an "investment." Thus, there is little support for the notion that *Reves* somehow repudiated the universal "investment" requirement articulated in *Daniel*.

In the context of the broad-based stock option plan, the question is whether the rank-and-file employee (the applicable "investing public") has "reasonable expectations" that by accepting or retaining employment s/he is making an "investment" in possible future grants of stock options. As was the case with the pension benefits in *Daniel*, broad-based stock options are part of a larger, indivisible employment relationship.[234] As was the case in *Daniel*, employees do not ordinarily have the right to bargain for more options by supplying additional labor or foregoing wages. Conversely, employees do not have the right to forego stock options in exchange for a higher salary or fewer hours. In fact, employees normally have no rights in the stock options apart from the employment relationship, as the options terminate shortly after termination of employment.[235] The economic reality of broad-based employee stock options is that the rank-and-file employee surrenders "his labor as a whole" in exchange for a total compensation package including option grants dependent more on the compensation policy of the employer than on the success of the company.

Moreover, unlike the notes at issue in *Reves*, the employment relationship is not typically marketed as an "investment." There is certainly an investment component to any employment relationship, whether involving equity compensation or not. Even an employee who does not receive equity compensation in some sense "invests" in the prospects of the company. An employee who parts with one job for another risks layoffs, salary cuts, or even possible insolvency, all of which are directly or indirectly related to the success of the company and could have a considerable effect on the value of the employment relationship. But in the *Daniel* case, there was substantially more of an "investment" component than these speculative concerns, as even the Court itself implicitly acknowledged.[236] *Daniel* nowhere provides that the presence of an

in its entirety (i.e., required to be investment contracts) to achieve "security" status, requiring all instruments to involve an "investment" would not require that those instruments be investment contracts in order to be "securities."

234. *See supra* notes 71-87 and accompanying text.

235. Many option plans have exceptions in the case of retirement, death, or disability, but those limited exceptions can hardly contribute to the "investment" character of the options.

236. *See, e.g.*, Soderquist, *supra* note 210, at 501. Professor Soderquist notes that:

> In finding the "investment" element missing . . . the [*Daniel*] Court merely said cursorily that "it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment." Although this is true, fringe benefits

investment component—even a substantial investment component—is sufficient to establish an "investment."[237] The key is whether the theoretical portion of labor exchanged for incidental equity compensation is the "primary" motivation of the employment relationship as a whole. The truly significant "investment" components for most rank-and-file employees are the security and growth of the cash portion of their compensation, which ordinarily completely overshadows any "investment" in company equity.

Finally, there are no "public expectations" that would require a court to regard options as securities under the third factor of *Reves*. It is true that, as *Forman* indicated, the name of a security is not "wholly irrelevant to the decision whether [an instrument] is a security,"[238] and particularly to the public perception as such. To start thinking about the typical employee's "expectations," consider, for example, whether the typical rank-and-file optionee would keep his stock option plan and grant agreements with his employment papers, such as pay stubs, employment agreements, and employment related correspondence, or with investment records, such as stock certificates and brokerage account statements. The author submits (on a purely anecdotal basis) that the former would be the classification of most rank-and-file employees. This consideration, though not a legal or financial analysis, is in fact the very heart of the third *Reves* factor—"the reasonable expectations" of the purported employee "investors."

These "reasonable expectations" that stock options are not securities are not, moreover, limited to mere laypersons outside the financial and legal industries. For example, an employee stock option generally does not constitute a "security" for the purposes of Article 8 of the Uniform Commercial Code, which governs the commercial law rules of investment securities.[239] Neither are employee stock options widely regarded as securities from the perspective of the brokerage community. For example, a leading brokerage firm's question-and-answer section on employee stock plans states that "[b]ecause stock options are not securities, they do not appear in your brokerage account."[240] It is an uneasy

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> obviously are a significant form of compensation, so by use of the word "primarily" the Court can be said to have found that the employees were, in a not insignificant part, selling their labor as an investment in their pensions . . . .

Id.

237. It must be remembered that the *Daniel* case did not call the pension benefits "insignificant," but "relatively insignificant"—i.e., relative to the entire compensation package. *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 560 (1979).

238. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 850 (1975).

239. *See* U.C.C. § 8-102(a)(15) (2001).

240. Charles Schwab & Co., *Frequently Asked Questions*, *at* http://www.schwab.com/SchwabNOW/SNLibrary/SNLib114/SN114mainFaqs.html (last visited Oct. 1, 2002).

argument, therefore, that an employee stock option *must* somehow be considered a security on the basis of public expectations.

It is certainly true that many equity compensation programs do not fit the profile described above. This is often the case, for example, with incentives granted to executive officers of a company who may truly bargain to "invest" their labor for a negotiated mix of salary and equity. The same might hold true for some rank-and-file employees in smaller, more entrepreneurial enterprises where equity compensation is individually negotiated. But when, as is normally the case, rank-and-file employees are offered stock options as a relatively insignificant, take-it-or-leave-it, indivisible part of their overall employment relationship, those options should not be categorized as securities.

d. Risk-Reducing Factor

The fourth element of the *Reves* test, the "risk-reducing factor," is fulfilled in a deceptively simple way in the case of employee stock options. It is true that unlike the certificates of deposit in *Marine Bank v. Weaver*,[241] which were subject to banking insurance and regulation, and unlike the pension plan in *Daniel*, which was regulated under ERISA,[242] employee stock options are generally not subject to any substantial non-securities federal regulatory regime. Note, though, that this analysis ignores the considerable *securities* regulatory regime that applies to stock options even if the options themselves are not securities. Options are unlike ordinary notes, certificates of deposit, or interests in pension plans in that the value of the option is its right of conversion into *other securities*, securities that are subject to the wholesale application of the securities laws. As illustrated below,[243] the securities laws provide a backstop of redundant regulation that regulates employee stock options even if such options are classified themselves as non-securities.

3. NOTES, EMPLOYEE STOCK OPTIONS, AND "FUNCTIONAL EXCLUSIONS"

The argument for non-security treatment of employee stock options, as described above, is so compelling precisely because broad-based employee stock options are so ill-suited for regulation as securities. The Supreme Court premised its decision in *Reves* to reject security treatment for notes, which are also a specifically enumerated security category, on the fact that notes "are used in a variety of settings, not all

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241. Marine Bank v. Weaver, 455 U.S. 551 (1982).
242. *See Daniel*, 439 U.S. at 569-70.
243. *See infra* Part IV.B.

of which involve investments."[244] The foundations for that rationale were laid in the *Landreth* case when the Court distinguished the term "notes," "a relatively broad term that encompasses instruments with widely varying characteristics,"[245] from the term "stock," "the paradigm of a security."[246] As illustrated above, employee stock options are also used in "a variety of settings" "with widely varying characteristics," and, particularly in the context of broad-based plans, are not always "investments." In fact, the argument should be even stronger with respect to the widely varying characteristics of stock options considering that the Court has previously listed "notes" along with "bonds" and "stocks" as instruments that are "pretty much standardized and the name alone carries well settled meaning."[247] Thus, the Supreme Court's rejection of a literal approach to notes should dispel the objection to scrutinizing stock options under a *Reves* context clause approach.

C. *The New Gestalt of a "Security"*

The transactional approach boasts the considerable advantage of forging a unified conceptual synthesis of the *Forman-Daniel-Reves* line of cases that explains the otherwise anomalous holdings of *Marine Bank* and *Landreth.* The heart of the transactional approach is the second-level scrutiny of the entire *transaction* or *context* that surrounds a purported security, rather than the first-level inquiry focusing exclusively on the characteristics of an instrument itself. *Forman* and *Daniel* each ultimately dealt with the fact that the incidental "security" aspects of the transaction cannot be disaggregated from the overall decision to create a security. It is indisputable that the instruments involved in *Forman, Daniel,* and *Reves* each had a "security" component as part of the overall transaction.[248] The second-level, entire transaction inquiry is to be applied with respect to the "economic reality" of the transaction as a whole, to ascertain whether the instrument was issued in an "investment

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244. *See supra* note 213 and accompanying text.

245. Landreth Timber Co. v. Landreth, 471 U.S. 681, 694 (1985).

246. *Id.* at 693.

247. *See* SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943). While the Court classified this statement as "dictum" in *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 850 (1975), and again in *Landreth*, 471 U.S. at 694 (emphasizing that the modern term "note" is "a relatively broad term"), that classification was intended to refute the notion that "notes" are somehow as standardized as "stock" because the two instruments were listed together as "pretty much standardized."

248. This is true despite the fact that the *Forman* court contended that they bought the stock "solely to acquire subsidized low-cost living space." *Forman*, 421 U.S. at 851. Even if that factual assertion were true, which would be difficult to defend, it would be no different from the commercial context where a seller took a note "solely to sell the product." There is still a security component embedded in the sale.

context."[249]

The decision in *Reves*, however, not only confirmed the transactional approach, but connected that approach the statutory legitimacy of the context clause. In *Reves*, the Court reaffirmed that economic reality is important not just to investment contracts, but in construing the scope of the securities laws generally.[250] Thus, after *Reves*, the "entire transaction" and "economic reality" approaches may be classified as criteria for determining whether "the context otherwise requires."[251] The reaffirmation of these principles allows us to say confidently, as even many literalists have conceded, that the phrase "the context otherwise requires" "refers to the *transactional* context in which an instrument appears rather than solely the *textual* context in which a defined term is used in the securities laws."[252] The *Reves* Court, without even explicitly acknowledging the context clause, adopted a second-stage analytical approach that grew from that clause.

The Supreme Court's opinion in *Forman* conceived the embryonic form of the functional, transaction-based approach to defining a security.[253] Only by looking to the underlying housing transaction could it reach its holding—at least on the investment contract issue analysis. Significantly, the *Forman* Court's observation that "when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument,"[254] reveals that even correspon-

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249. Reves v. Ernst & Young, 494 U.S. 56, 61-62 (1990).

250. *See id.* at 61. The seemingly innocuous notion that "economic reality" should govern the inclusion of an instrument within the scope of the securities laws was nonetheless thrown into doubt in the *Landreth* case. In *Reves*, however, the Court made it clear that *Landreth* should not be read as signifying "a lack of concern with economic reality," but simply that stock was a special case where the economic reality test was unnecessary. *See Reves*, 494 U.S. at 62.

251. Even the court of appeals decision in the *Daniel* case acknowledged the relationship between "economic reality" and the "context clause," explaining that the "context" referred to in that clause "is, of course, economic reality in view of the surrounding factual circumstances." Daniel v. Int'l Bhd. of Teamsters, 561 F.2d 1223, 1236 (7th Cir. 1979).

252. Gary S. Rosin, *Historical Perspectives on the Definition of a Security*, 28 S. TEX. L. REV. 575, 587-88 (1987) [hereinafter Rosin, *Historical Perspectives*].

253. The test in *Forman* might rightly be regarded as embodying both literalist and anti-literalist aspects. *Forman*'s discussion of "stock" focused heavily on the characteristics of the instrument itself. But *Forman*'s investment contract discussion was highly transaction based. Even some literalist commentators agree that *Forman* was a functional or transaction-based test. *See, e.g.*, Rosin, *Functional Exclusions*, *supra* note 166, at 335 ("The use of functional exclusions was spurred in 1975 by the Supreme Court in *United Housing Foundation, Inc. v. Forman*.").

254. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975). In *Landreth*, Justice Powell himself appears to have misquoted his own statement in *Forman*, stating that "we concluded that we must also determine whether those instruments possess 'some of the significant characteristics typically associated with' stock." Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985). Yet, there are really two parts to the test in *Forman* that are related. The first is whether the instrument itself bears the characteristics usually associated with its name, and the second is the likelihood that the purchasers were "misled . . . into believing that the federal

dence to the enumerated instruments themselves is to be ascertained by reference to the "entire transaction" or "underlying transaction," not merely to the terms of an instrument. The transactional analysis articulated in *Forman* blossomed into its mature form in *Daniel*, when the Court more directly explained that in order to determine whether a person "invested," "it is necessary to look at the *entire* transaction through which he obtained a chance to receive" the purported security.[255]

The 1982 case, *Marine Bank*, not only reaffirmed the "entire transaction" approach, but also further secured that approach to the statutory anchor of the context clause. In determining that a certificate of deposit and a business agreement were not securities, the Court applied the context clause by examining the factual setting of the entire transactions at issue. The Court explained its holding by emphasizing the importance of the transactional analysis, that in determining whether a particular business transaction falls outside the definition of a security, "[e]ach transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole."[256] This case, as literalist commentators have lamented, "appears to have *assumed* that the 'context' clause authorizes judicial exclusions on the basis of *factual* circumstances, even if an instrument otherwise falls within the statutory definition of a 'security.'"[257] That is, even if the instruments at issue had fallen within an enumerated category of security, the context would have "otherwise require[d]." Thus, the Court's analysis suggests a two-stage approach to defining a security. A first stage ascertains whether an instrument falls within the first level of security instruments, such as stocks, bonds, or investment contracts, and a second stage examines the "circumstances or context" justifying the application of the Acts."[258]

The contextual second-stage analysis allows a reading of the analytically outlying *Marine Bank* case consistently with the body of Supreme Court definition-of-security jurisprudence. The *Marine Bank* case drew considerable criticism for holding that the transactions there at issue were not securities without even considering the *Howey* investment contract test.[259] The very same commentators who realized that

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securities laws governed their purchase." *Forman*, 421 U.S. at 851. Obviously the first factor feeds into the second. This distinction might seem excessively fine, but it was reproduced twice in two-part form in *Landreth*, once to describe the *Forman* case and once to analyze the stock at issue in *Landreth*. *See Landreth*, 471 U.S. at 687.

255. Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 559 (1979).

256. Marine Bank v. Weaver, 455 U.S. 551, 560 n.11 (1982) (emphasis added).

257. Steinberg & Kaulbach, *supra* note 17, at 504.

258. *See* Chang, *supra* note 147, at 429-30.

259. Steinberg & Kaulbach, *supra* note 17, at 503. One commentator called the *Marine Bank*

Marine Bank was a context clause case[260] took the curious position that "the only reasonable conclusion" was that the *Marine Bank* decision constituted a "modification or supplement to the *Howey* test."[261] That position led those commentators to conclude that "*Weaver* signifies that an investment contract may not exist even if the *Howey* test is satisfied."[262]

The better interpretation of *Marine Bank*, however, is that the decision did not, and did not purport to, decide whether the transactions at issue were "investment contracts;" rather, it decided whether those transactions, even if investment contracts, were nonetheless not securities. The clear and explicit context clause analysis of the *Marine Bank* opinion clearly reveals that the case did not replace *Howey* or add further requirements to the *Howey* test; instead the Court found it unnecessary to apply the *Howey* text because the "context otherwise required." As demonstrated in the earlier *Reves* discussion, the context clause is better regarded not as affecting the first-level inquiry of whether a "stock," "note," or "investment contract" exists, but whether the context removes a "stock," "note," or "investment contract" from security status.[263] Thus, *Marine Bank*'s failure to grapple with the *Howey* test was not the reinterpretation of the meaning of an investment contract, but the recognition that, as Professor Chang put it, "[u]nder the two-tier test, a court need not rule on the first level if second level considerations would exclude the instrument."[264] Conversely, even if the first level criteria are satisfied, and even in the case of an "investment contract," the second-level criteria may still make the instrument a non-security.[265]

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decision the Supreme Court's "worst definitional opinion." *See* McGinty, *supra* note 128, at 1052.

260. Steinburg & Kaulbach, *supra* note 17, at 504-12.

261. *Id.* at 523.

262. *Id.* at 525.

263. As Professor Chang explained, there are "two versions" of the Court's decision in *Marine Bank*:

> First Version: The Supreme Court held that the agreement was not an investment contract and thus failed to fall within a class of level one instruments . . . . Second Version: The Supreme Court did not address the issue of whether the agreement was an investment contract. It held that even if the instrument were an investment contract . . . it would be excluded at the second level because it was not within the concept of a security.

Chang, *supra* note 147, at 446. If the Court adopted the first version, that would likely signal the Court's adoption of the so-called "horizontal commonality" requirement for investment contracts. *See id.* at 446. If the Court adopted the second version, however, it need not make any implication about the broader "horizontal commonality" requirement. *See id.* The second version is the better reading of *Marine Bank*. *Id.* at 447.

264. *Id.* at 444.

265. This fact was noted by a court of appeals case decided contemporaneously with *Reves*. *See* Uselton v. Commercial Lovelace Motor Freight, Inc., 940 F.2d 564, 579 (10th Cir. 1991).

This contextual approach is even supported in *Landreth*, where the Court found the context did not "otherwise require." In *Landreth*, the Court stressed the importance of "context" throughout the opinion,[266] and justified its literalist treatment of stock in a way that actually supports the necessity of a contextual finding of an "investment." The Court implicitly treated the context inquiry seriously enough that it felt the need to observe that the sale of stock was "the kind of context to which the Acts normally apply."[267] *Reves* confirmed this contextual inquiry, explaining that the reason the *Landreth* stock was necessarily a security was that "[s]ome instruments are obviously within the class Congress intended to regulate because they are by their nature *investments*."[268] The contextual discussion in *Landreth*, therefore, supports the proposition that traditional stock is always a security not merely because it is "stock," but because it has an "investment" context. After *Landreth*, even the literalist commentators seem to have grudgingly accepted the fact that the Court's context clause analysis takes into account the entire factual context of the transaction.[269]

The construction of the *Forman-Daniel-Reves* synthesis helps to reconcile the literal approach of *Landreth* with the contextual approach of *Forman-Daniel-Reves*. *Landreth* made it clear that stock is "likely to be covered by the definition" of a security, without a case-by-case economic analysis, provided it "possess[es] 'some of the significant characteristics typically associated with' stock."[270] But *Reves* revealed that the reason no "case-by-case analysis" is appropriate with stock is that stock is a "special case, explicitly limiting [the *Landreth* Court's] holding to that sort of instrument."[271] In fact, according to *Reves*, stock is "the quintessence of a security . . . and investors therefore justifiably assume that a sale of stock is covered by the Securities Acts."[272] Thus, notes are not subject to a "special case" contextual analysis as an exception to a generally applicable literal approach. Rather, stock is subject to a "spe-

266. Landreth Timber Co. v. Landreth, 471 U.S. 681, 687, 690, 694 (1985).

267. *Id.* at 687.

268. Reves v. Ernst & Young, 494 U.S. 56, 62 (1990) (emphasis added).

269. *See* Steinberg & Kaulbach, *supra* note 17, at 506 ("The language in *Weaver*, particularly when considered with the subsequent decision in *Landreth*, indicates that the Court apparently adheres now to the view that the 'context' clause refers (at least in part) to the underlying transaction's factual context.").

270. *Landreth*, 471 U.S. at 686.

271. *Reves*, 494 U.S. at 62.

272. *Id.* The *Reves* emphasis on "public perception" and "reasonable expectations" would suggest that stock whose characteristics accord with its name is automatically a security because stock always satisfies the third factor of the *Reves* test—the "reasonable expectations of the investing public." In fact, *Landreth* was cited by the Court as authority for the third factor of the test. *See id.* at 66-67.

cial case" *literal* analysis as an exception to a generally applicable *contextual* approach.

The Court's framework for determining whether an instrument is a security, therefore, proceeds as follows. If an instrument is nominally listed in the statutory formulation, the Court will examine the characteristics of the instrument *à la Forman* to determine whether it bears "some of the significant characteristics" of instruments of that type.[273] If the instrument is not listed in the statutory formulation, or if the instrument is listed in the statutory formulation but its characteristics do not match its label, then the instrument will need to qualify under the "catchall" categories and the court will apply *Howey*. When an instrument *is* an enumerated instrument and its characteristics match that label, the court will examine the economic reality of the underlying transaction according to the *Reves* test to determine whether the "context otherwise requires,"[274] applying a presumption that the enumerated instrument is a security.[275] If the instrument is "stock," and it bears some of the characteristics usually associated with traditional stock, then "a purchaser justifiably [may] assume that the federal securities laws apply,"[276] and the third factor of *Reves* will ensure that the instrument is a security. If the instrument is not "traditional stock," then the treatment of the underlying transaction depends on the application of the *Reves* factors.

D. *Limits to Non-Security Treatment*

This article explains why certain types of employee equity incentives, including some broad-based employee stock options, should not be regarded as securities under the *Forman-Daniel-Reves* line of cases. Throughout this article, however, in the context of both employee stock options and other equity incentive devices, I have emphasized that the "no investment" theory would not apply to "voluntary," "contributory" employee incentives, as would arise in employment arrangements subject to individual bargaining. This qualification merely acknowledges that just as the Commission's simplistic taxonomic approach should not be used to necessarily *include* employee stock options as securities, neither should that same approach be used to necessarily *exclude* employee stock options as securities. The thesis, therefore, of this arti-

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273. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975).

274. Like notes, many other instruments on the enumerated list, other than stock, "are used in a variety of settings, not all of which involve investments." *Reves*, 494 U.S. at 62.

275. *See id.* at 65. The name of the instrument is not determinative of its inclusion as a security, but it is relevant. *See Forman*, 421 U.S. at 850; *see also Reves*, 494 U.S. at 65.

276. Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985) (quoting *Forman*, 421 U.S. at 850).

cle is not that employee stock options are *necessarily not* securities, but that employee stock options are *not necessarily* securities.

The criteria for distinguishing between investment and non-investment employee incentives were set forth in the *Daniel* decision itself and, as described above, are identical under a "no sale" or "no investment" theory. The test for an investment (or a sale) is a voluntary contribution of a "specific consideration" in return for "a separable financial interest with the characteristics of a security." Under either a no-sale or a no-investment theory, the crucial question is whether the employee had the opportunity to contribute an individually bargained-for specific consideration, such as labor, cash, or other securities, or to forego an accrued compensatory interest, in return for a security. This approach is consistent with the no-sale analysis applied by the Commission with respect to stock "bonus" plans—that such plans ordinarily need not be registered because there would be no "sale"[277]—but that the no-sale treatment would not extend to a situation where the employee acquired securities pursuant to individual bargaining.[278]

The reason that individually bargained for agreements would involve an investment and therefore potentially a security is that such agreements would normally be "voluntary" and "contributory" in the language of *Daniel.* The notion of a "voluntary" and "contributory" arrangement, as noted earlier, is equivalent to the concept of a "sale," and the lower federal courts have been very generous in finding "sales" in appropriate circumstances. For example, in a pre-*Daniel* case, *Collins v. Rukin*,[279] the district court found a sale where a plaintiff accepted employment as an electrical engineer and an executive officer with a stock option as *quid pro quo.*[280] In a similar case, *Yoder v. Orthomolecular Nutrition Institute*,[281] Judge Friendly explained that there was "no reason" why a person who "commits herself to employment by a corporation in return for stock or the promise of stock should

277. In Release 6188, the Commission explained that although stock awarded to employees under stock bonus plans

> is a security, the staff generally has not required it to be registered. The basis for this position generally has been that there is no "sale" in the 1933 Act sense to employees, since such persons do not individually bargain to contribute cash or other tangible or definable consideration to such plans.

Release 6188, *supra* note 64, at 2073-15.

278. Specifically, the staff noted that its position generally is applicable only in the context of bonus plans which are made available to a relatively broad class of employees. With respect to stock awarded to, or acquired by, employees pursuant to individual employment arrangements, the staff generally has concluded that such arrangements involve separately bargained consideration, and that a sale of the stock has occurred. *Id.* at 2073-15 n.84.

279. 342 F. Supp. 1282 (D. Mass. 1972).

280. *Id.* at 1289-90.

281. 751 F.2d 555 (2d Cir. 1985).

not be considered an investor."[282] The same result would obtain if the instrument were an automatic incident of the employment relationship if that incident were the predominant motivating factor in the employment relationship.[283] An excellent example is *Dubin v. E.F. Hutton Group*,[284] where a district court found an "investment" and a "sale" where an executive entered into an employment relationship based on the prospects of acquiring stock and stock options under an incentive plan.[285]

While these lower court cases illustrate the limits to "no investment" and "no sale" treatment under the securities laws in the context of employment relationships, they do not undermine or contradict the analysis presented in this article. In each of these lower court cases, the plaintiff "changed his way of life and his job—in return for the stock and stock options available through the Plan"[286] or "part[ed] with his or her established way of life in return for a contract to issue stock."[287] Those circumstances differ dramatically from the "investment" decision of the typical rank-and-file employee receiving incidental option grants pursuant to an employment relationship he or she accepted "primarily to obtain a livelihood." These cases, involving executive or entrepreneurial employees and specifically negotiated compensation agreements, are more easily characterized as involving "investments." When an employee relies on promises of securities in accepting an employment opportunity, it is fully appropriate for courts to reach the result in *Yoder*—that the context does *not* "otherwise require."[288]

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282. *Id.* at 560.

283. In effect, when the predominant decisional criterion is the "investment" in the instrument itself, rather than in the employment relationship, there is a voluntary, contributory investment decision. This would be equally true (although unlikely as a practical matter) in the pension plan context, as one insightful federal court judge in Guam pointed out. *See* Sec. Adm'r v. Coll. Assistance Plan, 533 F. Supp. 118, 121 n.8 (D. Guam 1981) ("*Daniel* does not foreclose that the federal test may find an investment contract where the record demonstrates that the pension's investment potential was a primary motivation for a worker's choice of employment.").

284. 695 F. Supp. 138 (S.D.N.Y. 1988).

285. In *Dubin*, the court found a "sale" and an "investment" under *Daniel* solely on the basis that "interests in the Plan had to be recommended by management and approved . . . by the Compensation Committee of the Board" and therefore "an executive would expect to make some contribution to the company in return for the stock or stock options offered by the Plan." *Id.* at 145.

286. *Id.*

287. Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 560 (2d Cir. 1985).

288. *See, e.g., id.* at 559-61. The *Yoder* case is particularly instructive in that it examined whether the "context" clause would prevent a person from being "an investor" in the context of an employment relationship. The court noted that "[w]e see no reason why 'the context requires' us to hold that an individual who commits herself to employment by a corporation in return for stock or the promise of stock should not be considered an investor." *Id.* at 560. This case, unlike the broad-based employee incentive plan, dealt with an individually negotiated agreement pursuant to which the employee "part[ed] with his or her established way of life in return for a contract to issue stock." *Id.* In this case, the court found it unnecessary to hold whether the context otherwise

The more difficult problem—one not reached in the *Daniel* case—is where an existing employee has the election to receive either additional equity compensation or additional cash compensation, and may elect between the two. The immediate response, based on the *Daniel* analysis presented above, would be that the employee is being presented with an investment decision regarding "specific consideration"—i.e., alienating the cash compensation in exchange for the equity compensation. Yet, there is an analogous no-sale analysis in the context of dividends that would seem to compel the opposite conclusion. Well-settled administrative practice provides a firm's declaration and distribution of a stock dividend of its own stock does not involve a "sale" of a security.[289] The Commission, however, has for many years taken this "no-sale" analysis one step further. In one of the oldest Commission letters still applicable today, the Commission's General Counsel took the position that a dividend declared as an *election* between cash and stock would not constitute a "sale" unless the election were with respect to a cash dividend already declared—i.e., the stockholders waived "preexisting and vested rights to payment of the dividend in cash" in exchange for stock or other securities.[290] The "no-sale" conclusion applies today not only in the context of elections of dividends among cash and stock, but also in the context of elections among various classes of stock.[291]

The plain vanilla stock dividend situation is obviously analogous to the distribution of true employee "bonus stock," or stock with no *quid pro quo*. The dividend election context, similarly, is analogous to the situation where a company offers a bonus, again with no *quid pro quo* on the part of the employee, that is payable at the election of the employee either in stock or in cash. In that scenario, provided that the bonus right had not already accrued, and provided that the dividend analogy holds, no sale would occur. If, on the other hand, employees were given the option on a *prospective* basis to forego payment of future accrued salary in exchange for securities, then a slightly different analogy to dividends may provide the answer. The Commission takes the position that a dividend reinvestment program, in which stockholders may by prior agreement have dividends applied to purchase additional

required since the plaintiff parted not only with her "way of life" but also the assets of her business. *See id.* at 560-61.

289. *See* H.R. REP. NO. 73-152, at 25 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 21, at 25 (explaining there was no need to exempt stock dividends from the Securities Act because "they do not constitute a sale, not being given for value").

290. Dividend Payments, Exchange Act Release No. 33-929, Fed. Sec. L. Rep. (CCH) ¶ 1121, at 2099 (July 29, 1936).

291. *See, e.g.*, JDN Realty Corp., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,643, at 76,277 (Oct. 26, 1999).

shares of the issuer, can constitute sales.[292] Thus, to the extent this "sale" guidance is controlling, an individual election to accept a bonus in cash or equity would not involve a "sale" (or an "investment"), but entering into a program by which future salary was systematically deferred could constitute a sale (and an "investment").

IV. Policy Considerations

The characterization of certain broad-based equity incentives as non-securities is supported by sound policy considerations. As employee equity incentives have become generalized over the past three decades, employers and the Commission alike have struggled to reconcile a securities law regime designed to regulate capital-raising transactions with equity incentives designed to promote employee productivity, loyalty, and morale. The securities laws are oriented toward improving investment decisions, not toward evaluating employment opportunities or moving employment disputes into federal courts. And while these policy considerations, as the Supreme Court has repeatedly noted,[293] are proper factors to consider when interpreting this area of the law, there is another, overriding legal consideration that should palliate any concern associated with treating employee incentives as non-securities. As illustrated in this Part, the redundant regulation of rights, warrants, and options under the Securities Acts ensures that, where valid securities claims exist, complaints with respect to employee stock options will continue to state federal causes of action under the securities laws.

A. *Issuer Burdens and Commission Confusion*

The unfortunate reality is that the Commission's exemptive "relief" is not only not relief, but is not even sensitive to the mechanisms of the Commission's own regulations. First, the Commission's exemptive "relief," in some respects, imposes burdens *beyond* those associated with Exchange Act registration. For example, issuers registered pursuant to Section 12(g) are obligated to file their annual and quarterly reports with the Commission,[294] but have no obligation to "provide" security holders with quarterly reports and normally "provide" security holders with annual reports only upon proxy solicitation in connection with the election of directors.[295] Because holders of employee stock options almost

292. *See* Interpretation of the Division of Corporation Finance Relationg to Dividend Reinvestment and Similar Plans, Exchange Act Release No. 33-5515, Fed. Sec. L. Rep. (CCH) ¶ 79,907, at 84,323 (Aug. 8, 1974).

293. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975); *see also* Landreth Timber Co. v. Landreth, 471 U.S. 681, 694-95 n.7 (1985).

294. *See* 17 C.F.R § 240.13a-1 (2003); 17 C.F.R. § 240.13a-13 (2003).

295. *See* 17 C.F.R. § 240.14a-3(b) (2003).

never have the right to vote for directors, registration of those options would not generally trigger an obligation to distribute those reports.

Second, the Commission's conditions are so poorly adapted to the Commission's own disclosure system that an argument could be made that those conditions impose no duties at all. Specifically, the Commission's exemptive relief is conditioned on the issuer providing option holders with the same information they would have received had the company registered the class of securities under Section 12.[296] But as illustrated in the preceding paragraph, the stock option holders would not "receive" most types of information even if the options *were* registered under Section 12. The Commission simply assumed that there is an obligation imposed by Section 12(g) registration to distribute annual reports to shareholders, which is not, in fact, the case.[297] It is, of course, not hard to guess what the Commission meant to say, but the Commission's failure to seriously analyze the legal issues imparts a whimsical quality to the whole affair.

In order to dislodge the Commission from its regulatory stance or, in the alternative, to persuade the courts to overturn the Commission's regulatory position, it will be necessary to discredit the inevitable "parade of horribles" that will result from any suggestion of contracting the scope of the securities laws. The prospect of deregulating any established aspect of the securities laws is approached by the securities law community and the courts with a sense of trepidation about leaving true securities transactions unregulated. In fact, as discussed above, the presence of an alternative regulatory scheme or other "risk-reducing factor" was specifically incorporated in the *Reves* four-factor test for whether application of the securities laws is unnecessary. The discussion below attempts to outline the effects of the non-security approach on the principal regulatory linchpins of the federal securities laws.

B. *Coverage of the Securities Acts*

An overview tour of the Securities Acts reveals that the non-security approach to broad-based employee stock options would have little, if any, significant effect on the policy objectives of the those Acts. This is principally because stock options and other rights to acquire securities are subject to significant securities regulation even if they are not themselves securities. Employee stock options are both offers to sell securi-

296. *See* CURRENT ISSUES, *supra* note 10.

297. One reason for this might be the fact that Section 12(g) issuers almost universally distribute these documents to shareholders. First, most issuers distribute annual proxy statements and therefore incur an obligation to provide recipients of proxy statements with annual reports under Rule 14a-3(b). Second, even if a company was not making a solicitation, self-regulatory organizations such as NASD rule 4350(b) would require distribution of an annual report.

ties and contracts to buy or sell securities; these characteristics themselves subject options to considerable securities law regulation. Even in those cases where non-security treatment *would* exclude options from regulation under the Securities Acts, there is a high likelihood the relevant provision would not apply to stock options anyway. Employee stock options are so closely tied to employment relationships and so lacking in the ordinary hallmarks of traditional securities that many provisions of the Securities Acts are, by their own terms, inapplicable whether or not those options are securities.

1. SECURITIES ACT CONSIDERATIONS

The Supreme Court has held that the mere fact that a company offers its securities solely to its so-called "key" employees does not necessarily make the offering a "private" offering exempt from registration.[298] Accordingly, offers and sales of securities to broad groups of employees, "key" or not, require registration under the Securities Act or an exemption from registration. The Commission, however, has recognized that registration of employee stock options is not normally required in connection with the grant of those options.[299] This treatment results from the fact that in making an option grant, the issuer normally has not made a disposition of the options "for value" and therefore has not made an "offer" or "sale" of the options within the meaning of the Securities Act.[300] Accordingly, it would be unusual for an issuer to register employee stock options themselves under the Securities Act (as

298. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

299. *See, e.g.*, Analysis & Tech., Inc., SEC No-Action Letter (July 27, 1981), 1981 SEC No-Act. LEXIS 2789; Formation, Inc., SEC No-Action Letter (Dec. 5, 1977), 1977 SEC No-Act. LEXIS 2801; Computer Transmission Corp., SEC No-Action Letter (May 6, 1976), 1976 SEC No-Act. LEXIS 1044; Dayton Steel Foundry Co., SEC No-Action Letter (available Oct. 18, 1971), 1971 SEC No-Act. LEXIS 2392; *see also* Interpretive Release on Regulation D, Securities Act Release No. 33-6455, Fed. Sec. L. Rep. (CCH) ¶ 2380, at 2637-16 (Mar. 3, 1983), *available at* http:www.sec.gov/divisions/corpfin/forms/regd.htm#release (stating in response to Question 78 that "[i]n a typical plan, the grant of options will not be deemed a sale of a security for purposes of the Securities Act").

300. *See supra* note 299. At least one district court, however, has stated that a "sale" occurs upon the grant of a stock option within the meaning of the Exchange Act. *See* Safecard Servs. v. Dow Jones & Co., 537 F. Supp. 1137, 1142 n.6 (E.D. Va. 1982). But there are several reasons that this court's position is inapplicable to the present issue. First, as noted above, the Exchange Act, unlike the Securities Act, contains no express "value" requirement, so it is possible that the Exchange Act contains a looser definition of "sale." Second, for the general proposition that the grant of an option constitutes a "sale," the court relied on *Wright v. Heizer Corp.*, 560 F.2d 236 (7th Cir. 1977), which held only that a corporation issuing warrants for cash would be a "seller" of those warrants, an uncontroversial point. *See id.* at 246-47. Finally, although the Court in *Safecard* did not specify whether the grant of an option was the "sale" of the option or the stock underlying the option, the case upon which it relied, *Collins v. Rukin*, 342 F. Supp. 1282 (D. Mass. 1972), appears to hold only that the sale of the underlying stock occurred. *See id.* at 1288-89.

opposed to registering the stock underlying the stock options, which is common).

The principal Securities Act regulation of options, therefore, occurs in connection with their exercise, not their grant. An exercise for cash involves a sale within the meaning of the Securities Act because the optionee surrenders specific consideration (cash) for the shares of stock underlying the option. Further, each outstanding option embodies a continuing "offer" to sell the underlying stock on exercise, which, in the Commission's view, "generally will commence when the options become exercisable and will continue until the options are exercised or otherwise terminated."[301] In this regard the Commission has accorded issuers some relief, providing that "the underlying shares may be registered at any time before the option is exercised."[302] Therefore, to comply with the registration provisions of the Securities Acts, public companies generally register the stock underlying employee options on Form S-8, and private companies generally rely on the exemption from registration provided by Rule 701[303] for the underlying stock.

None of these results would be changed by classifying employee stock options as non-securities. As under present law, the grant of the options would be exempt from registration under the Securities Act and the offer embodied in the option would constitute an offer from and after the date the option becomes exercisable.[304] As under present law, the sale of the underlying stock upon exercise would not be exempt under Section 3(a)(9) and would require registration or an exemption therefrom.[305] The exercise of an employee stock option would still involve an investment decision and the classification of options as non-securities does not change anything from that perspective. To the extent the ongoing offer of common stock intrinsic in the option did not fall within a private offering or other exemption, that offer would still be subject to Securities Act registration. To the extent that ongoing offer was exempt

301. *See* Interpretive Release on Regulation D, *supra* note 299. The options do not constitute an offer of the underlying security until they are exercisable by virtue of Section 2(a)(3) of the Securities Act, which excludes from the definition of "offer," "[t]he issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer . . . which right cannot be exercised until some future date." *Id.*

302. *See* DIV. OF CORP. FIN., SEC, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS, No. 61 (July 1997) [hereinafter TELEPHONE INTERPRETATIONS].

303. 17 C.F.R § 230.701 (2003).

304. The Commission staff takes the position that, with respect to Form S-8, shares underlying employee stock options may be registered at any time before an option is exercised, without regard to when the option became exercisable. *See* TELEPHONE INTERPRETATIONS, *supra* note 302.

305. The 3(a)(9) exemption is normally unavailable to option exercises because the exercise involves a payment of the exercise price in cash to the issuer and therefore is not the "exchange" of a "security."

from registration, the decision has already been made to exempt that offer from the Securities Act.

Further, treating employee stock options as non-securities could actually increase the protections under the Securities Act for the increasingly common option exchange offer. Under present law, those offers and sales are normally exempt from registration pursuant to Section 3(a)(9) of the Securities Act, which exempts "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."[306] While such offers are currently subject to the tender offer rules, registration of the securities offered is not required. If employee stock options were treated as non-securities, such exchange offers would likely be required to be registered as the Section 3(a)(9) exemption would no longer apply.

2. EXCHANGE ACT CONSIDERATIONS

More importantly, classification of employee stock options as non-securities would have a minimal effect on the "investor" protection provisions of the Exchange Act. Most of the provisions of the Exchange Act are simply inapplicable to employee stock options, whether such options are securities or not. Employee stock options cannot be voted, so they do not need the protection of the proxy rules.[307] They cannot be purchased or sold, so they are not covered by the provisions of the anti-fraud rules.[308] They are not traded on exchanges, over the counter, or on national market systems, so the secondary trading regulatory provisions are inapplicable. In fact, other than the registration and reporting requirements of the Exchange Act, which Congress intended to apply only to publicly traded securities,[309] the classification of employee stock options as non-securities in most cases would not reduce any significant investor protections.

The most visible provisions of the Exchange Act specifically and probably "the most litigated provisions in the federal securities laws" generally[310] are the antifraud provisions centered around Section 10(b)

306. 15 U.S.C. § 77c(a)(9) (1996).

307. 17 C.F.R. §§ 240.14a-1 to 240.14a-104 (2003).

308. Note, however, that the courts and the Commission have, under certain circumstances, regarded an employee's voluntary departure resulting in an extinguishment of incentive securities or in their sale back to the employer as an "investment decision" and therefore potentially a "sale." *See, e.g.*, Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 437 (7th Cir. 1987).

309. *See infra* note 362 and accompanying text.

310. SEC v. Nat'l Sec., 393 U.S. 453, 465 (1968); *see also* Merritt B. Fox, *Insider Trading Deterrence versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2091 n.8 (1994) (noting that Rule 10b-5 generated the most reported cases of the federal securities laws for the period 1987 through 1992).

of the Exchange Act and Commission Rule 10b-5.[311] These provisions make unlawful manipulative or deceptive practices in connection with the purchase or sale of securities. As the language of Section 10(b) and Rule 10b-5 indicate and as the Supreme Court has held,[312] these antifraud provisions of the Exchange Act require a "purchase or sale of [a] security." In the context of stock options issued in a compensatory or incentive context, the question is whether the grant of such options without "value" would constitute a "sale" for the purpose of these very important antifraud provisions.

At one time, the view was common that the grant of an option did, in fact, constitute a "sale" of the *option itself* for the purposes of the Exchange Act, and therefore Rule 10b-5 applied.[313] *Daniel* made that interpretation uncertain, as that case suggested that in fact the Exchange Act concept of a "sale" may incorporate a "value" requirement also. Thus, the present position that option grants normally do not constitute the "value" necessary for a "sale" under the Securities Act brings the "value" requirement into controversy for the purposes of the Exchange Act in general, and Rule 10b-5 in particular. It has not been definitively decided whether the Exchange Act definition of a "sale" contains a "value" requirement.[314] The fact that the purported "sale" is bound up with a retirement decision does not preclude the applicability of Section 10(b), and therefore does not undermine a "sale" finding.[315] Other courts have cast similar situations under Section 10(b) in terms of

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311. Section 10(b) provides, in pertinent part, that

> [i]t shall be unlawful for any person, directly or indirectly . . . to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly . . . (1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

312. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

313. See Arnold S. Jacobs, *The Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 CORNELL L. REV. 27, 80 (1973) ("[I]ssuance by a corporation of a stock option is a 'sale' to which 10b-5 applies.").

314. *But see* Lawrence v. SEC, 398 F.2d 276, 280 (1st Cir. 1968) (arguing that there is "no reason to believe that Congress intended, one year after the passage of the Securities Act, to dilute the concept of a sale in the Securities Exchange Act").

315. *See, e.g.*, Foltz v. U.S. News & World Report, 627 F. Supp. 1143, 1159-61 (D.D.C. 1986).

whether information is "material."[316]

Whether or not the Exchange Act concept of a sale contains a value requirement, the option holder may still be a purchaser of a security. If the Exchange Act *does not* contain a value requirement, then there would be a sale of the option under the Exchange Act regardless of whether there is value under the Securities Act. If the Exchange Act *does* contain a value requirement, then for anti-fraud purposes a sale of the underlying stock could still occur on the grant of the option because the option would constitute a "contract" to sell the underlying stock for value (the price paid to be paid on exercise). *Blue Chip Stamps* made it clear that "holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities,"[317] and any value requirement would be satisfied by the exercise price to be paid for the underlying stock. Thus, for purposes of the Exchange Act in general and the antifraud provisions in particular, employee stock options would continue to be subject to the antifraud and insider trading provisions as "sales" of the underlying stock.

The implications of non-security treatment are less clear with respect to other employee incentives such as SARs. SARs, unlike employee stock options, do not necessarily constitute contracts to acquire securities, and therefore the exercise of such instruments may not constitute the "purchase or sale" of a security within the meaning of Section 10(b) and Rule 10b-5.[318] The fear, of course, is that insiders will manipulate stock appreciation rights and other incentives "as a form of shadow stock to achieve the same financial gains obtainable through legally impermissible transactions in actual securities."[319] Accordingly, the Commission has engaged in a regulatory sleight of hand to keep SARs from escaping Section 16 of the Exchange Act without explicitly

316. *See, e.g.*, Ayres v. Merrill Lynch, Pierce, Fenner & Smith, 538 F.2d 532 (3d Cir. 1976) (noting that the "voluntary decision to retire was also a voluntary decision to sell" where employer had an option to repurchase employee's stock and had indicated intent to do so on employee's retirement); Ryan v. J. Walter Thompson Co., 453 F.2d 444 (2d Cir. 1971) (holding undisclosed information was not material in a similar situation).

317. *Blue Chip Stamps*, 421 U.S. at 751. The Supreme Court has recently reaffirmed this position. *See* Wharf (Holdings) Ltd. v. United Int'l Holdings, 532 U.S. 588 (2001) (citing *Blue Chip Stamps*).

318. There exists some doubt, even apart from the approach articulated in this article, as to whether a SAR constitutes a "security." The exercise of a SAR for cash is the economic equivalent of an exercise of a stock option and the immediate sale of the shares subject to the option. *See* Fox, *supra* note 310, at 2188. The question, however, is analytically identical to that of cash-settled options, which were found to be securities in the recent case of *Caiola v. Citibank*, 295 F.3d 312 (2d Cir. 2002).

319. Stuart R. Cohn, *Stock Appreciation Rights and the SEC: A Case of Questionable Rulemaking*, 79 COLUM. L. REV. 66, 68 (1978).

taking a position on their security or non-security character.[320] But with respect to the garden variety of insider trading addressed by Rule 10b-5, institutional controls and the restrictions of fiduciary duties make the specter of abuse mere "conjecture."[321] Unlike common stock, SARs cannot be acquired in the open market; the acquisition and exercise of SARs occur at times determined by the board of directors or compensation committee of the employer.

Further, the approach proposed in this article would have almost no effect on Sections 13 and 14 of the Exchange Act on non-reporting issuers, and only a minimal effect on reporting issuers. It is true that the proxy rules of Section 14(a) and (c) would no longer apply to non-security employee stock options, and therefore solicitations of consents from holders of employee stock options would not be subject to the proxy rules. Nonetheless, these provisions would not ordinarily apply to employee stock options even if those options were registered under Section 12(g). This is because the provisions of Section 14(a) and (c) are only triggered by a vote or consent of security holders, and employee stock options are not generally entitled to vote or consent on corporate matters anyway.

Neither would this approach have any significant effect in general on the Williams Act treatment of issuers.[322] It is true that the classification of employee stock options as non-securities would arguably eliminate the applicability of the tender offer provisions of Sections 14(d) and 14(e) and the self-tender rules of Section 13(e),[323] meaning that cash tender offers for non-security employee stock options would no longer be subject to the tender offer rules.[324] On the other hand, unlike current

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320. The Commission treats the acquisition, exercise, and expiration of stock options and SARs as transactions in the so-called "underlying security" for the purposes of Section 16, not in the options or SARs themselves. The Commission's rules under Section 16 define a "derivative security" as "any option, warrant, convertible security, stock appreciation right, or similar right . . . or similar securities with a value derived from the value of an equity security." 17 C.F.R. § 240.16a-3(c) (2003). Although such "derivative securities" have some independent significance with respect to the reporting provisions of Section 16, *see* 17 C.F.R. § 16a-4 (2003), the operative disgorgement provisions of Section 16 simply treat "derivative security" transactions as transactions in the "underlying securities." *See* 17 C.F.R. § 240.16b-6 (2003).

321. Cohn, *supra* note 319 at 83-85.

322. 15 U.S.C. § 78m(d)-(e) (2000); 15 U.S.C. § 78n(d)-(f) (2000).

323. There is an argument, however, that the employee stock options would constitute securities for the purposes of the tender offer provisions. At least one court has held that the subsequent sale of a non-security under *Reves* could transform the non-security into a security by vitiating the *Reves* "plan of distribution" factor. *See* Mercer v. Jaffe, Snider, Raitt & Heuer, 736 F. Supp. 64 (W.D. Mich. 1990). Accordingly, it is conceivable that a plaintiff could argue that the option was transformed into a security by the tender offer. This argument is weak, however, for numerous reasons, not the least of which is the fact that the issuer's repurchase of the instrument, if anything, diminishes the "distribution" of the instrument.

324. I say "arguably," because it is possible that making a tender offer inviting the offeree to

practice, exchange offers for the employee stock options[325] would become subject to Securities Act registration, absent an applicable exemption.[326] Thus, in a sense, classifying employee stock options as non-securities would simply shift the regulatory emphasis from the awkward Exchange Act to the more conceptually appropriate Securities Act. The beneficial ownership reporting provisions of the securities laws, contained in Section 13(d) of the Exchange Act would also be unaffected by this article's position.[327] Although the provisions of Section 13(d) would not be applicable to the options themselves, the same purpose would be served because the stock options would still constitute the "right to acquire" the underlying stock even if not themselves "securities."[328]

The final major area of significance in the Exchange Act is "short-swing" trading requirement of Section 16[329] thereof, which imposes liability on "officers," "directors," and certain large shareholders for profits made from purchases sales or sales and purchases of "equity securities" of a reporting company within a six-month period.[330] The position advocated in this article, however, would have little effect on Section 16

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surrender vested rights (whether or not securities prior to the offer) would transform those non-security rights into securities *purchased by* the offeror. The protections of the tender offer rules may therefore apply to such rights.

325. Such "exchange offers" frequently occur in connection with option repricing, for example. Typical employee stock option agreements require the consent of the option holder to modify the option agreement in a manner adverse to such holder. The Commission takes the position that offers to modify such options will constitute an exchange offer if the modification is "fundamental." TELEPHONE INTERPRETATIONS, *supra* note 302. Under the current treatment of employee stock options, such exchange offers are exempt from registration under Section 3(a)(9) of the Securities Act.

326. Rule 701 under the Securities Act would ordinarily apply to such exchange offers by non-reporting issuers, provided the offer met the maximum offering amount limits and the other provisions of that rule. *See* 17 C.F.R. § 230.701 (2003).

327. The provisions of Section 13(d) require reporting to the Commission, subject to certain exceptions, of the acquisition of "beneficial ownership" of five percent or more of any class of "equity securities" registered pursuant to Section 12 of the Exchange Act. *See* 15 U.S.C. § 78m(d)(1) (2000).

328. *See* 17 C.F.R. § 240.13d-3 (2003) ("A person shall be deemed to be the beneficial owner of a security . . . if that person has the right to acquire beneficial ownership of such security . . . within sixty days, including but not limited to any right to acquire: (A) Through the exercise of any option, warrant or right.").

329. 15 U.S.C. § 78p (2000). Interestingly, until recently, Section 16 was the "only provision in the Federal securities law that explicitly deal[t] with [insider] trading." Fox, *supra* note 310, at 2202. Section 10(b) and Rule 10b-5, which govern the type of insider trading with which most people are familiar, arguably do not prohibit insider trading by their literal terms, but only by judicial construction. It was not until autumn of 2000, when the Commission adopted Rule 10b5-1, that the Commission's rules first contained the words "insider trading." *See* 17 C.F.R. § 240.10b5-1 (2003).

330. Section 16 was designed "to deter insiders from profiting at the expense of outsiders through the insiders' access to nonpublic information and to do so without requiring evidence that such nonpublic information was actually used." *See* Fox, *supra* note 310, at 2139.

for two principal reasons. As noted above, the Commission regards transactions in SARs as transactions in the "underlying" stock for the purposes of Section 16. Although the propriety of this treatment has certainly been controversial in the securities law literature, the fact is that classifying stock options or SARs as non-securities would have no significant effect on Section 16. Second, Section 16 is, by its own terms, only applicable to "officers" and "directors" of the issuer. In the Section 16 context, the term "officer" refers to the senior-level executives of the issuer that are called "executive officers" in other securities law contexts.[331] As discussed above, this article does not deny that such incentives may in fact constitute "securities." Thus, there is no reason to believe that the approach taken in this article would in any way impair the full functioning of the Section 16 short-swing profit provisions.

The duplicative regulatory coverage of employee incentives described above is important not only from the practical standpoint of maintaining regulatory continuity but also from the legal perspective of bolstering the case for non-security treatment. The fourth *Reves* factor, the "risk-reducing factor," looks for some protective measure "such as the existence of another regulatory scheme" to protect the purported "investor." Unlike the instruments found to be securities in the *Reves* case, which "would escape federal regulation entirely if the Acts were held not to apply,"[332] employee stock options continue to be subject to comprehensive federal regulation even if the Acts do not apply. Moreover, such comprehensive federal regulation is not merely the substitute supervision of the Federal Deposit Insurance Corporation, as was sufficient to supplant the securities laws in *Marine Bank.* That federal regulation is the very protection of the Securities Acts themselves.

C. *Legislative Purpose or "a Broad Federal Remedy for All Fraud"?*

1. LEGISLATIVE PURPOSE OF THE EXCHANGE ACT

The Supreme Court has emphasized that, as expansive as the coverage of the securities laws is, "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."[333] In the Court's ritualistic invocations of the broad scope of the securities laws, it still emphasized that the definitions "encompass virtually any instrument that might be sold as an *investment.*"[334] Thus, even in the expansive

331. *See* 17 C.F.R. § 240.16a-1(f) (2003); *see also* PETER J. ROMEO & ALAN L. DYE, COMPREHENSIVE SECTION 16 OUTLINE 37-38 (2001).

332. Reves v. Ernst & Young, 494 U.S. 56, 57 (1990).

333. Marine Bank v. Weaver, 455 U.S. 551, 556 (1982).

334. *Reves*, 494 U.S. at 61.

expressions of the legislative scope, the Court recognized that the securities laws are meant to regulate instruments that might be *sold* at "investments." But the broad literal scope of the securities laws, if not administratively restrained, can extend far beyond that animating purpose. For example, despite the fact that "notes" are literally included in the definition of a security, in the context of consumer transactions, Professor Loss has observed that the personal note given as a down payment on a television must not be a security, lest "every unsatisfactory picture tube might end up in federal court . . . as a fraudulent 'purchase' of a 'security.'"[335] The same argument applies to the employment incentive scenario, where expanding securities coverage beyond the context of *bona fide* investments runs the risk of converting every employment squabble, quite literally, into a federal case.

The legislative purpose of the Exchange Act, moreover, is consistent with the notion that employee incentives were not the type of securities Congress had in mind. Without getting excessively smart alecky, Section 12(g) is, after all, part of the Securities *Exchange* Act. That Act, according to the declaration of necessity for regulation, which precedes the Exchange Act, was designed to "provide for the regulation and control" of "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets," and of "practices and matters related thereto."[336] The Supreme Court has not only confirmed this purpose of the Exchange Act,[337] but also has reaffirmed the importance of legislative purpose in interpreting the scope of the securities laws. In the *Joiner* case for example, the Court emphasized that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in light of context, and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy."[338] Even those commentators who object to construing an act according to its "general purposes"[339] would ostensibly not object to interpreting the

335. LOSS & SELIGMAN, *supra* note 17, at 934-35.

336. 15 U.S.C. § 78b (2000).

337. *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) ("The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in the over-the-counter markets."); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 752 (1975) (holding that the Exchange Act is "chiefly concerned with the regulation of *post-distribution trading* on the Nation's stock exchanges and securities trading markets") (emphasis added).

338. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943).

339. *See, e.g.*, Rosin, *Functional Exclusions*, *supra* note 166, at 336 ("Statutory structure and the common understanding of statutory language are the best evidence of legislative intent and can be varied only by unambiguous legislative history, and not by recourse to the statute's *general purposes*.").

statute in accordance with the stated declaration of necessity for regulation.[340] And that "dominating general purpose" or declaration of "necessity for regulation" of the Exchange Act makes it difficult to "interpret the text so far" as to include non-tradable, employee incentive instruments in an Act designed to regulate trading "upon securities exchanges and over-the-counter markets."

2. THE COMMISSION'S RETREAT FROM REGULATORY MANIFEST DESTINY

The Commission's regulatory retreat from the employee incentive field is itself persuasive evidence against treating employee stock options as securities. Over the past few decades, the Commission has almost completely eviscerated the Securities Act regulation of employee benefit transactions. In the context of private companies, the Commission's Rule 701 allows public offerings and sales for cash to employees and consultants without registration or prospectus delivery requirements.[341] In the context of public companies, the Commission allows registration of compensatory securities transactions on its perfunctory Form S-8,[342] which lacks even the requirement of a filed prospectus, and consists of little more than a registration statement cover page and exhibits wrapped around the employee benefit plan itself. Furthermore, Form S-8 becomes effective immediately upon filing,[343] obviating SEC review and comment.

These regulatory reforms of employee incentives in the Securities Act arena, however, contrast dramatically with the Commission's stern position on employee stock options in the Exchange Act arena. Recall that issuers may obtain Section 12(g) relief with respect to employee stock options on the condition that issuers provide to their option holders "essentially the same Exchange Act registration statement, annual report and quarterly report information" as if the options were registered under 12(g). That position contrasts sharply with the position taken by the

340. *See, e.g.*, Rosin, *Historical Perspectives*, *supra* note 252, at 590. As discussed *supra* note 166, Professor Rosin argues for a narrow construction of the "context" clause, arguing that that clause does not limit the definition of "security" depending on the "transactional context" in which the purported security appears. *See* Rosin, *Historical Perspectives*, *supra* note 252 at 587-88. Professor Rosin concedes, however, that the declaration of necessity for regulation supports the argument that Section 10(b) of the Exchange Act should be limited in scope to "market-related fraud." *Id.* at 591. He does not, however, appear to believe the "context" clause of the definition of "security" is an appropriate mechanism to narrow the scope of the Exchange Act generally. It is not clear why the general statement of Section 2 of the Exchange Act should apply exclusively to Section 10(b) rather than to the Exchange Act generally, e.g., via the operation of the "context" clause.

341. *See* 17 C.F.R. § 230.701 (2003).

342. *Id.* § 239.16b.

343. *See id.* § 230.462(a).

Commission when it adopted amendments to Rule 701 only a few years ago:

> [t]he type and amount of disclosure needed in a compensatory securities transaction differs from that needed in a capital-raising transaction. In a bona fide compensatory arrangement, the issuer is concerned primarily with compensating the employee-investor rather than maximizing its proceeds form the sale. Because the compensated individual has some business relationship, perhaps extending over a long period of time, with the securities issuer, that person will have acquired some, and in many cases, a substantial amount of knowledge about the enterprise. The amount and type of disclosure required for this person is not the same as for the typical investor with no particular connection with the issuer.[344]

In this Release, the Commission appears to straightforwardly acknowledge that *even in securities transactions that involve true investment decisions*,[345] compensatory employee transactions do not warrant the same regulatory strictures as capital-raising transactions. In the same release, the Commission also noted that "[i]t would be an unreasonable burden to require these private companies, many of which are small businesses, to incur the expenses and disclosure obligations of public companies when their only public securities sales were to employees. Further, these sales are for compensatory and incentive purposes, rather than for capital-raising."[346] The Commission's policy on employee incentives under the Securities Act stands in stark contrast against its policy under the Securities Act. The Commission states that the "expenses and disclosure obligations" of Securities Act registration would constitute an "unreasonable burden" on private companies in connection with compensatory transactions. The fact is, though, that the disclosure items required by Form S-1, the basic Securities Act registration form, are virtually identical to those required by Form 10, the basic Exchange Act registration form. While a typical issuer focuses disproportionately more attention on preparing a Securities Act registration statement than Exchange Act registration statements or reports, that disparity reflects the difference in potential liability exposure, not the difference in the comprehensiveness of the "disclosure obligations." Therefore, the question should be asked why Securities Act registration, which is a one-time event, is an "unreasonable burden" on an issuer in

344. Release 7645, *supra* note 214, at 81,781.

345. Rule 701 is an exception from registration under the Securities Act, and therefore would only be necessary if an "offer" or "sale" were contemplated. *See* 15 U.S.C. § 77e (2002). As noted earlier, in the context of employee benefit transactions, the concept of an "investment decision" is a component of a "sale" or the equivalent concept of an "investment." *See supra* Part II.B.2.c.

346. Release 7645, *supra* note 214, at 81,777.

terms of "expenses and disclosure obligations," while Exchange Act reporting, which implicates almost the exact same disclosure items and which is an ongoing and continuous obligation, is not an "unreasonable burden"?[347]

Therefore, with respect to private companies, the Commission's position appears to be the following: holders of broad-based employee stock options who make no "investment" in the options and cannot transfer them need "essentially the same" Exchange Act disclosure as if the options were registered under the Exchange Act; on the other hand, employee purchasers of employer common stock, who actually pay cash or other "specific consideration" for shares underlying the options, require a lesser "amount and type of disclosure" than an outside investor in purchasing those shares.

V. THE 12(G) PROBLEM AND ISSUER RESPONSE

The practical reality of the Commission's position is that the looming registration ultimatum will force (and has already forced) many privately held companies to cut back employee incentive programs to avoid the registration provisions of the Act. Some issuers, of course, may take the approach articulated above that their broad-based employee stock options are not "securities," or the narrower approach articulated below that even if such options are "securities," they are not subject Section 12(g) of the Exchange Act. The more likely response, however, will be simply to curtail employee incentive plans to avoid the regulatory hassle of reporting requirements. The current position of the Commission, at least in its present form, could mean the eradication of truly broad-based plans from the range of realistic compensation alternatives for privately held firms.

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347. There are two answers that might be given to my rhetorical question, but neither is convincing in the context of the entire securities regulatory framework. The first potential answer is that the true "unreasonable burden" of Securities Act registration would be subjection to the strict-liability provisions of Section 11 of the Securities Act for material misstatements or omissions in the offering documents. See 15 U.S.C. § 77k (2002), which does not attend Exchange Act registration. This rejoinder may be quickly disposed of, though, with the Commission's own language; the Commission said that it would be unreasonable to impose "*the expenses and disclosure obligations*" of the Securities Act, not the liabilities associated with false or misleading statements. The second potential answer is that Securities Act registration itself would necessarily encompass the entrance of the registrant into the system of Exchange Act reporting, *see* 15 U.S.C. § 78o(d) (2002), and that it is the Exchange Act reporting that would be an "unreasonable burden." To the extent the real answer is based on the second consideration, however, that answer would, for obvious reasons, apply with equal force to the prospect of requiring Exchange Act registration directly under Section 12(g).

A. *Inapplicability of Section 12(g) to Employee Stock Options*

This article advances the thesis that certain types of employee stock options should not be treated as securities for purposes of the Securities Acts. If stock options do not constitute "securities," then they should not constitute "equity securities" within the meaning of the Exchange Act.[348] In turn, if the options do not constitute "equity securities," then the fact that there may be more than five hundred holders thereof will not trigger the registration and reporting requirements under the Exchange Act. From a practical perspective, however, issuers must acknowledge that the Commission is unlikely to embrace arguments that threaten its regulatory turf, no matter how persuasive. In addition, lower federal courts, even if persuaded by the merits of the argument, are likely to accord substantial deference to the judgment of the Commission. For most issuers, therefore, at least on a prospective basis, the practical alternatives are limited to those that accept the Commission's position that all employee stock options are securities.

Even if unwilling to rely on the "non-security" argument, issuers facing the registration mandate have another, narrower argument for non-registration that, while perhaps unlikely to prevail upon the Commission, may more readily persuade lower federal courts. As noted earlier,[349] Section 12(g) requires issuers with over five hundred record holders of any class of "equity security" to register with the Commission. The Commission is of the view that employee stock options are not only "securities," but also "equity securities" for the purposes of the Act, and commentators generally accept that view as a general matter without much serious question.[350] A stronger argument may be made, though, that non-transferable employee stock options, even if securities for the purposes of the Securities Acts generally, are not the "equity

348. The term "equity security" is defined as "any stock or similar security, or any security future or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right." 15 U.S.C. § 78c(a)(11) (2002). The ordinary stock option would constitute an "equity security" for two reasons—it would qualify both as a "security convertible . . . into such a security" and as a "warrant or right to subscribe to or purchase" an equity security. Under the approach of this article, the broad-based employee stock option, however, would not qualify under the first test because it is not a "security." The employee stock option would not qualify under the second test because the language "warrant or right to subscribe to or purchase" is the identical language contained in the definition of "security." Finally, although the definition of "equity security" empowers the Commission to include other instruments of a "similar nature" in the definition by rule or regulation, its power is limited to designating as an "equity security" "any other security." *See id.* § 3(a)(11) (2002).

349. *See supra* note 6 and accompanying text.

350. *See, e.g.*, Fox, *supra* note 310, at 2184 ("An [employee stock option] is clearly an equity security because it is an option and because Congress has amended the definition of 'equity security' to include stock options.").

securities" envisioned by Congress or the Commission for the registration provisions of Section 12(g).

The evidence for this narrower reading of Section 12(g) derives from the legislative history of the provision. Section 12(g) was not a part of the Exchange Act as originally enacted, but was added by the Securities Acts Amendments of 1964.[351] The impetus for those amendments was a Congressional directive to the Commission to make a review of "the rules governing the securities markets to see whether they are adequate to protect investors."[352] The Commission dutifully undertook a Special Study of the Securities Markets in 1961 and, after two years, recommended (among many other things) eliminating the informational disparity between exchange-traded securities and securities traded in the over-the-counter markets.[353] The "disparity" resulted from the fact that, prior to the 1964 Amendments, the registration and reporting provisions of the Exchange Act were applicable only to those securities listed on national securities exchanges and to those issuers that had made a prior public offering.[354] The addition of Section 12(g) was designed to extend to issuers of securities "traded in over-the-counter markets" the protections of Section 12, Section 13, Section 14, and Section 16 of the Exchange Act.[355]

The question remained, however, as to how to strike the "balance" between the Commission's Elysium, where "ideally" registration would include "every security in which there is a public investor interest," and the practical reality of limited regulatory resources and significant issuer burdens.[356] As a conceptual matter, the Commission decided to draw the line between public and private by reference to the degree of "public-investor interest" in the relevant issuer's securities.[357] But without any ready measure for the "public investor interest," the Commission recognized that it needed to adopt a "reasonably reliable and easily

351. Securities Act Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964).

352. *See* Pub. L. No. 87-196, 75 Stat. 465 (1961); *see also* H.R. REP. No. 88-1418, at 5 (1964).

353. *See* SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION 60-64 (1963) [hereinafter REPORT OF SPECIAL STUDY].

354. According to the Commission, the reason for the prior limited application of the registration and reporting provisions was that "too little was known about the over-the-counter market in 1934 to enable Congress feasibly to devise provisions as specific as those relating to listed securities." *Id.* at 1.

355. *See* H.R. REP. No. 88-1418, at 1 (1964). Section 12 of the 1934 Act contains the requirement that certain issuers register with the Commission by filing an Exchange Act registration statement. Section 13 requires periodic reports by issuers registered under Section 12. Section 14 contains the Commission's proxy statement and information statement rules. Section 16 deals with the recovery of "short-swing" trading profits by insiders of an issuer. *See supra* Part IV.B.

356. REPORT OF SPECIAL STUDY, *supra* note 354, at 17.

357. *Id.*

enforceable" surrogate measure for public investor interest.[358] After considering several possible measures, the Commission ultimately settled on the number-of-shareholders criterion on the basis of the Commission's belief that there existed "a clear relationship . . . between shareholders size and the apparent degree of trading activity indicated by numbers of transfers of record and frequency of broker-dealer quotations."[359] Thus, the reason the five hundred record holder measure was adopted was to approximate "trading activity indicated by numbers of transfers of record." Since ordinary employee stock options can normally have no transfers of record, the five hundred record holder rule loses its purpose as a proxy for the level of trading activity.

The rationale behind the five hundred record holder threshold, as described above, helps to illustrate why Section 12(g) should have no application to instruments such as employee stock options. The Commission's intent in proposing the Amendments was to extend "the comprehensive scheme of disclosure" of the Exchange Act to protect "investors . . . in the over-the-counter market."[360] The Commission's analysis of the "public-investor interest" above reveals the market the Commission was targeting: markets with "trading activity" evidenced by "numbers of transfers of record and frequency of broker-dealer quotations." None of these rationales could possibly encompass securities such as employee stock options that are, by their own terms, non-transferable. This intuition is borne out by practically every contemporaneous piece of legislative history pertaining to the Amendment, which describe the Amendments as applying to "publicly traded securities"[361] and "issuers of securities traded in the over-the-counter markets."[362] Reading a section designed to regulate "publicly traded securities" in the "over-the-counter markets" as encompassing instruments that cannot be traded, over-the-counter or otherwise, would violate the unambiguous intent of Congress.

The solution to the Commission's Section 12(g) interpretive problem is the context clause that precedes all of the statutory definitions in Section 3 of the Exchange Act. According to the Supreme Court, this context clause means that "the same words may take on a different coloration in different sections of the securities laws."[363] When interpreting the meaning of terms in the Securities Acts, the "purpose," along with the "language" and "history" of the relevant statutes, is relevant in

358. *Id.*
359. *Id.* at 61-62.
360. *See* S. REP. NO. 88-379, at 9 (1963).
361. *See, e.g.*, *id.*; H.R. REP. NO. 88-1418, at 1 (1964).
362. *See, e.g.*, S. REP. NO. 88-379, at 60 (1963); H.R. REP. NO. 88-1418, at 2, 15 (1964).
363. SEC v. Nat'l Sec., Inc., 393 U.S. 453, 466 (1969).

deciding whether to override an administrative agency's interpretation.[364] Therefore, while the Commission may interpret the term "equity security" in Section 12(g) to include employee stock options, and while that interpretation is entitled to "considerable weight," courts are not constrained to interpret the term as broadly in the context of Section 12(g) as in the context of other provisions of the Act. Instead, the "different coloration" of the term "equity security" in Section 12(g), "must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."[365]

What Congress was "attempting to accomplish" in the 1964 Amendments is plain from the expressed purpose of the bill itself; the purpose was "[t]o extend disclosure requirements to the issuers of additional *publicly traded* securities."[366] The Commission adopted a virtually identical view of the Amendments' objectives in a contemporaneous "summary analysis" of those Amendments, where the Commission described one of the "major objectives" of the Amendments as affording information to "investors in publicly-held companies whose securities are traded over-the-counter."[367] Few would argue that non-transferable stock options are even "traded," much less "publicly traded." Nor would many people argue that such options are part of the "over-the-counter market"; after all, the very term "over-the-counter" is descriptive of the act of exchange.[368] No reasonable construction of Section 12(g) that gives consideration to the clear Congressional purpose could favor a registration requirement under Section 12(g) for non-transferable employee stock options.

This narrower version of Section 12(g), when properly articulated, should satisfy, or at least persuade, even the literalist commentators. Even in the Commission's "ideal" scenario, requiring registration of any security with a "public investor interest," non-transferable options still would not qualify, at least according to the Commission's definition of "public investor interest."[369] As illustrated above, extension of Section 12(g) to cover non-transferable employee stock options would be antithetical to the Commission's own expression of the purpose of the Amendments. Thus, the purpose-oriented approach would also seem to

364. *See* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 566 n.20 (1979).

365. Reves v. Ernst & Young, 494 U.S. 56, 63 (1990).

366. Pub. L. No. 88-467, 78 Stat. 565 (1964) (emphasis added).

367. *See* Securities Act Release No. 4725 (CCH) at 82,099 (2002).

368. Black's Law Dictionary defines the "over-the-counter market" as "the market for securities that are not traded on an organized exchange. OTC trading usually occurs through telephone or computer negotiations between buyers and sellers. Many of the more actively traded OTC stocks are listed on NASDAQ." BLACK'S LAW DICTIONARY 1130 (7th ed. 1999).

369. *See supra* notes 357-63 and accompanying text.

satisfy even the "facial interpretation" advocates who would limit the "context" clause to a "focus on the intent of a specific provision."[370] Professor Rosin, for example, would seem to agree that even literalist courts are willing to bend the letter of the law when "there is a specific, unambiguous expression of legislative intent to the contrary."[371] And Professor Steinberg, while arguing for the irrelevance of "factual circumstances" surrounding a transaction, concedes that statutory text must yield when "the language, structure, or legislative history . . . warrants a different meaning."[372] Congress has provided sufficient specific, unambiguous expression of intent that even quasi-literalists should reject the applicability of Section 12(g) to employee stock options.

B. *Industry Reaction to the Section 12(g) Issue*

Companies faced with the 12(g) registration mandate have limited alternatives if they wish to continue employee incentive policies that would trigger Section 12(g). They may register their options under Section 12(g), beg for the Commission's exemptive relief from Section 12(g), or challenge the Commission's position on the applicability of Section 12(g). The first option would simply be unworkable from the perspective of most companies. The second option has already been described. Thus, as a practical matter, companies that wish to continue their broad-based compensation policies without complying with the Commission's conditions are left to the alternative of risking a potential challenge from the Commission or a disgruntled employee.

The prospect of engaging the Commission in a regulatory struggle is understandably unpalatable. The courts are likely to offer the Commission's interpretation "considerable weight"[373] and the risk of enforcement proceedings or litigation is likely to sufficiently intimidate most companies. The securities law community, moreover, has become so accustomed to the literal approach that in spite of the Supreme Court's guidance the momentum of the community is consciously and unconsciously driven by custom more than innovation.

The Introduction to this article noted that the Commission has indicated its willingness to extend no-action relief from the requirements of Section 12(g), provided issuers meet the Commission's conditions.

370. Rosin, *Functional Exclusions*, *supra* note 166, at 361. Professor Rosin describes his "facial interpretation" approach as one that "relies on legislative intent and purpose, but does so in a more focused manner than functional exclusion analysis. While the latter approach relies heavily on the legislature's overall concern, facial interpretation looks to the purpose or policy reflected in the specific provision in question." *Id.* at 360.

371. *Id.* at 341.

372. Steinberg & Kaulbach, *supra* note 17, at 505.

373. *See* United States v. Nat'l Assn. of Sec. Dealers, 422 U.S. 694, 719 (1975).

Already, a number of companies have formally requested no-action relief from the Commission with respect to their employee stock options.[374] But those companies that have already crossed the five hundred holder mark may need to develop some more active approach to managing their 12(g) option threshold. One approach would be to wait for option holders to exercise their options or to use a variety of techniques to encourage option holders to exercise their options prematurely.[375] Because an option to acquire common stock is generally not considered the same class of equity security as the common stock, the company could, by shifting people out of its options and into its more closely held common stock, keep both under five hundred. There is, of course, a limit to this strategy, as the number of holders of common stock could then also surpass five hundred. Nevertheless, a substantial portion of option holders likely will immediately sell the stock they acquire on exercise (if practicable),[376] and that effect plus the additional five hundred holder buffer will help many firms. Finally, some firms may try to further shave the numbers of outstanding options holders by taking the position that unvested employee stock options do not constitute "warrants" or "rights" to acquire securities.[377]

The specific approach that will gain industry currency in response to the broad-based employee incentive problem is still unclear. What is clear, however, is that the approaches outlined above are, at best, band-aid solutions for a regulatory hemorrhage. Once this problem becomes more well known, the regulatory position will create a number of negative effects on rank-and-file workers. The first is that employers will contract the scope of employees eligible for their stock options, whether prospectively or retroactively, whether explicitly or pretextually. In fact,

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374. *See, e.g.*, Gen-Probe Inc., SEC No-Action Letter (Aug. 15, 2001) 2001 SEC No-Act. LEXIS 694; AMIS Holdings, Inc., SEC No-Action Letter (July 30, 2001) 2001 SEC No-Act. LEXIS 673; Mitchell Int'l Holding, Inc., SEC No-Action Letter (Dec. 27, 2000) 2000 SEC No-Act. LEXIS 1033; Gen. Roofing Servs., Inc., SEC No-Action Letter (April 13, 2000) 2000 SEC No-Act. LEXIS 496; Kinko's, Inc., SEC No-Action Letter (Nov. 30, 1999) 1999 SEC No-Act. LEXIS 928; Millennium Pharm., Inc., SEC No-Action Letter (May 21, 1998) 1998 SEC No-Act. LEXIS 604.

375. Exercise of an option prior to expiration is normally not optimal, even when the option is "in the money." *See, e.g.*, ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 532 (1999). Early exercise can be optimal, though, if the underlying stock pays dividends. Moreover, the higher the dividends, the more likely early exercise is optimal. Nevertheless, the success of this technique would depend on the antidilution provisions contained in the stock option plan.

376. *See* Chip Heath et al., *Psychological Factors and Stock Option Exercise*, 114 Q.J. ECON. 601, 606 (1999) ("[T]he great majority of option-holders immediately sell the stock acquired on exercise."); *see also* Fox, *supra* note 310, at 2162 ("Any exercise prior to the expiration of the calls is simply the satisfaction of a necessary precondition for the sale of shares that will inevitably follow immediately thereafter.").

377. Because unvested employee stock options are not exercisable and may never become exercisable, it is conceivable that they may not constitute a present "right" to acquire a security.

some well-advised employers who are aware of the incentive problem are already responding to the Commission's ultimatum by reducing their present employee incentive programs or by constraining the growth of future incentives. The second result of the Commission's position is that those reductions will disproportionately affect the lower echelons of the corporate contingent. Thus, by the Commission's mechanical approach to the Exchange Act, stock options in private companies may once again become the exclusive privilege of more highly compensated key employees.

VI. CONCLUSION

The securities laws have historically been interpreted using the principle of economic reality to avoid the perils of an overly *constrictive* literalistic reading. The same principle, however, has traditionally been unavailable to avoid the perils of an overly *expansive* literalistic reading. The lower courts have ritualistically invoked the "remedial" nature of the securities laws in refusing to restrict the literal scope of the securities laws by principles of economic reality or even by the *ratio legis*. The Supreme Court reaction, in the form of the *Marine Bank* and *Reves* cases, stressed that in fact economic reality can contract as well as expand the scope of the securities laws, providing a counterweight to the heavy inclusionary bias exerted by *Howey*. While *Reves* is a weak decision from a theoretical standpoint and injects a degree of incremental ambiguity into an already murky area, the contextual approach embraced by *Reves* does provide a basis for avoiding certain undesirable regulatory excesses, like the ones identified herein.

The analytical relationship between notes and employee stock options described in this article also holds a certain historical interest, having been identified by Professor Loss over thirty years ago. In the 1968 supplement to his influential securities law treatise, Professor Loss noted that it was "arguable" that options given for personal services, like private promissory notes, should be treated as non-securities.[378] Not only did Professor Loss identify the analogy between promissory notes and employee stock options two decades before the *Reves* decision, but he did so at a time when notes were widely regarded as almost *per se*

378. *See* LOUIS LOSS, SECURITIES REGULATION 2494 (Supp. 1969) ("It is still arguable, as in the case of the ordinary promissory note given to a bank or another private lender, that a nontransferable option that is incident to a contract for personal services is not a 'security' for the purposes of the fraud provisions of the 1933 Act."). Professor Loss, in fact, had suggested the possible non-security character of such options even before the 1969 supplement. *See* LOUIS LOSS, SECURITIES REGULATION (1st ed. 1951); LOSS, *supra* note 118, at 467 ("The administrative construction is that an option which is incident to a contract for personal services may not be a security.").

securities,[379] just as employee stock options are today. Over time, the courts ultimately came to acknowledge that many types of notes are not securities, based on their commercial or consumer rather than investment, character.[380] The future of employee equity participation in privately held companies will depend, at least in part, on the courts' willingness to acknowledge the same with respect to employee stock options.

379. *See* Chang, *supra* note 147, at 410-11; *see also* Lehigh Valley Trust Co. v. Cent. Nat'l Bank, 409 F.2d 989, 991-92 (5th Cir. 1969) (noting that the "definition of a security has been literally read by the judiciary to the extent that almost all notes are held to be securities").

380. *See* Rosin, *Functional Exclusions*, *supra* note 166, at 338 ("The concept of functional exclusion of certain promissory notes is now generally accepted by the lower federal courts."); *see also* Martin Lipton & George A. Katz, *"Notes" Are (Are Not?) Always Securities—A Review*, 29 BUS. LAW. 861 (1974); Martin Lipton & George A. Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975).