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EXECUTIVE COMPENSATION AND FEDERAL SECURITIES LEGISLATION†

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"Pension funds and profit-sharing plans financed by payroll deductions and company contributions necessarily have new money to invest every month. . . . The trustees and investment officers of such outfits don't have much choice. Every month, certainly every year, they must buy more." Burton Crane, in Getting and Spending, *p. 232 (1956).*

Far more often than generally realized, plans or arrangements providing supplemental compensation or incentives for executives involve problems under the Securities Act of 1933[1] and the Securities Exchange Act of 1934.[2] The legislation in question,

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The various plans referred to in the footnotes to this article are exhibits to or incorporated in registration or proxy statements on file with the Securities and Exchange Commission, Washington, D.C., or are part of or filed with listing applications with the New York Stock Exchange. The writers will be glad to make available a copy of any cited document on payment of cost of reproduction.

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1 48 Stat. 74, as amended, 15 U.S.C. (1952; Supp. IV, 1956) §§77a to 77aa.

2 48 Stat. 881, as amended, 15 U.S.C. (1952; Supp. IV, 1956) §§78a to 78jj.

This article is confined to a review of registration and disclosure problems affecting compensation under the 1933 and 1934 acts. Liability for short-swing profits under §16(b) of the Act of 1934 [15 U.S.C. (1952) §78p(b)] is not discussed. For a comprehensive discussion of §16(b) liability, see Cook and Feldman, "Insider Trading Under the Securities Exchange Act," 66 HARV. L. REV. 385, 612 (1953); Rubin and Feldman, "Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders," 95 UNIV. PA. L. REV. 468 (1947).

Other federal securities legislation which may sometimes have a bearing includes the Public Utility Holding Company Act of 1935 [49 Stat. 803, 15 U.S.C. (1952) §§79 to 79z-6]; the Trust Indenture Act of 1939 [53 Stat. 1149, 15 U.S.C. (1952) §§77aaa to 77bbb]; the Investment Company Act of 1940 [54 Stat. 789, 15 U.S.C. (1952) §§80a-1 to 80a-52]. For a discussion of relevant provisions from such statutes, see WASHINGTON AND ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE, 2d ed., 345-350 (1951). The blue sky laws of individual states may also be pertinent and should be consulted.

Also beyond the scope of this article is the question of liability of directors and officers for failure to comply with registration and disclosure requirements under federal securities legislation. For an outline of these liabilities and a study of the question whether they may, in part, be assumed by the company itself, consult WASHINGTON, CORPORATE EXECUTIVES' COMPENSATION, cc. 18-19 (1942). See also Bishop, "Current Status of Corporate Directors' Right to Indemnification," 69 HARV. L. REV. 1057 (1956).

which has for one of its primary objectives the disclosure of material facts in connection with the sale of securities, seeks to attain this objective through requiring that under given circumstances the securities must be registered with the Securities and Exchange Commission before they can be sold and that the sale of the securities be accompanied by a prospectus. The objective of disclosure is also sought to be attained through the proxy statement which must accompany proxy solicitation by companies with stock listed on a national securities exchange; the proxy statement must set forth material facts bearing on the election of directors or on other action sought to be taken at the meeting for which proxies are being solicited.

A compensation or incentive arrangement such as a stock option or stock purchase plan, or a profit-sharing plan calling for eventual distribution of stock of the employing company, obviously contemplates the issuance of securities and hence presents the question whether the plan itself, apart from the securities, must be registered with the SEC and a prospectus issued to employees when the plan is adopted and the securities thereby "offered."

The question is by no means confined to listed companies; it may arise in the case of any company of any size, even though its stock is closely held. Apart from registration, the compensation or incentive arrangement will often constitute a material fact which, in the case of companies with stock listed on a national securities exchange, should be disclosed to stockholders when their proxies are being solicited and which, in the case of all companies, listed or unlisted, should be disclosed to the public at large if and when the public is offered stock of the employing company.

In this article we first consider the type of compensation plan or arrangement which must be registered with the Securities and Exchange Commission. We shall then outline the requirements for disclosing the plan and its terms, as imposed by federal securities legislation and administrative regulation thereunder.

I. REGISTRATION OF COMPENSATION PLANS

A. *Problems Under the Securities Act of 1933*

The Securities Act of 1933, in requiring the registration of securities offered to the public, may create problems for compensation plans which contemplate the issuance of stock, such as stock option and stock purchase plans. As we shall see, similar problems may arise for other types of plans, including pension and profit-

sharing plans, at least if stock is either to be acquired or to be issued under such plans.

A simple cash profit-sharing agreement with a single executive does not require registration; it involves no "security"[3] and, even if it did, there has been no "public offering."[4] However, stock plans, and group benefit plans generally, may involve both (a) a "security" transaction and (b) a "public offering"; registration may then be necessary.

1. *Does the Plan Involve a Security Transaction?* Our first question, then, is as to the existence of a security. If the compensation plan does not involve a "security" within the meaning of the 1933 act, we need look no further but may act on the assumption that no registration statement need be filed. If, on the other hand, a "security" is involved, the security may or may not require registration, depending on other factors.

The broad definition of the term "security" in the 1933 act,[5] which specifically includes any "participation in any profit-sharing agreement," has been liberally construed by the courts to bring within the act many forms of transaction which, on their face, do not appear to be "securities" in the commercial sense of the word.[6]

Obviously, the distribution of cash bonuses does not involve a "security" within the meaning of the 1933 act. But it seems clear

[3] The statutory definition of the term is set forth in note 5 infra.

[4] Registration is not required as to "transactions by an issuer not involving any public offering" of securities. Securities Act of 1933, §4 (1), 48 Stat. 77, as amended, 15 U.S.C. (Supp. IV, 1956) §77 (d) (1). See discussion in text at note 21 infra.

[5] "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." Securities Act of 1933, §2 (1), 48 Stat. 74, amended 48 Stat. 905, 15 U.S.C. (1952) §77b (1). Congress defined the term "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." H. Rep. 85, 73d Cong., 1st sess., 11 (1933).

[6] Various devices which purport to be a sale or lease of "property" have been held to be "securities" within the meaning of the statute because of their dominant characteristic of "investment contracts." SEC v. W. J. Howey Co., 328 U.S. 293 (1946) (units of a citrus grove development); SEC v. Joiner Corp., 320 U.S. 344 (1943) (oil and gas leaseholds); Blackwell v. Bentsen, (5th Cir. 1953) 203 F. (2d) 690 (units of a citrus development); SEC v. Payne, (S.D. N.Y. 1940) 35 F. Supp. 873 (foxes); SEC v. Cultivated Oyster Farms Corp., (S.D. Fla. 1939) 1 S.E.C. Jud. Dec. 672; SEC v. Chinchilla, Inc., CCH Fed. Sec. L. Rep. ¶90,618 (N.D. Ill. 1953) (chinchillas); SEC v. Evergreen Memorial Park Association, Civ. No. 11,821 (E.D. Pa. 1953) (consent injunction, burial lots). See note, 163 A.L.R. 1050 (1946); Loss, SECURITIES REGULATION 306, 314 (1950; 1951 Supp.).

that a plan which contemplates the distribution to employees of stocks or bonds will be deemed to involve a security subject to registration unless within some exemption or exception.

Government bonds. An exemption from registration exists in favor of bonds issued or guaranteed by governmental authorities.[7] Thus, if a pension or profit-sharing plan calls for investment of funds in United States government bonds or in the bonds of a state or municipality, a security requiring registration would not be involved. On the other hand, if the plan confers any discretion as to how funds under the plan are to be invested by the company or the trustee, the exemption would not apply even though the funds should actually be invested in government bonds.[8] Thrift plans, as well as other contributory plans of a pension or profit-sharing nature, often provide for investment of the employees' contributions in bonds, with the company's contribution being invested in stock,[9] or with the employees having an individual election with regard to investment of the company's contribution.[10]

[7] 48 Stat. 76, as amended by 48 Stat. 906, 15 U.S.C. (1952) §77c(a)(2). Prior to the 1934 amendments to the Securities Act of 1933, the exemption was limited to securities issued by instrumentalities "exercising an essential government function." That language was expanded by the 1934 amendments to include "activities in which governments are engaging." H. Rep. 1838, 73d Cong., 2d sess. (1934). See LOSS, SECURITIES REGULATION 354 (1951; 1955 Supp.).

[8] Compare discussion in connection with note 35 infra.

[9] E.g., General Finance Corp. Profit-Sharing Retirement Savings Plan. Cf. E. I. du Pont de Nemours Company Thrift Plan (effective September 1, 1955) (employees' contributions invested in U.S. Savings Bonds, Series E, with company contributions used to purchase company common stock). But cf. General Motors Savings-Stock Purchase Program for Salaried Employees in the United States, Proxy Statement for special meeting of stockholders held on September 23, 1955, Section III (employee savings invested 50% in "direct obligations of the U.S. Government" and 50% in General Motors common stock, with corporation guarantee that the value of securities and cash will at least equal employee's savings plus interest).

[10] E.g., Tennessee Gas Transmission Company Thrift Plan; Tidewater Oil Company Thrift Plan (employee has election between bonds and diversified securities); Continental Oil Company Thrift Plan (employee election as to entire fund between government obligations and Company stock); Standard Oil Company (New Jersey) Employees Thrift Plan (employee's choice of Company stock, life insurance, annuity contract, government securities or payment for hospital, medical or surgical insurance); Socony Mobil Oil Company Employees Savings Plan (employee's choice of government bonds, company stock or eligible investment company stock).

Cf. Sears, Roebuck prospectus, note 12 infra, at 9 (". . . it is intended that so far as practicable and advisable, the Fund shall be invested in capital stock of the Company, to the end that depositors may, in the largest measure possible, share in the earnings of the Company"). The problem is not confined to so-called thrift or savings plans; employes may have a choice of participation or investment under pension and other forms of plan, both contributory and non-contributory. E.g., Retirement Benefit Plan of American Airlines, Inc., as amended pursuant to stockholder approval given on May 15, 1956 (contributory pension plan with fixed benefits funded and balance of Trust Fund invested in securities of any kind, including common stocks); Profit-sharing Plan for Salaried Employees of St. Joseph Lead Company (non-contributory plan with each employee having a choice of investment of the company's contribution on his behalf among government obligations, corporate securities and stock of the employer), approved May 14, 1956.

Under this type of plan, the employees' contributions are automatically invested in government bonds and since, as will hereafter appear, the company's contributions to the plan cannot be considered an "offering,"[11] assuming that the contributions of the employees and the contributions of the company can each be considered independently of the other, it would seem that such a thrift or contributory plan does not need to be registered. On the other hand, the company's contributions to such a plan are in reality the inducement for the contributions of the employees and the plan must therefore be viewed as a whole; so viewed, the exemption may be held inapplicable when the company or the trustee has discretion as to the investment of company contributions. Perhaps on this theory, thrift and other contributory plans which authorize investment of funds in securities other than government bonds are usually registered as a matter of practice.[12]

Insurance policies and annuities. An exemption from registration also exists in favor of insurance or endowment policies and annuity contracts,[13] and a plan providing for the purchase of policies or contracts of this nature would not have to be registered.[14] Again, however, if discretion exists as to whether contributions will be used to purchase insurance policies or some other form of investment, the plan would appear to require registration even though insurance policies may in fact be the sole medium selected.

A question exists as to the need to register a plan confined to endowment policies or annuity contracts but which authorizes the purchase of "variable annuities," measurable in part by the values

[11] Note 31 infra, and connected text.

[12] E.g., Employees Savings Plan of Socony Mobil Oil Co.: see Proxy Statement for annual meeting on April 26, 1956, at 14. Prospectuses of The Savings and Profit-Sharing Pension Fund of Sears, Roebuck & Co. Employees. E.g., prospectus dated Aug. 15, 1951. The Division of Corporation Finance has taken the position that such a plan must be registered if investments in the employer's securities exceed the employer's contributions. See letter dated May 12, 1954, note 47 infra. It should also be noted that the thrift plan itself may be considered a security. If so, even though it invests only in government bonds, it should register.

[13] 48 Stat. 76, as amended, 68 Stat. 906, 15 U.S.C. (1952) §77c(a)(8).

[14] The commission has not sought to have such insurance or annuity plans registered, and they are probably not subject to the act. See Hearings on Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934, Committee on Interstate and Foreign Commerce, 77th Cong., 1st sess., 897 (1941-1942); Opinion of Assistant General Counsel, Sept. 1941, 1 CCH Fed. Sec. L. Serv. ¶2231.21. For the view that a plan involving the purchase of insurance or annuity contracts should be submitted to the commission for an opinion as to exemption because of the commission's unwillingness to commit itself to a general rule, see P-H, Pension and Profit-Sharing Serv. ¶6226 (1955).

of underlying common stocks.[15] The Securities and Exchange Commission has taken the position that contracts providing for variable annuities are securities and that a company issuing such contracts must register the contracts as securities subject to the provisions of the Securities Act, and the company itself must register as an investment company.[16]

Stock options. A stock option will, of course, involve the issuance of a security if and when the option is exercised. Whether the stock option itself constitutes a security presents a different question.

The definition of "security"[17] includes warrants and rights to subscribe or purchase other securities and on its face would appear to embrace stock options granted employees. However, it is perhaps arguable that an option granted an employee which is personal, non-transferable and hence non-negotiable is not a security contemplated by the registration requirements, and the Securities and Exchange Commission has so implied in a different context.[18] The implication would appear to apply to all restricted stock options meeting the prescribed conditions of section 421 of the Internal Revenue Code.[19] The point will rarely be of material significance when the stock covered by the option is subject to registration.[20]

15 For views favorable to variable annuity plans generally, see JOHNSON, THE VARIABLE ANNUITY (1952); Henderson, "A Better Pension Plan," 30 HARV. BUS. REV. 62 (Jan.-Feb. 1952); JOHNSON et al., AN EXPERIMENT WITH THE VARIABLE ANNUITY (1953); GREENOUGH, THREE YEARS EXPERIENCE WITH VARIABLE ANNUITIES (1955). Legislation to authorize insurance companies to issue variable annuities has been introduced in several states. See, e.g., N.J. Assembly Bills 305, 306, 307 (1955); SHANKS, THE NEED FOR VARIABLE ANNUITIES (1955).

16 SEC v. Variable Annuity Life Ins. Co. of America, Civ. Action No. 2549-56 (D.C. 1956).

17 Note 5 supra.

18 The definition of "security" in the 1933 act is in this respect identical with that in the 1934 act. 48 Stat. 881, 15 U.S.C. (1952) §78c(a)(10). For a long time, the commission, as a matter of administrative construction, advised officers, directors and substantial stockholders required to file a statement of their holdings of equity securities under §16(a) of the 1934 act (see note 153 infra, and related text) that personal contracts or options to purchase stock did not have to be included in these statements. This construction eventually culminated in a rule, effective November 1, 1952, calling for statements of ownership with respect to transferable options only. Rule X-16A-1(h), Exchange Act Release No. 4754 (1952).

19 A restricted stock option is specifically defined as an option which "by its terms is not transferable" by an employee "otherwise than by will or the laws of descent and distribution, and which is exercisable, during his [the employee's] lifetime, only by him." I.R.C., §421(d)(1)(B). Under §16(b) of the Securities Exchange Act such an option and the securities acquired pursuant thereto are both, in most instances, exempted from liability to the corporation for short-swing profits. Rule X-16B-3, Exchange Act Release No. 5312 (1956).

20 Note 60 infra, and connected text.

2. *Does the Plan Involve a Public Offering?* Even if the plan involves the distribution of securities, the absence of a public offering may make registration unnecessary.[21] To determine whether there is a public offering, two inquiries must be made. The first is as to the existence of an "offering"; the second is whether, if there is an offering, the offering is being made to the "public."

(a) *Is there an offering?* To constitute an offering subject to registration, the plan must contemplate a "sale," an "offer to sell," an "offer for sale" or an "offer of securities." Each of these terms is defined in the 1933 act. A "sale" is defined to include "every contract of sale or disposition of . . . a security or interest in a security, for value."[22] An "offer to sell," "offer for sale" or "offer" is defined to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[23] A security delivered as a bonus with or on account of a purchase of property is conclusively presumed to be part of the purchase and to have been offered or sold for value.[24] With these definitions in mind, let us examine various forms of compensation plans.

Plans not involving financial contributions by the executive. With many companies, a bonus award may be made in the form

21 See note 4 supra.

22 Securities Act of 1933, §2 (3), as amended, 15 U.S.C. (Supp. IV, 1956) §77b (3).

23 All the terms are defined to exclude "preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with the issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer. . . ." Ibid.

In connection with an attempt to amend the 1933 act made in 1941, it was proposed that §2 (3) of the act be amended to read as follows:

"3 (a) The term 'sale' or 'sell' includes every sale or other disposition of a security or interest in the security for value, and every contract to make any such sale or disposition.

"(b) The term 'offer to sell', 'offer for sale', or 'offer' includes every attempt or offer to dispose of, or solicitation of an order or offer to buy, a security or interest in a security for value." REPORT ON THE CONFERENCES WITH THE SECURITIES AND EXCHANGE COMMISSION AND ITS STAFF, ON PROPOSALS FOR AMENDING THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, by the Representatives of the Investment Bankers Association of America, et al., [hereinafter referred to as Report] July 30, 1941, at 9. See also Hearings on Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934, Committee on Interstate and Foreign Commerce, 77th Cong., 1st sess., p. 169 (1941-1942) [hereinafter referred to as Hearings].

24 Section 2 (3) of the Securities Act of 1933, as amended, 15 U.S.C. (Supp. IV, 1956) §77 (b) (3) provides: "Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value." It should be noted, however, that the stock issued to an executive as a bonus is not considered a purchase by the executive unless it is issued as an inducement to enter into or continue in the employment of the issuer. See cases cited note 26 infra.

of a distribution of common stock rather than cash.[25] Does such a distribution constitute a "sale" within the meaning of the 1933 act? While no cash or other financial contribution was made by the executive, the stock bonus cannot properly be considered as having been granted without any consideration; consideration is found in services rendered or to be rendered by the executive.[26] It may hence be argued that the stock was "sold" in consideration of such services.[27] The statutory definition of a "sale" as including a "disposition"[28] may be sufficiently broad to include the distribution of stock bonuses. Indeed, the acquisition of stock warrants by an executive in connection with his employment has been held to be a "purchase" of a security within the prohibition of short-swing profits imposed by the Securities Exchange Act of 1934.[29]

However, the reasoning and policy considerations which led

25 Stock may be distributed as a current bonus or, in more popular form today, under deferred plans requiring that the awards be earned out. Such deferred plans fall into two general categories: (1) the General Motors Corporation type of plan, under which the award is distributed in annual installments as it is earned out in years immediately following the year in which the award is made; and (2) the General Electric Company type of plan, under which the award, if earned out by a designated period of employment, will be distributed on retirement or other termination of employment. For a discussion of the stock bonus, see WASHINGTON AND ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE, c. 5 (1951). For a review of the various types of plans and their operation, see Lasser and Rothschild, "Deferred Compensation for Executives," 33 HARV. BUS. REV. 89 (1955).

26 Truncale v. Blumberg, (S.D. N.Y. 1950) 88 F. Supp. 677, affd. sub nom. Truncale v. Scully, (2d Cir. 1950) 182 F. (2d) 1021, where the court, in speaking of warrants acquired at the time a contract of employment was signed, said, at 679, "True enough these defendants paid no dollars for the warrants they received; nevertheless, they did not receive them for nothing. They surrendered their previous employment; they bound themselves contractually to work for a corporation whose prospects at the time were far from promising; they surrendered their freedom of action. There is no ready means of converting these imponderables into dollars and cents." Consult Eliasberg v. Standard Oil Co., 23 N.J. Super. 431, 92 A (2d) 862 (1952), affd. 12 N.J. 467, 97 A. (2d) 437 (1953); Kaufman v. Schoenberg, 33 Del. Ch. 211, 91 A. (2d) 786 (1952).

27 See LOSS, SECURITIES REGULATION 327 (1951). In addition to requiring earning out over a designated period of years, the General Electric type of stock bonus plan, referred to note 25 supra, often requires absence of competitive activity and sometimes consultive and advisory services during the pay-out period following termination of employment.

28 Note 22 supra. The definition speaks of a "contract or . . . disposition." It has been held that the phrase "contract to . . . acquire" in the definition of "purchase" in the Securities Act of 1934 includes an "executed acquisition" as well as an executory acquisition. Park & Tilford v. Schulte, (2d Cir. 1947) 160 F. (2d) 984, cert. den. 332 U.S. 761 (1947); Kogan v. Schulte, (S.D. N.Y. 1945) 61 F. Supp. 604. The term "purchase" is not defined in the Act of 1933.

29 Such was the decision of Judge Medina in a case arising under §16(b) of the Act of 1934. See Truncale v. Blumberg, (S.D. N.Y. 1948) 80 F. Supp. 387 at 392, app. dismissed (2d Cir. 1950) 182 F. (2d) 1021 (warrants received by executives pursuant to their employment contracts). See also cases cited note 64 infra. Distinguish Shaw v. Dreyfus, (2d Cir. 1949) 172 F. (2d) 140, cert. den. 337 U.S. 907 (1949) (receipt of stock rights by all stockholders held not a "purchase": stockholders "performed no act, made no agreement, paid no consideration" for such rights.

to this decision under section 16 (b) of the 1934 act appear inapplicable to a determination of whether the distribution of a stock bonus involves a "sale" to the executive requiring registration under the 1933 act. In the case of the usual stock bonus granted without any cash contribution from the executive, the executive has not purchased a security in any real sense, since he has not elected to make an investment. True, he has rendered services, but he has not done so for the purpose of buying a security; his principal motive is to keep his job and his salary.[30] Because of such considerations, the Securities and Exchange Commission has taken the view that no sale is involved in such a case.[31] This view appears applicable even when the transaction takes the form of a cash bonus which is automatically translated into the purchase of stock from the company to the extent of the cash award.[32]

The same view appears to apply to pension plans which require no contributions from employees. The pension is provided without affirmative action on the part of the executive and as an incident of employment.[33]

The situation may be different when a bonus or promised future payment is so large a part of the contemplated reward that the services may be deemed to have been rendered for the purpose of acquiring the stock or the company's obligation. The situation is clearly different when the executive may at his election accept

30 Cf. Shaw v. Dreyfus, note 29 supra.

31 "We have taken the position in the past that no 'offer' or 'sale' is involved in the case of a non-contributory plan, where the employees are not requested to make any contributions, or in the case of a compulsory plan, where there is no element of volition on the part of employees whether or not to participate and make contributions." Second opinion of Assistant General Counsel, Sept. 1941, 1 CCH Fed. Sec. L. Serv. ¶2231.21. See also first opinion, id., ¶2231.20. [These opinions will be referred to frequently as "Opinions."] The commission's position in this respect was subsequently stated to Congress by Ganson Purcell, a former Chairman of the commission. Hearings on Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934, Committee on Interstate and Foreign Commerce, 77th Cong., 1st sess. (1941-1942) at 896:

". . . even where a plan involves securities, registration is not required in the many cases where the employees pay nothing for the securities, but receive an interest in an investment fund by way of bonus from their employer; for, of course, a gift [sic] is not a sale, and the Securities Act is concerned only with sales of securities."

32 Corporate history has made the law suspicious of the sale of shares for services. "Hence the usual stock bonus plan uses a cash bonus as a measuring rod, converting cash into shares at current value or some other price set in advance." WASHINGTON AND ROTHSCHILD, COMPENSATING THE CORPORATE EXECUTIVE, 2d ed., 99 (1951). The stock bonus plan qualified under §401 of the Internal Revenue Code may use as a measure a percentage of payroll and must use such a percentage to determine its maximum deduction for federal income tax purposes. See, by way of analogy, Securities Act Release No. 929 (1936) dealing with dividends payable in cash or securities.

33 This may even be true of a contributory pension plan. See note 37 infra, and second opinion of assistant general counsel, 1 CCH Fed. Sec. L. Serv. ¶2231.21.

a bonus either in cash or in stock;[34] in such a case, the plan may involve an "offer" of the stock and, depending upon other factors to be discussed below, registration may be required under the 1933 act.[35] As a practical matter, too, registration and a prospectus may under such circumstances be desirable to furnish the executive or employee with a real understanding of the merits of the investment he is making.[36]

Plans involving financial contributions by the executive. Stock purchase plans and thrift or contributory pension or profit-sharing plans usually require cash payments by the employee. These payments may be of two types: (1) an automatic deduction

[34] E.g., California Eastern Aviation, Inc. Stock Option Plan (officers and key executives have election to take incentive compensation in cash or have amount thereof applied to purchase of option stock, with reduction in option shares to the extent that cash is elected). Cf. Deep Rock Oil Company Bonus Plan ("The Company may elect to pay the bonus in cash, in an option to purchase Deep Rock common stock, or in a combination of cash and option"). A few recent plans give employees an election to take their profit-sharing distributions currently in cash or to have such distributions deposited on their behalf under a deferred profit-sharing plan. E.g., Employees' Profit-Sharing and Savings Plan of The Hanover Bank (each eligible employee has the option annually of depositing all or one-half of his profit-sharing distribution in a trust, the funds of which are invested in the bank's stock). The qualified status of such plans under §401 of the Internal Revenue Code has been the subject of controversy with the Treasury Department. See Rev. Rul. 56-497, Int. Rev. Bul. 1956-41.

[35] In an opinion rendered in Sept. 1941, the Assistant General Counsel of the Commission said: "The Commission has always taken the position that the offer or sale of interests in certain types of voluntary, contributory plans is subject to the registration and prospectus requirements of the Securities Act of 1933, unless one of the general exemptions in Sections 3 and 4 of the Act is available." 1 CCH Fed. Sec. L. Serv. ¶2231.20.

In a second opinion he supplemented this statement with the view that the "security" involved in such plans is normally an "investment contract," and added: "Frequently the interests may come also within the phrase 'certificate of interest or participation in a profit-sharing agreement.' This is quite aside from the possibility that certain plans under which the funds are invested in the employer's own stocks or bonds may involve a registerable sale of the latter securities in addition to the investment contracts. Whereas the issuer of the investment contracts is frequently the trust which is created under the plan rather than the employer itself, the purchase of any of the employer's securities with the funds held under the plan would require the filing of a registration statement by the employer." 1 CCH Fed. Sec. L. Serv. ¶2231.21. Compare Securities Act Release No. 929 (1936) involving dividends payable either in cash or securities.

[36] On this subject, the debates in Congress in 1934, respecting an amendment proposed by Senator Hastings, are illuminating. Mr. Hastings offered an amendment to §4(1), adopted by the Senate, exempting offers to employees "in connection with a bona fide plan for the payment of extra compensation or stock-investment plan for the exclusive benefit of such employees." See 1 CCH Fed. Sec. L. Serv. ¶2266.40. The conferees rejected this amendment, concluding that "the participants in employees' stock-investment plans may be in as great need of . . . protection . . . as are most other members of the public." Id. at ¶2266.42, quoting H. Rep. 1838 (Conference Report), 73d Cong., 2d sess., p. 41 (1935). If the employees' position in the company is such that they would have as good an understanding of the investment as if furnished with a prospectus, registration is probably unnecessary. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953) and at note 68 infra. Registration would not be necessary, of course, if only a single employment contract were involved. Cf. form S-8.

from salary which is compulsory in the sense that it is an incident of the job and is accepted as part of the job;[37] and (2) a purely voluntary arrangement. In the first case, it would appear again that there is no real "sale" of a security: the employee has no choice in the matter, and registration is just as inapposite as in the case of a stock bonus distribution.[38] In the second situation, where the plan is voluntary, the executive is offered an affirmative choice: he has the alternative of giving up present benefits in exchange for deferred benefits under the thrift or other contributory plan. Here, the SEC has taken the position that registration may be required.[39] Its position is sufficiently broad in theory to embrace all contributory pension and profit-sharing plans qualified under section 401 of the Internal Revenue Code even though no stock is involved.

The commission's position in this respect has been subject to criticism.[40] Registration of employee plans operates to discourage employers from adopting them. The expenses and difficulties of registration may be far from negligible.[41] Also, double registra-

37 E.g., Contributory Retirement Plan, Catalin Corp., approved April 19, 1956 (each person who becomes a salaried employee of the company must, as a condition of employment, become a participant in the plan on the date of eligibility and cannot withdraw or suspend contributions); Motorola, Inc. Employees' Savings and Profit-sharing Agreement (employees are notified on entering employment that after one year of employment they must, as a condition of continued employment, become participants in the plan and contribute a minimum of 2% of their compensation up to $200 a year).

38 The commission's view applies to this situation as well as to that involving no cash contribution. See Opinions, notes 35 and 31 supra, and the statement of Ganson Purcell, former Chairman of the commission, at Hearings, note 31 supra, at 896-897:

"Similarly, compulsory plans do not require registration. If a plan is so set up that participation in it is a condition of employment, the Commission has taken the position that, as in the case of a noncontributory or bonus plan, there is no sale involved. The purpose of the registration provisions of the Securities Act is to disclose to prospective investors the essential facts about securities which they are asked to buy, and if the employees are given no choice as to whether to buy or to refuse to buy there hardly seems any point in the registration process. As a practical matter, people do not decide, it seems to me, to take jobs or leave them because they like or dislike the company's investment plan."

See also id. at 899.

39 See Opinions, notes 35 and 31 supra; Hearings, note 31 supra, at 895, 966, 974 et seq. In the course of such hearings, Mr. Purcell defined an investment contract as any plan under which employees are given the opportunity to place their earnings in a fund to be invested for their benefit and later returned to them. Id. at 895.

40 See Report, note 23 supra; Hearings, note 31 supra, at 941, 946, 949, 950.

41 The major item of expense incurred in connection with the usual registration of securities for public sale is the underwriter's commission. This, of course, is not incurred in connection with any executive compensation plan. However, the issuer must pay a registration fee equal to .01% of the maximum aggregate price at which the securities are proposed to be offered, various legal, accounting, and printing expenses, and transfer agent fees. The accounting expense may be minimized by issuing the securities just after the close of the fiscal year, when current financial statements are available. Otherwise, a new audit might be necessary. For a general discussion of costs of flotation, see Securities Act Release No. 3412 (1951) and the various cost of flotation studies prepared periodically by the commission.

tion has sometimes been required; where a company offers a contributory profit-sharing savings plan to its employees under which the fund is to be invested in whole or in part in stock of the company, it may have to register both the stock and the plan.[42]

These requirements prompted a suggested modification of the statute in 1941 and a proposal by the commission to exempt "a savings, pension, profit-sharing or other employees' plan" meeting specific requirements, including the requirement of a trust for the exclusive benefit of participating employees, periodic cash contributions thereto by the employing company, and non-forfeitability of employee contributions.[43] The proposal, which, with the entire amendment program put forward at the time, ultimately failed of enactment presumably because of more urgent matters following Pearl Harbor, was opposed by employers' representatives principally on the ground that such a statute would constitute recognition that employee plans not meeting the statutory requirements were subject to registration.[44]

Accordingly, the commission has continued to adhere to its position that many contributory pension and profit-sharing plans must be registered.[45] In keeping with that position, it adopted in 1953 a simplified form for registering a "stock purchase, savings or other similar plan, and of the interests in such plan, for the benefit of employees."[46] The form applies only to plans involving securities of the employer, and the commission has not ruled on its applicability to other plans for employees or taken any action against any of the many plans which have not been registered. Its present

42 See Opinions, notes 35 and 31 supra.

43 The text of the proposed amendment is set forth in the Report, note 23 supra, at 37. The commission also proposed an amendment giving it power to exempt certain plans from registration. See REPORT ON PROPOSALS FOR AMENDMENTS OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, by Securities and Exchange Commission, Aug. 7, 1941, at 73-75.

44 Hearings, note 31 supra, e.g., at 941, 946.

45 The commission has taken this position in unpublished rulings when request for a ruling has been made. In a staff letter following promulgation for comment of Form S-8, note 46 infra, the commission said: "In the event that the plan does invest in the securities of the employer company in excess of such amount [i.e., the amount of the company's contributions], a registration statement or statements should be filed (in the absence of an appropriate exemption), both with respect to [the plan] participations and the company's securities, regardless of whether such shares are purchased directly from the company or on the open market." Letter dated May 12, 1953, note 47 infra. See also 1 P-H Sec. Reg. Serv. ¶1945.2.

46 Form S-8, designated as "a simplified form for the registration of securities offered pursuant to employees stock purchase plans." See Securities Act Release No. 3480 (1953). In the letter published after the form was promulgated for comment but before it was adopted, referred to note 45 supra, the commission stated that promulgation of the form was not to be construed as a reconsideration of the earlier commission position.

position appears to require registration only of contributory plans (not otherwise exempt) involving the purchase of securities in excess of the employer's contributions.[47]

Special problems relating to stock option and stock purchase plans. We have seen that an ordinary stock bonus should not, generally speaking, require registration since there is no election to make an investment.[48] With stock option and stock purchase plans, this reasoning does not apply, and here registration may often be necessary. As to option plans, an option plan may require registration in two ways: under the statutory definition of securities, the stock covered by the option may be subject to registration; and the option itself may under certain circumstances also require registration.

Registration of option. First, as to the option itself. We have seen that certain forms of option may not be considered a "security."[49] Even if so considered, however, the usual option granted an employee is not, properly speaking, an offer within the "public offering" concept. An option to an executive is commonly granted without requiring any immediate cash payment.[50] His contribution is in the form of services[51] and any financial contribution

47 Speaking only for the Division of Corporation Finance, its Assistant Director wrote in 1953, at a time when Form S-8, note 46 supra, had been proposed but not yet adopted, that pending adoption of a suitable form "no question will be raised with respect to the registration of participations in a voluntary contributory pension, profit-sharing, or similar plan *that does not invest in the securities of the employer company in an amount exceeding the company's contributions.*" Letter to Prentice-Hall signed Gerald J. O'Leary dated May 12, 1953, P-H, Pension and Profit-Sharing Serv. ¶9921 (italics added). Whether Form S-8 as adopted is considered a suitable form for registration for a plan not involving securities of the employer is not clear. It is also not clear from this letter whether authority under a plan to invest in employer securities in excess of the designated maximum in itself brings the plan within the registration requirements or whether it is only exercise of the authority which will do so.

In 1941, when the commission sought a congressional determination as to whether pension and similar plans should be subject to registration (see note 43 supra and related text), the commission stated that it would not attempt to enforce compliance until that determination had been made. See Hearings, note 31 supra, at 914 and SEC report, note 43 supra, at 37, 73-75. The commission has, however, accepted pension plans for registration. E.g., Johns-Manville plan (1941); Sears, Roebuck plans, note 12 supra; General Shoe Corporation plan (1956). The Johns-Manville plan was said to have been filed "under severe protest." Hearings, note 31 supra, at 974.

48 Note 31 supra, and related text.

49 Note 18 supra, and related text.

50 "No monetary consideration is received by the Company for the granting of any option under the plan, but no option is exercisable unless the optionee remains in the service of the Company for at least one year after the option is granted." Aluminium Limited, Proxy Statement for Annual Meeting on April 26, 1956, at 6. But cf. Commissioner v. Stone, (3d Cir. 1954) 210 F. (2d) 33 (payment by executive for marketable warrants).

51 Consult cases cited note 26 supra.

on his part will be made, if at all, when he exercises the option (if in fact he ever does exercise it). To such an option the same considerations would seem to apply as to a stock bonus distributed as an incident to employment without the payment of any cash consideration, and, as in the case of a stock bonus, the receipt of the option should not be deemed a sale under the Securities Act of 1933.[52] Whether or not the option plan itself must be registered will, of course, be largely an academic question if registration is required of the stock covered by the option.

A stock purchase plan stands on a different footing. Here, stock is being sold for a cash consideration, and, given the other factors requiring registration discussed below, registration would appear to be necessary—except perhaps in the unusual case when the purchase of stock is required as an incident to employment and the executive thus has no alternative but to make the investment.[53] That registration of the usual stock purchase plan is necessary, given other requirements such as a sufficiently large offering, appears to have been the view of many companies which adopted and registered such plans during the period when they were particularly in vogue prior to the enactment of the Revenue Act of 1950, with its tax recognition of restricted stock options.[54] The requirement of registration would appear to be applicable to a stock purchase plan even though, because of the employee's right to rescind at any time, the plan is considered the equivalent of an option for tax purposes:[55] for the purposes of the Securities Act of 1933, the employee has elected to make at least a temporary investment.

Registration of stock. As to the registration of stock which is the subject of an option or a stock purchase plan: here we have a problem which presents considerable difficulty. The executive

[52] Note 31 supra, and related text.

[53] Cf. plans cited note 37 supra. The requirement of a stock purchase would, of course, be imposed in the case of an executive who is to become a director of a company incorporated in a state requiring stock ownership as a condition of qualifying as a director. E.g., N.J. Stat. Ann. (1939) §14:7-2; Mont. Rev. Code (1947) §15-401. But registration would scarcely be required in the usual situation of qualifying shares.

[54] E.g., Employees' stock purchase plans of Union Carbide & Carbon Corporation; Stock Purchase Plan of Sinclair Oil Corporation.

[55] E.g., Employees Stock Plans of American Telephone and Telegraph Company, Dayton Power & Light Company, International Harvester Company. The variable price option provisions of the 1954 code [§421 (d) (1) (A) (ii)] were designed to qualify such plans as restricted stock options. See Rothschild, "Executive Compensation under the 1954 Code," COMM. & FIN. CHRON., March 31, 1955; Rudick, "Compensation of Executives under the 1954 Code," 33 TAXES 7 at 10 (1955).

often does not have sufficient funds of his own to pay for the stock subject to option, and it has been common practice for the executive to sell sufficient shares following exercise of the option to enable him to pay taxes and discharge indebtedness incurred in financing the exercise of the option.[56] Under such circumstances, the executive's purchase of stock upon exercise of the option may be held a purchase with a view to resale, making the executive an "underwriter" and requiring the company to file a registration statement.[57] In addition, the underlying stock may have to be registered if the offering to the executives is sufficiently broad in scope. The option is a continuous offering of the underlying stock. Even if the stock is to be purchased on the open market by and for the plan it must be registered as a solicitation of an offer to buy if the company participates in the plan.[58]

Many options cover stock already authorized and issued, and held by the company as treasury stock. Whenever this is the case, the stock may have been registered under the 1933 act at the time the issue was offered to the public—assuming that the facts then existing were such as to require registration. As to stock so registered, no further registration would seem necessary under the language of the act.[59] However, the SEC has taken the view that it is the "offering" rather than the "security" which is registered, and that if a second offering of a security is made, this offering must be registered even though the securities involved have already been registered in connection with a prior offering.[60]

56 Consult Burton Crane, N. Y. TIMES, May 5, 1956, p. 23:6-7; GILBERT, DIVIDENDS AND DEMOCRACY 50 (1956). "To enable them to exercise options granted under the Plan, certain officers have sold at market value shares of Common Stock of the Corporation previously acquired by them." Westinghouse Electric Corporation, Proxy Statement for annual meeting of April 6, 1955. Compare statement of Gwilym A. Price, President, Westinghouse Electric Corporation, as quoted in Gilbert, Sixteenth Annual Report of Stockholder Activities at Corporation Meetings during 1955, at 125-126. Consult Rothschild, "Financing Stock Purchases by Executives," 35 HARV. BUS REV. 136 (1957).

57 Securities Act of 1933, §2(11), 15 U.S.C. (1952) §77(b)(11). See notes 102 and 103, infra and related text. For the possible need to register the option and liability for failure to do so, see discussion in the text below in connection with notes 76 and 102.

58 That this point is giving concern is evident from provisions such as that in the Restricted Stock Option Plan of The Delaware, Lackawanna & Western Railroad, making exercise of the option contingent upon an opinion of counsel to the railroad that registration under the 1933 act will not be necessary.

59 Section 5(a) of the 1933 act opens with the words "Unless a registration statement is in effect as to a security. . . ." A registration statement, once effective, remains effective until some further action by the commission. The prospectus may require revision because of the length of time that has elapsed since its original use. See SEC Rule 396 relating to the termination of the effectiveness of a registration statement, and SEC Rule 427. See also note 60 infra.

60 When a new offering is made, the offeror must, of course, use a prospectus meeting the requirements of §10. Under §10(a)(3), a prospectus used more than nine months after

Frequently, an option will be given against authorized but unissued stock.[61] When the option is exercised, the company will issue new shares. Registration of the new shares may, however, be deferred if the options are closely held or are not presently exercisable on the theory that the options occupy the same status as preliminary negotiations with an underwriter.

(b) *Is the offering a public offering?* Registration is not required as to "transactions by an issuer not involving any *public* offering" of securities.[62] What constitutes an offering to the public is not defined anywhere in the act. Obviously, a plan for the benefit of only one or two employees would ordinarily be exempt.[63] The commission has not set any definite number of persons as marking the limit, but in an early opinion its General Counsel expressed the view that "under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering."[64] He pointed out that numerous factors are relevant in determining whether a public offering is being made, with the number of prospective offerees by no means a conclusive factor.[65]

the effective date of the registration statement must contain information as of a date not more than sixteen months prior to the use of the prospectus; under SEC rule 427 information contained in a registration statement may be omitted from a prospectus used more than nine months after the effective date of the registration statement to the extent that information as of not more than sixteen months prior to the use of the prospectus is contained in the prospectus. If the prospectus is to be extensively amended, the commission may well require a new registration statement or the original registration statement to be amended, in place of a mere amendment to the prospectus. Any one of these forms of amendment may give rise to difficult problems under the civil liabilities sections of the act, particularly with regard to the statute of limitations.

61 E.g., The Procter & Gamble Stock Option Plan. See statement for special meeting on May 22, 1956 (resolution to increase authorized shares for sale in connection with Stock Option Plan and release pre-emptive rights in connection therewith).

62 Securities Act of 1933, §4(1), 48 Stat. 77, as amended 15 U.S.C. (Supp. IV, 1956) §77(d)(1) (italics added). See Restricted Stock Option Plan for Key Employees of C. I. T. Financial Corporation (as modified July 31, 1956) (reserving authorized but unissued stock).

63 Unless, of course, a resale or distribution by the employee to the public was contemplated. See note 57 supra, and related discussion.

64 Opinion of General Counsel dated Jan. 24, 1935, 1 CCH Fed. Sec. L. Serv. ¶2266.17. The opinion has been cited with approval by the commission. In re Cristina Copper Mines, Inc., Securities Act Release No. 3439 (1952), '48-'52 CCH Fed. Sec. L. Rep. ¶76, 113.

65 Opinion of General Counsel cited note 64 supra. In the course of this opinion, it is said: "I also regard as significant the relationship between the issuer and the offerees. Thus, an offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage. This factor would be particularly important in offerings to employees, where a class of high executive officers would have a special relationship to the issuer which subordinate employees would not enjoy."

However, an offer of securities to 2,450 employees of the X corporation is certainly a "public offering." See Securities Act Release No. 97, Part 6, Dec. 28, 1933, in 1 CCH Fed. Sec. L. Serv. §2266.41 (extracts of FTC letters).

In determining whether an offering is exempt from registration because not of a public nature, the courts have set down the following general factors:[66]

(1) The person claiming the exemption has the burden of proof.
(2) The exemption from registration is strictly construed against the person claiming its benefit.
(3) An offering may be public even though it is restricted to a particular group of persons.
(4) "To determine the distinction between 'public' and 'private' in any particular context, it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction."[67]

The United States Supreme Court in *Securities and Exchange Commission v. Ralston Purina Co.*[68] specifically admonished against "superimposing a quantity limit on private offerings as a matter of statutory interpretation."[69] Instead, the Court adverted to the purpose of the statute, which was "to protect investors by promoting full disclosure of information thought necessary to informed investment" and held that "the natural way to interpret the private offering exemption is in the light of the statutory purpose."[70] Therefore, the Court stated, "the applicability of [the exemption] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.' "[71]

The *Ralston Purina* case involved a plan adopted by resolution of the corporate directors which authorized the sale of common stock to employees of the company at a price equal to or lower than the current market price of the stock. The company employed approximately 7,000 persons, and it was conceded that an offering

66 SEC v. Sunbeam Gold Mines Co., (9th Cir. 1938) 95 F. (2d) 699; followed in Merger Mines Corp. v. Grismer, (9th Cir. 1943) 137 F. (2d) 335 at 341 (offering to 1,100 stockholders found to be a public offering); Corporation Trust Co. v. Logan, (D.C.Del. 1943) 52 F. Supp. 999 at 1002; Campbell v. Degenther, (W.D.Pa. 1951) 97 F. Supp. 975 at 977. Similar general principles are stated in decisions construing state securities laws. Ex parte Leach, 215 Cal. 536, 12 P. (2d) 3 (1932); People v. Montague, 280 Mich. 610, 274 N.W. 347 (1937).

67 SEC v. Sunbeam Gold Mines Co., (9th Cir. 1938) 95 F. (2d) 699 at 701.

68 346 U.S. 119 (1953).

69 Id. at 125.

70 Id. at 124-125.

71 Id. at 125.

to all its employees would be public. The company contended, however, that the plan was limited to "key employees," and therefore entitled to the exemption from registration for non-public offerings. The company estimated that the number of key employees to whom common stock was offered under the plan was about 500.

The Supreme Court did not mention the number of employee-offerees and, apparently, considered it of little significance. In a dictum the Court stated that an offering to executive personnel who, because of their position, have access to the same kind of information as the act would make available through a registration statement, would be an exempt offering regardless of the number of offerees.[72]

Rarely has the commission exempted an offering to employees when more than 100 are eligible to participate. In one case, a corporation with over 100,000 employees requested a commission interpretation as to whether an executive stock option program in which the number of employees would range from 100 to 220, depending upon the salary level chosen, would constitute a private offering. The commission ruled that it would not insist upon registration if the company amended the plan to limit the offering to not more than 125 key executives, all of whom were fully familiar with the business affairs of the company.

A different problem is presented if there is likelihood of a resale by the offerees. An offering to even one executive may call for registration if the purchase is made for resale to the public.[73] In an endeavor to obtain protection against this possibility, many companies follow the practice of asking for a certificate from the purchasing executive stating that he is buying for investment and

[72] Id. at 125-126. The commission had urged that "an offering to a substantial number of the public" was not exempt and that "whatever the special circumstances, the . . . exemption [was] inapplicable when a large number of offerees [was] involved." Brief for the Securities and Exchange Commission, p. 21. In rejecting this position, the Court conceded that an offering to a substantial number of persons would rarely be exempt and that the commission, in enforcing the statute, could use some kind of numerical test in deciding whether to investigate particular claims of exemption, but it stated that "there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation." Ibid. Conversely, the Court quoted (at 125, n. 11) from a dictum of Viscount Sumner in Nash v. Lynde, [1929] A.C. 158 at 169: " 'The public'. . . is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole."

[73] Cf. the dictum from the British decision in Nash v. Lynde, note 72 supra. Such persons are "underwriters" under §2(11) of the 1933 act. See notes 102 and 103 infra, and related text.

not for resale.[74] This may be made part of the original bargain. For example, an option agreement, in addition to providing that the option will be exercised only for the purpose of investment, may further require a certificate at the time the option is exercised that the shares are not being acquired with a view to their distribution. If the corporation in good faith relies on such a covenant in delivering the stock (or on a certification of intent furnished at the time the actual purchase is made), it should be entitled to freedom from liability for failure to register, even though some change of circumstances later forces the purchaser to make a sale.[75]

On the other hand, when the circumstances are such that an executive could not reasonably have been expected to finance exercise of the option except through sales of option shares, a certificate of intention by the executive may not serve to exonerate the company from liability.[76] Moreover, if an executive owning shares of his company's stock receives additional shares by way of a stock bonus or under a stock option or purchase plan and soon thereafter effects sales,[77] he may not be permitted to say that the sales were of the prior stock which he owned, and the transaction may be considered as a device to avoid registration of the newly delivered stock. When an executive already owning stock receives additional stock, the company may wish to have the executive's certificate contain an added statement that he is not acquiring the bonus stock (or will not exercise an option) with a view to distributing shares of stock previously acquired.

Another means of protecting the company, in cases where a security is being issued, is to impose a restriction on sales of the security. The plan may provide, for example, that the employee may not sell his securities without first giving the company an

74 "All stock purchased pursuant to each option shall be purchased for investment and not with a view to distribution. Each optionee, or his surviving spouse or children, as the case may be, shall be required to give satisfactory assurances to that effect in connection with the exercise of each option." Worthington Pump Co., Stock Option Plan. Cf. Stock Option Incentive Plan, Lithium Corporation of America, ¶5c: "Except in the case of exercise of an option by an executor or administrator of the estate of the holder of an option, the person exercising the option shall certify at the time of such exercise that he is acquiring shares being purchased for investment and not with any intention to resell or distribute the same." For other clauses, see CASEY AND ROTHSCHILD, PAY CONTRACTS WITH KEY MEN 46-47 (1953).

75 Cf. Opinion of General Counsel, Dec. 16, 1935, Securities Act Release No. 603, 1 CCH Fed. Sec. L. Serv. ¶2266.93.

76 See Raytheon Mfg. Co. plan, S.E.C. file No. 2-11885 (1955), where Form S-8 was unavailable to the issuer since the purchasers were not taking for investment. The filing was, therefore on Form S-1.

77 Consult note 56 supra.

opportunity to purchase. An even more extreme step is to agree that the company is to repurchase at a stated price upon demand by the employee, and that the employee must make no other sale. Or the company may require the executive to hold the stock for a designated period of time.[78] Agreements of this nature impair the market value of the stock, which may be of tax advantage, particularly in the case of closely held companies where fair market value may present an arguable question,[79] but may often not be practical.[80]

The consequences of a public sale by the executive after he has obtained a security will be discussed below.[81]

3. *Is the Transaction Exempt on Other Grounds?* The size of the total offering of securities under the plan may, in itself, give rise to specific exemption from general registration requirements. Pursuant to general statutory authority,[82] issuers of securities aggregating not more than $300,000 need not meet the requirements of full registration.[83] This exemption is not automatic but is available only after complying with prescribed conditions, which include filing a letter of notification of the issue with the regional office of the commission[84] and, for offerings aggregating over $50,-

[78] E.g., Employees Stock Purchase Plan of New York Central R. Co. (executives required to agree not to sell stock, without the consent of the Board of Directors, for a period of three years from the date of acquisition, in consideration of agreement by company to repay purchase price on tender of stock during such three-year period). A shorter period of time might be construed as an intention to sell after the period, which would be inconsistent with an investment intention.

[79] Consult Rothschild, "Compensation and Incentives for Executives," 381 at 395-396, and King & Mattersdorf, "How to Make Restrictive Deals Fixing Value of Property," 1003 at 1009-1010, ENCYCLOPEDIA OF TAX PROCEDURES (1956); Greenberger, "Valuation Problems in Dispositions of Property," 14th INST. FED. TAX. 409 at 419 (1956) (discussing related gift and estate tax questions). For a discussion of other methods of fixing the option price of stock of closely held corporations, see Lentz, "Restricted Stock Options—Problems of the Executive," 14th INST. FED. TAX 1053, 1058 (1956).

[80] Legal considerations may also enter. For example, under local law the corporation's obligation to repurchase may be enforceable only if the company has a surplus. See Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (1928).

[81] Note 102 infra, and related text.

[82] Securities Act of 1933, §3(b), as amended by 59 Stat. 167 (1945), 15 U.S.C. (1952) §77c(b).

[83] SEC Reg. A. The regulation does not confer exemption from civil liabilities for misstating or omissions or from the criminal liabilities for fraud imposed by §17 of the act. The exemption was originally confined by statute to small issues and by regulation thereunder first to issues aggregating not more than $30,000 and later to $100,000. The increase to $300,000 took place on May 21, 1945. An increase in the exemption to an aggregate of $500,000 was proposed by the commission in 1954 and incorporated in a bill which was passed by the Senate. S. 2846, 83d Cong., 2d sess. But the change was rejected by the House and eliminated from the measure in conference.

[84] Form 1-A.

000, filing and use of an offering circular giving basic information about the issuer and the securities.[85]

The exemption is available if the total offerings of the same security during a twelve-month period do not exceed $300,000.[86] Corporations may thus be able to meet option or bonus plan requirements by issues within successive twelve-month periods not exceeding $300,000 each. However, it may often be difficult to predict in advance whether the $300,000 exemption will be available. For example, if options are given allowing each of three grantees to take down $100,000 of stock each year for five years, who can say whether the $300,000 total in the third year will be the only stock in that class offered by the corporation in that year? If the corporation should offer stock in that year to other purchasers, it would appear that the $300,000 limit has been exceeded even though the $300,000 issue had been provided for in a prior year. Nor would it be in the best interests of the company to contract against exhausting the $300,000 limit by sales to others. Such considerations may render the $300,000 exemption of limited usefulness in many situations.

Additional grounds for exemption may be available in a particular case. For example, the plan may not involve any offering in interstate commerce or require the use of the mails.[87] However, such a possibility is rare and this will usually be a risky exemption on which to rely. To bring the transaction within the act it is not necessary that a prospectus or a security be mailed; any use of the mails or of interstate communication is sufficient.[88]

[85] The information is filed in the office of the commission for the region in which the corporation's principal business operations are conducted. Filing must take place at least ten days before the offering commences.

[86] SEC Reg. A, Rule 254. Under an early regulation, the exemption (then $100,000) was available even though successive offerings of the same class were contemplated. See note, 26 CORN. L. Q. 343 (1941). With regard to contributory plans, the Division of Corporation Finance has taken the position that exemption may be obtained for a plan "if the amount of the offering, as measured by the employees' contributions, does not exceed $300,000 for any one-year period." Letter dated May 12, 1953, cited note 47 supra. By a change in the regulation adopted in 1956 it has been specifically provided that the computation of the $300,000 maximum amount of securities which may be offered under Regulation A includes all securities issued or proposed to be issued to directors, officers, promoters, or underwriters unless such securities are effectively kept off the market for one year after the commencement of the offering under the regulation. Securities Act Release No. 3663 (1956).

[87] Securities Act of 1933, §3 (a) (11), as amended, 15 U.S.C. (Supp. IV, 1956) §77c (a) (11).

[88] Landay v. United States, (6th Cir. 1939) 108 F. (2d) 698; Kopald-Quinn & Co. v. United States, (5th Cir. 1939) 101 F. (2d) 628, cert. den., sub nom. Ricebaum v. United States, 307 U.S. 628 (1939); Pace v. United States, (5th Cir. 1938) 94 F. (2d) 591 (letter expressing thanks for orders given salesmen); Coplin v. United States, (9th Cir. 1937) 88 F. (2d) 652 (long-distance telephone call only); Kaufman v. United States, (6th Cir. 1947) 163 F. (2d) 404, cert. den. 333 U.S. 857 (1948); Bobbroff v. United States, (9th Cir. 1953) 202 F. (2d) 389 (merely mailing an offer violates the Securities Act).

The plan may also be exempt because offers and sales are limited to employees residing in the state in which the company is incorporated and doing business.[89] Exceptional circumstances may give rise to still other grounds for exemption.[90]

4. *What Will Be the Consequences of a Sale by the Executive?* So far we have been speaking only of the company's obligation to register. What of the executive's obligation? If the company in fact registers, the executive commonly has no cause for worry: he can freely resell, to one or many purchasers.[91] If the company should have registered, but has not, the directors and officers will be subject to liability for their part in the failure to register,[92] and may also face liability if they resell securities they themselves have purchased.[93] If the company was not required to register and did not do so, may the executive sell his securities without registering? To answer this question we must make much the same inquiries we made when deciding whether the company itself must register. Thus, if the executive makes no public offering, e.g., if he sells to a limited group of persons, and such persons purchase without a view to distribution, he has not violated the act.[94]

Again, suppose that the company would have been required to register except for the executive's certification that he was buying for investment and not for resale: if he later resells to the public because changed circumstances force him to do so, he may do so

89 Securities Act of 1933, §3 (a) (11), as amended, 15 U.S.C. (Supp. IV, 1956) §77c (a) (11) (formerly §5 (c) of the act of 1933). See second opinion of General Counsel, cited, note 31 supra. For limitation as to applicability of this exemption, see opinion of General Counsel, SEC Release No. 1459, May 29, 1937, 1 CCH Fed. Sec. L. Serv. ¶2245.25.

90 The General Counsel's second opinion, note 34 supra, states: "The exemptions which may be available for plans instituted by the normal industrial company are Section 3 (a) (1), in the case of plans which have been continuously in existence since some date prior to July 27, 1933, and under which there has been no substantial change since that date in the nature of the security or of the terms of the offering; Section 3 (a) (8), for certain types of insured plans; Section 3 (a) (11), for plans which are limited to employees residing in the state in which the issuer is a resident or is incorporated and doing business; Section 3 (b) and Regulation A thereunder, for plans under which the maximum potential employees' contributions do not exceed $100,000 [now $300,000] each year; and Section 4 (1), for plans which are offered privately to a limited number of employees."

The commission has adopted three other sets of exemptive regulations: Regulation A-M exempts certain issues of assessable mining stock of less than $100,000; Regulation B is applicable to various kinds of fractional undivided interests in oil or gas rights of up to $100,000 in total amount; and Regulation B-T exempts certain certificates of interest in trusts or unincorporated associations whose assets consists substantially of fractional oil or gas leasehold interests.

91 If he is an "underwriter" or "dealer," he may be subject to special risks. See discussion below.

92 Under §11 of the act.

93 Under §12 of the act. See also §§5, 20, 24 and §11.

94 Cf. Opinion cited note 75 supra and text in connection therewith.

legally.[95] However, if in such a situation and in spite of such a certificate he makes an unregistered public offering, as by selling his shares on a national securities exchange, and if in fact there has been no change in circumstances, he may be held to be guilty of a violation of the act.[96]

Under many stock option plans, the executive is unable to finance the exercise of his option with his own funds. A frequent practice has been for him to borrow in order to exercise the option. Following the six-month holding period prescribed by the Internal Revenue Code for the favored tax treatment accorded restricted stock options[97] and long-term capital gains generally[98] and, in the case of listed companies, by the Securities Exchange Act of 1934 to avoid liability for short-swing profits,[99] the executive will sell sufficient shares to discharge or reduce his indebtedness and to pay taxes on the profits realized upon such a sale. In such circumstances, failure to register the stock may well give rise to a claim that the option was exercised and at least part of the option shares were purchased with a view to sale to the public,[100] which would destroy the exemption for the entire transaction. Such a claim may well be sustained if the executive is unable to disprove that he could not reasonably have expected to finance such purchase except through sale of option shares. It may likewise be held a violation of the act if the executive, soon after purchasing shares under a stock option or stock purchase plan, or receiving a stock bonus, sells other shares that he may own.[101]

By purchasing with the intention of selling the securities received, the executive may subject himself to the liabilities of an underwriter, defined by the 1933 act as "any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertak-

95 Ibid.

96 The statute of limitations provided by §13 of the act may, of course, provide a defense.

97 I.R.C., §421 (a).

98 Id., §1201.

99 1934 act, §16 (b), 15 U.S.C. (1952) §78p (b).

100 But cf. Siebenthaler v. Aircraft Accessories Corp., CCH Fed. Sec. L. Rep. 1941-44, ¶90,122 (W. D. Mo. 1940) (transferable options were held to be exempt from registration, in spite of the possibility that they might be sold), app. dismissed (8th Cir. 1941) 121 F. (2d) 1018.

101 Note 76 supra.

ing. . . ."[102] An underwriter is subject to liability to any person acquiring a security under a registration statement containing an untrue statement of a material fact or omitting to state a material fact.[103] Upon sale of the securities, the executive may also be subject to the somewhat more limited liability of a seller.[104]

Where there has been a failure to register, sales of stock have resulted in the issuance of injunctions pursuant to commission action.[105] Criminal prosecutions under section 5 of the 1933 act are in the hands of the Department of Justice, but appear seldom to have been instituted unless there has been evidence of deliberate intention to avoid registration or a considerable background of fraud and actual loss to investors.[106]

The commission has another means of enforcement in these situations without invoking the assistance of the Department of Justice. If a sale has been made by *A* through *B*, a broker, and the security (in violation of law) is not registered, the commission can move to revoke *B*'s broker-dealer registration.[107] In such proceedings, however, the commission must show (1) a willful violation of the 1933 act, and (2) that it would be to the public interest to revoke the broker-dealer registration.[108] In view of the second requirement, the commission brings such proceedings only in flagrant cases.[109] The sale of unregistered securities for a corpo-

102 Securities Act of 1933, §2 (11), as amended, 15 U.S.C. (1952) §77 (b) (11). Conceivably, he can also be a "dealer," defined as "any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling or otherwise dealing or trading in securities issued by another person." Id., §2 (12), 15 U.S.C. §77 (b) (12).

103 Securities Act of 1933, §11 (a) (5), 15 U.S.C. (1952) §77k (a) (5). This liability also extends to every person who signed the registration statement, and to every person who was a director or partner of or in the issuer. Securities Act of 1933, §11 (a) (1), (2), 15 U.S.C. (1952) §77k (a) (1), (2). Irrespective of his conjectural liability as an underwriter, the executive granted the option may have incurred liability as a director of the issuer.

104 Id., §17, as amended, 15 U.S.C. (1952; Supp. IV, 1956) §77q.

105 See Annual Reports to Congress of the Securities and Exchange Commission; e.g., Annual Report for Fiscal Year ending June 30, 1954 at pp. 19-20.

106 See e.g., SEC, TWENTIETH ANNUAL REPORT 100-104 (1954).

107 Securities Exchange Act of 1934, §15 (b), as amended, 15 U.S.C. (1952) §78o (b).

108 Under §15 (b), other grounds exist for the revocation of registration but the two mentioned are those here pertinent. It has been proposed that the commission be given the power of suspension as well as revocation. See Representatives' Report, note 23, supra at 251.

109 Matter of Marks, Exchange Act Release No. 3906, Jan. 30, 1947, 1 CCH Fed. Sec. L. Serv. ¶2281.47 (public interest held to require denial of registration as a broker and dealer to applicant who had sold and delivered non-registered shares); Matter of Ira

rate executive would seldom demand this penalty against a broker, unless the latter acted willfully and with full knowledge of all the facts.

5. *Will a Violation of the Act Render the Compensation Plan Invalid?* Under what circumstances will nonobservance of the 1933 act prevent enforcement of rights granted to an executive of the issuer? A partial answer to this question was supplied by the decision of the United States Supreme Court in *A. C. Frost & Co. v. Coeur D'Alene Mines Corp.*[110] An option was given to one Boland by the defendant Mines Corporation, Boland's connection with the company (if any) not appearing in the opinion or the record. Boland assigned the entire option to the plaintiff, Frost & Company. The defendant repudiated the option agreement, and plaintiff sued for damages. The issuer's defense to the action was that the subject of the option was treasury stock which had never been registered under the Securities Act of 1933, and that the option contract was, therefore, illegal and void.

The Supreme Court pointed out that the purpose of the securities legislation was the protection of innocent purchasers, and that, rather than declaring such contracts void, the Act of 1933 imposes sanctions and raises liabilities in favor of those who are injured. The contract itself was held not to be against public policy and not unenforceable, the Court indicating that the only consequences of failure to register were deprivation of the use of the mails and of instrumentalities of interstate commerce, and liability to reimburse purchasers of such securities.

Haupt & Co., Exchange Act Release No. 3845, Aug. 21, 1946, 2 CCH Fed. Sec. L. Serv. ¶23,361.15 (20-day suspension from NASD for use of mails in sale of unregistered securities); Matter of Stowitts, 6 S.E.C. 97 (1939) (sales made after warning that instruments sold were securities). Matter of Gearhart & Otis, Exchange Act Release No. 5186 (1955) (public interest held to require supervision from membership in National Association of Securities Dealers for 10 days for selling unregistered securities); Matter of Petroleum Equities Corp., Exchange Act Release No. 5168 (1955) (public interest held to require suspension from membership in National Association of Securities Dealers for 90 days for selling unregistered securities; Matter of Reilly and Company, Exchange Act Release No. 5149 (1955) (sales of unregistered securities, after warning, held to require revocation of broker's registration).

110 312 U.S. 38 (1941). More recently, Justice Harlan of the Supreme Court has pointed out, upon authority of the Frost case, that shares may be validly issued even if necessary approval of the issuance by the appropriate government agency has not been obtained. Breswick & Co. v. United States, 75 S. Ct. 912 at 917 (1955). See also A. C. Frost & Co. v. Coeur d'Alene Mines Corp., 63 Idaho 20, 115 P. (2d) 928 (1941).

The commission has taken the position that the contract in the *Frost* case was not calculated to harm the investing public and that, notwithstanding the *Frost* case, a contract in violation of the Securities Act calculated to cause such harm should not be enforceable.[111] The United States Court of Appeals for the Second Circuit has concurred in this general view and has declared that each case must be governed by its particular facts.[112]

The *Frost* case does not preclude rescission by an investor of a sale of a security in violation of the 1933 act. Under the act, such an investor is entitled to recover the consideration paid,[113] a provision which has been held to authorize a bill in equity for rescission.[114] Thus, while under the *Frost* case employees participating in a stock purchase or pension plan can enforce their rights thereunder, irrespective of whether the plan was registered in accordance with the Securities Act of 1933, they may at the same time be entitled to rescind, and to a return of payments theretofore made, if the plan should have been but was not in fact registered under the act.

B. *The Securities Exchange Act of 1934*

Registration. Registration under the Act of 1934 is at the present time required only for securities listed on a national securities exchange.[115] Since securities so listed are necessarily offered to the public, they must, to the extent so offered after 1933, in

111 See brief filed by commission in Judson v. Buckley, (2d Cir. 1942) 130 F. (2d) 174, cert. den. 317 U.S. 679 (1942).

112 Judson v. Buckley, 130 F. (2d) 174 at 179-180.

113 Sec. 12, as amended, 15 U.S.C. (Supp. IV, 1956) §77*l*. See also §§5 and 17, as amended, 15 U.S.C. (Supp. IV, 1956) §§77e and 77q.

114 Deckert v. Independence Corp., 311 U.S. 282 (1940); Corporation Trust Co. v. Logan, (D.C. Del. 1943) 52 F. Supp. 999 at 1003 (distinguishing the Frost case).

115 In 1946 and again in 1950 the Securities and Exchange Commission proposed to Congress amendment of the Act of 1934 to extend the provisions of sections 12, 13, 14 and 16 of the act to corporations having at least $3,000,000 in assets and at least 300 security holders. See SEC, Proposal to Safeguard Investors in Unregistered Securities, H. Doc. 672, 79th Cong., 2d sess. (1946), and Supplemental Report to Congress (1950). A bill incorporating this proposal in the 81st Congress was sponsored by Senator Frear. S. 2408, 1st sess. (1949). In 1955 Senator Fulbright sponsored a bill to extend the provisions of such sections to corporations having at least $5,000,000 in assets and at least 500 security holders. 84th Cong., 1st sess., S. 2054, and Hearings on S. 2054. In 1956, the extension received the support of the Cabinet Committee on Small Business. N. Y. TIMES, Aug. 10, 1956, p. 21: 3. In 1957 Senator Fulbright again sponsored a bill with the same general purpose, S. 1168, 85th Cong., 1st sess.

most circumstances have been registered under the Securities Act of 1933.[116]

In the field of compensation, the only securities likely to be listed on an exchange are shares of stock issued under a bonus, stock option or stock purchase plan. As to options: aside from the requirements for registration of the stock which is the subject of the option, the option itself is considered by the commission as embraced within the definition of both a "security"[117] and an "equity security"[118] in the Securities Exchange Act of 1934, unless the option is personal and non-transferable.[119] However, registration of the option itself, as distinguished from the option stock, would be required only where a class of options or warrants is sought to be listed on a national securities exchange, the trading to be conducted in the options or warrants rather than in the stock.[120]

We have seen that under the Act of 1933 it has been possible to register authorized stock when it is proposed to issue the stock within a reasonable time after the registration statement becomes effective.[121] Under the 1934 act, immediate registration of the entire block of securities may be made, even though some securities will be issued only at a later time, provided the purpose of the later issue is stated at the time. Application for registration of the whole eventual issue is made initially, but the unissued shares may be temporarily exempted while traded on a "when-issued" basis.[122]

116 Unless, of course, the securites were sold prior to July 27, 1933, when the registration provisions of the 1933 act took effect. See Securities Act of 1933, §3 (a) (1), 15 U.S.C. (1952) §77c (a) (1).

117 "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement . . . or warrant or right to subscribe to or purchase any of the foregoing; . . ." 48 Stat. 883, 15 U.S.C. (1952) §78c (a) (10).

118 "The term 'equity security' means any stock or similar security; 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; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security." 48 Stat. 884, 15 U.S.C. (1952) §78c (a) (11).

119 See note 18 supra, and related text.

120 Compare the situation under the 1933 act as discussed note 48 supra, and related text.

121 See note 60 supra, and related text.

122 Securities Exchange Act Rule X-12A-5.

Listing Securities on a Stock Exchange. Requirements for listing on securities exchanges vary with each exchange. The New York Stock Exchange, for example, asks issuing corporations to enter into a form of agreement designed to protect the exchange and the investing public.[123] In addition, that exchange requires the approval of stockholders, following appropriate disclosure, as a condition of listing securities to be issued under options to directors, officers or key employees, regardless of whether such stockholder authorization is required by law or company charter.[124] Exceptions to this policy may be made for option plans in which all, or substantially all, employees participate, depending on the maximum amount issuable to any individual and the proportionate distribution contemplated; such approval may likewise be dispensed with in the case of an option granted an executive prior to his employment as an essential inducement for his contract.[125]

The exchange prevents dealing in unlisted blocks of listed securities through agreements made between the exchange and various banks which act as registrars for issuing corporations.[126] The corporation, in its listing application to the exchange, agrees to maintain a transfer agent and registrar in Manhattan, and such

[123] The current form of New York Stock Exchange listing agreement includes the following paragraph bearing upon stock options (Art. I):

> "6. The Corporation will disclose in its annual report to shareholders, for the year covered by the report, (1) the number of shares of its stock issuable under outstanding options at the beginning of the year; separate totals of changes in the number of shares of its stock under option resulting from issuance, exercise, expiration or cancellation of options; and the number of shares issuable under outstanding options at the close of the year, (2) the number of unoptioned shares available at the beginning and at the close of the year for the granting of options under an option plan, and (3) any changes in the exercise price of outstanding options, through cancellation and reissuance or otherwise, except price changes resulting from the normal operation of anti-dilution provisions of the options."

N.Y. Stock Exchange, COMPANY MANUAL (1956) A-24; see also B-16, B-17.

[124] "As a matter of policy, the Exchange looks for stockholder approval in relation to options granted to directors, officers or key employees as a prerequisite to its authorizing listing of the securities issuable pursuant to such options, whether or not such approval is required by law or by the company's charter." N. Y. Stock Exchange, COMPANY MANUAL (1956) B-16, B-17, A-118, A-119.

[125] Id., A-119, A-120. The New York Stock Exchange formerly had a rule which limited the term of an employee stock option to ten years from the date when the option was granted and precluded the grant of an option after five years from the date of stockholder approval. COMPANY MANUAL (1956 edition prior to amendment), note 124 supra, at A-119 and A-121.

[126] These agreements, of course, do not prevent an active over-the-counter market in listed securities.

agent enters into an agreement with the exchange not to issue new securities without authority from the exchange.[127]

It is understood that the exchanges generally do not undertake responsibility for the enforcement of the Securities Act of 1933. The listing application must describe the status of the securities under federal securities legislation and is accompanied by an opinion of the issuer's counsel as to whether registration under the Act of 1933 is necessary. The exchanges usually accept such an opinion, unless there is some particular reason to investigate. In the case of an ordinary option to corporate executives, for example, the customary certificate by the executives that they do not plan to make a public distribution will commonly be accepted without question. This attitude of the exchanges is understandable. The primary responsibility in such matters must rest with the commission. When a company files a registration statement with the commission under the 1934 act, the application for registration must indicate whether or not registration under the Act of 1933 has been obtained and, if not, why not.[128] During the thirty-day waiting period,[129] the commission has ample opportunity to investigate; if it is satisfied, the exchanges ordinarily do not feel called upon to raise further inquiries as to the observance of the 1933 act.

II. DISCLOSURE OF THE TERMS OF COMPENSATION ARRANGEMENTS

If a compensation contract or plan, or a security to be issued in connection therewith, is registered as a security issue under either the Securities Act of 1933 or the Securities Exchange Act of 1934, a disclosure of its terms will be effected through the registration statement. However, a company which is not required to register a compensation plan may, nevertheless, be called upon to disclose the plan's terms by reason of having registered one or more of the

127 Listing Agreement, note 123 supra, §III, ¶1; COMPANY MANUAL, note 124 supra, at A-27.

128 See Item 11 (b) of Form 10 promulgated under the 1934 act, 1 P-H Sec. Reg. Serv. ¶13,141.

129 Unless the commission takes action, a registration statement under the 1934 act becomes effective thirty days after receipt by the commission of a certification of approval by the exchange authorities. Securities Exchange Act of 1934, §12 (d), as amended, 15 U.S.C. (Supp. IV, 1956) §78*l* (d). The commission may, however, accelerate the effective date. See Exchange Act Release No. 3085, Dec. 6, 1941, 2 CCH Fed. Sec. L. Serv. ¶22,845.10.

company's issues of stock or bonds under the 1933 act or under the 1934 act. Most large companies are also called upon to disclose the terms of special compensation plans for executives in proxy statements as well as in registration statements.

In the pages which follow, we will take up the disclosures required by the registration statement, and then turn to those required by the proxy regulations and the reports required under the Securities Exchange Act of 1934.

Registration Requirements Under the 1933 Act. The Securities Act of 1933 requires that registration statements include "dates of and parties to, and the general effect concisely stated of every material contract, made not in the ordinary course of business. . . . Any management contract or contract providing for special bonuses or profit-sharing arrangements . . . shall be deemed a material contract."[130] In addition, the form issued by the commission requires the registration statement to give the remuneration of directors and of its officers and others, naming them whenever the remuneration exceeds $30,000 a year.[131]

Through forms promulgated under the act, the commission requires registration statements to disclose in some detail the remuneration paid by the registering corporation to its top executives. In addition, material contracts not made in the ordinary course of business must be filed as exhibits, the commission's instructions specifically requiring that any management contract or any contract providing for special bonuses or profit-sharing arrangements shall be deemed material with only minor exceptions, including as an exception agreements with managers of stores in a chain store or similar organization and contracts for salesmen's bonuses.[132]

Registration Requirements Under the 1934 Act. The Securities Exchange Act of 1934 requires applications for registration of securities under that act to contain information with respect to the remuneration, among others, of directors and officers, with respect to their interests in securities of the issuer and other material contracts with the issuer, with respect to others than directors

130 Securities Exchange Act of 1933, Schedule A (24), 48 Stat. 88, 15 U.S.C. (1952) §77aa.

131 Id., Schedule A (14).

132 Instructions as to exhibits to Form S-1; Items 13 (a) and 13 (c).

and officers exceeding $30,000 per annum, with respect to bonus and profit-sharing arrangements and options, and with respect to options existing or to be created.[133]

The form prescribed by the commission under the 1934 act contains the same requirements with respect to remuneration and related subjects as the form prescribed under the 1933 act.[134]

Proxy Statements. The Securities Exchange Act of 1934[135] makes it unlawful, with minor exceptions,[136] to solicit proxies in respect of any securities subject to registration under that act[137] except in accordance with rules prescribed by the commission. The purpose of this provision was to compel full disclosure of the nature and effect of any proposal which stockholders are being asked to adopt—to enable the stockholder to have "adequate knowledge as to the manner in which his interests are being served."[138] Pursuant to the authority thus conferred, the commission has adopted detailed rules requiring, with respect to remuneration and related matters, substantially the same information as that required for registration under the 1933 and 1934 acts, respectively.[139] Such infor-

133 Securities Exchange Act of 1934, §12(b)(1), 15 U.S.C. (1952) §78*l*(b)(1).

134 Form 10, Items 9, 10, 11 and 13.

135 Sec. 14(a), 15 U.S.C. (1952) §78n(a). See Dean, "Non-Compliance with Proxy Regulations: Effect on Ability of Corporation to Hold Valid Meeting," 24 CORN. L.Q. 483 (1939); Bernstein and Fischer, "The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy," 7 UNIV. CHI. L. REV. 226 (1940). See also 1 P-H Sec. Reg. Serv. ¶¶11,570 to 11,591. Regulation X-14 was promulgated by Exchange Act Release No. 1823, Aug. 11, 1938, effective Oct. 1, 1938, last amended by Exchange Act Release No. 5276 (1956). The proxy rules do not compel submission of any corporate acts to stockholders; they simply provide for disclosure in case submission is made. See note 141 infra, and related text. Investment companies, on the other hand, are required to submit certain compensation plans to stockholders unless adopted by a disinterested board of directors. Investment Company Act of 1940, §15(c), 54 Stat. 813, 15 U.S.C. (1952) §80a-15(c).

136 SEC Reg. X-14, Rule X-14A-2. The exceptions are solicitations otherwise than on behalf of management when less than 10 people are solicited; solicitations by persons who hold securities and receive no remuneration for the solicitation and who do no more than impartially instruct the person solicited; solicitations with regard to securities held beneficially; solicitations involved in the offer or sale of a certificate of deposit or other security registered under the Securities Act of 1933; solicitations with respect to a plan of reorganization under chapter X of the Bankruptcy Act made after compliance with sections 174 and 175 of that act; solicitations subject to Rule U-62 under the Public Utility Holding Company Act; solicitations in newspapers which simply state the source from which copies of the proxy statement, proxy, and other soliciting material may be obtained.

137 At the present time, corporations with a security listed on a national securities exchange. For the proposed extension of these requirements, see note 115 supra.

138 S. Rep. 792, 73d Cong., 2d sess. (1934). See also H. Rep. 1833, 73d Cong., 2d sess. (1934).

139 Schedule 14A to SEC Reg. X-14. Companies with securities registered on a national securities exchange must file their material contracts as part of the original applica-

mation must be furnished if action is to be taken at a stockholders' meeting with respect to the election of directors, the approval of any bonus, profit-sharing, or other remuneration plan in which any director or nominee for director or officer will participate or the approval of any pension or retirement plan in which such a person will participate, or the grant or extension of any option, warrant, or right of purchase to such a person.[140]

The proxy rules further provide in substance that if the stockholders are to be asked to ratify any action of directors, officers, or committees, disclosure must be made as to the matter involved and information furnished as required by the appropriate item of the proxy rule concerning the subject matter.[141] The effect of this rule is to preclude the possibility of the evasion of the requirement by simply requesting ratification by stockholders of action taken by directors or other bodies.

Reports by the Company Under the 1934 Act. Corporations subject to the Securities Exchange Act of 1934 are required to file periodic reports with the commission and with the exchange on which their securities are listed.[142] Annual reports within 120 days of the close of the fiscal year are required in nearly all cases;[143] semi-annual financial reports within 45 days of the close of the year and of the close of the first half of the fiscal year are also required in many cases.[144] In most instances, annual reports must be filed with the same information concerning remuneration, pension and retirement plans, as that required under the 1933 and 1934 acts and by the proxy rules.[145] Information similar to that required for registration under the 1933 and 1934 acts must be given with respect to options, warrants, and rights.[146]

The willful concealment in its annual reports of the existence of a profit-sharing plan for certain officers and employees has led to an indictment and a conviction for false and misleading state-

tion for registration and as part of annual reports. Form 10, Instruction 9 (a) to exhibits; Form 10K, Instruction B to exhibits.

140 Id., Item 7.
141 Id., Item 18.
142 Sec. 13; 15 U.S.C. (1952) §78m.
143 See SEC Rule X-13A-1.
144 Form 9-K. See SEC Rules X-13A-3 and X-15D-13.
145 Form 10-K. See Item 7.
146 Id., Item 8.

ments.[147] In addition to the annual and semi-annual reports, current reports are required of a company subject to the 1934 act not more than ten days after the close of a month in which any designated event takes place not previously disclosed in a filed document.[148] Among the events requiring such a report is the granting or the extension or the exercise of any options, warrants, or rights to purchase securities if the securities called for exceed 5 percent of the outstanding securities of the class.[149]

Reports by the Company Registered Under the 1933 Act. The Securities Act of 1933, in its original form, contained no provision requiring registrants to furnish periodic reports. Section 15 (d) of the Securities Exchange Act of 1934 (adopted in 1936)[150] required that thenceforth all registrants under the 1933 act should file an undertaking to furnish the commission with periodic reports similar to those required under the 1934 act. Generally speaking, this undertaking was to apply only if (a) the aggregate offering price of the securities registered, plus the aggregate value of all other securities of the same class outstanding, was $2,000,000 or more, and (b) the issuer was not required to furnish reports under the 1934 act by reason of having securities listed on an exchange.[151] The undertaking thus required by the commission makes it incumbent for the registrant to file the annual and periodic reports which companies subject to the 1934 act are required to file.[152]

Reports by Executives, Directors, and Stockholders. Apart from the reports which must be filed by the company, the Securities Exchange Act of 1934 requires every director, officer, and beneficial owner of more than 10 percent of any class of any equity security registered on a national securities exchange to notify the exchange and the commission of his holdings and to report monthly any changes in such holdings.[153] The holdings which must thus

147 United States v. Liggett & Meyers Tobacco Co., (E.D. Pa. 1949) reported in SEC, FIFTEENTH ANNUAL REPORT 170 (1949).

148 Form 8-K. See SEC Rule X-13A-11.

149 Form 8-K, Information to be included in Report, Item 9. There appears to have been no decision on non-transferable warrants, but they are not, as a matter of practice, registered.

150 49 Stat. 1375, 15 U.S.C. (1952) §78o (d).

151 Nor is the undertaking required by §15 (d) if the amount of all outstanding securities of the class issued is reduced to less than $1,000,000.

152 See SEC Reg. X-15D and, in particular, Rules X-15D-1, 11 and 13.

153 Sec. 16 (a), 15 U.S.C. (1952) §78p (a). Apart from the exemption relating to non-transferable options, note 18 supra, the exemptions to this requirement are relatively minor.

be reported relate to all transferable equity securities of the company beneficially owned, unlisted as well as listed.[154] Changes in holdings through the exercise of options, as well as through the acquisition or disposition of stock, must also be reported. However, the requirement as to options applies only to transferable options[155] and hence would not apply to restricted stock options or other options that are non-assignable by their terms.[156]

These reports, the filing of which has been compelled by mandatory injunction,[157] are used by the commission for a monthly official summary of security transactions and holdings. They may also provide a method of checking the good faith of a certificate of intention to hold securities for investment given to exempt the securities from registration under the 1933 act. The commission examiner may learn through these reports that the stock in question, although not registered under the 1933 act, was sold on the market soon after being acquired, and bring the matter to the attention of the commission for appropriate action.

The primary purpose of the reports, however, is to make available to investors information concerning stock transactions by so-called "insiders" and to make possible recovery for short-swing profits.[158]

SUMMARY AND CONCLUSION

The requirements of federal securities legislation should be considered in connection with any stock option or stock purchase plan and in connection with pension, profit-sharing, stock bonus

They are set forth in SEC Rules X-16A-4, 5, 6 and 9. Rule X-16A-4 exempts for 12 months following their appointment securities held by executors, administrators, guardians or committees for an incompetent, receivers, trustees in bankruptcy, assignees for the benefit of creditors, and similar persons authorized to administer the estate or assets of others. Rule X-16A-5 exempts securities purchased or sold by odd lot dealers. Rule X-16A-6 exempts securities as to which reports are required by the Public Utility Holding Company Act. Rule X-16A-7 exempts securities already subject to reporting requirements by the Investment Company Act. Rule X-16A-8 exempts securities held in trust which meet the conditions in the section. Rule X-16A-9 exempts small transactions considered de minimis. Extension of §16(a) to other corporations has been proposed. See note 115 supra.

154 See Form 5, Instruction 3.

155 SEC Rule X-16-A(h), note 18 supra, and related text.

156 Note 19 supra, and related text.

157 See FIFTEENTH ANNUAL REPORT, note 147 supra, at 70.

158 SEC, FOURTEENTH ANNUAL REPORT 36 (1949). For a comprehensive discussion of grounds for recovery of short-swing profits under §16(b) of the Securities Exchange Act of 1934, see authority cited note 2 supra.

and supplemental incentive and compensation arrangements generally. Such plans and arrangements may require registration unless the group of employees covered is confined to top executives.

Even when confined to top executives, a stock option or stock purchase plan, or the securities to be acquired by the executive pursuant thereto, may require registration if acquisition is to be financed through the sale of part of the securities or of other securities theretofore owned by the executive, at least if it is reasonably apparent that the acquisition is to be so financed. Controlling persons must also register any stock distributed by them through underwriters. The position adopted by the commission with reference to thrift plans and pension and profit-sharing plans generally would also appear to call for the registration of all plans of this nature to which employees are required or permitted to contribute, at least if such plans permit investment in securities of the employer or affiliates of the employer.

The registration requirements are not being observed in the case of many forms of compensation arrangements to which such requirements might be held to apply, but the commission has not heretofore taken action to enforce compliance.

Apart from the disclosure called for by registration, proxy statement regulations require disclosure of substantially all material compensation arrangements for executives of companies which solicit proxies to vote securities listed on a national securities exchange. Even companies with securities so listed which do not solicit proxies are called on to disclose material compensation arrangements as an incident of the annual and semi-annual reports that they are called on to file.

With limited exceptions, no penalties are imposed if the disclosure requirements are met, the basic premise of federal securities regulations in this, as in other respects, being simply to make the facts available, with the onus to correct any abuse that may be thus revealed on stockholders and public opinion generally. Lack of organization on the part of stockholders as a group and the slowness of public opinion to react effectively have undoubtedly permitted abuses to continue, but, on the whole, over a period of time the disclosure requirements have accomplished their purpose in obviating the more flagrant abuses of a past era and in instilling a sense of self-restraint and responsibility upon management.

Perhaps the single most important effect of federal securities

legislation in the executive compensation field to persons considering the adoption of a plan of compensation to executives has been the wealth of information that disclosure requirements have made available to business generally. The data as to the nature and amount of executive compensation and of supplementary compensation plans and practices thus available have made possible impressive surveys and studies of the great management organizations. These studies are beginning to serve as guideposts within each industry, to influence thinking, and to establish general standards in a field that was once taboo for discussion.