SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 231

[Release No. 33-6188]

Employee Benefit Plans; Interpretations of Statute

AGENCY: Securities and Exchange Commission.

ACTION: Interpretations of statute.

SUMMARY: The Commission has authorized the issuance of a release setting forth the views of its staff on the application of the Securities Act of 1933 to employee benefit plans. The purpose of the release is to provide guidance to the public and thereby assist employers and plan participants in complying with the Act.

FOR FURTHER INFORMATION CONTACT: Peter J. Romeo, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 20549, (202) 272-2573.

SUPPLEMENTARY INFORMATION: On January 16, 1979, the Supreme Court issued a decision in which it addressed for the first time in its history the application of the Securities Act of 1933 ("1933 Act") [15 U.S.C. 77a et seq.] to participation interests in a private pension plan. The decision, which was rendered in the case of *International Brotherhood of Teamsters* v. *Daniel ("Daniel")*,[1] has generated considerable controversy and comment.[2] Moreover, it has raised questions about the application of the Act to many types of employee benefit plans[3] not covered by the decision. In an effort to resolve the uncertainty which has developed and thereby assist employers and plan participants in complying with the 1933 Act, the Commission has authorized the issuance of this release setting forth the views of its Division of Corporation Finance (hereinafter, the "staff")[4] on the application of the Act to such plans.

The release initially discusses the circumstances under which interests in plans and related entities may be subject to the requirements of the 1933 Act. In this connection, an analysis is provided of the criteria to be used in determining when an offer or sale of a security will occur. There is also a discussion of the various exemptions from the Act's registration provisions that may be available for such offers or sales. This is followed by a brief discourse on the application of the Act both to the various types of securities transactions in which plans may engage

[1] 99 S. Ct. 790, —— U.S. —— (1979). In *Daniel*, the Supreme Court held that neither the 1933 Act nor the Securities Exchange Act of 1934 ("1934 Act") [15 U.S.C. 78a et seq.] apply to a compulsory, noncontributory pension plan.

[2] *See*, e.g., L. J. Haas, *Supreme Court in Daniel leaves open possibility that some plans may be subject to securities laws* J. Tax., 263-267 (May 1979); J. D. Mamorsky and T. L. O'Brien, *Securities Law and the Daniel Case*, Pension World (May 1979); H. S. Bloomenthal, *The ABC's of Employee Benefit Plans—D for Daniel*, Sec. Fed. Corp. L. Rep. Vol. 1, No. 3 at 17 (March 1979); B. W. Nimkin, *Noncontributory Benefit Plans*, Rev. Sec. Reg., Vol. 12:4 (February 28, 1979); H. L. Pitt, *Daniel: A Seed for More Difficulties for the SEC*, Legal Times of Wash., January 29, 1979 at 27, Col. 1; M. Siegel, *Pension Outlook*, N.Y.L.J. Vol. 181, No. 48 at 1, Col. 1; P. M. Kelly, *Securities Regulation of Retirement Plans after Daniel*, Loyola Univ. L. J., 631-665 (Summer, 1979).

[3] As used in this release, the term "employee benefit plan" means a pension, profit-sharing, or similar plan. It does not include welfare and similar plans which provide for hospitalization or disability benefits, funeral expenses, or social or cultural activities. These latter plans historically have not been considered subject to the securities laws because they do not involve any expectation of financial return on the employee's part.

[4] While this release was prepared by the Division of Corporation Finance, in some instances the views described were originally expressed by the Commission's Division of Investment Management. All such instances are duly noted in the release.

and to resales by plan participants of securities acquired through the operation of plans. Finally, the release describes the methods of registration under the Act of securities issued by plans and related entities.

Although this release is intended to provide guidance to the public on the application of the 1933 Act to employee benefit plans, it should not be viewed as an exhaustive or all-inclusive treatment of the subject. The complexity and ever-increasing variety of such plans precludes the issuance of a release sufficiently comprehensive to cover all issues that might arise. Because this release is necessarily limited in its scope, the Commission's staff will continue its past practice of providing interpretive advice and assistance to the public regarding such plans upon request, except where otherwise indicated herein.

The staff recognizes that many of the issues discussed herein are controversial and that differences of opinion can exist with respect to them. Although it believes the positions described in the release are in accord with the general policies and purposes of the 1933 Act, the staff nevertheless invites interested members of the public who wish to express an opinion on such positions to submit their views in writing.[5] All comments received from the public will be given serious consideration by the staff and, to the extent they are persuasive, could result in a revision of some of the views expressed herein.

Because of the length of this release, the staff believes it would be helpful at the outset to summarize briefly the positions expressed herein. The summary, however, should not be read without also referring to the explanatory section of the release, where the various positions are discussed in detail.

Summary

The registration and antifraud provisions of the 1933 Act are applicable to the offer and sale of securities. Registration, however, would not be necessary if one of the exemptions specified in the Act is available.

1. The Term "Security".—There are two types of securities that may be issued in connection with employee benefit plans: (1) participation interests of employees in their respective plans,[6] and (2) participation interests of plans in the collective investment vehicles in which such plans invest their assets.

The interests of plans in collective investment vehicles are in all instances securities, generally in the form of investment contracts. They are therefore subject to both the registration and antifraud provisions of the 1933 Act. The interests of employees in a plan, however, are securities only when the employees voluntarily participate in the plan and individually contribute thereto. Thus, employee interests in plans which are not both voluntary and contributory are not securities and therefore are not subject to the Act.

2. The Term "Sale".—A sale of interests in voluntary, contributory plans occurs where there is both an investment decision and the furnishing of value by participating employees. Consistent with this view, the staff does not believe a sale occurs when an existing plan is converted into an ESOP [7] or other type of plan, except where employees are given a choice in the matter and therefore have the opportunity to make an investment decision. Similarly, there is no sale under noncontributory plans when employees make elections as to the manner of investing the employer's contributions.

The definition of "sale" in the 1933 Act also encompasses any "solicitation of an offer to buy" securities of the employer. Such solicitations sometimes will be attributed to employers in the context of certain employee stock purchase plans which acquire the employer's securities in the open market. If the employer's involvement in such a plan is limited to performing ministerial-type functions, no solicitation of an offer to buy is deemed to exist. But if the employer's involvement is so substantial that there are significant differences between acquiring stock under the plan and acquiring it in ordinary brokerage transactions, the employer will be deemed to be soliciting its employees to buy its securities, and registration generally will be necessary. An exception to this general rule, however, exists in the case of a TRASOP [8] where the employer's involvement is limited primarily to performing ministerial-type functions and paying half the price of stock purchased by employees under the plan.

3. Exemptions from Registration.—Registration of securities offered or sold pursuant to employee benefit plans is necessary unless an exemption is available. In most instances, an exemption is available and registration therefore is not required. Some of the exemptions that are frequently relied upon are those provided by the 1933 Act for nonpublic offerings, intrastate offerings, and certain small offerings. The only exemption, however, which is specifically designed for interests issued in connection with employee benefit plans is the one provided by section 3(a)(2) of the Act.

The section 3(a)(2) exemption applies both to the interests of plans in certain investment vehicles maintained by banks and insurance companies and to the interests of participants in the plans themselves. Interests issued in connection with Keogh plans, however, are specifically excluded from the exemption, although the Commission can exempt such interests from registration under certain conditions.

Although the language of section 3(a)(2) can be read to suggest otherwise, the staff does not believe that a single trust fund for a plan must be maintained by a bank in order for the exemption to be available. However, if the trust fund involves a single employer and invests employee monies in securities of the employer, the exemption cannot be utilized. For purposes of section 3(a)(2), the term "single employer" is deemed to include the employer and any entity controlling, controlled by, or under common control with, the employer. Thus, a parent and its subsidiaries are considered a single employer under this interpretation.

While the section 3(a)(2) exemption is not available by its terms for so-called "guaranteed investment contracts" issued to plans by insurance companies, the staff has taken a no-action position with respect to the offer and sale of such contracts if certain specified conditions are met. A similar position, again subject to certain conditions, also has been taken with respect to the offer and sale of interests in multiple-employer trusts established by insurance companies for the offering of various forms of annuity contracts to unrelated employers.

4. Securities Transactions by Plans. In addition to issuing participation interests to employees or fostering the purchase of employer stock by such persons, a plan may engage in various other transactions involving the purchase, sale or distribution of securities. It may, for instance, acquire stock of the employer from various sources, including the company. For a

[5] Letters pertaining to this release should be addressed to Peter J. Romeo, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 20549.

[6] In some plans, such as stock bonus and certain stock purchase plans, where stock is directly acquired by employee participants, there may not be separate employee interests, apart from the stock, that are deemed to be securities. The stock acquired by employees under such plans, however, is a security.

[7] "ESOP" is a shorthand designation for "Employee Stock Ownership Plan."

[8] "TRASOP" is a shorthand designation for "Tax Reduction Act Stock Ownership Plan."

variety of reasons, however, registration usually would not be necessary with respect to the acquisition transaction.

A plan also may offer or sell securities of the employer or other entities held in its portfolio. If the plan is considered to be an affiliate [9] of the employer, sales by it of the employer's securities would be subject to the registration provisions of the 1933 Act in the same manner as if the employer were engaging in the transaction. Sales by the plan of non-employer securities, however, usually would not have to be registered because of the availability of the exemption provided by section 4(1) of the Act for transactions not involving issuers, underwriters or dealers.

The distribution, or actual delivery, of employer stock by a plan to individual participants would not be subject to registration, although any offers or sales of such stock to participants prior to actual delivery would have to be registered, unless an exemption were available.

5. Resales by Plan Participants.—Employees who receive securities under a plan may freely resell such securities without restriction if the securities have been registered and they are not affiliates of the issuer. If the securities have not been registered, they generally must either be registered or sold in reliance upon some exemption, such as that provided by section 4(1) of the 1933 Act. An exception to this general rule occurs when non-affiliates receive unregistered securities under a plan which satisfies certain conditions.

6. Methods of Registration.—If the securities to be issued under a plan must be registered, Form S–8 [17 CFR 239.16b] would be the appropriate form for this purpose if the employer were able to satisfy the requirements for its use. If Form S–8 cannot be used, the issuer would then consider other forms, such as S–1 [17 CFR 239.11] or S–18 [17 CFR 239.28].

Affiliates who receive securities under a plan and wish to have them registered for resale may utilize a Form S–16 [17 CFR 239.27] reoffer prospectus for this purpose if the securities were originally issued pursuant to a Form S–8 filing. If the securities were not so issued, Form S–1 may be utilized, assuming the issuer is agreeable to a filing on that form, or the securities may be resold pursuant to Rule 144 [17 CFR 240.144] under the 1933 Act.

[9] An "affiliate" of an entity is defined in Rule 405 [17 CFR 230.405] under the 1933 Act as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the [entity]."

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I. General Structure of the Act

According to its preamble, the 1933 Act is intended "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof * * *" Sections 5 and 17 of the Act are the principal provisions used to implement the Act's disclosure and antifraud purposes. Section 5 provides that every offer or sale of a security made through the use of the mails or interstate commerce must be accomplished through the use of a registration statement [10] meeting the Act's disclosure requirements,[11] unless one of the several exemptions from registration set out in sections 3 and 4 of the Act is available.[12] Section 17 of the Act prohibits the use of fraud or misrepresentation in the offer or sale of a security.[13]

To promote compliance with the registration and antifraud requirements, the Act provides for both civil liabilities and potential criminal penalties in the event violations occur. The civil liabilities are specified in sections 11 and 12 and basically give the buyer the right to rescind the sale and recover the net cost of the security. The criminal penalties are prescribed in section 24 and consist of a fine of up to $10,000 or imprisonment for up to five years, or both, if the Act is willfully violated. In addition, section 20(b) of the Act authorizes the Commission to bring injunctive actions whenever it appears a person is engaged, or is about to engage, in violations of the Act.

II. The Term "Security"

In order for the registration and antifraud provisions of the 1933 Act to be applicable, there must be an offer or sale of a security. The term "security" is defined in section 2(1) of the Act [14] and includes, among other things, stocks, bonds and investment contracts. The Commission believes that two types of securities, generally in the form of investment contracts, may be issued in connection with employee benefit plans: (1) interests of participants in their respective plans, and (2) interests of

[10] A registration statement generally consists of two parts: a prospectus which is delivered to investors before a sale becomes final and a separate section containing information which is on file with the Commission but which is not required to be furnished to investors. Sales of securities cannot be made until the registration statement becomes effective.

[11] The types of information required to be included in registration statements are specified in Schedules A and B of the 1933 Act and in the various registration forms under the Act adopted by the Commission.

[12] Part IV of this release will discuss some of the exemptions commonly relied upon for transactions involving employee benefit plans.

[13] It should be noted that Section 10(b) of the 1934 Act and rule 10b–5 [17 CFR 240.10b–5] thereunder prohibit the use of any manipulative device or contrivance in connection with the purchase or sale of any security.

[14] Section 2(1) states in its entirety 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, 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.

plans in collective investment media, such as bank collective trust funds and insurance company separate accounts, in which such plans invest their assets.[15] Each of these interests will be discussed in detail in the sections which follow.

A. Interests of Participants in Plans

An investment contract involves "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entreprenurial or managerial efforts of others."[16] The Commission has traditionally applied this test, which is often called the "*Howey* test" because it was first articulated in the case of *S.E.C.* v. *W. J. Howey Co.*,[17] to the interests of employees in pension, profit-sharing and similar plans. In this regard, it has in the past determined that such interests are investment contracts because the plans are in essence investment vehicles designed to produce profits in the form of retirement or other benefits for the employees through the efforts of plan managers.[18]

Although the Commission has believed that employee interests in pension and profit-sharing plans generally are securities, it has required such interests to be registered only where a plan is both voluntary [19] and contributory [20] and invests in securities of the employer an amount greater than that paid into the plan by the employer.[21] The basis for this administrative practice, which was codified by Congress in 1970 in Section 3(a)(2) of the 1933 Act,[22] is as follows:

(1) Registration serves no purpose where a plan is involuntary, since a participant is not permitted to make an investment decision in such a circumstance; and

(2) The costs of registration are a significant burden to an employer and should be imposed only where the employer has a direct financial interest in soliciting voluntary employee contributions, as in the case where such contributions will be used to purchase the employer's securities.

The Commission's belief that the registration provisions of the 1933 Act should be applicable to voluntary, contributory plans which involve the purchase by employees of employer stock is supported by the legislative history of the Act. In 1934 Congress considered and rejected a proposed amendment to the Act that would have exempted employee stock investment and stock option plans from the Act's registration provisions. The amendment, which had been passed by the Senate but was eliminated in conference, was not adopted "on the ground that the participants in employees' stock investment plans may be in as great need of the protections afforded by the availability of information concerning the issuer for which they work as are most members of the public."[23]

The decision by the Supreme Court in the *Daniel* case, in which the Court held that the interests of employees in involuntary, noncontributory pension plans are not securities, has raised questions concerning the applicability of the 1933 Act to other types of employee benefit plans not covered by the decision.[24] In the interest of providing guidance to the public and because of uncertainty with respect to the implications of *Daniel*,[25] the staff believes it is appropriate at this time to set forth its own views regarding the application of the 1933 Act to employee benefit plans. Those views are expressed according to the major categories into which pension and profit-sharing plans may fall (i.e., defined benefit and defined contribution, corporate, Keogh, IRA, and miscellaneous plans).

1. *Defined Benefit and Defined Contribution Plans.*—Employee benefit plans are of an infinite variety. All such plans, however, can be reduced to two broad categories: defined benefit plans and defined contribution plans.

A defined benefit plan[26] pays fixed or determinable benefits.[27] The benefits ordinarily are described in a formula which specifies the amount payable in monthly or annual installments to participants who retire at a certain age.[28] As long as the plan and the employer(s) contributing to the plan remain solvent, and the plan continues to be operated, vested participants will receive the benefits specified. In the event the investment results of the plan do not meet expectations, the employer(s) usually will be required, on the basis of actuarial computations, to make additional contributions to fund the promised benefits.[29] Conversely, if plan earnings are better than anticipated, the employer(s) may be permitted to make contributions that are less than the projected amounts.

A defined contribution plan[30] does not pay any fixed or determinable benefits. Instead, benefits will vary, depending on the amount of plan contributions, the investment success of the plan, and allocations made of benefits forfeited by nonvested participants who terminate employment. Thus, the amount of benefits is based, in part, on the earnings generated by the plan.

Both defined benefit and defined contribution plans can provide for employee contributions. In addition, defined contribution plans maintain individual accounts for all participating employees.[31] These accounts reflect each participant's share in the underlying trust assets and are adjusted annually to take into account plan contributions, earnings and forfeitures. In contrast, defined benefit plans ordinarily do not maintain individual accounts, except to the extent necessary under the Internal Revenue Code to record benefits attributable to voluntary contributions by employees.[32]

The *Daniel* decision dealt with an involuntary, noncontributory plan which

[15] A plan could, of course, invest its assets directly in stocks, bonds and similar instruments, rather than in collective investment vehicles. Such instruments clearly are securities, for they are expressly referred to in Section 2(1) and otherwise possess the characteristics of securities.

[16] *United Housing Foundation, Inc.* v. *Forman*, 411 U.S. 837, 852 (1975).

[17] 328 U.S. 293 (1946).

[18] Opinion of the Assistant General Counsel of the Commission—first opinion (1941), (hereinafter, "Opinion of Assistant General Counsel") CCH Fed. Sec. L. Rep., 1941–1944 Transfer Binder, ¶ 75,195.

[19] A "voluntary" plan is one in which employees may elect whether or not to participate.

[20] For purposes of this release, a "contributory" plan is one in which employees make direct payments, usually in the form of cash or payroll deductions, to the plan.

[21] Letter to *Commerce Clearing House* dated May 12, 1953.

[22] Pub. L. 91–547 (December 14, 1970) and Pub. L. 91–567 (December 22, 1970). Section 3(a)(2) exempts from registration interests or participations issued in connection with certain corporate plans, unless the plan is held in a single trust or separate account for a single employer and "an amount in excess of the employer's contribution is allocated to the purchase of securities * * * issued by the employer or by any company directly or indirectly controlling, controlled by or under common control with the employer."

[23] H.R. Report No. 1838, 73rd Cong., 2d Sess. (1934), 41.

[24] Some courts have applied the *Daniel* decision to other types of pension plans. See *Black* v. *Payne*, 591 F. 2d 83 (9th Cir. 1979); *Tanuggi* v. *Grolier, Inc.*, 471 F. Supp. 1209 (S.D.N.Y., 1979); and *Newkirk* v. *General Electric Company*, CCH ¶ 97,216 (N.D. Cal., 1979).

[25] See Note 2, *supra*.

[26] All defined benefit plans are considered to be pension plans. *See* Internal Revenue Code ("IRC") [26 U.S.C. 1 et seq.] § 414(j).

[27] IRC Reg. § 1.401–1(b)(1) (1956).

[28] If retirement occurs at a different age or in a different form, participants will receive an adjusted monthly or annual amount. See IRC § 415(b)(2)(B).

[29] An exception to this general rule arises in the case of multi-employer collectively bargained defined benefit plans (such as the one at issue in *Daniel*) where the contribution obligations of participating employers are limited to contractually fixed amounts for each hour, day or week employment.

[30] Some examples of defined contribution plans are profit-sharing plans, stock bonus plans, ESOPs, and so-called money purchase pension plans.

[31] In fact, defined contribution plans are sometimes characterized as "Individual Account Plans."

[32] IRC § 411(b)(2)(A). The benefits must not be less than the employee's contribution with statutory interest. IRC § 411(a)(1) and § 411(c)(2)(B).

was also a defined benefit plan. The Supreme Court's opinion in that case, however, did not rest on the fact that the plan was a defined benefit one. Instead, the Court based its decision on the involuntary nature of the plan (unlike all prior cases of the Court involving securities, the employees did not have a choice whether to participate)[33] and the fact that the plan did not provide for direct, identifiable contributions by employees (the employees' labor could be considered a contribution "only in the most abstract sense").[34] This view is supported both by the Court's statement of the issue presented by the case ("whether a noncontributory, compulsory pension plan constitutes a 'security' ")[35] and by its later statement that "We hold the Securities Acts do not apply to a noncontributory, compulsory pension plan."[36] In neither instance did the Court refer to the defined benefit nature of the plan.

In light of the foregoing, the staff is of the view that the defined benefit or defined contribution nature of a plan is not dispositive in determining whether a security is present. Other factors, such as whether the plan is voluntary or involuntary, and contributory or noncontributory, must be taken into consideration, as indicated in the analysis of the major types of plans which follows.[37]

2. Corporate Plans.—Perhaps the largest single category of plans in terms of the number of participants are so-called "corporate" plans. Such plans may be defined benefit or defined contribution in nature, but all share the common characteristic of being established by corporations. Common types of corporate plans are pension, profit-sharing, bonus, thrift, savings and similar plans. Almost all such plans are established pursuant to Section 401 of the Internal Revenue Code.[38]

To determine whether or not a participant's interest in a corporate plan is a security, the Court in *Daniel* indicated that it is necessary to demonstrate that a participant "chose" to give up "specific" consideration in return for a "separable financial interest" that had "substantially the characteristics of a security."[39] A participation interest possesses the essential characteristics of a security when the elements of an investment contract are present.[40]

The foregoing suggests that some of the key factors to be considered in connection with the "security" question are whether a plan is voluntary or involuntary, and whether it is contributory or noncontributory. There are four possible combinations in which these elements can appear, each of which is separately discussed in the sections which follow.

a. Involuntary, Noncontributory Plans. The Court in *Daniel* held that "* * * the Securities Acts do not apply to a noncontributory, compulsory pension plan."[41] This holding clearly precludes the finding that interests in such plans are securities. Accordingly, the 1933 Act is not applicable to such interests.

b. Involuntary, Contributory Plans. Where a plan requires direct contributions by employees, it would be possible to take the position that there is an "investment" (in the form of employee contributions) "in a common enterprise" (the plan) "with an expectation of profits" (the excess of benefits over contributions) "from the efforts of others" (the plan managers). In the *Daniel* decision, however, the Supreme Court based its decision that no investment contract was present at least in part on the involuntary nature of the plan involved in that case. The Court noted in this regard that in its other decisions involving investment contracts the person found to have been an investor "*chose* to give up a specific consideration in return for a separable financial interest with the characteristics of a security."[42]

After consideration of the foregoing, the staff believes it is appropriate from an administrative standpoint for it to take the position that the interests of employees in involuntary, contributory plans are not securities[43] and that the registration and antifraud provisions of the 1933 Act do not apply to them.

C. *Voluntary, Noncontributory Plans*

Plans in which employees may voluntarily participate without making any personal contributions generally arise in rather limited circumstances.[44] The staff traditionally has not required participation interests in such plans to be registered.[45] In its view, no practical purpose is served by requiring registration of such interests, since in almost all instances employees would chose to participate, due to the fact that they would receive benefits without incurring any out-of-pocket expenses.[46]

Whether interests in voluntary, noncontributory plans are securities is a matter that has not been addressed by a court. As previously indicated, the "security" question depends to some extent on whether a plan is voluntary. But the mere presence of a voluntary feature in a plan would not, by itself, necessarily indicate the presence of a security, since the other elements of an investment contract also must be present.

In most instances, the fact that a plan is noncontributory would mean that the

[33] 99 S. Ct. 796.

[34] 99 S. Ct. 796–797.

[35] 99 S. Ct. 793.

[36] 99 S. Ct. 802.

[37] See, in particular, the section herein entitled "Voluntary, Contributory Plans."

[38] Plans which are qualified under Section 401 become entitled to certain tax benefits.

[39] 99 S. Ct. 796–797. The Court also stated that the consideration should be "tangible and definable." 99 S. Ct. 797.

[40] As indicated in Note 6, *Supra*, some plans, such as stock bonus and certain stock purchase plans, which are in essence mechanisms for the acquisition of stock, may not involve separate securities in the form of participation interests that are investment contracts. The stock acquired by employees under such plans, however, is a security.

[41] 99 S. Ct. 802.

[42] 99 S. Ct. 796.

[43] At least one court subsequent to *Daniel* has addressed the issue of whether such interests are securities in the context of a plan sponsored by a public (i.e., governmental) employer. In *Black* v. *Payne*, 591 F. 2d 83 (9th Cir. 1979), the question raised was whether participation in a state sponsored involuntary, contributory pension plan (which appeared to share the characteristics of a defined benefit plan) constituted an investment contract. The District Court held that such participation failed to satisfy the definition of a security enunciated by the Supreme Court in *Daniel*. The Court of Appeals for the Ninth Circuit agreed, noting that even though the plan was contributory, participation therein did not involve a reasonable expectation of profit nor the element of volition sufficient to bring the transaction within the scope of the securities laws. Pointing to the Supreme Court's discussion of the impact of the Employee Retirement Income Security Act of 1974 ("ERISA") [29 U.S.C. 1001 et seq.] in the *Daniel* situation, the Court also expressed the view that the existence of extensive state regulation and control over the plan constituted a formidable factor militating against extending the federal securities laws to cover this type of plan. *Id.* at 87, n. 3.

[44] The circumstances usually are that the plan contains a number of alternatives for the investment of the employer's contribution, and participating employees are allowed to determine: (1) whether they will participate in the plan (the response almost always being in the affirmative), and (2) the investment alternative they prefer to have an interest in.

[45] *See*, e.g., letter re *Four Phase Systems, Inc.* dated October 5, 1978.

[46] Perhaps the only circumstance in which any employee might choose not to participate would arise where it is more advantageous for tax reasons not to do so. In this regard, one commentator [Nimkin, note 2, *supra*, at 971] has stated that: "[Under a noncontributory plan], the employee's choice is not between giving or not giving consideration (his labor) in exchange for the plan interests, but between two retirement plans that under the tax law are mutually exclusive: a personally-financed IRA and an employer-financed plan. It is the Internal Revenue Code that requires the employee to make this choice, not the employer. [However], it can be argued that once the employee has an alternative, he needs to be adequately informed about the employer's plan, and that this need is best protected by the registration and antifraud provisions of the federal securities laws. This suggests that "opt-out" provisions should not be included in noncontributory plans without awareness of their possible securities law implications."

"investment of money" aspect of the *Howey* test is not met.[47] Even where a noncontributory plan meets the "investment" requirement, it may not satisfy the "profit" element of the *Howey* test. The Court in *Daniel* seemed to dismiss the earnings generated by the plan managers as being too insignificant in relation to employer contributions to qualify as "profits" in the investment contract sense.[48] Moreover, the Court seemed to believe that any participation by employees in the earnings of the plan at issue in that case depended primarily on the personal efforts of the employees to meet the vesting requirements, rather than on the plan actually generating such earnings.

Although a commentator has suggested that a security may be present in some voluntary, noncontributory plans,[49] the staff, as a matter of administrative practice, will assume that such plans do not involve securities. Accordingly, the registration and antifraud provisions of the 1933 Act are not considered by the staff to be applicable to such plans.

d. *Voluntary, Contributory Plans.* Since 1941, the Commission and its staff have adhered to the position that interests in voluntary, contributory pension and profit-sharing plans are securities.[50] The articulated basis for this view is that such interests constitute investment contracts, although it also has been suggested that they may be "certificates of interest or participation in a profit-sharing agreement" as well.[51]

The Commission recently confirmed its view in the testimony of its Chairman before the Senate Committee on Human Resources on the antifraud provisions of the proposed ERISA Improvements Act of 1979 (S. 209),[52] wherein it was noted that

> * * * An employee who is given a choice whether to participate in a voluntary pension plan, and decides to contribute a portion of his earnings or savings to such plan, has clearly made an investment decision, particularly when his contribution is invested in securities issued by his employer. Employees making such decisions should continue to be afforded the protections of the antifraud provisions of the federal securities laws.

The Commission's view that the interests of employees in voluntary, contributory plans are investment contracts appears to be supported by the reasoning used in the *Daniel* decision. Certainly, where a plan is voluntary, the requirement that employees be able to choose whether or not to invest has been met. And the other elements of an investment contract would also appear to be present where a plan is contributory, regardless of whether the plan is defined contribution or defined benefit in nature, as the following analysis indicates.

(1) *Investment of money.* The payment of cash or its equivalent by an employee to a contributory plan clearly satisfies the "investment" requirement in that the consideration paid is "specific, tangible and definable."[53]

(2) *In a common enterprise.* The opinion in *Daniel* suggests that a plan will satisfy the common enterprise requirement where the interests of employees therein are "separable" and possess "substantially the characteristics of a security."

With regard to the separability aspect, it appears the Court believed that where there is an investment contract, it is possible to segregate the non-investment (or employment) portion of a person's total compensation package from the investment (or pension) portion. In contributory plans, the amount set aside for investment purposes can be readily identified by examining the contributions made by each individual participant. A record of such contributions is always available in defined contribution plans because such plans maintain individual accounts for participants. And it also should be present in defined benefit plans, by virtue of the requirement that, in order to qualify for favorable tax treatment,[54] such plans must return to nonvested employees who cease being participants accrued benefits based upon the employee's contributions. Thus, in both defined contribution and defined benefit plans, there is, in effect, a separate account maintained for each participant to the extent of such person's contributions to the plan. Accordingly, the investment aspects of an employee's compensation package are segregated under both types of plans.

(3) *With an expectation of profits.* An employee who voluntarily contributes his own funds to a pension or profit-sharing plan can expect that in return for his contributions the plan will generate earnings through the efforts of the plan managers that will result in his receiving pension or similar benefits that will exceed his total contributions. In terms of economic realities, the excess of benefits over contributions, to the extent they are dependent on earnings by the plan, may be deemed a profit which the employee fully expects to receive as a result of his payments to the plan. By deciding to participate in the plan voluntarily, the employee implicitly has made an investment decision to the effect that his contributions will achieve investment results that will be equal to or superior to those he could obtain from investing his funds elsewhere. Accordingly, from the employee's standpoint, there would appear to be an "expectation of profits" in the investment contract sense.

The foregoing analysis clearly appears to be valid when applied to a defined contribution plan, for the level of benefits under such a plan is directly related to the plan's investment success. Further analysis, however, is necessary for defined benefit plans.[55]

In *Daniel,* the Court indicated there was no "expectation of profits" with respect to the defined benefit plan at issue in that case because (1) the plan did not depend substantially on earnings

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[47] 99 S. Ct. 797.

[48] 99 S. Ct. 797–798.

[49] One commentator [Nimkin, note 2, *supra,* at 970] has suggested that where some or all of the following characteristics are present in a noncontributory plan, a security may exist:

(a) the interests are close to the commonly understood notion of a security, such as interests in an ESOP that are invested solely in employer stock, and they either satisfy the other elements of the *Howey* test or do not call for a *Howey* investment contract analysis at all;

(b) the value of the interests is measurable and is not insignificant in dollars or in percentage of total compensation;

(c) the amount of employer contributions attributable to each of the interests can be identified, as in a case where such contributions are a percentage of employee compensation; and

(d) there is a fixed relationship between employer contributions and employee benefits as there normally would be in a profit-sharing or other individual account plan.

[50] Opinion of Assistant General Counsel, Note 18, *supra.*

[51] Opinion of the Assistant General Counsel of the Commission—second opinion (1941), CCH, 1941–1944 Transfer Binder, ¶75,195.

[52] The ERISA Improvements Act of 1979 would, among other things, remove the interests of employees in employee benefit plans from the definitional scope of the term "security" for purposes of the antifraud provisions of the 1933 and 1934 Acts. The proposed legislation, however, would not limit the application of the registration provisions of the 1933 Act to such interests. The Commission's views on the bill are set forth in the Statement of Harold M. Williams, Chairman, Securities and Exchange Commission, Before the Senate Committee on Human Resources, on S. 209, 96th Cong., 1st Sess. (February 8, 1979).

[53] This is not to say that a person's "investment," in order to meet the definition of an investment contract, must always take the form of cash. Goods and services may also be sufficient in some instances. 99 S. Ct. 797, n. 12.

[54] IRC §§ 411(a)(1) and 411(c)(2)(B).

[55] *See,* e.g., the recent case of *Tanuggi* v. *Grolier Inc.,* 471 F. Supp. 1209 (S.D.N.Y. 1979). The question presented in that case was whether the securities laws applied to interests in a voluntary, shared contribution, defined benefit plan. The particular plan featured a mandatory contribution component and a voluntary contribution component. The Court found no security present with respect to the mandatory contribution component. It did not, however, reach the question of whether interests in the voluntary component constituted a security, inasmuch as the plaintiff's contributions did not exceed the mandatory level.

to meet its benefit obligations, since it could rely on increased employer contributions to cover any shortfalls in earnings, and (2) the vesting requirements for the plan were so substantial that an employee's participation in the plan's earnings depended more on his own efforts to meet the vesting requirements than it did on the plan actually generating the earnings.[56] The Court's statements can be interpreted to suggest that unless a defined benefit plan has a substantial dependency on earnings, as well as vesting requirements that are not excessively difficult to satisfy, there may be no expectation of profits in the investment contract sense.

Several points should be kept in mind with respect to the Court's statements. First, they were made in the context of an involuntary, noncontributory defined benefit plan, in which employees neither invested any funds of their own nor had any investment choice to make. The situation is materially different in voluntary, contributory plans, where employees clearly make investment decisions by deciding to invest their funds in such plans rather than in other investment media. An employee who participates in such a plan implicitly does so because he expects the plan to generate earnings that will be sufficient to provide him with a return on his investment, in the form of certain promised benefits, that will be equal to or superior to other investment alternatives available to him.

Second, many, if not most, defined benefit plans substantially depend on earnings to pay the benefits promised by them.[57] Quite often, in the case of multi-employer plans, a shortfall in earnings (and thus a shortfall in assets to pay benefits) results not in increased employer contributions, as the Court suggested is usually the case,[58] but in a revision downward of the level of benefits to be paid.[59] Or, in some instances, the plan itself may be terminated and benefits may be paid only to the extent that the Pension Benefit Guaranty Corporation[60] is able to do so within its prescribed limitations. The fact that a plan may reduce its level of benefits or terminate altogether in the event earnings are insufficient to pay benefits underscores the dependency which many plans have on such earnings.

Third, vesting requirements under ERISA (which was not applicable to Daniel) are much less strict than the requirement of 20 years continuous service with which Daniel had to comply.[61] Because the ERISA requirements are substantially less difficult to satisfy than the vesting provision in *Daniel*, the staff takes the position that the ERISA requirements would not be a barrier to finding an investment contract present.

On the basis of all of the foregoing, the staff is of the view that where a plan is both voluntary and contributory, regardless of whether it is defined contribution or defined benefit in nature, a participant generally would have an expectation of profits from it in the investment contract sense.

(4) *From the efforts of others.* Any earnings generated by a plan would, of course, result from the efforts of the plan managers. Thus, the requirement of an investment contract that there be reliance on the efforts of others to produce profits would seem to be satisfied in the context of a voluntary, contributory plan.

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As a result of the foregoing anlysis, the staff believes that the interests of employees in voluntary, contributory, corporate pension and profit-sharing plans are securities within the meaning of section 2(1) of the 1933 Act. Moreover, as indicated in Part III of this release, such securities are deemed to be offered and sold to employees within the meaning of section 2(3) of the Act. Accordingly, they are subject to both the registration and antifraud requirements of the Act. But, as indicated in the discussion of section 3(a)(2) in Part IV of the release, such securities generally would be required to be registered only where the plan invests in employer securities an amount greater than that contributed to the plan by the employer.

3. Keogh Plans

Keogh plans (also known as "H.R. 10 plans") are tax-deferred retirement plans established by self-employed individuals[62] for the benefit of themselves and their employees. They were authorized by Congress in 1962[63] to permit such individuals to share some of the favorable tax benefits[64] which prior therto were available only in conection with certain corporate plans.

There are two types of securities that may be issued in connection with Keogh plans: (1) interests in collective funding vehicles arising from investments made by the plans, and (2) interests of employee participants in the plan themselves.

With respect to the interests of Keogh plans in collective funding vehicles, these clearly are securities, often in the form of investment contracts. There is an investment of money by the plan in a common enterprise (the funding vehicle) with the expectation that the managers of the funding vehicle will generate earnings on that investment.

Congress gave implicit recognition to the fact that interests in collective funding vehicles maintained for Keogh plans are securities when it amended section 3(a)(2) of the 1933 Act in 1970. In both the Senate and House reports relating to the 1970 Amendments, it was indicated that such interests were not being exempted under section 3(a)(2) "because of their fairly complex nature as an equity investment and because of the likelihood that they could be sold to self-employed persons, unsophisticated in the securities field."[65] Clearly, the reference to such interests in the reports (and in section 3(a)(2) as well) was based on the belief that they are securities. As explained in Part IV of this release, however, the Commission possesses authority under section 3(a)(2) to exempt interests or participations

[56] 99 S. Ct. 797–798.

[57] The Supreme Court appeared to believe otherwise, as indicated by its statement that "a plan usually can count on increased employer contributions, over which the plan itself has no control, to cover shortfalls in earnings." 99 S. Ct. 798.

[58] *Id.*

[59] Of course, benefits accrued by participants up to the date the level of benefits is revised would be payable on the basis of the schedule of benefits in effect until then.

[60] The Pension Benefit Guaranty Corporation ("PBGC") was created by ERISA to provide some assurance that the benefits promised to vested participants in employee benefit plans would, in fact, be paid. Pursuant to ERISA, every single-employer defined benefit plan must meet certain minimum funding standards and pay annual premiums to the insurance fund maintained by the PBGC. The PBGC guarantees a portion of the defined benefit in the event the employer terminates the plan. The extent of PBGC coverage is set forth in 29 U.S.C. 1301–1381.

[61] Daniel was denied his pension because, although he had over 22 years of service as a teamster, he had suffered an involuntary break-in-service of approximately four months midway through his career. Thus, the years prior to the break-in-service could not be used to satisfy the requirement of 20 years of "continuous" service.

[62] An individual who is an "employee" within the meaning of Section 401(c)(1) of the Internal Revenue Code of 1954 may establish a Keogh plan.

[63] The Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. 87–792 (1962).

[64] The tax advantages to a self-employed person in establishing a Keogh Plan are essentially twofold: A deduction can be taken for at least a part of his contributions to the plan and the income earned on his contributions is not taxed until it is distributed.

[65] Senate Report No. 91–184 (1969), at 27–28, and House Report No. 91–1382 (1970), at 44. Although Section 3(a)(2) may not be available, the intrastate offering exemption (see Part IV) often can be relied upon for the offer and sale of interests in collective funding vehicles maintained for Keogh plans. However, if the funds in that vehicle are commingled with those from exempt qualified plans sold to non-residents, the two offerings would be integrated, and the intrastate exemption would not be available.