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PRIVATE PENSIONS AND FEDERAL SECURITIES REGULATIONS: THE DECADES OF NEGLECT

RALPH R. SMITH*

I. INTRODUCTION

During his testimony before a committee of the House of Representatives in 1941, a member of the Securities and Exchange Commission (hereinafter cited as SEC or Commission) contended that although his agency had jurisdiction over the still fledgling pension fund industry, it had no interest in regulating it.¹ In fact, he expressed the hope that Congress would limit the SEC's authority in this area by exempting most pension plans from the Securities Act of 1933.² Some members of the committee regarded this position with suspicion.³ Even in 1941 it was unusual for an administrative agency to voluntarily seek to limit its own authority. But strange as it may have seemed at the time, that was the SEC's position. The even more surprising fact is that that position remains substantially unchanged to this day. Over three decades later, the SEC continues to contend that in theory,

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** This portion of the paper was written prior to the passage of the Employee Retirement Income Security Act of 1974 (ERISA) and therefore does not refer to that important piece of legislation. Nor does the paper cover those developments in the area which have occurred since 1974. It was written, rather, to serve as a framework for an extensive analysis of ERISA, which will be published as a second installment in this Journal.

1. *Hearings on Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934 Before the House Comm. on Interstate and Foreign Commerce*, 77th Cong., 1st Sess. 895 (1941) [hereinafter cited as *1941 Hearings*].

2. Securities Act, § 1, 15 U.S.C. § 77a-aa, § 77b-h (1970) (original version at ch. 38, § 1 et. seq., 48 Stat. (1933)) [hereinafter cited as Securities Act].

3. One particular interchange demonstrates the skepticism:

—Commissioner Purcell: Well, I must remind you again, Congressman, you must keep this clear, our suggestion is for exemption and not for inclusion in the Act.

—Mr. Wolverton: I am perfectly aware of the adroitness that can be readily discerned in the presentation of an exemption which in fact establishes a basis of control as to other cases.

—Commissioner Purcell: May I say, for the Commission, that that is not our intention in submitting this proposal, Mr. Congressman.

—Mr. Wolverton: Well, I cannot just agree with the statement that you have made, but for the moment, I will just pass it with the thought that when any commission comes to Congress and asks exemptions, and it is presented on the theory that you want to take away some of the authority that they now have, I am just a little bit suspicious, because in most instances the commissions come asking additional power. So, you can readily understand why I am inquiring so carefully into this question of exemptions. It just seems a reversal of the usual procedure. Most commissions are reaching out for more power rather than less.

—Commissioner Purcell: I hope, sir, that we will represent a notable exception to your views with respect to commissions.

—Mr. Wolverton: It would be a notable exception if you established it.

1941 Hearings, *supra* note 1, at 904-05.

interests in pension plans are within the ambit of federal securities legislation. However, in practice the SEC still refuses to apply the provisions of this legislation to the plans. And recently, through its own efforts, the legislative exemption it sought since 1941 was finally granted.⁴

Like its earlier reticence, the SEC's consistency is not a hallmark of administrative agencies. It also leads one to suspect that this consistency is either a case of remarkable farsightedness, a settled area, or a studied indifference to any changes three decades may have wrought.

Unchanged this area of the law is not. Americans have become increasingly concerned with the necessity of protecting themselves against the financial hazards of death, serious illness, permanent disability, unemployment, and retirement. This concern has triggered the creation and stimulated the growth of a number of protective devices, among which are government-assured unemployment and social security programs,⁵ and privately sponsored insurance against death, disease, disability and retirement.⁶ Whether considered individually or collectively, however, none of these devices sufficiently allay the concern of American workers. Unemployment compensation is essentially a between-job allowance of limited duration and amount.⁷ Social security is a rather rigid system which barely assures subsistence to the retired or disabled worker and guarantees a significant reduction in style of living for all but families of most modest income.⁸ Finally, group insurance is essentially concerned with the welfare needs of present employees and seldom provides for adequate post-retirement or death benefits.

Partly in response to the clear need for a more comprehensive and flexible device for protecting the interest of the American worker, a fourth response was developed—the private employer-sponsored employee benefit plan. It can be broadly divided into two categories: *one*, welfare benefits providing for sick pay, hospitalization costs; *two*, retirement or pension benefits which are activated by satisfaction of a minimum service requirement or

4. See note 40 *infra* and accompanying text.

5. Practically every state in the country statutorily guarantees the temporary continuation of compensation in cases of forced unemployment. Generally financed by mandatory contributions from employers, the plans annually provide compensation to over one million temporarily displaced American workers. The Federal government does its share by way of the Social Security Administration. Created in 1935, this agency presently administers benefits under a compilation of statutes providing for Old Age Survivors Disability and Hospital Insurance (OASDHI) benefits.

6. One indication of the growing popularity of private insurance plans is the tremendous increase in benefit payments for income loss due to short term illness. In 1948, total benefit payments were 286.8 million. By 1967 this figure increased 500% to 1,377.4 million. Price, *Income-Loss Protection Against Illness*, 1947-48, 32 SOC. SEC. BULL. 21, 26 (1969).

7. The average weekly benefit for total unemployment rose from \$10.56 in 1940 to \$49.11 in 1970. *Current Operating Statistics*, 33 SOC. SEC. BULL. 21, 26 (1970).

However, this latter figure can hardly be considered adequate even in the areas of the country with low cost of living.

8. Average monthly OASDHI cash retirement worker benefits rose from \$63.09 in 1956 to \$100.40 by the end of 1969.

occurrence of a permanent disability. As with group insurance, employee benefit plans, especially pension plans, have experienced a period of unparalleled growth in recent decades.⁹ In 1940 there were some 1,965 private employee pension plans covering under four million workers.¹⁰ By 1970, there were over one hundred thousand plans covering some thirty million workers—approximately half of the labor force.¹¹ During this same period assets of these plans increased ten thousand percent (from 1.1 billion dollars to over *130 Billion*) making private pension plans one of the largest sources of investment capital in the United States today.¹²

Thus, the intransigence of the SEC must be viewed against a landscape which has changed remarkably over the past generation. It is against this background that one must judge whether the policy of benign neglect, if ever justified, is still warranted—or whether it is of any consequence at all. Since much of the administrative policy has been sanctioned by statute, the wisdom, efficacy, and necessity of the legislative action must be considered.

This portion of this paper will attempt to review the various rationalizations which are the underpinnings of both the administrative and legislative “hands-off” approach, discuss what the impact of such a posture has been, and ascertain whether the present treatment is necessitated by or consistent with the purpose and scheme of federal securities legislation. The second installment will discuss SEC policy in 1972; the Employee Retirement Income Security Act of 1974 and recent development in this area.

II. PRIVATE EMPLOYEE PENSION PLANS

A. *Potential Means of Regulation*

The “issuer”¹³ of a private employee pension plan that was not exempted in the Securities Act of 1933 would be prohibited from offering employees

9. To some extent, this growth seems to have resulted from a general belief that the benefits would boost employee morale and productivity and possibly form a mild increase in social responsibility on the part of employers. For the most part, however, the dramatic growth since 1940 must be attributed to three significant factors. First, employee benefit plans became more attractive with the sharp rise in corporate income taxes after 1940 and the favorable treatment afforded to qualified plans under § 165 (now § 401) of the Internal Revenue Code. Briefly, that section provides that contributions to the trust through which the plan is funded are deductible when made; payments are not taxable to employees until actually received; and the trust itself is exempt from taxation. Second, the wage ceiling imposed during World War II stimulated the granting of pension and other benefits as additional compensation. *See generally* Note, *The National War Labor Board: The Evolution of a National Wage Policy*, 91 U. PA. L. R. 340 (1942). Third, the growth in the number and influence of labor unions led to increased pressure for employee benefit plans. These demands received the sanction of the federal labor laws with the holding in *Inland Steel Co. v. NLRB*, 170 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949), that such plans are a mandatory issue of collective bargaining.

10. S. REP. NO. 1440, 85th Cong., 2nd Sess. 6 (1958).

11. S. REP. NO. 93-383, 93rd Cong., 2nd Sess. 2-3 (1973).

12. *See* note 78-83 *infra* and accompanying text.

13. An “issuer” is defined to mean “every person who issues or proposes to issue any security. . . .” Securities Act, *supra* note 2, at § 2(4). The person most likely to be deemed the

the opportunity to participate in the plan prior to filing a registration statement with the SEC.¹⁴ The absence of a properly filed registration statement would subject the issuer to the criminal penalties of the statute,¹⁵ and would allow any employee contributing to the plan to bring a civil action to recoup his contribution.¹⁶ Once filed, the issuer would be subject to investigation and review by the Commission and to a stop order proceeding which, once lost, would forbid any further offering or sale of the interest involved.¹⁷ Assuming the registration statement was favorably reviewed (the issuer would still be civilly liable for any misrepresentations contained in it at the time it became effective), the issuer could then "sell"¹⁸ and/or deliver the interests. However, prior to or contemporaneously with delivery, the issuer would be required to furnish employee—participants with a current prospectus, disclosing vital information about the plan. The issuer would again be criminally and civilly liable for misstatements or misrepresentations.¹⁹

Note that absent the H.R. 10 situation or a clear case of overreaching, no registration would be required at the investment medium level because private offering exemptions would be available. The issuer of a plan not exempt from the Securities Act of 1934 would generally be required to register the plan with the Commission, as soon as its assets rose to \$1,000,000 and it covered 500 or more employees, whether or not it chose to make a new offering. A condition precedent to the invocation of this registration would be a finding that the plan in some manner satisfied the interstate commerce jurisdictional requirement. This would hardly be a difficult task. Once required to register, the administrator would have to file an application providing the Commission with detailed information on the organization, financial structure, and nature of the plan,²⁰ and whatever other information the Commission might deem "necessary or appropriate . . . for the proper protection of investors. . . ."²¹ According to the

"issuer" in an employee benefit plan is the administrator of the plan. In his absence, or prior to his designation, issuer status and liabilities would probably be accorded the employer establishing the plan.

14. Actually the use of "means or instruments of transportation or communication in interstate commerce or of the mails" in connection with any such offering or sale is forbidden. *Id.* § 5. This jurisdictional requirement must be satisfied if the Securities Act is to be activated.

15. *Id.* § 24.

16. *Id.* § 11.

17. *Id.* § 5.

18. "Sell" is minimally defined as "disposition of a security . . . for value." *Id.* § 2(3). This is where the Commission's "no sale" theory wrecks havoc on the application of the Securities Act.

19. Section 11 relief is triggered by a misstatement or material omission in the registration statement at the time it "became effective." Claims for post-effective misdeeds must be made under Section 12.

20. Securities Exchange Act, § 12b, 15 U.S.C. § 78a-h (1970) (original version at ch. 404, § 1 et. seq., 48 Stat. 881 (1934)) [hereinafter cited as Securities Exchange Act].

21. *Id.* § 12(e).

statute, such registration statement will become effective sixty days after filing or "within such shorter period as the Commission may direct."²² Once registered, the plan will be required to file annual or even quarterly reports with the Commission.²³ Moreover, the Commission can require the filing of any information it deems necessary to keep the file "reasonably current."²⁴ As with all other provisions, failure to comply with this provision would expose the issuer to both civil and criminal liability.²⁵

Absent the exemption from the Investment Company Act, any private employee pension plan would fall within one of the statutory definitions of "investment company" and thus be required to register.²⁶ Registration under the statute is accomplished by filing a "notification of registration" with the Commission.²⁷ Upon receipt by the Commission of such notification, the plan would be deemed registered. As such, it would be exempt from the registration requirement of the Exchange Act.²⁸ However, the plan would still be required to file a registration statement setting forth much the same information, plus describing the plan's policy with respect to diversification, borrowing and lending of money, and special investments such as real estate or commodities.²⁹ The employee benefit plan, once registered as an investment company, would probably be considered a "unit investment trust."³⁰ As such, it need not have a board of directors and is excluded from many of the more stringent capital structure provisions. However, as a registered investment company, it may not deviate from the investment policies set forth in its registration statement, unless such change is authorized by a majority of its outstanding voting securities—or the equivalent, which in this case would be the participant.³¹ Moreover, the contract between the investment adviser and the plan would also have to (1) be approved by the participants, (2) precisely describe the compensation arrangement, (3) expire at the end of two years, (4) provide for its termination upon 60 days notice, and (5) provide for its automatic termination in the event of its assignment.³²

Perhaps most importantly, as a registered investment company, the Plan's transactions with "affiliated persons" are closely scrutinized and in many cases outright prohibited.³³ Unless the Commission agrees that a proposed

22. *Id.*

23. *Id.* § 13(a).

24. *Id.*

25. *Id.* § 32.

26. Investment Company Act, § 8a, 15 U.S.C. § 80a-3(a) (1970) (original version at ch. 686, tit. 1, § 1, 54 Stat. 789 (1940)) [hereinafter cited as Investment Company Act].

27. *Id.* § 8(b).

28. Securities Exchange Act, *supra* note 20, at § 12(g)(2)(B).

29. *See* note 85 *infra*.

30. Investment Company Act, *supra* note 26, at § 4(2).

31. *Id.* § 13.

32. *Id.* § 15.

33. *Id.* § 17(a).

transaction is fair and consistent with the plan's policy, as set forth in the regulation statement, no exemption order will be forthcoming.³⁴ Employers would thus be almost automatically precluded from all but the most routine dealings with the plans they establish.

Much of the same analysis would apply to the chosen investment medium unless the medium served less than one hundred but more than ten plans.

B. Exemption from Regulation

Today, none of the scenario need to occur. A series of key exemptions effectively preclude application of any of the three acts to private employee pension funds.

1. The Investment Company Act

Although the most recent, the Investment Company Act, contained the first direct mention of private employee pension plans, it adopted and has maintained from its inception a two-tiered exemption. First, the statute automatically exempts all plans "qualified" under the Internal Revenue Code.³⁵ Second, it empowers the SEC to exempt any and all others "if and to the extent that such exemption is consistent with the protection of investors."³⁶ One searches in vain for legislative history explaining the rationale and purposes of the exemption. There is none. As with many of the key provisions in that particular statute, the curious course which led to the statute's enactment necessitates looking elsewhere.³⁷ One source holds that two explanations suggest themselves: "*One*, it may have been felt that adequate protection was already provided by the Internal Revenue Code and thus Investment Company Act coverage could be superfluous; *two*, there may have been a general unwillingness to place the burdens of the Act upon

34. *Id.* § 17(b).

35. *Id.* § 3(c)(11).

36. *Id.* § 6(b).

37. Pursuant to § 30 of the Holding Company Act of 1935, the Commission made an investigation of investment trusts and investment companies which covered a period of four years and generated eleven reports to Congress. Legislation was introduced and extensive hearings were held during which the Commission and the industry were heard. *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3rd Sess. (1940) [hereinafter cited as *1940 Hearings*]. Although it was apparently clear to the industry that some form of regulations was inevitable and might well serve to restore public confidence in the operation of investment trusts, representatives of the companies affected nonetheless voiced strong objection to the bill in its original form. Almost immediately after the conclusion of the hearings, these representatives commenced private negotiations with the Commission in an attempt to reach agreement on the scope and terms of the bill. The work product of these meetings was reintroduced as S. 4108 and HR 10065, the latter bill passing unanimously and with little debate. Speaking in support of the Senate version, its sponsor, Mr. Wagner, stated: "[N]ot only do the witnesses who appeared before us in opposition to the original bill now support this compromise measure but also it has the unanimous support . . . of the entire industry. It is almost a miracle. I have never known it to happen in my experience as a legislator that the industry affected has sought such regulation." 86 CONG. REC. 8843 (1940).

employees who are not in the investment company business.”³⁸ Another source contends that “the most likely reasons” for the exemption were probably: *one*, the relative unspeculative nature of the plans’ assets in 1940, and *two*, a desire to keep the cost to participants at a minimum.³⁹ The continued efficacy of these reasons will be discussed later. Suffice it to say for the present that the Investment Company Act in unambiguous language eliminates private employee pension plans from its coverage. Thus, even were the SEC so inclined, it could not apply the provisions of this particular statute to these plans.

2. *The Securities and Securities Exchange Act*

A different picture presents itself when one focuses on the Securities and Securities Exchange Acts. The exemptive provisions have only recently been added. With virtually no discussion, the 91st Congress included in the Investment Company Amendments Act of 1970⁴⁰ provisions, which in fact and effect, exempted almost all existing and prospective employee pension plans from the requirement of both statutes. The scarcity of legislative history or commentary suggests that an analysis of the pre-1970 stance of the Commission may be instructive.

With respect to the Securities Exchange Act of 1934, the SEC’s pre-1964 attitude is of little importance. The 1934 Act originally required registration of, and therefore subjected to its reporting provisions, only those issuers whose securities were traded on the national securities exchanges.⁴¹ Thus, it was not likely that any employee benefit plans could have been affected. However, the 1963 amendments brought the then revolutionary 12(g).⁴²

38. “Since the employer is prevented (by the Internal Revenue Code) . . . from benefit from the administration and operation of the pension trust . . . imposing the protections of the Investment Company Act may not provide sufficient additional benefits to justify the cost of requiring compliance with the act. The reluctance to impose the cost of compliance . . . on a person who is not in the securities business, but who has decided to create a pension or other benefit plan for his employee is reflected . . . (in the exemptive provisions).” Mundheim & Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans*, 29 LAW AND CONTEMP. PROB. 795, 815 (1964) [hereinafter cited as Mundheim & Henderson].

39. Note, *Commingled Trust Funds and Variable Annuities: Uniform Federal Regulation of Investment Funds Operated by Banks and Insurance Companies*, 82 HARV. L. REV. 435, 460 (1968).

40. Pub. L. No. 91-547, § 206A, 84 Stat. 1413, 15 U.S.C. § 80a (1970).

41. Securities Exchange Act, *supra* note 20, at § 12(a).

42. The “revolution” was destined to occur since Congress acted to regulate transactions in outstanding securities under the Securities Act of 1934 by regulating national exchanges and the securities registered on such exchanges. Section 15 of that Act provided the Commission with authority to prescribe rules regulating the trading of securities over-the-counter in interstate commerce and to provide protection comparable to that provided in the case of national exchange. This “double standard of investor protection” resulted not from any conviction that adequate disclosure and other safeguards were not essential with respect to securities traded in the OTC market, but start rather from a lack of understanding of and information regarding the workings of that market. 2 L. LOSS, SECURITIES REGULATION 1149-64 (2d ed. 1961) [hereinafter cited as 2 LOSS]. After thirty years of periodically updated studies and ill-fated legislative

After the section became law, it was clear that a large number of plans had the requisite \$1,000,000 in assets, and 500 participants, to bring the plans within the ambit of both registration and reporting provisions. The SEC responded immediately and decisively. By rule, the agency expressly exempted from 12(g) "any interest or participation in (any employee benefit plan) which is not transferable by the holder except in the event of death or mental incompetency"⁴³ With one ruling, it erased the possibility that the 1934 Act would ever have any bearing on employee benefit plans.

Dealing with the Securities Act was not quite as simple, however. The discretionary exemptive powers of the SEC are more circumscribed.⁴⁴ Thus, it was necessary to fashion a far more creative scheme of avoidance. First, the SEC invoked a variant of the "no-sale" theory whenever a plan called for either compulsory contribution or no contribution from the employee-participants.⁴⁵ If there was no sale and no offer, there was no need to file a registration statement and thus no violation of § 5. Next, the agency adopted a "no-action" posture where the plan did not allow the actual investment in the securities of the employer to exceed the contributions of the employer.⁴⁶ And thirdly, a Regulation A exemption was afforded to even voluntary plans so long as the amount contributed within any given year did not exceed the statutory limit of \$300,000.⁴⁷

proposals, the *Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), finally stimulated the enactment of § 12(g). Briefly, the effect of 12(g) is to bring within the registration requirements of § 12 OTC issues which are engaged in or affect interstate commerce and have both \$1 million in assets and a class of equity securities held of record by 750 (subsequently 500) persons. This, in turn, subjects such issues to the periodic reporting, proxy solicitation and insider trading requirements of § 13, § 14, and § 16. See generally Phillips and Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706; Sargent, *The Securities Acts Amendments of 1964: Background, Effect and Practicalities*, 20 SOUTHWESTERN L.J. 434 (1966); Comment, *An Appraisal of Some Coverage Aspects of the 1964 Securities Act Amendment*, 60 NW. U. L. R. 331 (1965).

43. 17 C.F.R. § 240.12h-2 (1976).

44. Securities Act, *supra* note 2, at § 3(b)(c) contains the only two discretionary exemptions.

45. "As to the question of finding a 'sale' within the meaning of Section 2 (3) of the Act, wherever a plan involves an investment contract or a certificate of interest or participation in a profit-sharing agreement and the employees have a choice whether or not to make contributions, there is obviously an 'attempt or offer to dispose of * * * a security * * * for value.' On the other hand, it is because of the language of Section 2(3) that we have taken the position in the past that no 'offer' or 'sale' is involved in the case of a non-contributing plan, where the employees are not requested to make any contributions, or in the case of a compulsory plan, where there is no element of violation on the part of the employees whether or not to participate and make contributions." Op. Ass't Gen. Counsel of Comm. [1941] 1 CCH FED. SEC. L. REP. ¶ 2105.53, *as amended*, [1953] 1 CCH FED. SEC. L. REP. ¶ 2105.51.

46. *Id.* Knowledgeable sources contend, however, that this has not always been the position of the commission, and that "prior to 1951 companies were advised that plans under which any contributions were invested in employer stock had to be registered." Mundheim and Henderson, *supra* note 39, at 809 n.45.

47. Letter to CCH from Ass't Dir., Div. of Corp. Fin., [1953] 1 CCH FED. SEC. L. REP. ¶ 2105.51.

Even with so liberal a policy, a substantial amount of plans would still not seem to come within this exemptive scheme. Even if many of these plans were excused from registration by one of the other automatic exemptions, there would still be some left over to register. Few have. It also appears that the general disinclination to proceed with registration reflects an accurate perception of the SEC's unarticulated policy.

The exception to this disinclination is the H.R. 10 plan.⁴⁸ Immediately after the enactment of the self-employed Individual Tax Retirement Act in 1962, the Chase Manhattan Bank announced that it would establish two collective trust funds for these plans. The SEC immediately responded and indicated that it considered such announcement a public offering of a security and therefore, violative of Section 5 because no registration statement had been filed.⁴⁹ The ensuing debate with the Comptroller of the Currency has been well documented.⁵⁰ The jurisdictional dispute over the regulation of common trust funds remains to this day.⁵¹ Nevertheless, the H.R. 10 plan, at least on the level of the investment medium, remains the notable exception to the SEC's laissez-faire attitude toward private employee pension plans.

III. SEC RATIONALE FOR INACTION

The SEC never articulated a definitive rationale for its relaxed posture on private pension funds. Several reasons may be advanced for the SEC's reticence, however. The agency may have been reacting to the contention that employee-benefit plans were not within the scope of the Securities Act; it may have felt that the plans were both sufficiently numerous and different, as to make enforcement administratively impossible; it may have thought that forced compliance with the Act would be sufficiently burdensome as to

48. Pub. L. 87-792, 76 Stat. 809 (1962) [hereinafter cited as Self-Employed Individuals Retirement Act].

49. Authors Mundheim and Henderson report that the initial response came that very day during a discussion of pension and profit-sharing plans for the self-employed then being sponsored by the Practising Law Institute in New York. Mundheim & Henderson, *supra* note 38, at 795.

50. *Id.* at 824 et. seq.

51. The SEC has taken the position that the investor on a bank-managed commingled fund, was in much the same position as the investor in a mutual fund, and thus the bank commingled agency accounts were in fact the functional equivalent of a mutual fund. Letter from William Cary, Chairman of the SEC to Senator Robertson, November 27, 1963 reported in *Hearings on S. 2704 Before a Subcomm. of the Comm. on Banking and Currency of the U.S. Senate*, 89th Cong., 2nd Sess. [hereinafter cited as *Senate Hearing*]. The Comptroller of the Currency asserted that Congress had not intended to include the activities of banks within the Investment Company Act of 1940 and in fact specifically excluded the commingled funds with the § 3(c) (3) language exemplify from the definition of "investment company" "... any common trust fund or similar fund maintained by the bank . . . in its capacity as a trustee, executor, administrator, or guardian . . ." Letter from Comptroller of the Currency, James Saxon to Senator Robertson (January 20, 1964), *reprinted in Senate Hearings*, at 634. The matter appeared to reach a plateau with the ruling of the Supreme Court in *Investment Company Institute v. Camp*, 401 U.S. 617 (1971).

discourage the growth of the plans; it may have felt that while securities were involved in these plans, this was not primarily a securities matter but pertained more closely to the fields of labor relations and taxation.

Absent other considerations and even without a clear indication from the SEC, these factors suggest a cogent rationale for its low profile approach. However, close scrutiny casts doubt on the efficacy of any of the reasons propounded.

A. *Applicability of the Securities Act*

It is true that there were those who questioned the Commission's contention that an interest in a plan of this nature was a "security" within the meaning of the Securities Act. Congress had defined "security" in Section 2(1) of the Act to mean:

. . . any note, stock, treasury stock, bond debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting trust certificate . . . or, in general, any interest or instrument commonly known as a "Security" . . .⁵²

At no time did the Act make any specific reference to employee benefit plans. It is the absence of such reference which constitutes a basis for the contention that Congress had not intended to include such plans within the scope of the Act.

In 1941, when the SEC sought to have Congress amend the Securities Act to exclude certain well-defined plans from the registration provisions of the statute, it was opposed by industry.⁵³ Realizing that such exemption would

52. This definition was intentionally broad so as to assure that "the many types of instruments that in our commercial world fall within the ordinary concept of a security" would be subjected to the provisions of the Act. H.R. REP. NO. 85, 73rd Cong., 1st Sess. 11 (1933).

53. The proposed exemption reads as follows:

(1) Any interest or participation in a savings, pension, profit-sharing or other employees' benefit plan, if (A) the assets are required to be held in trust under the terms of which no part of the corpus or income may be used for, or diverted to, purposes other than the exclusive benefit of participating employees; (B) the employer is obligated to make cash contributions at least annually, or, in the case of those plans in which the contributions of the employer are determined by earnings before or after deduction of dividends, at least annually in those years in which there are the specified earnings; (C) at least seventy-five per centum of the assets is required to be held in cash or invested bonds, notes, or debentures, or in securities exempted under paragraph (2) or (8) of this subsection, and no part of the assets is permitted to be invested in securities of the employer or any associate of the employer; (D) no portion of the interest of any employee in the plan other than that in excess of the amount of his contributions is subject to forfeiture at any time by any reason of termination of employment or otherwise; (E) it is required that annually there be sent a report covering the preceding fiscal year of the trust and containing in substance, (i) a statement of assets and liabilities, (ii) a statement of income and expenses, (iii) a statement of cash receipts and disbursements, and (iv) a schedule showing the computation of amounts contributed by the employer to the trust, and there be made available upon request to any employee or organization of employees a schedule covering the preceding fiscal year of the trust and showing in substance the description, number of shares, or principal amount, cost, carrying value, and, where determinable, market value of each

create the negative implication that these interests are securities and are subject to the fraud and other provisions of the Act, industry contended that since Congress had intended to include employee benefit plans in the first place, no such exemption was required.

In support of that contention, the industries purported to show that no "State blue-sky law commission (had) even taken the position that these plans . . . involve the issuance of or sale of securities. [further, that] hundreds of these employee benefit plans . . . in existence in 1933, and many more have been adopted . . . developed and used by the country's largest and presumably best advised corporations,"⁵⁴ and "no single instance had been brought to light of a voluntary registration. . . ."⁵⁵ Finally, the industries argue that the SEC itself evidenced an initially more narrow construction of the Act; no claim of jurisdiction was asserted for many years after the law became effective, and even now no substantial number of these plans have been subjected to a demand for registration.⁵⁶

The agency countered with the contention that Congressional intent to permit the desired reading of "investment contract" could be inferred from the explicit attention paid to "employee securities companies" by the Investment Company Act of 1940.⁵⁷ The agency argued that the existence of this exemption evidenced an intention to consider such interest a "security" in the absence of language to the contrary.⁵⁸

In this regard, it has been noted:

It is a tenet of statutory construction that similar to words and phrases which should not be isolated and given an abstract meaning, the statute itself should be interpreted in reference to other relevant laws, particularly those in *pari materi*. But this aid in construction has its greatest usefulness in referencing an ambiguous enactment to pre-existing or contemporaneous legislation. The Commission's ar-

investment owned at the end of the fiscal year, the number of shares, and principal amount of each investment acquired or disposed of, and the income or dividends received from each investment held at any time during the year; and (F) it is required that before any interest or participation is offered to any employee (or, in the case of any plan which is in operation at the date this paragraph takes effect, within sixty days after such a date) a summary of the plan be sent or given to such employee, and a copy of the trust instrument creating the plan and a copy of the rules and regulations under the plan be made available upon request to any employee or organization of employees, and such a summary and such copies be filed with the Commission. 1941 Hearings, *supra* on note 1, at 908.

Mudnheim and Henderson observe "no industry witness appeared to testify on behalf of the proposed amendments; but several industry witnesses testified against them." Mudnheim & Henderson, *supra* note 38, at 811.

54. 1941 Hearings, *supra* note 1, at 968.

55. *Id.*

56. *Id.* at 958-62, 967, 975, 994.

57. See notes 15 and 16 *supra*. Investment Company Act, 15 U.S.C. 80a-3(a): "As used in this section, 'investment securities includes all securities except . . . (B) securities issued by employees' securities companies. . . ."

58. 1941 Hearings, *supra* note 1, at 895.

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gument would be entitled to greater weight if the enactment particularly naming pension plans had preceded the more general one.⁵⁹

The SEC also contended that there was even stronger legislative history to support their version of Congressional intent. They pointed to the defeat of a proposed amendment which would have exempted from registration "an offering made solely to employees by an issuer, or by its affiliates, in connection with a bona fide plan for the payment of extra compensation or stock investment plan for the exclusive benefits of such employees."⁶⁰ A dubious Congress was never convinced, however, as subsequent events in 1941 buried the legislation in the avalanche of World War II.

While Congressional receptivity to the SEC position in 1941 was not warm, the agency could not claim that this was a major setback. Barring further Congressional action, it is unlikely that the judiciary would have afforded relief to a potential defendant. The U.S. Supreme Court has literally adopted the SEC's definition of "investment contract"⁶¹ and has continuously reaffirmed its determination to consider all claims for exemptions and exclusions in light of the broad remedial purposes of the Act.⁶² The burden on the opposition would have been enormous had the SEC chosen to act.

B. Administrative Difficulty

The SEC's work load has been a cause of concern for some time.⁶³ The agency currently processes over 3,000 Securities Acts registration statements a year—a staggering amount when one considers what is at stake.⁶⁴ It is only through the constant utilization of multiple, informal mechanisms,⁶⁵ and a procedure which has been termed "an excellent example of the vaunted flexibility of the administrative process,"⁶⁶ that the paper crunch at the SEC has not brought work to a grinding halt. It is clearly no simple

59. Note, *Pensions Plans As Securities*, 96 U. PENN. L. REV. 549, 561 nn. 84, 85, & 86 (1948).

60. 78 Cong. Rec. 8708 (1934). The amendment was eliminated by the Conference Committee on the ground that participants in employees' stock investment plans may be in as great need of protection afforded by availability of information concerning the issues for which they work as are most other members of the public. H.R. REP. NO. 1838, 73rd Cong. 2nd Sess. 42 (1934).

61. SEC v. Howey, 328 U.S. 239 (1945) and lower federal cases cited therein at n. 5.

62. SEC v. Howey has been followed frequently and is "perhaps the most frequently cited case on the meaning of 'security' as used in the Securities Act." JENNINGS & MARSH, SECURITIES REGULATIONS: CASES AND MATERIALS 299 (3rd ed. 1972).

63. 1 L. LOSS, SECURITIES REGULATIONS 273 (2d ed. 1961) [hereinafter cited as 1 L. LOSS].

64. 298 Statements involving over \$6.3 billion in offerings were processed by the Commission in November of 1972 alone. 32 SEC STATISTICAL BULL. NO. 1, 20 (1973).

65. The Commission has recently expanded its efforts to expedite the processing of registration statements. A division Officer presently conducts a "cursory review of every registration statement" and decides whether it will receive: (1) no further review due to serious deficiencies, (2) summary treatment of (3) full statutory review. Smith, *An Overview of the Registration Statement Process*, in LEVENSEN, GOING PUBLIC: FILING PROBLEMS 14, 15, 16 (1970).

66. 1 L. LOSS, *supra* note 63, at 272.

matter to suggest an activist role for this particular agency in an area with a potential of tens of thousands of additional filings.⁶⁷

Employee benefit plans are not only numerous, they are also versatile. There are endless ways to set up a plan which depend on the desires, temperament, idiosyncrasies, and resources of the parties involved. A plan could be contributory or noncontributory, trusted or not trusted, funded or pay-as-you-go. It could be a savings plan, a stock purchase plan, a stock bonus plan, or a profit-sharing plan. It could include an option for lump-sum payments or merely provide for annuities. It could provide for defined benefits or a defined contribution.

All these factors considered in light of the present work load suggest that were this the SEC's concern, it would not be unfounded. However, the reality of the situation is that insofar as the Securities Act is concerned, many of these factors need not be considered by the SEC. Unlike the "fair, just, and equitable" standard of the California Corporations Code,⁶⁸ the Securities Act is a disclosure statute calling for a less substantive analysis by the SEC. Moreover, the inclination to indulge in intricate or unique plans is curbed by the desire to conform to the patterned plans which qualify for favorable tax treatment. This tax incentive has effectively narrowed the area in which the bulk of the private pension plans operate to those trusted and funded stock bonus, profit-sharing and pension plans.

C. *Conflicting Social Policies*

Private provision of welfare and retirement benefits remains a relatively new phenomenon, which is viewed as socially desirable and worthy of

67. The Commission officially expressed its concern during the hearings preceding enactment of the Welfare and Pension Plans Disclosure Act. One of the two major versions of the act proposed that the SEC assume responsibility for the administration of its provisions. The Commission responded:

The Commission has serious doubts that it should be named as the agency charged with the administration of any of the pending bills in the fields of welfare and pension plan legislation. The Commission's reasons are:

(1) The magnitude of the task imposed by this legislation would tend to overshadow the Commission's present work. The Commission is reluctant to assume a job of such potential size that would tend to submerge the Commission's main mission.

(2) Many of the plans involved in this legislation are the fruits of collective bargaining. Accordingly, these plans are inseparably intertwined with labor-management relations. Abuses in this area then have their main effect upon an economic area in which the Commission does not possess expertise. It is true that the Commission and its staff have developed an expertness in financial analysis of corporate securities and full disclosure of financial information. Inasmuch as welfare and pension plan beneficiaries generally have no individual choice as to the securities to be purchased by a welfare or pension fund, the type of meaningful information furnished to them as to the management, investments and transactions of their funds may involve quite different criteria from those presently employed by the Commission under the various federal Securities Acts. An agency which has had closer contact with the needs and problems in the labor-management field would be in a better position to determine the appropriate criteria.

Hearings on Welfare and Pension Plans Legislation Before a Subcomm. of the Senate Comm. on Labor and Public Welfare, 85th Cong., 1st Sess. 119 (1957) [hereinafter cited as *1957 Hearings*].

68. CAL. CORP. CODE § 25113, 25140 (West 1976).

government support in the form of tax incentives. Even more important is the perceived need for the elimination of significant governmental obstacles which tend to retard the development of this endeavor. The issue was stated most clearly in a recent Congressional report:

It is . . . important to recognize that as desirable as strengthening requirements for pension and profit-sharing plans may be, these plans are essentially voluntary insofar as employers are concerned, with the result that stronger requirements tend to discourage the widening of the use of private pension and profit-sharing plans. Therefore, a careful balancing of these two conflicting considerations is needed in considering recommendations to strengthen provisions relating to private pension and profit-sharing plans.⁶⁹

Such a view is clearly not unreasonable. It may be, however, that a perfect balance need not be struck, and that the underlying concern is premised on a misapprehension of the extent to which "fringe benefits" have become institutionalized.⁷⁰ It is relatively certain that parties dealing with unions on an individual or industry-wide basis are not likely to abolish or seriously impair the growth of presently existing plans. Nor will subsequent attempts by unions to negotiate employee benefits be significantly hampered by securities considerations. Moreover, in the non-union situation, there is no reason to expect a change in the significant role fringe benefits play in obtaining and retaining good employees. In sum, the deterrence or the discouragement to which the committee referred is more imagined than real.

D. Labor and Taxation Interests

Partly as a result of continued, unfavorable publicity regarding the administration of employee benefit plans and partly due to Presidential prodding, a Senate subcommittee was formed to conduct a congressional inquiry in May 1954.⁷¹ The investigation continued in 1955 with the final report being submitted in April 1956.⁷² After subsequent hearings, Congress enacted the Welfare and Pension Plans Disclosure Act in 1959.⁷³ Until quite recently that legislation was the single most important governmental incursion in the area of employee benefit plans.⁷⁴

69. *Panel Discussion on Tax Reform Before House Comm. on Ways and Means*, 93rd Cong. 1st Sess. 6 (Comm. Print 1973) [hereinafter cited as *Panel Discussion* (1973)].

70. See note 112 *infra*.

71. S. Res. 225, *as amend.*, 83rd Cong., 2d Sess. 100 CONG. REC. 4311 (1954).

72. S. REP. NO. 1734, 84th Cong., 2d Sess. (1956).

73. 72 Stat. 997 (1958), 29 U.S.C. § 301-09 (Supp. 1975) [hereinafter cited as *Welfare and Pension Plans Disclosure Act*].

74. As finally passed in 1958, the Welfare and Pension Plans Disclosure Act was a watered down version of what the Eisenhower Administration desired. It was amended in 1962 to afford certain minimal regulatory powers to the Department of Labor. See Scaife, *Problems with Compliance with the Welfare and Pension Plans Disclosure Act*, 14 BUS. LAW 762 (1959); and Comment, *The Welfare and Pension Plans Disclosure Act*, 8 DEPAUL L. REV. 59 (Autumn-Winter 1959).

The fact that the legislation emanated from the Senate Committee on Labor and Public Welfare, coupled with the normal fact pattern of these plans, would lend credence to a contention that this is not primarily a securities matter. Even though the contention itself is arguable, it is nevertheless an unprincipled reason for administrative inaction.

Even prior to 1970, the Securities Act textually afforded the Commission the opportunity to bypass the entire issue. Section 2(1) states that all enumerated interests were securities "unless the context otherwise requires."⁷⁵ This was not a phrase with which the Commission was unaccustomed.⁷⁶ Therefore, had the SEC felt that this was an area of little, if any, significance insofar as federal securities law was concerned, the "investment contract" debate could have been avoided. But more important, to say that an area is not *primarily* a securities area cannot be considered dispositive. It can be just as strongly contended that condominiums and oil wells are primarily real estate questions, that franchises are matters of commerce, and that proxies and tender offers are primarily corporation law. Yet each of these businesses have important securities interests which are recognized and dealt with as such. It is difficult to see how the interests of the participants in a pension plan, regardless of how obtained, are any less worthy of protecting than the investor in orange groves.⁷⁷

E. Speculativeness or Private Pensions

The dramatic growth in the size and coverage of the private employee pension plans was noted earlier. Not yet mentioned, however, is the equally dramatic change in the investment policy of these funds. Here are some of the statistics. In 1951 (the earliest date for which figures are available) over 80% of all the assets of these funds were invested in U.S. government securities and corporate bonds.⁷⁸ Only 15% was invested in equity securities and of that about 4% was in preferred stock.⁷⁹ At the end of 1961 the SEC could report:

75. "The touchstone should always be substance rather than form—whether it operates to include or to exclude." 1 L. LOSS, *supra* note 63, at 462.

76. *Id.* at 461, 467.

77. SEC v. Howey involved an "offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor." 328 U.S. at 294. The Court held that this was an offering of an investment contract, saying *inter alia*:

[A]n investment contract for purpose 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. 328 U.S. at 299.

78. DIV. OF ECON. AND POLICY RESEARCH, SECURITIES EXCHANGE COMM., RELEASE NO. 1335, SURVEY OF CORPORATE PENSION FUNDS, 1951-1954, 2 (1955) [hereinafter cited as CORPORATE PENSION FUNDS].

79. *Id.*

. . . corporate securities accounted for \$27.6 billion of pension fund investments, or 85 percent of all assets; at best value. Of the total, \$15.1 billion was in corporate bonds and \$12.4 billion in common and preferred stock. U.S. Government to [only] \$ 2.1 billion while cash, mortgages and other investments . . . make up the balance of \$2.8 billion. *Based on market values, investments in common and preferred stock comprised 51 percent of fund assets at the end of 1961.*⁸⁰ (emphasis added)

By the end of 1975, the private employee pension plans have over 70% of the assets—\$111 billion dollars—in common stock alone.⁸¹

This represents a clear and definite shift from “protected securities” to common stock. The pension funds are the second largest investors in the capital market. Only banks, via personal trust funds, and life insurance companies, have greater assets⁸² (the life insurance companies have less than 10% of its assets in common stock).⁸³ Only the investment companies are more heavily invested in common stock—over 80%. This being the case, it is difficult to conceive that one could justify any current policy on the grounds that private employee pension plans are “relatively unspeculative.”⁸⁴

F. Costs of Compliance

A final rationale for the Commission’s recalcitrance need only be stated here, because it will be dealt with extensively in the latter portion of this note.

To a great extent, these participants did not appear to be true investors and . . . the employer who created the pension plan was not in the pension plan business and . . . it [is] therefore inappropriate to saddle him with the costs of complying with the provision of the federal securities law.⁸⁵

Though far more formidable than any of those will show, this reasoning begs the question and presupposes both indivisibility between registration (with its inherent costs) and disclosure, and the impossibility of reducing the costs. Subsequent discussion will explore both premises and take issue with them.

IV. REGISTRATION AND DISCLOSURE UNDER 1970 AMENDMENTS

Prior to the 1970 legislative changes, the Commission’s position was clear, if not definite. Unless an H.R. 10 or employer stock purchase plan

80. SEC STATISTICAL BULL., Release 1828, 1 (May 22, 1962).

81. 35 SEC STATISTICAL BULL., No. 11 (Nov. 1976).

82. *Id.*

83. *Id.*

84. *Id.*

85. S. REP. NO. 91-184, 91st Cong., 1st Sess. (1969).

was involved, neither registration nor disclosure was required. To what extent the 1970 amendments in fact codified administrative policy remains to be seen. What is clear, however, is that post 1970 policy is equally unsupported by any affirmative, articulated rationale. Less than two pages of the committee's report was devoted to the two sections containing the amendments, and almost all of that was interpretive in nature.⁸⁶ It may thus be assumed that whatever rationale undergirded the pre-1970 legislation must be attributed to the 1970 legislation as well. As the validity and viability of the conceivable reasons are questionable at least, it is unlikely that the subsequent action is in any way supportable.

However, rather than allowing the 1970 amendments to fall on the ground that they reflect a policy which is demonstrably uncertain, it may be instructive to evaluate the changes on their own merits.

The 1970 amendments created a special exemption from the Securities Act and Securities Exchange Act for "any interest or participation in a single or collective trust fund maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with [an employee benefit plan] which meets the requirements for qualification under [the Internal Revenue Code]."⁸⁷ Excluded from this sweeping exemption were H.R. 10 plans and "[plans] the contributions under which are held in a single trust fund maintained by a bank, or in a separate account maintained by an insurance company for a single employer, and under which an amount in excess of the employers contribution is allocated to the purchase of securities . . . issued by the employer or by any company [in a control relationship] with the employer."⁸⁸

To qualify under the relevant provisions of the tax code⁸⁹ prior to ERISA, a plan had to be (1) a trustee plan; (2) providing for contributions by either employer or employee or both; (3) with the purpose of distributing both corpus and income to the employees or their beneficiaries at some future date in accordance with such plan; (4) with a trust instrument that makes it impossible to divert either corpus or income; and (5) which is nondiscriminatory and non-forfeitable. The wording of the exemption adopts these criteria and further requires—that the funds must be "maintained" by a bank or insurance company.

Once the requirements are satisfied, the amended language of 3(2) exempts from the non-fraud provisions of the Act the security interest held by the plan in the investment medium, as long as the investment medium is the separate account of an insurance company or a single or commingled bank

86. See note 40 *supra*.

87. *Id.*

88. *Id.*

89. Internal Revenue Code §§ 401-404.

fund. To the extent that the 1970 legislation exempted interests in the single and collective trust fund of banks from the Act, it did partially codify pre-existing Commission policy. It did expand somewhat on that policy by including the separate accounts of insurance companies within the purview of the exemption.⁹⁰ But its refusal to include H.R. 10 plans, and plans in which an amount in excess of the employer's contribution is directly invested in stock of the employer or of a company in a control relationship, is perfectly in accord with pre-1970 practice.

Two caveats must be noted at this point. The first concerns the statutory language "maintained." The second is a limitation of the term "collective."

The Commission takes the position that "maintained" means much more than the mere carrying out of ministerial duties. In 1971, Bank of America sought to establish a new method of handling both corporate and industry-wide employee benefit plans. The essence of the proposal involved the creation of three competing separate funds, each with a different investment advisor and medium. Bank of America felt that this competitive situation would maximize profits and improve all around investment performance. Specifically referring to the "maintained by a bank" language in the amended Act, the Division of Corporate Finance said:

We interpret the exclusion and the exemption to be unavailable where the bank acts as a mere custodian for the collective trust fund and does not exercise substantial investment responsibility.⁹¹

An equally firm pronouncement was soon forthcoming on the commingling issue. In 1971, the Commercial National Bank in Shreveport decided that operational reasons made it desirable to administer two common trust funds on a commingled basis. One fund had been restricted to funds held by the bank as trustee of corporate refinement, pension and profit-sharing plans. The other consisted of restricted funds held by the bank as trustee for qualified H.R. 10 plans. The SEC refused to issue a no-action letter, stating:

This Division has consistently taken the position that where a security is offered or sold to two different classes of persons only one offering is involved and it thus follows that if the trusts are commingled, neither exemption will be available for the trust and registration under the Act would be required.⁹²

90. See note 87 *supra*, and accompanying text.

91. Bank of America [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78, 614 at 81, 308.

92. Commercial National Bank [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78, 384, at 80, 865. Investment Company Act § 3(c)(1) exempts from the definition of company "any issuer whose outstanding securities (other than short term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." The section goes on to say that "beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except

It may be argued that since a literal reading of the text shows no mention of the employees interest, no exemption was intended on this level. Such an argument is, of course, too narrow and contrary to the scant legislative history of the amendments. It is more accurate to say that the employee interest is exempt in retrospect—that is, from the moment the plan is “maintained” by the bank or insurance company.

Thus, the only real change may be that in effect, if not in fact, the plan be qualified and the designated trustee be banks or insurance companies.

V. EFFECT OF S.E.C. INACTION

The net effect of the present treatment is a blanket exemption from the registration, disclosure and civil liability provisions of federal securities legislation. Arguably the shotgun approach is unnecessary or inconsequential due to a similar protection afforded by other statutes. A cost benefit analysis might suggest that the protective scheme is not worth it. However, with these considerations in mind, the inquiry should focus on whether a more finely tuned exception, if any at all, would be more appropriate.

A. Registration

Registration, as we now know it, is seen as a means of assuring disclosure and has little value in itself. Yet accountant fees, legal fees, and filing fees make this process extremely costly. Unlike the producers of goods or services, the employee benefit plan has no consumers among whom it can spread the cost. Nor are there tax provisions to reduce the impact. Costs incurred will be borne out of pocket by someone. That someone will more than likely be the plan itself, and in reality, its beneficiaries. This consideration suggests that the relief from the registration process afforded by this exemption is both justifiable and desirable.

B. Reporting

To a large extent, many of these same considerations apply to those provisions requiring periodic reporting. Annual, semi-annual or quarterly reports can be quite costly. However, as distinguished from registration (at least registration in the Securities Act sense), the reporting provisions bring into play the ongoing oversight function of the involved governmental agency. Regarded by Congress as “the minimum which is requisite for the

that, if such company owns 10 percent or more of the outstanding voting securities of the issue, the beneficial ownership shall be deemed to be that of the holder of such company’s outstanding securities.”

Thus, while less than one hundred plans may take the investment medium out of the definition of investment company, less than ten could bring it back in again if the greater than 10% interest of the at least one participating plan would trigger the latter provision. Query, however, whether what is involved is a voting security.

adequate protection of investors,"⁹³ the reporting provisions should not have been so hastily abandoned, and deserve reappraisal as much as any provisions. The current prospectus and reporting provisions only theoretically assure "disclosure" for the employee-participant in a non-exempt plan. (For purpose of the following discussion, the SEC's "private offering" analysis of relationship between the plan and its investment medium will be accepted and attention will be focused on the primary level of interest—that of the employee-participant). Form S-8⁹⁴ would require that each prospective participant be given the following information in writing prior to joining the plan: (1) who may participate; (2) contribution arrangement; (3) withdrawal procedure; (4) default effect; (5) administrative set up; (6) detailed investment policy and activity; (7) lien provisions; (8) termination and extension conditions; (9) other charges and deductions; (10) financial statement of the plan. Form S-8 and these requirements would apply to very few current plans.

C. Disclosure

It certainly has not been the case that the refusal of the federal securities laws to impose its prospectus provisions on employee benefit plans was compensated by any significant disclosure requirements in other legislation. Neither the language nor administrative policy of the Welfare and Pension Plans Disclosure Act,⁹⁵ and the Internal Revenue Code,⁹⁶ even approximate the disclosure standards of the Securities Act. Not surprisingly, no mention of disclosure is made in the Internal Revenue Code. A descriptive note conspicuously displayed in the principal place of employment suffices insofar as administratively required disclosure is concerned.⁹⁷

The Welfare and Pension Plans Act disclosure requirements were more elaborate, but hardly any more effective. Under the provisions of that statute, the administrator of the plan was required to publish a description of the plan, and the annual reports were to be filed with the Secretary of Labor.⁹⁸ To "publish" these documents, the administrator had only to (1) make them "available for examination by any participant or beneficiary in the principal office of the plan;" and (2) "deliver upon written request to such participant or beneficiary a copy of the description of the plan . . . and an adequate summary of the latest annual report, by mailing such documents to the last known address of the participant or beneficiary making such request."⁹⁹ Whatever the content, it is clear that the mode of disclosure and the absence of civil liability for improper or no disclosure, created, in both

93. 2 L. Loss, *supra* note 42, at 811.

94. Form S-8 was adopted on May 7, 1953.

95. See discussion in Mundheim & Henderson, *supra* note 38, at 815-819.

96. *Id.* at 906.

97. Rev. Rul. 61-157, 1961—2 C.B. 67, 74.

98. Welfare and Pension Plans Disclosure Act, *supra* note 73, at § 304.

99. *Id.*

instances, disclosure of a much different kind than that normally required by the Securities Act.¹⁰⁰

D. Civil Liabilities and Remedies

The third and related consequence is the complete reprieve from the civil liability provisions which the exemption occasions. As these plans are not subject to the registration provisions at section 5, the section 11 remedy for untrue statements in or material omissions from the registration statement is of no avail. As an exempted security (as opposed to an exempted transaction), however, the exemptive protection is not limited to sections 5 and 11.

100. The question underlying this discussion, however, is "why disclosure?" Admittedly much of how one answers that question depends upon a predisposition in an area unsusceptible to tangible proof. As has no doubt been perceived, the author would err in favor of disclosure. While disclosure has not been sanctioned by its four decade reign as conceptual monarch of securities law, the rationale supporting it is still persuasive in general, and specifically applicable to employee benefit plans.

First and foremost, disclosure should provide the investor with information needed to make a sensible decision. Such information should be in a form clearly understandable to the ordinary investor. In the *Matter of Universal Camera Corp.*, 19 SEC 648 (1945). See generally 1 L. Loss, *supra* note 63, at 261 et seq. Experience bears testimony to the fact that there are occasions when due to the complexity of the security or the relative lack of sophistication of the investor, disclosure in no way rationalizes an unassisted investor function. It is in instances such as these that a secondary function, that of providing the professionals with the relevant information, becomes important. "The act thus operates to put the security dealer (and the investment advisor), who should possess the financial and economic erudition to analyze and evaluate the (information) . . . between the investor and the (issuer) . . ." Heller, *Disclosure Requirements, under Federal Securities Regulations*, 16 BUS. LAW 301 n.6 (1961). A third and important aspect of disclosure is its "chilling effect" upon borderline conduct. This point has not been stated better than Mr. Justice Brandeis' 1914 rendition:

Publicity is justly recommended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants: electric light the most efficient policeman. BRANDEIS, *OTHER PEOPLE'S MONEY* 62 (1917).

A fourth and often overlooked feature of disclosure is its catalytic potential. Much of the information being used to spearhead the current agitation in the area of corporate responsibility and corporate reform was discovered in prospectuses and registration and proxy statement.

An oft expressed notion in the area of employee benefit plans is that the area of violation is so small as to make meaningful choice impossible. After all, to work or not to work is no choice at all. True, but hardly responsive. A prospective participant in an employee benefit plan may have a choice between jobs. The prospective participant may have to choose what, if any, investments to make with his take-home pay; what kind of any insurance he should purchase; and when and under what conditions to retire. Moreover, the minimal volition argument ignores the third and fourth functions of disclosure. It is certainly possible to assert that at least a portion of the alleged mismanagement of existing plans would not occur were they required to make available a great deal more information. And it is equally certain that disclosure would readily lend itself to more actual participation in the plan by the inactive investor thus far called "participants".

For the author at least, the most cogent reason for applying the more stringent disclosure and civil liability provisions sounds in *a fortiori*. If an employee who as a hobby invests \$1000 of his take-home pay in various and sundry securities can count on being afforded the protection of the federal securities laws, certainly that same employee who contributes in one way or another to a plan on which he depends to provide for his family in case of illness, disability, retirement or death, deserves at the very least the same protection. The real impact of the exemptive treatment is that it refuses to extend even the minimal disclosure protection to the employee who must blindly trust his family's entire future to the goodwill of a few big-time investors.

It extends to section 12(2).¹⁰¹ The exemptive language, strategically placed in subsection 2 of section 3, completes the coverage. Section 3(2) is the only subsection also exempted from 12(2).

The effect of these sections is that an employee could have become a participant in a plan due to false and misleading statements of the plan administrators and have no remedy whatsoever under the statute unless he can prove actual fraud. Otherwise, he is left to the uncertain mercy of his common law remedies.¹⁰²

As with the disclosure provisions, no other statutory provisions are available to fill the breach. Theoretically, the Internal Revenue Service could disqualify the plan—a move of dubious implications and of no benefit for the employee participant.¹⁰³ The Welfare and Pension Plans Disclosure Act imposes a different type of liability for failure or refusal to disclose, and none for false and misleading statements.¹⁰⁴

Crucial to this discussion are the substantive restrictions imposed by the Investment Company Act. Viewed in light of the fact that the employee benefit plans are no longer “unspeculative”, one searches for an explanation to exclude these plans from the scope of the Act’s protection. The question to be asked again is whether there is comparable legislation that imposes similar restrictions on investment policy transactions potentially inimical to the plan’s beneficiaries. Again the answer seems negative. No help is forthcoming from either current state law, common law fiduciary standards, or existing federal legislation.

Until ERISA, neither the Internal Revenue Code nor the Welfare and Pension Plans Disclosure Act purported to deal directly with investment policy. In the latter, the issue of investment came up solely in connection with the disclosure requirements. In the Internal Revenue Code, investment policies were only indirectly affected by the “exclusive benefit” rule and by prohibition of certain types of transactions. Section 401 requires that trust funds be used for the exclusive benefit of the employees and their beneficiaries. This requirement is satisfied if:

101. Section 2(1) merely provides a civil remedy for a violation of section 5. Securities Act, *supra* note 2, at § 12(1).

102. There may be times, especially in cases of deceit, where the relatively short statute of limitations may make a common law action preferable. Those times are few and far between.

103. See note 106 *infra*.

104. Section 308 of the Welfare and Pension Plans Disclosure Act Provides:

(a) Penalty for violations

Any person who willfully violates any provisions of this Act shall be fined not more than \$1,000, or imprisoned not more than six months, or both.

(b) Liability for failure or refusal to make publication.

Any administrator of a plan who fails or refuses, upon the written request of a participant or beneficiary covered by such plan, to make publication to him within thirty days of such request, in accordance with the provisions of section 307 of this title, of a description of the plan or an annual report containing the information required by sections 305 and 306 of this title, may in the court’s discretion become liable to any such participant or beneficiary making such request in the amount of \$50 a day from the date of such failure or refusal.

1. the cost of the investment (does) not exceed its fair market value at the time of purchase, and
2. the investment (will) provide a fair return commensurate with the prevailing rate, and
3. sufficient equity (is) maintained to permit distribution in accordance with the terms of the plan, and
4. the safeguards and diversity that a prudent investor would adhere to are present.¹⁰⁵

Reasonable as these guidelines may initially appear, they present an unenforceable standard. Enforcement depends upon the sporadic audits conducted by the IRS. Even where questionable transactions are detected, the IRS has been reluctant to act in all but the most extreme cases.¹⁰⁶ Such reluctance is no doubt engendered by the realization of the inherent non-exclusivity in this area. Rarely will the trust receive a benefit without some commensurate (even if intangible) benefit accruing to the employer—that is, unless such benefit is at the employer's expense.

A greater reason for IRS reluctance may be the exclusivity of the remedy. The agency has at its disposal only its ultimate weapon of disqualification, which is the same remedy available should the plan engage in any so-called "prohibited transactions." Under Section 503 of the Internal Revenue Code, a qualified trust can lose its exempt status if it engages in certain "prohibited transactions" specified in Section 503(b). These involve any transaction in which the Qualified Trust (i) lends any funds to the employer without the receipt of adequate security and a reasonable rate of interest; (ii) pays any compensation to the employer in excess of reasonable compensation for services actually rendered to the Trust; (iii) makes any substantial purchase of securities or other property from the employer for more than an adequate consideration; (iv) sells any substantial part of its securities or other property to the employer for less than an adequate consideration; or (v) engages in any other transaction which results in a substantial diversion of its funds to the employer. Section 503(b) prohibits any diversity of funds, pursuant to the enumerated prohibited transactions, not only to the employer, but also to (i) any person who has made a substantial contribution to the Trust (or any family member of such person), or to (ii) any corporation

105. Fries, *Investing for Qualified Deferred Compensation Plans*, ALI-ABA COURSE OF STUDY: PENSION, PROFIT-SHARING AND OTHER DEFERRED COMPENSATION PLANS (1973) [hereinafter cited as Fries].

106. Rev. Rul. 73-352, 1973—2 C.B. 324.

The Service advised that the services performed by individuals who became employees of a regional authority and received coverage under the State's retirement system when the authority acquired a privately owned transit company do not constitute "covered transportation service" within the meaning of section 3131(j)(3) of the Code and are excepted from employment under section 312(b)(f). Social Security coverage may be obtained only by an agreement between the State and the Secretary of Health, Education and Welfare.

controlled (through 50% stock ownership) by the employer.¹⁰⁷ But as was pointed out by the Senate Finance Committee, "(the current) prohibited transaction provision is not effective both because the present prohibited transactions are limited in nature and because the penalty for noncompliance is the disqualification of the pension plan. . . . This penalizes the covered employees who have had no part in any wrongdoing."¹⁰⁸ This is a far cry from Investment Company Act protection.

VI. THE FUTURE OF THE BLANKET EXEMPTION

In the light of the preceding analysis, it is not presumptuous to inquire whether this blanket exemption is necessary. Is it necessitated by the overall exemptive scheme of federal securities legislation? By its internal consistency? By the over-riding considerations of costs? By lack of a suitable alternative? The answer is "no" on all counts.

A. Exemptive Scheme

Were one to generalize about the exemptive scheme of the 1933 Act, one could say that the exemptions fall into five categories: *one*, where there could presumptively be no abuse, i.e., where the security is reissued or guaranteed by an agency or instrumentality of a governmental unit; *two*, where alternative government regulatory machinery is mandatorily and directly involved, i.e. Interstate Commerce Commission, Federal Reserve Board, state insurance commissions; *three*, where there is clearly no investment intent, i.e., short-term notes, drafts, bills, non-profit organization; *four*, where federalism prescribes federal intervention, i.e. intrastate ex-

107. "Section 503(b) does not, by its terms, extend to all parties affiliated with the employer, such as a parent corporation of the employer or stockholders, officer or directors of the employer. In Rev. Rul 58-526, the Service was satisfied with a literal interpretation and held that the purchase by a Trust of debentures issued by the parent of the employer was *not* a prohibited transaction. Similarly, the Service held in Rev. Rul. 72-532 that an unsecured loan by a qualified trust to a corporation with the same controlling stockholder as the employer corporation did not constitute a prohibited transaction under Section 503 (b) since the "brother-sister" corporation was not one of the parties specified in Section 503 (b). Despite Rev. Ruls. 58-526 and 72-532. I recommend that the spirit of the prohibited transaction rules be followed in all situations involving any transactions between the exempt trust and any person or entity having any interest in the employer. Any violation of the spirit of the prohibited transaction rules could be attacked by judicial interpretation of Section 503 (b) extending the statute beyond its literal language, or alternatively, by contending that the transaction is not for the exclusive benefit of the employees. The latter approach has in fact been taken in Rev. Rul. 73-282, disqualifying a pension fund which made an unsecured loan of substantially all its funds to a corporation whose stock was owned by the principal shareholder of the employer corporation. The Service held that the loans were not for the exclusive benefit of the employees since they did not provide the safeguards and diversity that a prudent investor would require. This approach had previously been intimated in Rev. Rul. 71-462, holding that a loan from a multi-employer pension trust administered by a joint employer-union board to the union that negotiated the plan was not a prohibited transaction since the union is not a party specified in Section 503 (b), but warning that the loan must still be for the exclusive benefit of the employees." Fries, *supra* note 105, at 182-83.

108. S. REP. NO. 93-383, 93rd Cong., 1st Sess. 18 (1973).

emption; *five*, where the investor should be able to fend for himself—i.e. private offering exemption. Four of the five are of no real consequence to the instant discussion. As no agency or instrumentality of any governmental unit issues or guarantees the interest in private employee benefit plans, the presumption portion of the generalization can be disposed of with dispatch. Since wholly intrastate plans are exempted anyway, that issue resolves itself. Finally, any assertion that the average investor-employee meets all but the very minimal level of sophistication in the management, investing policies and actuarial computation of a normal employee benefit plan, would be so contrary to experience as to deserve no rebuttal. Whether there is a lack of investment intent may raise a more fundamental question. It is true that the employee-participants do not appear to be “playing the market”, but neither is the investor in a mutual fund. Despite language indicating that employee participants do not appear to be “true investors,” the nature of the expectation clearly defies any but the most determined attempts to distinguish between the interest involved and other protected interests, on the basis of investment intent.

The fifth and final part of the exemptive scheme, which defers to the intimate involvement of alternative governmental regulatory mechanisms, seems apposite. The involvement of the Department of Labor and the IRS, mandated by the Federal Welfare and Pension Plan Disclosure Act and the Internal Revenue Code respectively, lends credence to a contention that it is with this portion of the generalized scheme that the employee benefit plan exemption is compatible. Analysis of the present exemption under this proposed rationale, however, casts doubt upon the validity of this contention. The common and indispensable feature of the specific exemption is the supervisory role played by the governmental agency. Neither the role of the Labor Department or of the Internal Revenue Service is supervisory in nature. Any attempt to analogize them to the Federal Reserve Board, state banking and insurance commissions, or the Interstate Commerce Commission is inapposite. The IRS is primarily concerned with assuring that the income on which no tax is paid by the employer is truly divorced from his use, and that the plan is not merely a gimmick to provide a tax shelter for highly compensated officers and employers. The IRS has little to do with the amount and quality of information provided participants, with management decisions or with investment provided participants, or with management decisions or with investment policies in general. While some of its primary concerns result in vesting requirements and reduced discrimination in coverage, which no doubt protects the interest of employee participants, serendipity should not be substituted for supervision.

On the other hand, the legislative history of the Welfare and Pension Plans Disclosure Act specifically states that its objective is disclosure, not regulation or supervision.

It is designed to place the primary responsibility for the policing and improved operations of these plans upon the participants themselves. The scope of the bill is limited to disclosure and reporting and does not go into the field of regulation.¹⁰⁹

It is obvious that Congress could have amended the statutes and invalidated any alleged pre-existing legislative scheme. The above discussion neither assumes nor suggests otherwise. However, it does illustrate that the elimination or modification of the exemption in question will work no doctrinal or structural harm to the overall exemptive scheme. In the absence of such harm, concern for the demonstrably heavy impact on the investment interest of the employee-participant ought to be given greater weight.

B. Internal Consistency

In addition to being poorly and ambiguously worded, the current blanket exemption abounds with discrepancies. Both the Securities and Securities Exchange Acts distinguished H.R. 10 plans from regular corporate plans; they both distinguish between employer and employee contributions for the purpose of limiting the amount capable of being invested in the employer's securities. The Investment Company Act does neither. However, all three acts distinguish the IRS "qualified" plans from those which are not—a distinction that is not necessarily significant in terms of effect but of questionable justification nonetheless.

The Commission's historical antipathy to the H.R. 10 plan has been well-documented and, as indicated earlier, was codified in the 1970 amendments. History aside, however, in view of the additional restriction imposed by the IRS on the H.R. 10 plan, it appears anomalous that the H.R. 10 plan, rather than the corporate plan, does not more readily deserve exemptive treatment. That decision can certainly be argued by the Congress, which has otherwise chosen to rely on IRS policing.

This anomaly raises the two-tiered analysis mentioned earlier. It has been the Commission's consistent position that it is at the second level—the investment medium—that it is interested. At this level, the normal owner-employee, lacking both sophistication and bargaining power, may be as much in need of protection as the average investor. This might be true. But it does not serve as a total explanation for the statutory prescription. No distinction is made between the tiers, and one may conclude that even on the participant level of a H.R. 10 plan, the exemption is inapplicable, and compliance with at least the Securities Act is required. Such may not have been the intent but in theory it is the effect.

It was once thought that some minimum protection could be offered participants if the corporate employers were discouraged from investing all

109. *Report of the Senate, House and Conference Comm.*, 85th Cong., 2nd Sess., reprinted in [1958] U.S. CODE CONG. & AD. NEWS 4137, 4154.

or substantially all the assets of the plan in the employer's securities. Though never articulated, it may have been perceived that the alternative course was tantamount to vitiating any funding requirement, or that it was anomalous to allowing an employee a deduction for funds which would wind up in his capital accounts. Whatever the case, it was determined that if an amount in excess of the employer's contribution was invested in the employer's stock, the plan would be required to comply with the 1933 and 1934 acts. As with any crude rule of thumb, this determination was not perfect to begin with, and in this particular instance, became meaningless. Such a limitation was of questionable significance in 1951 when employee contributions amounted to 1.2 billion dollars.¹¹⁰ In 1974, employers contributed in excess of 16.9 billion dollars.¹¹¹ Under the existing limitations, all of this amount could be invested in the employer's securities with the exemption still applicable.

From its beginning, such a formulation was ill-advised, but it illustrates a significant point. The SEC and Congress continue to distinguish between employer and employee contributions; and they fail to conceptualize the employee benefit plan as a part of the total compensation package arranged to maximize convenience and/or minimize taxes.¹¹² The immediate source of the contribution is not nearly as important as the fact that this is a bargained for exchange.

Finally, by refusing to articulate distinct substantive bases for the exemptions, and by relying totally on the IRS, the Securities and Securities Exchange Acts made possible the situation where a perfectly sound plan and an investor point of view is excluded from the exemption, because, for one reason or another, it does not comply with IRS requirements. That this is not a widespread problem is undisputed. But neither is its existence. When considered with the other internal inconsistency of the blanket exemption, this situation is yet another reason for the exemption's demise.

110. CORPORATE PENSION FUNDS, *supra* note 78.

111. See note 81 *supra*.

112. Remarks of Brandisi, Louis J. Jr., and Kielley, James E., "The Concept of Total Composition" to the Electronics, Wage, & Salary Association (Dec. 8, 1966):

"The development of effective programs in the direct compensation area without equally good programs in the indirect area, does not achieve the overall compensation objectives of most companies

Within the framework of sound organizational planning and the problems of motivation facing the individual company, the emphasis as to compensation must be on a total compensation approach.

By 'total compensation' we mean the sum of all the direct and indirect compensation elements utilized by a company in compensating its employees. This is our thesis, that all of these elements should be effectively mixed and balanced to help satisfy (a) the important *needs* of the individual and, at the same time, (b) the compensation objectives of the corporation.

Although a mixed and blanced approach to total compensation is desirable, the authors note a number of factors which inhibit the development and implementation of such programs. Among those factors is:

3. Government control—the extent to which certain elements of total compensation are allowed or appropriate.

The current security treatment of employee benefit plans offers the worst of two worlds. It refuses to extend valuable investor protection to the employee participant. At the same time, it leaves many questions open—questions which the SEC has and will be called upon to answer.