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Employee Compensation Plans: The Need for Stricter Regulation Student Symposium - Interpreting the Statutory Definition of a Security: Some Pragmatic Considerations.

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EMPLOYEE COMPENSATION PLANS: THE NEED FOR STRICTER REGULATION

In relationship to federal securities regulation, an employee compensation plan may be defined generally as a system of planned investments, determined and made by an employer with or without contributions by the employees, for the future benefit of the employees. Because participation in compensation schemes has grown so rapidly, and because their development has been so varied, compensation plans have outdistanced the measures designed to regulate them.[336]

The dramatic increase in the use of such programs began with the announcement in 1948 that the courts would consider as compensation those schemes awarding employees benefits in excess of their usual wages and, as such, to be proper subjects for collective bargaining.[337] Unions then began negotiating for the establishment of beneficial investment plans, to which employers responded favorably, particularly in light of the tax advantages offered under the Internal Revenue Code of 1954.[338]

Methods of Classification

Compensation schemes may be divided into some general categories on the bases of purpose, funding methods, and investment and administrative policies. A pension fund, for example, is characterized by its purpose, which is to provide a fixed and predetermined retirement income. Profit sharing plans, on the other hand, have a variety of purposes. In addition to retirement benefits, they may provide for bonuses, severance pay, ownership in the business, or any combination of these benefits. Stock options are a third alternative and are generally offered to key employees for the purpose of giving them work incentives and tax breaks.[339]

Types of compensation plans may also be distinguished on the basis of the method used to obtain funds for investment; a "funded" plan is one which requires or accepts voluntary contributions from the employees, while a "nonfunded" plan is non-contributory.[340] Pension plans and combination

336. For a history of the rapid growth of employee compensation plans, see 1 L. Loss, Securities Regulation 2206 (Supp. 1969).

337. Inland Steel Co. v. NLRB, 170 F.2d 247, 251 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949). *See also* S. Rep. No. 1440, 85th Cong., 2d Sess. 4 (1958).

338. Int. Rev. Code of 1954, §§ 401-405.

339. The usual advantages and types of such plans are detailed in Comment, *Stock Compensation Plans*, 1971 Wis. L. Rev. 854.

340. Comment, *Securities Aspects of Pension, Profit-Sharing, and Stock Bonus Plans*, 17 Sw. L.J. 444, 445 (1963). This source also contains an explanation of the general characteristics of pension, profit sharing, and stock plans.

plans involving pensions are the most frequent examples of contributory or "funded" programs. In addition to their contributory or non-contributory nature, compensation systems may also be classed according to their compulsory or non-compulsory participation requirements. This distinction is especially important with regard to securities regulation, since a voluntary plan obviously involves inducement of the employees to participate.

Plans may also be classed according to their methods of investment and administration. Pension plans require a fixed annual contribution by the employer and provide for a fixed benefit to be paid the recipient upon retirement. The allocation of benefits is based on a predetermined formula involving two elements—the employee's rate of compensation and his length of service.[341] Pension plan funds are usually invested, at least partially, in insurance, at a fixed interest rate, to ease the employer's investment risk. The most common type of pension plan is one which is compulsory, non-contributory, and placed in a trust to be administered by a bank or insurance company.[342]

The major difference between this type of plan and the profit sharing plan is the placement of the investment risk. Since the eligibility and benefits of a pension plan are predetermined, the risk lies with the employer. Even in a contributory pension plan, the employer bears the investment risk due to the fact that the employee has a vested right in the fund in the amount of his own voluntary contributions. In contrast, the risk of investment in a profit sharing plan falls completely on the employee. This is because the employer's contributions to the fund are not fixed, but are taken only from the profits of the business. Thus, if there are no profits in a particular year or years, there is no contribution to the fund, and the benefits to be paid to the employees are reduced. Since neither the contributions nor the benefits of a profit sharing plan are fixed, the participant never knows, until the time for payment, how much, if anything, he will receive.

The fact that the investment risk may fall upon either the employer or the employee leads to another important distinction among compensation schemes—the nature of the participant's interest. Because a participant in a profit sharing plan is entitled to the proceeds from the investment of his percentage share of the fund, his interest in the investment is that of an owner of his proportional part of the fund's assets. Conversely, a beneficiary of a pension plan has only a contractual right to the promised pension

341. Goldworn, *Pension Plans: Their Background, Current Trends, and An Agenda for Inquiry*, 25 OHIO ST. L.J. 234, 241-43 (1964) discusses the various types of formulae on which payment of benefits may be based.

342. *E.g.*, Fiduciary Counsel, Inc. v. Wirtz, 383 F.2d 203, 204 (D.C. Cir.), *cert. denied*, 389 U.S. 1005 (1967). *See also* Comment, *Corporate Employee Retirement: The Economic and Tax Aspects of Qualified Pension, Profit-Sharing, and Stock Bonus Plans*, 16 S.C.L. REV. 481 (1964).

payments upon fulfillment of eligibility requirements. In both types of funds, the employee's rights to benefits vest according to the plan's particular provisions. "Vesting" in this context is understood to mean "a right given a plan participant who meets specified age and/or length of service conditions to receive, upon attaining retirement age without reference to his continued employment, a pension benefit based upon his required service."[343]

Pension and Profit Sharing Plan Variations

The most common variations of pension and profit sharing schemes are money purchase plans and stock bonuses. A money purchase plan is a combination of the two. As in a pension plan, a fixed annual payment into the trust fund is required of the employer, regardless of the existence of profits in a given year. But, as in a profit sharing plan, the employee is not guaranteed a fixed benefit. Rather, the amount realized by a participant depends on the investment success of the trust. Each employee's share accrues until payable; then his account is paid to him in a lump sum or used to purchase an annuity.[344] Stock bonus plans are similar to profit sharing, except that the contributions are made in company stock instead of money. The stocks given into the trust are not necessarily purchased with company profits and the plan may be contributory. The employer corporation or a bank serves as trustee of the stock fund, and the employee holds stock certificates as his interest in the fund. In this type of compensation scheme the investment risk lies completely on the employee. If the stock falls in value, there may be little or nothing to distribute among the participants.[345]

Another classification of pension, profit sharing, and stock bonus programs is one created by the Internal Revenue Code of 1954. Plans may be "qualified" for tax advantages to both the employer and the employees. To receive a preferred tax status, a compensation scheme must have a fixed and permanent plan of benefit distribution;[346] it must not discriminate between lower and higher salaried employees,[347] and in a profit sharing plan no more than 50 percent of the corporate contributions may be invested in insurance premiums.[348] Unqualified plans are not subject to these administrative regulations.

343. *Vesting, Funding, Portability and Other Aspects of Proposed Pension Legislation*, 6 REAL PROP., PROBATE & TRUST J. 231 (1971).

344. Miller, *A Primer on Pension and Profit Sharing Plans—A Perspective For the General Practitioner*, 27 BUS. LAW. 451, 454 (1972). This article includes a good general discussion of the basic variations of pension and profit sharing plans.

345. Comment, *Corporate Employee Retirement: The Economic and Tax Aspects of Qualified Pension, Profit-Sharing, and Stock Bonus Plans*, 16 S.C.L. REV. 481, 500 (1964).

346. INT. REV. CODE OF 1954, § 401(a)(1), (b).

347. INT. REV. CODE OF 1954, § 401(a)(4).

348. Rev. Rul. 61-157-2(d), 1961-2 CUM. BULL. 67, 70.

Stock Plans

Another type of employee compensation is the stock option.[349] In a stock option the employee receives the right to purchase stock from his employer corporation in response to a written offer and at a preferred price. There is no favorable tax treatment for the employer, but if the option qualifies under the Internal Revenue Code, the employee gains certain tax advantages.[350] There are two types of statutory stock options that qualify for these tax advantages. One of these is the qualified stock option which is offered to executives and other key employees. This qualified stock option includes restrictions concerning plan approval by the stockholders, implementation by the directors, and use of the stock by the employees.[351] The other type of statutory stock option is the employees' stock purchase plan which is offered to all employees who have a minimum length of service. These plans are statutorily limited concerning eligibility, offering, price, employee control of the corporation, and stockholder approval.[352]

Recently the most significant growth in the stock plan field has been in non-statutory or unqualified plans. In these schemes there is no option extended; the employer makes a direct transfer to the employee of stock or interest in stock in an amount based on length and nature of service.[353] The transfer is subject to restrictions concerning transferability and forfeiture is allowed under certain conditions. Although there is no favorable tax treatment for the employee in the restricted stock plan, there is an advantage over the option type in that the employee is not required to invest out of pocket funds to take advantage of the benefit. Another non-statutory plan, which has recently gained popularity, is the "phantom" stock program wherein the participant is awarded a number of "units" which usually correspond to the fair market value of company stock. The units are apportioned according to a formula based on length of service and wage rate. The employee is subsequently credited with any dividends accrued to the imaginary stock. Eventually the units are totted and the employee receives the gain on the stock, the accumulated dividends, the stock itself, or a combination of these benefits.[354]

Until 1962 the benefits of tax sheltered retirement and benefit plans were

349. *See generally* Comment, *Stock Compensation Plans*, 1971 WIS. L. REV. 854, 854-62.

350. INT. REV. CODE OF 1954, § 421(a)(1) (1970); Treas. Reg. § 1.421-7(a) (1971).

351. *See* INT. REV. CODE OF 1954, § 422(b).

352. INT. REV. CODE OF 1954, § 423(b).

353. *See generally* Comment, *Stock Compensation Plans*, 1971 WIS. L. REV. 855, 862-63.

354. *See generally* Perham, *New Executive Perk: Loans for Options*, 97 DUN'S REV. 39 (1971); Shuster, Hart & Clark, *EPIC: Breakthrough in Compensation Planning*, 36 ADV. MGMT. J. 51 (1971).

limited to corporate employees. With the implementation of the Self Employed Individuals Tax Retirement Act, commonly called H.R.-10, tax advantages were established for self-employed persons who pay into a retirement plan for themselves and their employees.[355] H.R.-10 plans may be either pension or profit sharing, but they must be invested in either bank administered trusts, non-transferable annuity contracts, exempt shares, or special government bonds.[356] The employer may, however, retain a certain amount of control over the nature and amounts of the investments.[357]

The H.R.-10 plans have prompted another new development in compensation investment—the collective trust.[358] This is actually a method of investment rather than a compensation plan since any type of plan may be funded through a collective trust. Instead of holding each plan's fund in a separate trust, a bank may create a commingled account in which several plans are combined in a single trust managed by the bank as one unit. This is particularly attractive to H.R.-10 plans because an individual H.R.-10 fund is usually small in size. Through the use of a collective trust each of the plans involved gains the advantage of having a share in larger investments which provide for larger returns and the safety of diversification.

Regulation of Compensation Plans

The fact that all these varied plans involve an investment by the participating employees makes their relationship to the federal securities laws an important question. Before attempting to determine if any or all employee compensation plans can be included in a definition of the term "security," it should be decided whether or not their nature and purpose is compatible with federal securities legislation. It is generally agreed that the purpose of the Securities Act is protective, but that it aims to protect the investor by informing him rather than preventing him from making bad investments.[359] The courts have reiterated this goal and clarified it by requiring disclosure of all information necessary to a prospective investor in order for him to make an informed investment decision.[360] Moreover, the information must be provided in a manner which is understandable enough "for ordinary investors to form a reasonably sound judgment concerning the nature of the securi-

355. *See* Mundheim & Henderson, *Applicability of the Federal Securities Laws to Pension & Profit-Sharing Plans*, 29 Law & Contemp. Prob. 795, 797-800 (1964) [hereinafter cited as Mundheim & Henderson].

356. *Id.* at 798-99.

357. *Id.* at 800.

358. *Id.* at 819-37. *See generally* Bronston, *Bank Collective Investment Funds*, 105 Trusts & Estates 1185 (1966); Church & Seidel, *The Entrance of Banks Into the Field of Mutual Funds*, 13 B.C. Ind. & Com. L. Rev. 1175 (1972).

359. SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946); A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 43 (1941); 1 L. Loss, Securities Regulation 127-28 (2d ed. 1961).

360. *See, e.g.*, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

ties or . . . the investor's rights as a holder of such securities should he buy them."[361] Thus disclosure is to be protective: "A fundamental purpose, common to these statutes was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor,* and thus to achieve a high standard of business ethics in the securities industry."[362]

The disclosure provisions of the Securities Act require that offerors of securities to the public must register and disclose pertinent information so that it will be available to any prospective investor. To evaluate the need for securities regulation in the field of employee compensation, it is useful to examine the present disclosure requirements for such plans.

Most obvious in this area is the Welfare and Pension Plans Disclosure Act (the Act).[363] Its stated purpose is similar to that of the Securities Act:

> It is declared to be the policy of this chapter to protect interstate commerce and the interests of participants in employee welfare and pension benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto.[364]

The Act requires that, upon adoption of a plan, its administrator must furnish to all eligible employees information consisting of: (1) the names and addresses of the plan administrators and their relationship to the employer corporation, (2) a description of the plan and its administration, (3) a schedule of benefits, (4) identity of plan trustees, (5) the collective bargaining status of the plan, (6) a copy of the instrument under which the plan is funded, (7) the method of financing, (8) basis on which records are kept, and (9) the procedure for filing claims.[365] In addition, the administrator is required to publish an annual report which, if the plan is contributory, must include:

> The amount contributed by each employer; the amount contributed by the employees; the amount of benefits paid or otherwise furnished; the number of employees covered; a statement of assets specifying the total amount in each of the following types of assets: cash, Government bonds, non-Government bonds and debentures, common stocks, preferred stocks, common trust funds, real estate loans and mortgages, operated real estate, other real estate, and other assets; a statement of liabilities, receipts, and disbursements of the plan; a detailed statement of the salaries and fees and commissions charged to the plan, to whom paid, in what amounts, and for what purposes.[366]

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361. *In re* Universal Camera Corp., 19 S.E.C. 648, 659 (1945).

362. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

363. 29 U.S.C. §§ 301-309 (1970). *See generally* Note, *The Welfare and Pension Plans Disclosure Act—Its History, Operation, and Amendment,* 30 GEO. WASH. L. REV. 682 (1962).

364. 29 U.S.C. § 301(b) (1970).

365. *Id.* § 305.

366. *Id.* § 306(b).

If the plan is non-contributory, the annual report need contain only the total amount of benefits paid, the average number of eligible employees, and a notification if the only assets available for the payment of claims are the assets of the employer.[367] These reports are to be submitted to the Secretary of Labor,[368] and there are provisions for criminal liability for fraud.[369]

The other vehicle requiring disclosure of compensation fund information is the Internal Revenue Code. The obvious limitation of this law is that its coverage is limited to plans which qualify for tax advantages. These qualified plans must disclose their type, eligibility requirements, a synopsis of benefits, methods of contribution, vesting policy, and the employer's investment commitment.[370]

There are serious shortcomings in the extent to which both of these laws require meaningful disclosure to potential investors. The inadequacies of the Internal Revenue Code are the more obvious. Besides the fact that non-qualified plans are not covered, there is another shortcoming in that the information required from qualified plans provides the investor-employee no insight into the manner of administration, the investment policy, the financial condition, or the actual operation of the plan. Actually, the disclosure required by the Internal Revenue Service operates to inform the employee of technical requirements for his use of the plan's benefits, but has no practical value toward making available to him information necessary for a prudent investment decision.

The weaknesses of the Welfare and Pension Fund Disclosure Act are more subtle, but no less serious than those of the Internal Revenue Code The provisions of the Act do not necessarily operate to further its stated purpose of protection through disclosure. The most glaring example of this inadequacy is that while members of non-contributory plans must receive the original statement of the planned funding and investment policy status of the program, they do not receive the specific information concerning the plan's relative efficiency and success required in the annual reports. The fund administrator is not required to furnish this class of potential investors with any information as to the program's history of return on the participants' investments, or even of how much of the fund is invested in particular assets. It may be argued that since the employee makes no voluntary contribution to the fund, it is not necessary for him to be able to evaluate the efficiency of the plan's administration; it is sufficient that he know how to use the benefits of the fund. This reasoning fails to consider the more realistic view that although the participating employee makes no out of pocket contributions to finance the plan, his interest in it or in its bene-

367. *Id.* § 306(c).
368. *Id.* § 307.
369. *Id.* § 308.
370. Rev. Rul. 61-157, 1961-2 CUM. BULL. 67, 74.

fits are part of his employment compensation. Employee benefit plans are a major force in enticing individuals to accept employment and remain with their particular employer.[371] For this reason it seems necessary that an employee whose compensation will be invested for him should be given the relevant information upon which to differentiate among programs offered by various employers. This is true even if the employee is never to receive his money before it is transferred into the compensation fund. Furthermore, the participants in a plan must know in what way and how effectively their investments are being administered in order to make any informed decision concerning needed changes in the plan which could be negotiated in collective bargaining.

In addition to its failure to cover a significant portion of the eligible investors in employee compensation plans, the Pension and Welfare Disclosure Act has other weaknesses which tend to prevent it from adequately protecting investors. Even the disclosure required of contributory plans is not as complete as it might be. This inadequacy is illustrated in one of the few examples of litigation in this field, *Doherty v. Sylvania Pension Plan.*[372] In that case an employee sued after having been refused his request to be furnished a report of the total assets of his plan and the amounts of benefits which had been paid out to employees. The court decreed, without elaboration, that the information was outside the scope of the requirements of the Welfare and Pension Fund Disclosure Act.[373]

Even when disclosure of the specific information requested and denied is required by the Act, its terms make enforcement against plan administrators very difficult. To invoke penalties for failure to disclose, an employee must, satisfactorily to the court's discretion, show "bad faith" in the defaulting administrator.[374] The difficulty of proving bad faith was exemplified in *Harrold v. Coble,*[375] in which the participant requested a copy of his company's plan and its trust agreement, as required by the statute. The administrator refused to furnish this information, and the court found that his refusal constituted a violation of the Act. But it also held that because bad fath had not been proven to the court, no penalty would be assessed.[376]

PRESENT RELATIONSHIP OF SECURITIES LAWS TO EMPLOYEE COMPENSATION PLANS

Congress has shown its intent to protect investors in employee compensation plans through enactment of the Welfare and Pension Fund Disclosure Act. However, it has failed to adequately fulfill this purpose because the

371. Mundheim & Henderson at 808.
372. 310 F. Supp. 1331 (D. Mass. 1970).
373. *Id.* at 1333.
374. 29 U.S.C. § 308(b), (c), (d) (1970).
375. 380 F.2d 18 (4th Cir. 1967).
376. *Id.* at 19.

Act covers only some plans and has weak provisions for enforcement. The same purpose of disclosure is implicit in the federal securities legislation, which also includes more complete registration and enforcement provisions.

The present position of compensation plans with respect to the securities laws is uncertain. Under the statutory definition of "security"[377] the SEC has consistently adhered to the opinion that pension and profit sharing plans which invest in securities are themselves securities under the designations of investment contracts or evidences of indebtedness.[378] In all but a few instances, however, the SEC has declined to require registration of such plans, justifying this position under the various exceptions listed in the Act.

A large group of employee compensation plans are excluded from securities regulation under the "no sale or public offering" exception.[379] Any compulsory or non-contributory pension, profit sharing, or stock bonus plan does not, according to the SEC, involve a sale to the participants. The reasoning is that since the employees have no choice in the manner in which the investments are administered, or even in whether to invest, there is no offer of sale to them.[380] Other compensation plans, notably stock options offered to key employees, have been exempted on the theory that there is no *public* offering.[381] Voluntary plans in which employee contributions are invested in exempt securities—insurance and annuities in particular—have also been exempted by the SEC. The Commission's opinion in these cases is based on the "conduit theory" that since the plan's investments are excepted, the participants' investment in the plan should also be exempt.[382] Finally, in the case of voluntary plans, it has been the position of the SEC that no action will be taken on programs which invest even in the securities of the employer, as long as the amount invested in such securities does not exceed the amount of the employer's contribution to the fund.[383]

377. The Securities Act of 1933, 15 U.S.C. § 77b(1) (1970) provides that

> 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 . . . or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in . . . any of the foregoing.

378. Opinion of Ass't Gen. Counsel of Commission, 1 CCH FED. SEC. L. REP. ¶ 2105.53, at 2579 (1941).

379. Securities Act of 1933, 15 U.S.C. § 77b(3) (1970); *see* Phillips & Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706, 766.

380. 1 L. Loss, SECURITIES REGULATION 506-11 (2d ed. 1961); Mundheim & Henderson at 807; Phillips & Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706, 766.

381. Phillips & Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706, 767 n.213.

382. Those securities exempted from regulation are enumerated in 15 U.S.C. § 77c (1970).

383. Comment, *Securities Aspects of Pension, Profit-Sharing, and Stock Bonus Plans*, 17 Sw. L.J. 444, 451 (1963).

The disclosure and regulation of offered securities is supplemented by the Investment Company Act of 1940, also administered by the SEC.[384] Under definitions in this act, both pension and profit sharing plans which invest in securities or in collective trusts maintained by banks are investment companies which must register with the Commission as issuers primarily engaged in the business of investing or trading in securities.[385] But plans which qualify for special tax treatment under Section 401 of the Internal Revenue Code of 1954 such as employees' stock bonus, pension, or profit sharing trusts are exempted from registration.[386] Any non-qualified plan which invests in securities is included within the act, since the Investment Company Act does not require a public offering to comply with its provisions.[387] Any such plan may, however, be exempted from registration requirements upon the approval of its application[388] by the Commission, which, adding to the uncertainty, has not advanced any specific standard by which it proposes to grant these exemptions. The practical result of these two large loopholes in the enforcement of the Investment Company Act, combined with those in the Securities Act, is that the majority of employee compensation plans escape completely the disclosure requirements of federal securities legislation.

This exclusion of compensation schemes, however, is not complete. In some cases, the Commission has required plans to register. Voluntary contributory plans have been held to be securities which are offered to the public; the Supreme Court has stated that "[a]bsent a showing of special circumstances, employees are just as much members of the investing 'public' as any of their neighbors in the community."[389] Even though the SEC has refused to act in cases where such plans invest in exempted securities, it has required registration of schemes which include variable annuities.[390] Another type of plan which has been required to register is the stock bonus plan which invests substantially in company stock.[391] Finally, the SEC has taken the position that collective or commingled bank administered trusts which involve a public offering are to be classed as investment companies and must register.[392] In this light, bank administered collective trusts for

384. 15 U.S.C. § 80a, 80b (1970).
385. *Id.* § 80a-3(a)(1).
386. *Id.* § 80a-3(c)(11).
387. *Id.* §§ 80a-2(a)(36), 80a-3(a)(3).
388. *Id.* § 80a-6(b).
389. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).
390. This is based on the Supreme Court's holding that variable annuities are securities. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). *See also* SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 212 (1967).
391. Mundheim & Henderson at 813.
392. For an explanation of the SEC's position and reasoning, see *Relationship of the SEC to Qualified Employee Plans*, 2 REAL PROP., PROBATE & TRUST J. 570, 573 (1967); Bronston, *Bank Collective Investment Funds*, 105 TRUSTS & ESTATES 1185, 1186 (1966).

H.R.-10 plans have been viewed by the Commission as nonexempt securities.[393]

PROPOSALS FOR CHANGE IN SECURITIES TREATMENT

Thus, even though employee compensation plans have been recognized as investments for which public disclosure is desirable, no existing legislation has adequately required such disclosure. The Welfare and Pension Fund Disclosure Act demands only partial disclosure from only some types of plans and the provisions of the Act are not easily enforced. The obvious solution to this problem would be to include employee compensation plans within the more stringent and detailed protection of the federal securities laws. The SEC has prevented the implementation of this solution, not by failing to interpret the definition of security to include such plans, but by failing to recognize the purpose and need for securities regulation in its interpretations of the overall thrust of the laws with regard to these particular forms of investment. Regardless of the need to apply particular statutory exemptions in other securities areas, the purpose of the Act is not served by applying them to most forms of employee compensation plans.

A standard which aids in demonstrating the need for inclusion of compensation schemes within the scope of securities legislation has been suggested by Professor Coffey:

> A "security" is a transaction whose characteristics distinguish it from the generality of transactions so as to create a need for the special fraud procedures, protections, and remedies provided by the securities laws.[394]

To this can be added the interpretative admonition offered in *SEC v. C.M. Joiner Leasing Corp*:[395] Do these schemes involve "the evils inherent in the securities transactions which it was the aim of the Securities Act to end"?[396] The purpose of the federal securities law is agreed to be that of enabling members of the public who are potential investors in securities to protect themselves from unwise investment. This is done by requiring the offerors of securities to provide their prospective investors with such information as is necessary to allow them to make an informed investment decision. Employees are members of the public; if employee compensation plans are securities, then disclosure should be necessary.

Although there has been no litigation in the area, it is apparent that most compensation plans may be brought within the statutory definition of "security" through designation as investment contracts.[397] Judicial attempts to

393. *See generally* Mundheim & Henderson at 819-24; Bronston, *Bank Collective Investment Funds*, 105 TRUSTS & ESTATES 1185, 1186 (1966).

394. Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 CASE W. RES. L. REV. 367, 373 (1967) [hereinafter cited as Coffey].

395. 320 U.S. 344 (1943).

396. *Id.* at 349.

397. *See* Note, *Pension Plans as Securities*, 96 U. PA. L. REV. 549, 550-51 (1948);

define the term "investment contract" culminated in the test formulated by the Supreme Court in *SEC v. W.J. Howey Co.*[398] Applying this test to pension, profit sharing and stock compensation plans, it becomes obvious that they come within its scope. First, such plans involve the investment of money. Regardless of whether the plan is voluntary or compulsory, contributory or non-contributory, a portion of the participant's income from his employment is being invested. Second, the joining of a group of employees with their employer in order to fund investments is clearly a "common enterprise." Third, the participant obviously expects to gain a profit in the most traditional sense of the word—he expects and is told that the monetary value of the benefits he will receive will be greater than the amount he has invested.[399] Finally, the administration of employee compensation plans, whether performed by the employer or by a trustee is in the hands of "the promoter or a third party."

The *Howey* test has been criticized, particularly by Professors Long and Coffey, who have both proposed modifications of it. The suggested additions also describe the salient characteristics of employee compensation plans. Long, for example, suggests that an additional test should be included which would pose the question of whether the participant has contributed risk capital to the enterprise.[400] Again, regardless of the mechanical form in which his investment is made, the participant in a compensation scheme has contributed to a fund, the corpus of which is to be used for speculation. Coffey has emphasized the risk of loss of the original investment as a critical component of classification as an investment contract.[401] It is true that an employee has a vested right in all of his voluntary contributions into pension and profit sharing plans, but even this guarantee is subject to forfeiture.[402] In addition, participants in the so-called non-contributory plans, as well as those in stock option and purchase plans, have no guarantee of the safety of their original investments. Thus, it does seem

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Opinion of Ass't Gen. Counsel of Commission, 1 CCH FED. SEC. L. REP. ¶ 2105.53, at 2579 (1941).

398. 328 U.S. 293 (1946). The test, as set forth by the Court announced that

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

Id. at 298-99.

399. The employee's investment need not be of cash; his "services rendered" are also considered investments. *E.g.*, SEC v. Addison, 194 F. Supp. 709, 722 (N.D. Tex. 1961).

400. Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 174 (1971).

401. Coffey at 374.

402. *See* Miller, *A Primer on Pension and Profit Sharing Plans—A Perspective for the General Practitioner*, 27 BUS. LAW. 451, 453-54 (1972).

"hardly worth denying" that pension, profit sharing, and stock plans fit the technical definitions of "investment contract."[403]

Having established that employee benefit plans pass the test of what constitutes a security, can they justifiably be excluded from the operation of the securities laws? Keeping in mind the protection through disclosure purpose of the Act, compensation schemes do "create a need for the special fraud procedures, protections, and remedies provided by the securities laws."[404] This special need is twofold: "[C]ontrol and management of the investment is in the hands of someone other than the investor; the risk is borne by the investor."[405]

Considering this need, many exemptions currently given to compensation funds are unjustified. The primary example of an unjustified exemption is the use of the "no sale" exception under which all compulsory and non-contributory plans are now excluded from required registration as securities. It is difficult to agree with the SEC's justification of this wholesale exemption on the grounds that an employee's contribution has not been solicited if he must, as a condition of his employment, join or contribute to an investment fund.[406] The reality of the situation is that the employee contributes the fruits of his labor, regardless of the form of contribution. All benefit plans are compensation for employment;[407] therefore all plans are contributory. Likewise, all employment choice is voluntary; therefore all plans are voluntary. Following this reasoning it is obvious that the SEC's decision not to require registration of voluntary contributory plans which do not invest in company securities in excess of company contributions is clearly unjustified in light of the purpose of the securities law. The participant's stake in the success of the plan is in the total fund, not only in his particular portion. In order to make an informed decision, the potential investor should know what kind and amount of investments are to be made, regardless of who offers investment securities to the fund. This same need for disclosure is also present when the funds' investments are in exempt securities such as annuities and insurance. However justified these exemptions may be for these securities, they do not remove the need of an investor in a security (the compensation plan) which purchases them

403. Note, *Pension Plans as Securities*, 96 U. PA. L. REV. 549, 556 (1948); *see* Penfield Co. v. SEC, 143 F.2d 746, 750 (9th Cir. 1944).

404. Coffey at 373.

405. Frankel, *Variable Annuities, Variable Insurance and Separate Accounts*, 51 B.U.L. REV. 173, 214 (1971). *See also* Welch, *Investment For and Management of Employee Benefit Trusts*, 110 TRUSTS & ESTATES 350, 352 (1971); Comment, *Proposed Amendments to the Welfare and Pension Plans Disclosure Act*, 4 U. MICH. J. OF L. REFORM 268, 271, 275 (1970).

406. Mundheim & Henderson at 806-07.

407. Goldworn, *Pension Plans: Their Background, Current Trends, and an Agenda for Inquiry*, 25 OHIO ST. L.J. 234, 255-56 (1964); S. REP. No. 1440, 85th Cong., 2d Sess. 4 (1958).

to know what assets are held by his investment fund.

Although the numerous forms of employee compensation plans are in many ways distinguishable from one another, for the purpose of definition they may be grouped together as investment contracts and therefore, as securities. Their nature gives rise to a special need for the protection provided in the federal securities laws—a need which is not adequately satisfied by any other existing legislation. Given this need, and most plans' compliance with the technical, as well as the broad definitions of a security, the SEC has misinterpreted the statutory exemptions through which it has allowed the majority of these plans to escape registration and disclosure. The federal securities law exists to remedy this situation; appropriate definitions and regulations are already built into it. All that remains is to change its administrative interpretation so that its legislative intent can be carried out with respect to this particular field of the securities industry.

CONCLUSION

The various kinds of financing schemes analyzed in this symposium present some of the thornier problems facing the regulatory agencies and the courts. From the previous discussions it can be seen that determination of whether a particular scheme is a security has ranged from examining the component elements to applying hazy, conceptual abstractions. In an investment oriented economy where the problem of defining a security arises often, these varying methods of determination have led to uncertainty and at times, incongruous results.

The purpose in examining franchises, founder-member contracts, mineral interests, real estate ventures, club memberships, and profit sharing plans has been to illustrate that while there are diverse and distinctively characterized interests, common elements exist which reveal the basic characteristics of a security. Since the type of scheme which may give rise to a security interest is limited only by the promoter's imagination, it has been suggested that these common elements of a security be identified and flexibly applied to aid the courts and agencies in achieving the general purpose behind the securities acts—investor protection. Professor Long has called this identification process "definition by specification." This would seem to be a superior method and is already receiving support and acceptance in many courts. Certainly, the trend is away from inflexible examination of enumerated interests. This is shown by the broad, theoretical foundation upon which many recent decisions have been based: substance will be elevated over form. The concept behind definition by specification is to provide guidance in identifying the substance of the scheme then under scrutiny. If common characteristics exist, and they do even in interests as seemingly diverse as royalty interests and employee compensation plans, then isolating, identifying and consistently applying them should yield correct results.