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# Employee Equity Incentive Plans For Small Companies: A Proposal For A Specific Registration Exemption From The 1933 Act

# EMPLOYEE EQUITY INCENTIVE PLANS FOR SMALL COMPANIES: A PROPOSAL FOR A SPECIFIC REGISTRATION EXEMPTION FROM THE 1933 ACT

Employee equity incentive plans have become a popular means of attracting and compensating key employees who hold responsible managerial, professional, and advisory positions with a company.[1] Employee equity incentive arrangements range from outright stock sales at or below market prices, to stock options, stock bonuses, and cash plans that a company tailors to an employee's job performance.[2] Employee equity incentive plans

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1. *See* The Conference Board, *Top Executive Compensation* 6-8 (1982 ed.) (prevalence of equity incentive plans ranges from 81% for manufacturing companies to 20% for gas and electric utilities); Frederic W. Cook & Co., Inc., *Long Term Incentive Compensation Plans*, at 1 (1982) (187 of 200 largest industrial companies have equity incentive plans for key employees); *see also* Duke, *Employee Stock Option Plans Under the Securities Act: A Time for Reexamination*, 38 BUS. LAW 1429, 1430-31 (1983) (examining typical equity incentive plans); *infra* notes 10-38 and accompanying text (discussing common equity incentive plans for small companies).

2. Duke, *supra* note 1, at 1430-31 & n.8. The employee equity incentive plans that companies most often utilize generally fall into a familiar pattern. *Id.* Because of changing federal income tax considerations, employee equity incentive plans contain various characteristics that attempt to give the recipient favorable tax consequences. *Id.* Common examples of employee equity incentives are incentive stock options ("ISOs"), stock appreciation rights ("SARs"), tax offsets, stock-for-stock exchanges, and limited cash-out rights. *Id.* An ISO is an incentive stock option that, by meeting the requirements of § 422A of the Internal Revenue Code, affords the recipient potentially favorable tax consequences when the recipient exercises the option. I.R.C. § 422A (1986); *see* Duke, *supra* note 1, at 1430-31 & n.8 (discussing ISOs and tax consequences of ISOs); *see also infra* notes 17-24 and accompanying text (discussing ISOs in context of small companies' employee equity incentive plans). An SAR is a stock appreciation right affording the recipient a method of realizing in cash or securities the difference between the stock's market value and the stock's option price, without actually exercising the underlying option. *Id.* The SAR holder, therefore, is able to obtain the fair market value increase of the holder's stock without expending any additional funds. 2 R. HAFT, VENTURE CAPITAL AND SMALL BUSINESS FINANCINGS § 4.03 (1986); *see infra* note 25 (discussing small businesses use of SARs in connection with employee equity incentive plans). A tax offset option provides that upon exercising a non-ISO stock option the recipient will receive a cash payment to meet any tax liability that the recipient incurs when exercising the non-ISO option. Duke, *supra* note 1, at n.8. A stock-for-stock exchange provides that upon the recipient's exercise of the stock option, the recipient must surrender company stock that the recipient already owns in full or partial payment of the option stock. *Id.* Finally, a limited cash-out right provides the recipient with the ability to cash-out an option in case of an unfriendly tender offer. *Id.* A limited cash-out right, therefore, allows the recipient to avoid potential short-swing liability under section 16(b) of the Securities Exchange Act of 1934. *Id; see* Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1982). Under the short-swing profit rules, any director or officer of a corporation who realizes a profit from the purchase and sale of the company's stock within a six-month period must forfeit the profit to the company. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1982). The 1934 Act's concept of purchase and sale are broad, applying to an officer or director's rights to acquire or dispose of the stock. Keller, *Employee Equity Incentive Arrangements*, REV. OF SEC. & COM. REG. 156, 159 (Je. 25, 1986).

are useful particularly to small, closely-held corporations,[3] which often have less cash available to attract, compensate, and retain key employees, and which want to preserve capital for future business expansion.[4] Present federal securities laws and the Securities and Exchange Commission ("SEC") fail to recognize the predominantly compensatory nature of employee equity incentive plans.[5] Consequently, the SEC requires companies utilizing employee equity incentive plans to comply with the present federal securities laws and regulations that Congress and the SEC primarily have designed to

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3. *See* Donahue v. Rodd Electrotype Company of New England, Inc., 367 Mass. 578, 586, 328 N.E.2d 505, 511 (1975) (defining closely-held corporation as corporation with small number of shareholders who participate substantially in management and operations of corporation and whose shares have no readily available market for resale).

4. *See* Keller, *supra* note 2, at 156 & 160 (discussing importance of equity incentive plans to small businesses). Employee equity incentives provide small companies with the attraction of equity growth for a prospective employee and enhance the company's ability to recruit desired employees from a limited pool of candidates. *Id* at 156. While small companies have a wide variety of employee equity incentive plans from which to choose to compensate and motivate their key employees, the plans that small companies most commonly utilize are plans using "restricted stock" subject to repurchase options or obligations; incentive stock option plans receiving potentially favorable tax treatment for the recipient; nonqualified stock option plans receiving ordinary tax treatment for the recipient; and, issuances of convertible junior common stock subject to lesser rights and privileges for the recipient compared to the company's ordinary common shareholders. *See* R. Haft, *supra* note 2, at § 4.03 (discussing employee stock option plans and stock appreciation rights). Incentive stock options (ISOs) are stock options that a company offers to the company's employees to allow the employees to purchase stock from the company at favorable prices. *Id.*; *see infra* notes 17-24 and accompanying text (discussing ISOs and tax consequences of ISOs); *see also* R. Haft, *supra* note 2, at § 4.03 (discussing nonqualified stock option plans); *infra* notes 25-29 and accompanying text (same); R. Haft, *supra* note 2, at § 4.04 (discussing junior common stock); *infra* notes 30-38 and accompanying text (same).

5. *See* Keller, *supra* note 2, at 156 & 160 (discussing importance of equity incentive plans for small businesses). Stanley Keller, a practitioner specializing in small business formation and financing, distinguishes an investment securities plan and a compensatory securities plan. *Id.* at 156. The commentator defines an investment-oriented equity incentive plan as a stock transaction, usually offered as part of a stock offering to outside investors, that a company undertakes primarily as a means of generating operating capital. *Id.* These capital-raising stock distributions, such as employee stock purchase plans, are primarily investment opportunities for the recipient, and Keller maintains that the investor protection principles of the present federal securities laws should continue to govern investment types of stock transactions. *Id.* Keller contends that employees who participate in investment stock plans should continue to have access to the financial and operational information that the current federal securities laws require a company to disclose when offering securities to the public. *Id.*

In contrast to investment securities plans, Keller defines a compensatory stock plan as a plan that a company undertakes primarily to benefit that company's employees. *Id.* Examples of primarily compensatory plans are stock sales to employees below market prices, or favorable stock options that require little or no cash investment by the employee. *Id.* While an employee participating in such stock plans may be making an investment decision of a sort in deciding to accept the securities offering in lieu of cash, the compensatory nature of these plans is predominant. *Id.* Consequently, Keller argues that these plans do not require the protection of the present federal securities laws, which Congress and the SEC have designed to affect primarily companies' stock offerings to outside investors. *Id.* Because the current federal security laws fail to recognize the compensatory nature of employee equity incentive plans, Keller argues that the securities laws prevent small companies from using these compensatory protect investors participating in capital-raising transactions.[6] Small companies that want to implement an employee equity incentive plan, therefore, must pay the high cost of registering the securities of the company's employee equity incentive plan with the SEC, or alternatively, attempt to manipulate the employee equity incentive plan to fall within either a registration exemption or the "no sale" concept of the Securities Act of 1933 ("1933 Act" or "Act").[7] Small companies, however, by relying on the present registration exemptions or the "no sale" concept, often violate the 1933 Act inadvertently when implementing an employee equity incentive plan and risk sanctions from the SEC.[8] Because of the present dilemma

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plans effectively. *Id.*

Similarly, another commentator, Robert Duke, senior vice president and general counsel of Freeport-McMoRan, Inc., has recognized a distinction between employee stock option plans, which are compensatory, and employee stock purchase plans, which are investment-oriented. *See* Duke, *supra* note 1, at 1433-34 (discussing economic difference between stock option and stock purchase plans). Duke maintains that while companies normally use stock option plans to provide incentives to key employees in achieving high performance with their company, companies normally use stock purchase plans as an equity capital source. *Id.* at 1434 n.23. The commentator indicates that corporate issuers, anxious to make the stock option plan an effective incentive, ordinarily go to considerable lengths to explain the relevant legal and tax aspects of these options to their employees. *Id.* at 1435. The commentator argues that because companies supply their employees with information concerning the companies' stock option similar to the information that the federal securities laws require the company to disclose, the SEC should exempt these plans from registration. *Id.* at 1434; *see infra* note 40 and accompanying text (discussing SEC's securities registration process and principles that underlie securities registration).

6. Keller, *supra* note 2, at 160; *see infra* notes 41-47 and accompanying text (discussing registration process for employee equity incentive plans).

7. *See* Keller, *supra* note 2, at 156 (discussing securities registration options for companies instituting equity incentive plans); Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1982); *see also infra* note 45 and accompanying text (discussing costs of securities registration for employee equity incentive plans); notes 48-125 and accompanying text (discussing 1933 Act's registration exemptions and "no sale" concept).

8. Keller, *supra* note 2, at 160. Deficiencies in a company's registration materials or a company's failure to register its securities offering can result in administrative action by the SEC, criminal sanctions, and civil liability. T. Hazen, The Law of Securities Regulation § 7.1 (1985). The SEC possesses the statutory authority to deny, suspend the effective date of, suspend for the period of a year, or withdraw the registration of a security because of a company's failure to comply with any provision of the 1933 Act. *See* 15 U.S.C. § 78s(a)(2) (1982) (delineating sanctions available to SEC in reprimanding companies that fail to comply with 1933 Act); 3 H. Bloomenthal, Securities and Federal Corporate Law § 3.19[2] (1986 rev.) (discussing sanctions that SEC commonly uses to discipline companies that fail to comply with registration requirements of 1933 Act).

Additionally, the SEC has the authority to suspend summarily any security from trading in both the exchange and over-the-counter markets. 15 U.S.C. § 78s(a)(4) (1982); H. Bloomenthal, *supra*, at § 3.19[3]. Another means that the SEC employs to encourage compliance with the 1933 Act's registration requirements is criminal sanctions. H. Bloomenthal, *supra*, at § 3.19[1]. Under the 1934 Act, any willful failure to file a registration statement or the willful use of false or misleading statements on a registration statement is a criminal offense punishable by a possible two-year imprisonment and a $10,000 fine. 15 U.S.C. § 78ff (1982). The SEC possesses the authority to refer appropriate cases to the United States Justice concerning the registration obligations of small companies desiring to institute employee equity incentive plans, the SEC should adopt a specific registration exemption under which small companies can forego the expensive registration process with more certainty than present federal securities laws afford.[9]

Small companies often implement employee equity incentive plans in which the company issues restricted stock to the company's key employees.[10] A company usually places restrictions on the stock that not only affect when the recipient can purchase the stock, but also afford the corporate issuer the right to repurchase the stock upon the occasion of certain stated events.[11] Typically, any restrictions that the company places on the stock concern employment-related conditions, such as the duration of the recipient's employment with the company.[12] The employment-related restrictions determine at what time the recipient may purchase the stock, or at what time the company may exercise its repurchase right.[13] The time period in which the stock vests in the recipient is a matter for negotiation between the company and its employee and will vary from plan to plan.[14] The stock purchase agreement between the company and the employee, however, must provide not only the stock purchase price, but also the conditions that an employee must fulfill to purchase the stock and the stock repurchase price.[15]

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Department for criminal prosecution. Securities Act Release No 10214 [1973 Transfer Binder] FED. SEC. L. REP. ¶ 79,394 (Je. 11, 1973). Finally, a company that fails to register its securities with the SEC may be liable in a civil action to the purchaser of the unregistered securities for the price of the securities plus interest from the date of the sale. T. HAZEN, *supra*, at § 7.2.

9. *See infra* notes 126-33 and accompanying text (discussing proposal for exemption of small companies' equity incentive plans from security registration).

10. R. HAFT, *supra* note 2, at § 4.02.

11. *Id.* Examples of restrictions that companies usually place on stock issuances to their employees include subjecting the stock to a repurchase right in the company should the employee leave the company within a five year period after the company issues the stock to the employee, and subjecting the stock to an automatic repurchase right in the company should the company terminate the employee. *Id.* Companies adopt restrictions, such as the companies' right to repurchase an employee's stock, to encourage the employee to work efficiently and to give the employee an incentive to remain with the company. *See* C. HENN & J. ALEXANDER, LAW OF CORPORATIONS § 281 (3d ed. 1983) (examining theories behind companies' issuance of restricted stock).

12. *See* C. HENN & J. ALEXANDER, *supra* note 11, at § 281 (examining reasons why companies issue restricted stock).

13. *Id.*

14. R. HAFT, *supra* note 2, at § 4.02; *see supra* notes 12-13 and accompanying text (discussing examples of restrictions that companies commonly place on restricted stock).

15. R. HAFT, *supra* note 2, at § 4.02. The stock repurchase agreement in the stock purchase contract may provide a repurchase price for stock that has vested in the employee that is different from what the employee originally paid for the stock. *Id.* Further, the company may require that the employee place the stock in escrow prior to vesting, thus allowing the employee to receive the stock out of escrow only after the employee has completed the stated conditions. *Id.* Moreover, the company may retain additional rights to repurchase the stock, such as a right of first refusal in appropriate circumstances. *Id.* Thus, the stock purchase agreement could provide that the recipient must first allow the company an opportunity to

Finally, restricted stock that a corporate issuer transfers to an employee subjects the employee to a tax liability for the difference between the price that the employee paid for the stock and the fair market value of the stock on the date that the restrictions lapsed.[16]

In addition to restricted stock plans, companies generally employ incentive stock option plans ("ISOs").[17] An ISO is a stock option plan that a company offers to an employee as an incentive to work harder and more efficiently.[18] Most corporate issuers argue that providing ownership potential to an employee increases the employee's efficiency because, upon receiving an equity interest in the company, the employee has a personal stake in the profitability of the company.[19] The company must grant the ISO pursuant to a plan that states the aggregate number of shares that the company may issue, the employees who are eligible under the plan, and that the shareholders of the company have approved the ISO within twelve months before or after the company has adopted the ISO.[20] The statutory time limit for granting options under an ISO is ten years from the date the shareholders of the company adopt the plan.[21] The recipient of an ISO may not exercise the option after the ten-year statutory period.[22] Further, the option price of the ISO may not be less than the fair market value of the stock at the time the company grants the ISO.[23] Finally, the amount of option stock under

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repurchase the employee's restricted stock before the employee can sell the stock to an outside party. *Id.*

16. *Id.* Section 83(a) of the Internal Revenue Code subjects the recipient of restricted stock to a tax liability for any market appreciation of the stock when the restrictions lapsed over what the recipient originally paid for the stock. I.R.C. § 83(a)(1) (1986). Section 83 of the Revenue Code governs any stock issuance that a company makes to an employee in connection with the employee's performance of services. *Id.* at § 83(e). Thus, under § 83(e), an employee should include the appreciation of the employee's stock in the employee's gross taxable income for the first taxable year in which the employee freely can transfer the stock and the employee's stock is not subject to a substantial risk of forfeiture. *Id.* at § 83(c)(1). Section 83 defines an employees stock as transferable when the employee's rights in the stock are not subject to a substantial risk of forfeiture. *Id.* at § 83(c)(2). According to § 83, a substantial risk of forfeiture exists where a company conditions an employee's right in stock upon the employee's future performance of services. *Id.* at § 83(a). The possibility of forfeiture is substantial under § 83 if the employee does not satisfy the conditions that the company places on the stock that the company issues to the employee. *Id.*; *see* . Haft, *supra* note 2, at § 4.01[2] n.7 (discussing stock subject to substantial risk of forfeiture).

17. *See* R. Haft, *supra* note 2, § 4.03 (discussing incentive stock option plans).

18. *Id.*; *see* I.R.C. § 422A (1986) (delineating requirements with which company must comply in adopting incentive stock option plans ("ISOs") to receive potentially favorable tax consequences); *see also infra* notes 20-24 and accompanying text (discussing statutory requirements of ISOs).

19. *See* R. Haft, *supra* note 2, at § 4.03 (discussing employee incentive stock option plans).

20. *See* I.R.C. § 422A(b)(1) (1986) (providing statutory requirements for companies instituting incentive stock option plans).

21. *Id.* at § 422A(b)(2) (1986).

22. *Id.* at § 422A(b)(3) (1986).

23. *Id.* at § 422A(b)(4) (1986).

an ISO that a company issues to one employee must not exceed $100,000.[24]

A third type of option plan that small companies often utilize to compensate their employees is a nonqualifying stock option plan ("NSO").[25] NSOs are company stock option plans that do not afford the recipient special tax treatment under the Internal Revenue Code.[26] If the company

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24. *Id.* at 422A(b)(7) (1986). The Internal Revenue Code provides that any recipient of an ISO may not own more than 10% of the voting shares of his company's stock. *Id.* at 422A(b)(6). In the Tax Reform Act of 1986, however, Congress repealed the 60% deduction for net capital gains that Congress provided for in the Internal Revenue Code before the 1986 amendments. *See* ALI-ABA Tax Reform Act of 1986 (volume II), at 892 (discussing impact of Tax Reform Act on equity incentive plans). As a result, the Internal Revenue Service ("IRS") taxes ISOs at ordinary income rates. *Id.* Congress' repeal of the capital gains deduction in the Tax Reform Act, therefore, reduces the tax advantages of ISOs relative to other types of equity incentives such as nonqualified stock options. *Id.*; *see infra* notes 25-29 and accompanying text (discussing nonqualified stock options and tax consequences of nonqualified stock options). Although the IRS continues to defer a recipient's recognition of the ISO as income until the recipient exercises the ISO, the IRS will tax the ISO at ordinary income rates, which are the same rates that apply to the income that the recipient would recognize upon exercising a nonqualified stock option. ALI-ABA Tax Reform Act of 1986 (volume II), at 893; *see infra* notes 27-29 and accompanying text (discussing tax consequences of nonqualified stock options). Moreover, upon the recipient's exercise of an ISO, the recipient must include the difference between the option price and the fair market value of the stock as part of the recipient's minimum tax base. ALI-ABA Tax Reform Act of 1986 (volume II), at 893. Congress provides for a minimum tax rate of 21% to the recipient for the difference between the fair market value of the stock when the recipient exercised the ISO and the ISOs option price. *Id.* Should the recipient decide to sell the stock, however, Congress provides in the Tax Reform Act that the IRS will tax any gain that the recipient receives on the sale at the ordinary maximum tax rate for individuals. *Id.* In the Tax Reform Act,Congress does allow a recipient of an ISO to credit against the recipient's regular tax liability the portion of the recipient's minimum tax liability attributable to tax preferences that relate to deferred income. *Id.*

25. *See* R. HAFT, *supra* note 2, at § 4.01[2] (discussing nonqualified stock option plans). Companies often include with the companies' incentive and/or nonqualified stock options stock appreciation rights ("SARs") affording the employee a method of realizing in cash or securities the spread between the stock's fair market value and the stock's option price. *Id.* The SAR holder, therefore, may obtain the fair market value increase of the holder's stock without expending any additional funds. *Id.* Companies may grant an SAR wholly apart from the companies' grant of any type of option. *Id.* When a company grants an SAR separately, the SAR becomes a long-term incentive program for the holder giving the holder a form of deferred compensation. *Id.* SARs that a company utilizes for deferred compensation involve "phantom" stock rather than actual shares. *Id.* The company grants to the company's employees units equivalent to stock, whose value equals the market value appreciation of the company's stock from the date the employee acquires the stock to the settlement date. *Id.* The settlement date is usually the employee's date of retirement or date of termination of employment. *Id.* The company may pay the amount of appreciation to the employee as a lump sum or in installments over a period of time. *Id. See generally* Herzel & Perlman, *Stock Appreciation Rights*, 33 BUS. LAW. 749, 755-58 (1978) (discussing business aspects of stock options and SARs).

26. R. HAFT, *supra* note 2, at § 4.01[2]. Section 83 of the Internal Revenue Code subjects an employee to a tax liability for any property, including stock, that a company transfers to the employee in connection with the employee's performance of services. I.R.C. § 83(a)(1) (1986). The Internal Revenue Code provides that the employee is subject to a tax liability for the difference between the purchase price of the property and the property's fair market value.

complies with the procedures set forth in the Treasury Regulations of the Internal Revenue Code when the company institutes an equity incentive plan using nonqualified stock options, the company is entitled to a business deduction.[27] The Internal Revenue Code provides that stock that a company transfers to an employee in connection with that employee's performance of services becomes taxable as ordinary income to the employee only in the year in which the stock that the recipient acquired in exercise of the NSO is no longer subject to a substantial risk of forfeiture or becomes transferable.[28] The Internal Revenue Code provides further that the company's business deduction shall equal the amount that the employee includes as income at either the time that the company grants the stock under the NSO or the time the employee exercises his option to purchase the stock under the NSO.[29]

A final form of employee equity incentive that small companies often utilize is convertible junior common stock.[30] Junior common stock is a separate class of common stock that a company's board of directors may authorize.[31] Junior common stock possesses only a fraction of the rights, preferences, and privileges of a company's regular common stock.[32] For example, while regular common stock entitles the holder to voting rights at annual or special shareholders meetings, junior common stock does not entitle the holder to any voting rights.[33] Holders of junior common stock receive the last claim to any dividends that a company may declare, and,

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*Id.* The tax consequences for a recipient of a nonqualified stock option are the same as the tax consequences for a recipient of a stock plan using restricted stock. R. Haft, *supra* note 2, at § 4.01[2]. The Internal Revenue Code also provides that stock under an NSO becomes taxable to the employee only in the year in which the stock becomes transferable and is no longer subject to a substantial risk of forfeiture. I.R.C. § 83(a)(1) (1986); *see supra* note 16 (discussing transferable stock and stock not subject to substantial risk of forfeiture).

27. *See* I.R.C. § 83(h) (1986) (providing for tax deduction by company for stock that company grants to employee in connection with employee's performance of services).

28. I.R.C. § 83(a)(1) (1986); *see supra* note 16 (discussing Internal Revenue Code's rules concerning when stock is transferable and not subject to a substantial risk of forfeiture).

29. I.R.C. § 83(h) (1986). Section 83(h) of the Internal Revenue Code provides that when a company exchanges its stock for an employee's services, the company is entitled to deduct from the company's gross taxable income an amount equal to the amount that the employee values the stock in calculating the employee's gross taxable income. *Id.* The Code provision allows the company to take the deduction only in the same year that the employee includes the stock in the employee's gross taxable income. *Id.*

30. R. Haft, *supra* note 2, at § 4.04.

31. *Id.*

32. *Id.* Except as otherwise provided in a company's Articles of Incorporation, all of a company's common shareholders enjoy equal rights. C. Henn & J. Alexander, *supra* note 11, at § 160. Among the rights that the common shareholders enjoy are the rights to receive dividends, when, and if, the company's board of directors choose to declare dividends, the right to the net assets of the company upon liquidation and after the company has satisfied the claims of creditors, and the right to vote or participate in the control of the company. *Id.* at § 160.

33. R. Haft, *supra* note 2, at § 4.04; *see supra* note 32 (discussing rights and privileges of holders of company's ordinary common stock).

therefore, receive shares that have the lowest dividend priority of the equity holders of the company.[34] Accordingly, a share of junior common stock has a lesser market value than an ordinary share of common stock.[35] Upon the occurrence of certain stated events that the company provides for in the stock purchase agreement, however, the junior common stock automatically converts into one share of the company's regular common stock.[36] Companies using junior common stock often tie the recipient's job performance to the convertibility of the recipient's junior common stock to regular common stock.[37] Thus, the recipient's attainment of specific production quotas, earnings, or profit figures will warrant conversion of the recipient's junior common stock to regular common stock under most employee equity incentive plans utilizing convertible junior common stock.[38]

Although small companies commonly use several forms of employee equity incentive plans, the stock registration rules of the 1933 Act impede a small company's effective use of employee equity incentives.[39] Under the 1933 Act a company must register all sales of the company's securities with the SEC.[40] Companies that issue stock under the typical employee equity

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34. R. Haft, *supra* note 2, at § 4.04.

35. *See* C. Henn & J. Alexander, *supra* note 11, at § 124 (because junior common shareholders enjoy fewer rights and privileges than ordinary common shareholders, junior common stock is less valuable).

36. R. Haft, *supra* note 2, at § 4.04.

37. *Id.* Companies employing equity incentive plans using convertible common stock often apply standards to determine the junior stock's convertibility that are similar to the standards that companies implementing incentive plans with restricted stock use to gauge when the restricted stock will vest in the employee. *Id*; *see supra* notes 12-13 and accompanying text (discussing conditions employee must fulfill to obtain company's restricted stock).

38. R. Haft, *supra* note 2, at § 4.04. There exists little precedent under tax law for the treatment of an employee's conversion of junior common stock to ordinary common stock. *Id.* The Financial Accounting Standards Board of the United States "(FASB)" determined in August 1984 that junior common stock was simply a method of compensating employees. *Id.* The FASB required companies using junior common stock to charge the stock against the employees income. *Id.* Following the determinations of the FASB, the IRS taxes junior common stock transactions under the same principles of § 83 as the IRS taxes a company's stock plans employing restricted stock and NSOs. *Id.*; I.R.C. § 83 (1986); *see supra* note 16 and accompanying text (discussing tax consequences of restricted stock plans); notes 27-29 and accompanying text (discussing tax consequences of NSOs).

39. Keller, *supra* note 2, at 156; *see infra* notes 92-125 and accompanying text (discussing deficiencies of registration exemptions and "no sale" concept of 1933 Act).

40. *See* Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1982) (prohibiting companies from using instruments of interstate commerce or mails to sell unregistered securities). The 1933 Act requires companies distributing securities to file both a registration statement and a prospectus with the SEC. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1982). Congress defines the term "security" comprehensively in the 1933 Act, encompassing nearly every conceivable type of instrument with investment characteristics. *See* C. Henn & J. Alexander, *supra* note 11, at § 295 (discussing registration requirements of 1933 Act). *See generally* Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1982) (defining term "security" as any note or treasury stock or warrant or right to subscribe or purchase note, stock, or treasury stock). Once a company decides to offer the company's securities to the public, the company, in consultation with its financial advisors, will prepare a registration statement. T. Hazen, *supra* note 8, at § 3.1. The registration statement will fix the relative rights and preferences of the

incentive plan usually register the stock on a Form S-8.[41] The SEC has designed Form S-8 to provide information to employees concerning the particular equity incentive plan that the company is instituting and the type of securities that the issuing company has chosen to use.[42] The SEC also requires that the Form S-8 contain certain information concerning the issuing company's business operations, including the company's balance sheets and audited financial statements.[43] Because employees are more familiar with

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securities that the company will offer. *Id.* In preparing the registration statement, the company must include information concerning the company's operations. *Id.* This aspect of the registration statement entails a thorough, factual investigation of all facets of the company, including an examination of the activities of any subsidiary or affiliated company. *Id.* Additionally, detailed disclosure requirements for registration statements mandate that a company include a thorough analysis of the company's business operations, including a detailed description of all divisions, departments, and accounting practices of the company. *Id.* Further, the disclosure provisions require the company to disclose an analysis of the company's management structure as well as a description or identification of all of the company's securities arrangements. *Id.* In addition to the registration statement, the 1933 Act requires that the company provide the recipient of the company's securities a prospectus before consummating any sale pursuant to a registered offering. Securities Act of 1933 § 10(a), 15 U.S.C. § 77e(b)(2) (1982). Among the items that a company must include in the statutory prospectus are the company's balance sheets and audited financial statements. T. HAZEN, *supra* note 8, at § 3.2. The basic purpose of the registration requirements of the 1933 Act and § 5's prohibitions and limitations on permissible sales of securities is to assure that the investor has sufficient information to decide intelligently whether to accept the company's securities offering. *Id.*

41. *See* FED. SEC. L. REV. REP. (CCH) ¶¶ 7197-99 (July 13, 1983) (discussing disclosure requirements of Form S-8). Form S-8 represents the disclosure form that a company would utilize if registering securities offered to the company's employees pursuant to an option, purchase, incentive, or bonus plan. 3A H. BLOOMENTHAL, *supra* note 8, at § 7.14; *see supra* notes 10-38 and accompanying text (discussing employee equity incentive plans.) To use Form S-8, however, the registering company must have been a reporting company under the Securities Exchange Act of 1934 for at least 90 days and must have filed all reports that the 1934 Act requires during the preceding twelve month period. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982); *see* 3A H. BLOOMENTHAL, *supra* note 8, at § 7.14 (discussing eligibility requirements of Form S-8); *see also infra* note 46 (discussing reporting companies under 1934 Act).

42. *See* Securities Act Release No. 6188 [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 1945.1 (Feb. 1, 1980) (discussing application of registration requirements of 1933 Act to employee equity incentive plans); *see also supra* note 40 (discussing registration requirements of 1933 Act). The information concerning the plan that Form S-8 requires the company to disclose includes the eligibility requirements for employees under the plan, the employee and employer contributions to the plan, the plan's withdrawal provisions, and the company's proposed administration of the plan. Securities Act Release No. 6188 [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 1945.1 n.182 (Feb. 1, 1980). Form S-8 also requires the registering company to include audited statements of the financial condition of the plan and the income and changes in equity of the plan for each of the last two fiscal years. *Id.* Further, Form S-8 requires the registering company to include information concerning the rights and privileges of the securities that the company is offering its employees. *Id.* at n.183. The information concerning the securities includes the securities' dividend rights, voting rights, liquidation rights, and redemption rights. *Id.*

43. Securities Act Release No. 6188 [1980 Transfer Binder] FED. SEC. L. REP. ¶ 1945.1 (Feb. 1, 1980). In addition to requiring the disclosure on Form S-8 of all audited financial statements from the company's annual report, the SEC requires that the registering company disclose other information on Form S-8. *Id.* The SEC also requires a registering company to

their company than most outside investors, however, the disclosure requirements of Form S-8 are not as extensive as those of other registration forms.[44] Notwithstanding the limited disclosure requirements of Form S-8, compliance costs for a company using the form are nonetheless substantial.[45] Additionally, Form S-8 is not available to a company that is not already public and subject to the disclosure requirements of the Securities Exchange Act of 1934.[46] Small companies, therefore, must try to find a registration exemption or struggle with the "no sale" concept of the 1933 Act in order to implement an employee equity incentive plan.[47]

The 1933 Act provides a number of exemptions from the Act's registration requirements that a small company may utilize in implementing an employee equity incentive plan.[48] A common registration exemption of the

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include in Form S-8 a summary of the company's operations for each of the five preceding fiscal years, the market prices of the company's securities, the company's dividend policy, any significant developments in the company in the past three years, a summary of the company's business and management, and a list of any of the company's parent corporations. *Id.* at n.184. The SEC, however, provides that the company may incorporate information concerning the company's operations by reference to the company's annual report, which the company also must furnish to the employee recipients of the company's equity incentive plans. *Id.*

44. Securities Act Release No. 6188 [1980 Transfer Binder] FED. SEC. L. REP. ¶ 1945.1 (Feb. 1, 1980).

45. *See* Duke, *supra* note 1, at 1432 (discussing costs and benefits of securities registration under Form S-8). According to the responses of general counsels of more than 100 large companies listed on the New York Stock Exchange to questionnaires concerning securities registration costs, the average cost of preparing the initial registration statement on Form S-8 is more than $18,000 combined with average annual updating costs of nearly $7,000. *Id.* at n.12.

46. *See* 2 SEC. REG. (P-H) ¶ 4541 (May 4, 1983) (delineating rules for use of Form S-8). According to the general instructions for using Form S-8, any company that seeks to register stock pursuant to Form S-8 must be a "reporting company" under the Securities Exchange Act of 1934. *Id.*; Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982). A "reporting company" under the 1934 Act is any company that has stock listed on a national securities exchange, or, if a company's stock is traded on the over-the-counter markets, any company with more than $3 million dollars in total assets and more than 500 shareholders. 3 H. BLOOMENTHAL, *supra* note 8, at § 3.03[2]. Thus, only companies that the 1934 Act requires to file periodic disclosure information may use Form S-8 to register the company's issuance of stock under an employee equity incentive plan. Securities Act of 1934 Rule 14a-3, 17 C.F.R. 240.14a-3 (1986). Because of the unavailability of Form S-8 to companies with less than $3 million in total assets and less than 500 shareholders, most closely-held corporations must undertake the lengthy and expensive registration process of the 1933 Act in implementing an employee equity incentive plan. Keller, *supra* note 2, at 156. According to Keller, however, the nonreporting small company is unlikely to undergo the cost and burden of full registration necessary to institute an employee equity incentive plan. *Id.* at n.4. Keller also indicates that most small companies do not even have the certified financial statements necessary to complete registration even if the company desired to register the company's employee equity incentive plan. *Id.*

47. *See infra* notes 48-125 and accompanying text (discussing 1933 Act's registration exemptions applicable to employee equity incentives and 1933 Act's "no sale" concept).

48. *See* H. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 7.02 (1985-86 ed.) (discussing 1933 Act's registration exemptions). The most significant registration exemptions that apply to a small issuer of securities pursuant to an employee equity incentive plan are the "private" offering exemption, conditional exemptions that the 1933 Act authorizes the SEC to adopt for

1933 Act for small companies is the private offering exemption under section 4(2) of the 1933 Act.[49] Section 4(2) exempts from registration a company's securities transactions that do not involve a public offering.[50] In creating this exemption from the 1933 Act's registration process, Congress neglected to define the term "public offering," and the term's converse, "private placement."[51] In 1953, however, the United States Supreme Court attempted to clarify the prerequisites to a company's utilization of the private offering exemption in *SEC v. Ralston Purina Co.*[52] In *Ralston Purina*, the Ralston Purina Company had sold nearly $2 million of the company's treasury stock to as many as 414 of the company's employees without registering the stock offering with the SEC.[53] The SEC filed suit against Ralston Purina in the United States District Court for the Eastern District of Missouri to enjoin the company from offering any further shares of the company's common stock to the company's employees without first registering the shares with the SEC.[54] The SEC contended that the legislative history of section 4(2), as well as the commission's own administrative interpretation of the section, established that the private offering exemption of section 4(2) required a numerical test for determining when a securities offering becomes public.[55] The SEC maintained that a stock offering to 414 investors was too great an offering to constitute a private placement under the SEC's numerical test.[56] Ralston Purina countered by arguing that because the company offered the company's shares only to a limited number of the company's total employees as a means of encouraging stock ownership among the company's key employees, the company's stock offering represented a private offering under section 4(2).[57]

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security issuances less than $5 million, the intrastate exemption, and the exemption for issuances not involving a "sale" of securities. *Id.*; *see infra* notes 49-91 and accompanying text (discussing common registration exemptions that small companies utilize in implementing employee equity incentives); *see also* Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1982) (requiring registration of all securities); *supra* note 40 (discussing registration requirements of 1933 Act).

49. *See* Securities Act of 1933 § 4(2), 15 U.S.C. § 77(d) (1982) (exempting from registration securities offerings that do not constitute a public sale of securities); *see also infra* note 50 and accompanying text (discussing private placement exemption of § 4(2) of 1933 Act).

50. *Id.* Section 4(2) of the 1933 Act provides that a company's securities issuance that does not constitute a securities offering to the public is exempt from the registration requirements of the 1933 Act. *Id.*; *see supra* note 40 and accompanying text (discussing registration requirements of 1933 Act).

51. *See* Kessler, *The Effect of the Securities Laws Upon Small Business*, 28 PRAC. LAW. 11, 18 (1982) (examining small companies' use of 1933 Act's § 4(2) registration exemption in companies' stock offerings to investors).

52. 346 U.S. 119 (1953).

53. SEC v. Ralston Purina Co., 346 U.S. 119, 121 (1953); *see* C. HENN & J. ALEXANDER, *supra* note 11, at § 158 (defining treasury stock as stock that company has authorized and issued, but has reacquired by either donation, purchase, conversion from, or forfeiture by original holder).

54. *Ralston Purina*, 346 U.S. at 119.

55. SEC v. Ralston Purina Co., 102 F. Supp. 964, 966-67 (E.D. Mo. 1952).

56. *Id.*

57. *Ralston Purina*, 346 U.S. at 121-22.

Both the District Court for the Eastern District of Missouri and the United States Court of Appeals for the Eighth Circuit, to which the SEC appealed the district court's decision, accepted Ralston Purina's argument concerning the applicability of section 4(2) to the company's employee stock offering and dismissed the action.[58] On appeal to the Supreme Court, however, the Court reversed the determination of the two lower federal courts.[59] In resolving the issue of whether the registration exemption of section 4(2) applied to Ralston Purina's employee stock purchase plan, the Court rejected the arguments of both the SEC and the company that the applicability of the exemption should focus exclusively on the number of investors or types of investors that the plan included.[60] The Court provided that a flexible test should determine the availability of the exemption.[61] The Court reasoned that the conceptual purpose underlying any securities registration exemption is that the individuals involved in an exempt transaction do not need the protection of the 1933 Act.[62] Thus, the Court determined that the threshold issue governing whether a particular stock offering is private or public for purposes of securities registration centers on the relative knowledge and sophistication of the individuals involved in the transaction.[63] The Court concluded that the test of an individual's sophistication depends on the factual question of whether the individual has access to the same financial and operational information that the 1933 Act would require a company to disclose to outside investors on the company's registration statement.[64] Because Ralston Purina failed to show that the employees involved in the company's stock plan had access to information that the company would have disclosed through registration under the 1933 Act, the Court held that Ralston Purina's stock purchase plan constituted a public offering.[65]

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58. *See Ralston Purina*, 102 F. Supp. at 970 (holding that Ralston Purnia's stock offering was not public and dismissing action); *Ralston Purina*, 200 F.2d 85, 93 (affirming district court's opinion).

59. *Ralston Purina*, 346 U.S. at 127.

60. *Id.* The United States Supreme Court held in *SEC v. Ralston Purina* that while the SEC could employ a numerical test in deciding when to investigate certain exemption claims, the 1933 Act does not require the SEC to incorporate a numerical test in the commission's rules governing the availability of the exemption for nonpublic offerings. *Id.* In short, the Court held that the number of people involved in a company's stock issuance plan is only one factor bearing on a determination of whether the offering is public or private. *Id.*

61. *See id.* at 125 (Court found no justification for imposing strict limits on private offerings as matter of statutory interpretation).

62. *Id.* at 124-25.

63. *Id.*

64. *Id.* The Supreme court noted in *Ralston Purina* that employees are just as entitled to the protection of the 1933 Act as the private investor. *Id.* at 126. Thus, the Court held that § 4(2) of the 1933 Act does not deprive employees of the safeguards of the 1933 Act. *Id.*

65. *Id.* at 127. *SEC v. Ralston Purina* stands as controlling precedent regarding the conceptual framework of the 1933 Act's private offering exemption. *See* Duke, *supra* note 1, at 1438-40 (examining regulatory developments of 1933 Act after *Ralston Purina*). Since the *Ralston Purina* decision, courts and the SEC have maintained that the availability of the private offering exemption depends on whether every offeree in a particular securities trans-

To provide additional certainty to the meaning and availability of the private offering exemption to small issuers of securities, the SEC promulgated Regulation D.[66] Regulation D consists of a set of six rules that provide three exemptions from the registration requirements of the 1933 Act.[67]

action has available the same information that the offeree otherwise could uncover through the issuing company's registration statement. *See, e.g.*, Lawler v. Gilliam, 569 F.2d 1283, 1291 (4th Cir. 1978) (sale to single investor of two notes not exempt when court found that investor did not have access to information that registration statement would have supplied to investor); Doran v. Petroleum Management Corp., 545 F.2d 893, 905-06 (5th Cir. 1977) (indicating that issuer's disclosure and recipient's access to information are disjunctive requirements for purposes of private placement exemption); Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971) (defining sophistication for purposes of private placement exemption as "exceptional business experience").

66. Donahue, *Regulation D: A Primer for the Practitioner,* 8 DEL. J. CORP. LAW 495, 499 (1983). Under § 3(b) of the 1933 Act, the SEC has the statutory authority to add any class of securities to those that Congress otherwise exempts in the 1933 Act if the SEC determines that registering the securities is unnecessary for the protection of the parties involved because of the small amount of securities involved in the securities offering. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1982). Under § 3(b) of the 1933 Act the SEC only may exempt securities of less than $5 million. *Id.*; *see infra* notes 67-80 and accompanying text (discussing Regulation D).

67. Securities Act Release No. 6389 [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106 (Mar. 8, 1982) (codified at 17 C.F.R. § 230.501-.506) (1986). In March of 1982, the SEC adopted Regulation D to provide additional exemptions from the registration requirements of the 1933 Act. *Id.* Regulation D constitutes the SEC's response to public concern that prior rules and regulations had imposed disproportionate financial and administrative burdens on small issuers of securities. *Id.* These disproportionate financial and administrative burdens have impeded the ability of small companies to raise capital. *Id.* According to the SEC, the commission promulgated Regulation D to achieve three main goals. *Id.* The first goal that the SEC sought to achieve through Regulation D was to simplify and clarify the existing limited offering rules and regulations under § 4(2) of the 1933 Act. *Id.*; Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1982). The second of the SEC's goals was to eliminate unnecessary restrictions and regulations that § 4(2) placed on small companies and enhance the attractiveness of the § 4(2) exemption. Securities Act Release No. 6389 [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106 (Mar. 8, 1982); Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1982). The final goal that the SEC sought to achieve was to provide uniformity between state and federal registration private offering exemptions to facilitate a company's capital formation. Securities Act Release No. 6389 [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,106 (Mar. 8, 1982).

Regulation D consists of a set of six rules prefaced by seven preliminary notes. *See* 17 C.F.R. §§ 230.501-.506 (Preliminary Notes 1-7) (1986) (notifying corporate issuers relying on Regulation D that provisions of Regulation D do not exclude issuers from adhering to other statutory duties and obligations apart from Regulation D). Note 1 of Regulation D informs issuers that although Regulation D offerings are exempt from the registration requirements of the 1933 Act, Regulation D offerings are not exempt from the antifraud, civil liability, or other provisions of the securities laws. *Id.* at Preliminary Note 1. Note 2 of Regulation D emphasizes the issuer's obligation to comply with applicable state securities laws. *Id.* at Preliminary Note 2. Note 3 stresses that an issuer's reliance on Regulation D does not preclude the issuer from utilizing other statutory exemptions for small securities offerings and private placements. *Id.* at Preliminary Note 3. Thus, even if the issuer fails to meet the requirements of Regulation D, the issuer still may employ the private placement exemption of § 4(2) of the 1933 Act. Donahue, *supra* note 67, at 499; *see supra* notes 49-65 and accompanying text (discussing private placement exemption of § 4(2) of 1933 Act). Note 4 of Regulation D

Under Rule 504 of Regulation D, the SEC exempts a company's securities offerings from registration if the total amount of the offering is less than $500,000 during a twelve month period.[68] The Rule 504 exemption contains no limit on the number of investors involved.[69] Furthermore, the Rule 504 exemption does not require disclosure statements or sophistication standards for the investors involved in an offering.[70] Rule 505 of Regulation D exempts a company's stock offerings of up to $5 million during a twelve month period.[71] The Rule 505 exemption allows a company to issue securities to any number of accredited investors and up to thirty-five nonaccredited

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provides that Regulation D is available only to the issuer of the securities and not to the issuer's affiliates or to other persons for resale of the issuer's securities. 17 C.F.R. §§ 230.501-.506 (Preliminary Note 4). Note 5 of Regulation D states that an issuer may use Regulation D for business combinations. *Id.* at Preliminary Note 5. The business combinations that the SEC contemplates in Regulation D are an issuer's reclassification of the issuer's securities, a statutory merger or consolidation of the issuer, and an issuer's transfer of assets. *See* 17 C.F.R. § 230.145(a) (1986) (describing business combinations that SEC recognizes in 1933 Act's securities registration provisions). Note 6 of Regulation D warns issuers that mere compliance with all of the regulation's technicalities will not allow the issuer to use the regulation if the SEC discovers that compliance was part of the issuer's scheme to evade the registration provisions of the 1933 Act. 17 C.F.R. §§ 230.501-.506 (Preliminary Note 6). Note 7 of Regulation D states that issuer's who sell or offer securities outside of the United States need not register the securities under the 1933 Act. *Id.* at Preliminary Note 7.

68. 17 C.F.R. § 230.504 (1986). Rule 504 of Regulation D provides that the Rule 504 exemption is available only to an issuer that is neither an investment company nor subject to the reporting requirements of the 1934 Act. Owens & Makohin, *Small Business Exemptions Under Regulation D*, 1 SEC. REG. (P-H) ¶ 1123 (Jan. 10, 1985); *see supra* note 46 (discussing companies subject to reporting requirements of 1934 Act). To take advantage of the Rule 504 exemption, a company's offer and sale of securities must conform to the terms and conditions set out in Rules 501-503 of Regulation D. Owens & Makohin, *supra*, at ¶ 1123. Rule 501 of Regulation D provides definitions of certain terms that the SEC uses in the remainder of Regulation D. *Id.* For instance, Rule 501 defines the terms "affiliate," "aggregate offering price," "issuer," and "executive officer" for purposes of the remainder of the regulation. *Id.* Rule 502 states that the concept of integration applies to all offerings under Regulation D. *Id.* The concept of integration generally requires that the combination of all securities offerings, which may be technically separate, are part of the same securities offering for purposes of the registration provisions of the 1933 Act. *Id.*; *see infra* note 96 (discussing SEC's use of integration concept in securities registration). Rule 502, however, establishes a six-month safe harbor respecting the integration concept. Owens & Makohin, *supra*, at ¶ 1123. The six-month safe harbor provides that companies may sell securities either six months before or six months after the companies' securities offering under Regulation D without encountering the problem of integration. *Id.* Additionally, Rule 502 expressly prohibits a company's use of general advertising or general solicitation in the offer and sale of securities exempt from registration under Rule 504 of Regulation D. *Id.* Rule 503 of Regulation D sets forth requirements for filing notices with the SEC of security sales that a company makes under Regulation D. *Id.* Rule 503 requires a company to file a notice form with the SEC 15 days after the company's first sale of securities under Regulation D, and no later than 30 days after the company's last sale, and every six months between sales. *Id.*

69. 17 C.F.R. § 203.504 (1986).

70. *See id.* (discussing suitability or investment sophistication standards under Rule 504 of Regulation D); *see also infra* note 72 (discussing distinction between accredited and nonaccredited investors).

71. 17 C.F.R. § 230.505 (1986). A company relying on the Rule 505 exemption of Regulation D must not be an investment company, and must satisfy the terms and conditions

investors.[72] Rule 505 does not require that the nonaccredited investors satisfy any sophistication standards.[73] Moreover, Rule 505 does not require that the investors, accredited or nonaccredited, have the ability to bear the economic risks of the investment.[74] Rule 505, however, does include information requirements depending on the type of issuer and the type of investor involved in the transaction.[75] Rule 506 of Regulation D, substantially similar to Rule 505, contains no limitation on the type of corporate issuer that may rely on the Rule's exemption or on the aggregate offering price of the securities that the company may issue in an offering.[76] Like Rule 505, Rule 506 limits to thirty-five the number of nonaccredited investors who may participate in a company's securities offering under the Rule 506 exemption.[77] Rule 506 also includes disclosure requirements similar to the

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of Rules 501-503 of Regulation D. *See* Owens & Makohin, *supra* note 68, at ¶ 1123 (discussing Rule 505 of Regulation D); *supra*, note 68 (discussing Rules 501-503 of Regulation D).

72. 17 C.F.R. § 230.505(b)(2)(ii) (1986). In calculating the number of purchases under Rule 505 of Regulation D, the SEC excludes relatives of the management of the issuer, including trusts and estates of the relatives of the issuer's management, as well as the issuer's affiliated corporations and accredited investors. 17 C.F.R. § 230.505(e) (1986). Under Rule 501 of Regulation D, accredited investors include banks and insurance companies, business development companies, small business investment companies, employee benefit plans, individuals who purchase at least $150,000 worth of securities in one transaction when the purchase price does.not exceed 20% of the individual's net worth, persons whose net worth exceeds $1 million, persons whose income exceeded $200,000 in each of the two preceding years and will exceed $200,000 for the current year, and directors, executive officers or general partners of the issuer. 17 C.F.R. 230.501(a)(1-8) (1986). The SEC counts a corporation, partnership, or other business entity as one purchaser for purposes of the Rule 505 registration exemption, unless promoters formed the entity for the specific purpose of investment. *Id.* If the entity is an investment entity, the SEC will count each equity owner of the entity individually for purposes of the purchaser limitation of Rule 505. *Id.*

73. Owens & Makohin, *supra* note 68, at ¶ 1123.

74. *Id.*

75. *Id.* Under Rule 505, if all of the purchasers of a company's securities are accredited, the company does not need to disclose any financial information. *Id.*; *see supra* note 72 (discussing accredited investors under Regulation D). If/the purchasers include nonaccredited investors, however, the type of information that the issuer must disclose to the nonaccredited investors depends on whether the issuer is a reporting company under the 1934 Act. *See* Owens & Makohin, *supra* note 68, at ¶ 1123 (discussing disclosure requirements for companies offering securities to accredited and nonaccredited investors); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982); *see supra* note 46 (discussing reporting companies under the 1934 Act). Regardless of whether a purchaser is accredited or nonaccredited, Rule 505 requires the reporting or nonreporting issuer to give each purchaser the opportunity to ask questions and receive answers concerning the terms and conditions of the securities offering and to obtain additional information that the issuer possesses or can acquire without unreasonable effort or expense. Owens & Makohin, *supra* note 68, at ¶ 1123.

76. 17 C.F.R. § 230.506 (1986). Like Rules 504 and 505, Rule 506 requires companies issuing securities under the Rule to comply with the terms and conditions of Rules 501-503 of Regulation D. *Id.*; *see* Owens & Makohin, *supra* note 68, at ¶ 1123 (discussing applicability of Regulation D exemptions for small business); *supra* note 68 (discussing Rules 501-503 of Regulation D). Rule 506, however, is the only Rule under Regulation D that places no ceiling on the dollar amount of an issuer's securities offering. 17 C.F.R. § 230.506 (1986).

77. 17 C.F.R. § 203.506(b) (1986); *see supra* note 72 and accompanying text (discussing SEC's purchaser limitation of 35 nonaccredited investors in Rule 505 of Regulation D).

requirements of Rule 505, which concern the corporate issuer's business operations and financial condition.[78] Unlike Rule 505, however, Rule 506 requires that nonaccredited investors satisfy sophistication standards.[79] Moreover, Rule 506 requires a corporate issuer to believe, immediately prior to making any sale of securities, that each investor possesses sufficient knowledge and experience in financial and business matters to enable the investor to evaluate the merits and risks of the prospective investment.[80]

In addition to the 1933 Act's registration exemptions for private placements under section 4(2) and Regulation D of the Act, small companies may take advantage of the intrastate registration exemption under section 3(a)(11) of the Act in implementing employee equity incentive plans.[81] In order for a company to utilize the intrastate exemption, the company must make all offers and sales of the company's securities to bona fide residents of a single, appropriate jurisdiction.[82] The appropriate jurisdiction under section 3(a)(11) is that state in which the company incorporates and conducts business.[83] To determine the jurisdiction under section 3(a)(11) in which the company conducts its primary business, the company must have its principal place of business in the same jurisdiction in which the company plans to use most of the proceeds of the company's securities offering.[84] Finally, for

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78. 17 C.F.R. § 230.506 (1986). The SEC requires in Rule 506 that the corporate issuer disclose to the investor the issuer's financial statements for the three fiscal years immediately preceding the date of the securities offering. *Id.* The SEC also requires in Rule 506 that the corporate issuer disclose to the investor the issuer's balance sheets for the two fiscal years prior to the securities offering. *Id.*; *see* Owens & Makohin, *supra* note 68, at ¶ 1123 (discussing disclosure requirements of Rule 506); *supra* note 75 (discussing disclosure requirements of Rule 505).

79. 17 C.F.R. § 230.506 (1986); *see* Owens & Makohin, *supra* note 68, at ¶ 1123 (discussing sophistication standards under Rule 506); *supra* text accompanying notes 73-74 (discussing sophistication standards of Rule 505).

80. 17 C.F.R. § 230.506 (1986). The issuer's subjective determination of an investor's sophistication in business and financial matters applies only to nonaccredited investors under Rule 506. Owens & Makohin, *supra* note 68, at ¶ 1123. The issuer may accomplish its burden of investigating the sophistication of the issuer's proposed investors through use of investor questionnaires in which the investor discloses facts concerning the investor's education, financial background, prior investments of similar nature, and other relevant information documenting the investor's business knowledge and experience. *Id.* The SEC, however, does not provide a standard for determining when the SEC will consider the issuer to have satisfied sufficiently the issuer's burden of establishing the sophistication of an investor. *Id.*

81. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1982). Section 3(a)(11) of the 1933 Act exempts from registration any security that is part of an offering that the issuer sells only to investors in the same state or territory. *Id.* To take advantage of § 3(a)(11) the issuer must be incorporated and have its principle place of business in the same state or territory as the investors in the issuer's securities. *Id.*

82. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1982); *see* H. BLOOMENTHAL, *supra* note 48, at § 7.10 (discussing requirements of intrastate exemption of 1933 Act).

83. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1982); *see* H. BLOOMENTHAL, *supra* note 48, at § 7.10 (discussing requirements of intrastate exemption of 1933 Act).

84. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1986); *see* H. BLOOMENTHAL, *supra* note 48, at § 7.10 (discussing requirements of intrastate exemption). An offering is not

securities offerings qualifying for an exemption pursuant to section 3(a)(11), a shareholder's inadvertent resale of securities to a nonresident could destroy the availability of the exemption for the entire securities offering that the issuing company has undertaken.[85]

Because section 3(a)(11) is not a detailed statutory provision, the SEC promulgated Rule 147 as a "safe harbor" for the intrastate exemption.[86] In Rule 147 the SEC defines the term "resident" for purposes of the intrastate exemption and specifies numerical standards on which a company may rely in determining whether the company satisfies the jurisdictional requirement of the section 3(a)(11) exemption.[87] Additionally, the SEC clarifies in Rule 147 when a recipient of stock issued in reliance on the intrastate exemption may resell the stock to nonstate residents without rendering the exemption unavailable to the company's stock offering.[88] In Rule 147, the SEC provides a nine-month resale limitation period to gauge when a company's share-

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exempt under the intrastate exemption when the issuer plans to use the proceeds of the offering to finance the issuer's out-of-state ventures. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1982); *see* Kessler, *supra* note 51, at 15 (discussing requirements of intrastate exemption). For example, a company seeking to utilize the intrastate exemption for its securities offering could not use the proceeds of the offering to purchase out-of-state oil and gas interests, or to make loans to out-of-state land developers and still claim the offering exempt under the intrastate exemption. *Id.*

85. Securities Act of 1933 § 3(a)(11) (1986), 15 U.S.C. § 77c(a)(11) (1982); *see* T. HAZEN, *supra* note 8, at § 4.12 (discussing securities resale under intrastate exemption).

86. SEC Securities Act Release No. 33-5450 (Jan. 7, 1974) (codified at 17 C.F.R. § 230.147 (1986)); *see* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 375 (1983) (defining "safe harbor" in securities law as guidelines that SEC adopts to provide objective standards upon which companies may rely in interpreting statutory provision of 1933 Act). The SEC frequently adopts "safe harbor" rules to provide objective standards upon which companies may rely in implementing securities offering under a registration exemption of the 1933 Act. L. Loss, *supra*, at 375. The SEC's "safe harbor" rule to a particular securities registration exemption of the 1933 Act usually will provide more definite conditions for a company to satisfy than Congress has provided for in the statutory language of the exemption provision. *Id.*; *see infra* notes 87-91 and accompanying text (SEC provides in Rule 147 definite residency, conduct, and resale standards for companies to rely on in implementing securities offering under intrastate offering exemption of 1933 Act).

87. 17 C.F.R. § 230.147 (1986). Under Rule 147, an individual's residence is the individual's principal residence at the time a corporate issuer, relying on Rule 147, offers or sells securities to the individual. 17 C.F.R. § 230.147(d)(2) (1986). The SEC's residency test in Rule 147 seems to limit each individual's residence to one state, thus eliminating vacation homes as indicia of an individual's residence. T. HAZEN, *supra* note 8, at § 4.12. In addition to the investor's residency requirements, the SEC defines in Rule 147 when the SEC will consider the corporate issuer a resident of a state. 17 C.F.R. § 230.147(c)(1) (1986). Under rule 147, the SEC requires the corporate issuer to have its place of incorporation and its principle place of business in the same state. *Id.* The SEC considers the issuer to have its principle place of business in the state in which the issuer derives at least 80% of its gross revenue per year. 17 C.F.R. § 230.147(c)(2)(i) (1986). The SEC also consider the issuer to have its principle place of business in the state in which the issuer has 80% of its assets within the past fiscal year. 17 C.F.R. § 230.147(c)(2)(ii) (1986).

88. *See* 17 C.F.R. § 230.147(e) (1986) (providing limitation for stock resales to nonresidents).

holders may resell stock to nonresidents.[89] The SEC assumes under Rule 147 that a securities offering made pursuant to the intrastate exemption has ended nine months after the last sale that a company has made in reliance on the exemption.[90] The SEC, therefore, allows shareholders who obtained their stock in a principal offering pursuant to Rule 147 to resell their stock to nonresidents after the nine month limitation period without affecting the availability of the intrastate exemption for the company's principal offering.[91] While the 1933 Act seems to provide a small company with numerous registration exemptions from which to choose when implementing an employee equity incentive plan, none of the 1933 Act's exemptions satisfy the precise circumstances of a small company's equity incentive plan with sufficient certainty.[92] For instance, under the private offering exemption of section 4(2) of the 1933 Act, the SEC requires that the recipients possess the requisite knowledge and sophistication to warrant nonregistration under the Act.[93] Unless the company restricts the recipients of the plan to top

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89. 17 C.F.R. § 230.147(e) (1986).

90. *See* 17 C.F.R. § 230.147(e) (1986) (providing nine-month limitation period for stock resales to nonresidents).

91. *See id.* (providing nine-month limitation period for stock resales to nonresidents). A small company desiring to use the intrastate exemption may rely on either a general interpretation of § 3(a)(11) or on Rule 147 in determining whether the company's securities offering is exempt from registration under the 1933 Act. *See* BLOOMENTHAL, *supra* note 48, at § 7.10 (discussing availability of intrastate exemption and Rule 147 to securities issuers). Because of its more detailed standards, Rule 147 provides greater certainty to a company desiring to implement a securities offering under the intrastate exemption of the 1933 Act. *Id. see supra* note 87 and accompanying text (discussing residency standards and conduct requirements of Rule 147).

92. *See* Keller, *supra* note 2, at 156-57 (discussing deficienies of present federal securities registration exemptions); *see also infra* notes 93-110 and accompanying text (discussing deficiencies of securities registration exemptions for small companies' equity incentive plans).

93. Keller, *supra* note 2, at 156-57. Each recipient of securities under the private placement exemption of the 1933 Act must have access to the types of information that full disclosure under the 1933 Act requires. T. HAZEN, *supra* note 8, at § 4.21; *see supra* notes 49-65 and accompanying text (discussing private placement exemption). The issuer will not satisfy the knowledge requirement under the private placement exemption unless the issuer provides each potential recipient with access to the issuer's disclosure information. T. HAZEN, *supra* note 8, at § 4.21. The issuer must provide the potential recipient with access to the disclosure information even if the potential recipient decides not to participate in the securities offering that the issuer conducts pursuant to the private placement exemption. *Id.*; *see* Doran v. Petroleum Management Corp., 545 F.2d 893, 904-05 (5th Cir. 1977) (holding that plaintiff offeree's knowledge and sophistication concerning facts underlying securities offering would not save availability of private placement exemption if one of fellow offerees was not privy to same information). The availability of the private placement exemption also depends on the recipient's sophistication in financial matters generally. T. HAZEN, *supra* note 8, at § 4.21. The corporate issuer carries the burden of proving that all of the recipients of the company's stock issued pursuant to the private placement exemption are sophisticated. *Id.* Accordingly, one court denied a company the availability of the private placement exemption because the company failed to show that all of the recipients of the company's stock received access to information concerning the company that the recipients might have required in deciding whether to purchase the company's securities. SEC v. Continental Tobacco Company of South Carolina, Inc., 463 F.2d 137, 160-61 (5th Cir. 1972). The United States Court of Appeals for the Fourth

management or independently wealthy employees, however, corporate issuers frequently have difficulty determining whether the recipients satisfy the private offering exemption's sophistication requirements.[94] The corporate issuer carries the burden of investigating and proving that all of the recipients of equity incentives have access to all of the information that the company's registration statement would disclose.[95] Additionally, the small corporate issuer must incur the cost of communicating the existence of the employee stock plan directly to the company's employees.[96]

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Circuit has held that when the recipient of a company's securities lacks sufficient sophistication and access to information, even an offering involving only one purchaser will not meet the requirements of the private placement exemption. Lawler v. Gilliam 569 F.2d 1283, 1290-91 (4th Cir. 1978). Recent cases concerning the sophistication requirements of the private offering exemption reveal that a company relying on the private offering exemption may subject itself to a great deal of uncertainty in instituting a securities offering pursuant to the exemption. T. HAZEN, *supra* note 8, at § 4.21. In addition to the sophistication guidelines that appear from the recent judicial decisions, the company also must recall the factors that the Supreme Court set out in *SEEC v. Ralston Purina. Id.; see SEC v. Ralston Purina*, 346 U.S. 119 (1953) (holding that individual's sophistication under private offering exemption depends on whether individual has access to financial information that registration under 1933 Act would disclose); *see also supra* notes 60-65 and accompanying text (discussing Supreme Court's holding in *Ralston Purina*). In evaluating the availability of the private placement exemption, therefore, the courts and the SEC will scrutinize not only the number and sophistication of the recipients of a company's stock, but also the recipient's access to information, the relationship of the recipients to the company, the manner of the securities offering, and the number of shares the company offers pursuant to the private placement exemption. T. HAZEN, *supra* note 8, at § 4.21.

94. *See* Keller, *supra* note 2, at 156 (discussing deficiency of private placement exemption for small companies' equity incentive plans). Because companies often have difficulty determining the knowledge and sophistication of the potential recipients of the companies' stock, companies commonly must risk stretching the concept of "private offering" to manipulate the exemption to fit the companies' equity incentive plans. *Id.* The companies, therefore, risk destroying the availability of the private placement exemption by extending the concept too far. *Id.*

95. *See* T. HAZEN, *supra* note 8, at § 4.21 (discussing requirements and availability of private placement exemption); *supra* note 93 (discussing companies' burden of proving that recipients of companies' stock issued under private placement exemption are sophisticated).

96. *See* T. HAZEN, *supra* note 8, at § 4.21 (discussing disclosure requirements under private placement exemption). In addition to the sophistication and disclosure requirements of the private placement exemption, the integration doctrine poses problems for the small securities issuer relying on the private placement exemption. *Id.* Under the integration doctrine, the SEC will scrutinize closely securities offerings that may appear to be separate transactions to determine whether the commission will treat the offerings as part of a single offering or as two distinct transactions. *Id.* at § 4.13. Thus, the integration doctrine potentially operates to combine two or more seemingly separate securities transactions into part of a single securities offering. *Id.* In determining whether the integration doctrine will apply to a particular series of securities offerings, the SEC considers several factors: whether the securities offerings are part of a single financing plan; whether the offerings involve the same class of security; whether the company makes the offerings at or about the same time; whether the company receives the same consideration for the company's offering; and, whether the company makes the offering for the same general purpose. *Id.* Regarding the private placement exemption, the integration doctrine could destroy the availability of the exemption. *Id.* A recipient's downstream sale of securities, which the recipient obtained through a principle offering under the private placement exemption, to a third party may relate back and destroy the exemption for

Despite the SEC's attempt in Regulation D to clarify the uncertainty and inconsistency of the private offering exemption, the registration exemptions of Regulation D provide little comfort for the small company implementing an employee equity incentive plan.[97] While the registration exemption in Rule 504 of Regulation D removes the obligation of small companies to file financial statements and simplifies the sophistication standards of the recipients of the company's employee equity incentive, the $500,000 ceiling that Rule 504 imposes on the company's securities offering effectively limits the availability of equity plans.[98] The $500,000 limitation is especially burdensome to small companies who are uncertain how to measure the ceiling.[99] Similar to the exemption in Rule 504, the exemption in Rule 505,

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the principle offering. *Id.* Because the third party purchaser may not qualify as a sophisticated purchaser under the private placement exemption, the SEC may consider a downstream sale to an unsophisticated third party within a short time to constitute part of the company's principal securities offering under the private placement exemption. *Id.*; *see supra* note 93 (discussing sophistication standards of private placement exemption). By integrating the downstream sale with the principle offering, the SEC may not allow the company to use the private placement exemption for the company's principal offering. T. HAZEN, *supra* note 8, at § 4.13. The SEC, therefore, may require the company to register all of the stock the company originally sold pursuant to the private placement exemption. *Id.*

97. *See* Donahue, *supra* note 66, at 520 (discussing implications of Regulation D to small securities issuers). Mark Donahue, an investment banker with Merrill Lynch's Capital Markets Group, indicates that whether Regulation D will fulfill the SEC's intentions of creating simplified registration exemptions for small securities issuers depends on how strictly the SEC and the courts enforce the regulation's provisions. *Id.* The commentator contends that if the SEC requires overly strict compliance with Regulation D, the commission could impede small issuers' effective use of Regulation D's registration exemptions. *Id.* A small company considering a securities offering under Regulation D may hesitate to implement a securities offering under Regulation D when the company realizes the potential liability the company could face by failing to comply strictly with the regulation's technical and complex provisions. *Id.* The company may decide that the risk is too great and not attempt to utilize Regulation D. *Id.* The commentator recommends, therefore, that the SEC adopt a substantial compliance policy in evaluating Regulation D transactions by small securities issuers. *Id.* The commentator argues that the SEC's adoption of a substantial compliance policy would further the SEC's purpose of allowing small companies to raise capital through limited securities offerings without forcing the companies to comply with needlessly burdensome rules. *Id.*; *see supra* notes 66-80 and accompanying text (discussing Regulation D).

98. Keller, *supra* note 2, at 157; *see* 17 C.F.R. § 230.504(b)(2)(i) (1986) (imposing $500,000 limit on securities offerings under Rule 504 of Regulation D); *supra* notes 68-70 and accompanying text (discussing Rule 504 of Regulation D).

99. Keller, *supra* note 2, at 157; *see* 17 C.F.R. § 203.504(b)(2)(i) (1986) (imposing $500,000 maximum on securities offerings under Rule 504 of Regulation D). Any company that is planning to offer securities under Rule 504 must determine what portion of the $500,000 maximum is available for the proposed offering. J. HICKS, NEW LIMITED OFFERING EXEMPTIONS: REGULATION D 149-50 (1982). Under Rule 504, the company must subtract from the maximum amount of $500,000 the aggregate offering price of all securities that the company sold within one year prior to the proposed offering. *Id.* at 150. The company must diminish the available maximum amount by the aggregate offering price of securities that the company previously has offered in reliance on any exemption under § 3(b) of the 1933 Act, which include offerings under Rules 504 and 505 of Regulation D. *Id.*; Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1982). Rule 504, however, does not explain how the company should value securities

which limits a company's securities offering to $5 million, does not impose a sophistication requirement on the equity plan recipients.[100] The Rule 505 exemption, however, limits the number of nonaccredited investors who may participate in the plan to thirty-five and requires disclosure of detailed information comparable to the registration materials that the 1933 Act requires.[101] Thus, companies relying on the Rule 505 exemption gain no real advantage because Rule 505 requires the company to undertake the trouble and expense of preparing extensive disclosure materials for the benefit of

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that the company proposes to offer pursuant to the Rule 504 exemption in calculating the amount of securities that the company may sell. J. HICKS, *supra*, at 145-46. Rule 504 incorporates Rule 501's definition of "aggregate offering price," which provides the basis for making the required calculation. *Id.* at 146; *see supra* note 68 (discussing Rule 504's incorporation of Rules 501-503 of Regulation D). Rule 501(c) contemplates several types of transactions to assist a company that is planning to offer securities under rule 504. J. HICKS, *supra*, at 61; 17 C.F.R. § 230.501(c) (1986). One securities transaction that Rule 501(c) recognizes as pertinent to employee equity incentive plans is a company's offering of securities in exchange for the recipient's services. 17 C.F.R. § 230.510(c) (1986). Under Rule 501(c), the company must value the services according to the fair market value of the services as determined by "an accepted standard." J. HICKS, *supra*, at 64; 17 C.F.R. § 230.501(c) (1986). Rule 501's vague calculation method for valuing a recipient's services as consideration for a company's stock offers little comfort to the company in determining the aggregate offering amount of the company's stock issued under Rule 504. J. HICKS, *supra*, at 64. Companies instituting securities offerings under Rule 504 of Regulation D to employees in exchange for services, therefore, often have no set standard for placing a value on the employee's services to determine whether the company's securities offering to the employees exceeds the $500,000 ceiling of Rule 504. *Id.*

In addition to the valuation problem, the integration doctrine also affects a company's securities offering under Rule 504. T. HAZEN, *supra* note 8, at § 4.19. The SEC will use the same five factor test that the commission employs in evaluating offerings pursuant to the private placement exemption to determine whether the company's securities offering is a single securities issue and qualifies under the $500,000 ceiling of Rule 504. *Id.*; *see supra* note 96 (discussing integration doctrine and five-factor test for determining whether SEC will integrate offerings). Thus, the SEC could integrate a company's securities offering to outside investors with the company's principal offering to the company's employees under Rule 504, conceivably resulting in an aggregate securities offering exceeding $500,000. T. HAZEN, *supra* note 8, at § 4.19. The integration of an outside offering with the principal offering to the company's employees, therefore, could destroy the availability of the Rule 504 exemption to the principle securities offering. *Id.*

100. 17 C.F.R. § 230.505 (1986); Keller, *supra* note 2, at 157; *see supra* notes 71-75 and accompanying text (discussing Rule 505 of Regulation D).

101. 17 C.F.R. § 230.505 (1986); *see* Keller, *supra* note 2, at 157 (discussing disadvantages of registration exemption of Rule 505 of Regulation D). The disclosure obligation of Rule 505 that requires a company to provide potential purchasers with the company's audited financial statements is particularly burdensome to small companies that often have had no previous audited financial statements. J. HICKS, *supra* note 99, at 231; *see supra* notes 73-75 and accompanying text (discussing Rule 505's disclosure requirements and nonaccredited purchaser limitation). The integration doctrine also applies to stock offerings that a company institutes under Rule 505. T. HAZEN, *supra* note 8, at § 4.18. The SEC uses the same five factor test that the commission employs in evaluating stock offerings under the private placement exemption and Rule 504 to determine both the number of nonaccredited purchasers involved in a Rule 505 securities offering and the $5 million maximum that Rule 505 imposes. H. BLOOMENTHAL, *supra* note 48, at § 4.05[7]; *see supra* notes 96 & 99 (discussing effect of

the company's employees.[102] Finally, the exemption contained in Rule 506 also is unsuitable to the small securities issuer because the exemption limits the number of nonaccredited investors to thirty-five, and requires the company to furnish information as extensive as the registration materials that the 1933 Act requires.[103] Additionally, companies often have difficulty proving that the employees participating in the equity plan have the knowledge and experience to make an intelligent purchase decision as Rule 506 requires.[104]

While the intrastate offering exemption under section 3(a)(11) of the 1933 Act also is available for equity incentive plans for small companies, compliance with the requirements of the exemption is often difficult.[105] The intrastate exemption is not available for companies with employees living in more than one state unless the company restricts the plan only to the employees who reside in the state in which the company incorporated and has its principle place of business.[106] Additionally, Rule 147, which the SEC adopted as a safe harbor for the intrastate exemption, contains impediments

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integration doctrine on securities offerings under private placement exemption and Rule 504); note 72 and accompanying text (discussing accredited and nonaccredited purchasers).

102. 17 C.F.R. § 230.505 (1986); *see* Keller, *supra* note 2, at 157 (discussing deficiencies of Rule 505).

103. 17 C.F.R. § 230.506 (1986); *see* Keller, *supra* note 2, at 157 (discussing deficiencies of Rule 506 for equity incentive plans for small companies); *see also supra* notes 77-80 and accompanying text (discussing Rule 506's nonaccredited investor standards and disclosure requirements). Similar to the criticisms of the disclosure obligations of Rule 505, small companies attempting to rely on the registration exemption of Rule 506 will have difficulty satisfying the Rule's mandate that a company supply all of the potential purchasers with audited financial statements. J. Hicks, *supra* note 99, at 231; *see supra* note 101 (discussing deficiencies with disclosure requirement of Rule 505 for small companies).

104. 17 C.F.R. § 230.506 (1986); *see* Keller, *supra* note 2, at 157 (discussing deficiencies in Rule 506 registration exemption for small security issuers); *see also supra* notes 78-80 (discussing Rule 506's requirement that companies relying on Rule show that nonaccredited investors have access to same information that full disclosure would provide to investor). The integration doctrine and the five-factor test that the SEC employs in evaluating offerings under the private placement exemption and the other registration exemptions under Regulation D also apply to securities offerings under Rule 506. T. Hazen, *supra* note 8, at § 4.22; *see supra* notes 96, 99 & 101 (discussing integration doctrine and SEC's five-factor test for determining whether integration will apply to particular securities offering under either private placement exemption, Rule 504, or Rule 505). The SEC primarily uses the five-factor integration test to evaluate the number of nonaccredited purchasers involved in a securities offering under Rule 506. T. Hazen, *supra* note 8, at § 4.22.

105. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1982); *see* Keller, *supra* note 2, at 157 (discussing limitations of intrastate exemption for small companies instituting equity incentive plans); *see also supra* notes 82-85 and accompanying text (discussing requirements of intrastate registration exemption).

106. *See* Keller, *supra* note 2, at 157 (discussing deficiency of intrastate exemption to small securities issuers). Under the intrastate exemption of § 3(a)(11) of the 1933 Act, not only all purchasers but all offerees of a particular securities offering must be residents within a single state. T. Hazen, *supra* note 8, at § 4.12; Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1982); *see supra* notes 82-85 and accompanying text (discussing requirements of intrastate registration exemption). In addition to the limitation on the potential number of

to a company relying on the Rule.[107] Most notably, the nine-month holding period that Rule 147 provides does not commence until the company completes the entire securities offering.[108] The company will not complete its offering under an employee equity incentive plan until the employees exercise all of the options under the offering, which often does not occur until several years after the company originally implements the employee equity incentive plan.[109] Thus, an employee probably will not be able to resell the stock that the employee received under the equity incentive for several years, placing the employee at a potential liquidity disadvantage.[110]

Aside from the 1933 Act's specific registration exemptions for a securities offering, a small company may attempt to avoid registration under the 1933 Act by manipulating the company's employee equity incentive plan

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participants in a securities offering under the intrastate exemption, the exemption's residency requirements for the corporate issuer often impede a company's effective use of the exemption. T. HAZEN, *supra* note 8, at § 4.12; *see supra* notes 83-84 and accompanying text (discussing intrastate exemption's residency requirements for corporate issuers). The exemption's corporate residency requirements necessarily eliminate the vast number of companies that, while doing business in one state, select some other jurisdiction such as Delaware in which to incorporate to take advantage of the latter state's more attractive corporate laws. T. HAZEN, *supra* note 8, at § 4.12. Futhermore, even if the company and the purchasers and offerees participating in the securities offering satisfy the intrastate exemption's residency requirements, the company's subsequent use of the proceeds of the offering in an out-of-state venture could destroy the availability of the exemption for the offering. *Id.*; *see* SEC v. McDonald Investment Co., 343 F.Supp. 343, 346-47 (D.Minn. 1972) (holding that Minnesota corporation's securities offering was not exempt under the intrastate exemption because value of corporation's securities depended on success of corporation's out-of-state land developments). Thus, the intrastate exemption's application is questionable for any company with out-of-state operations because the SEC could attribute proceeds from an offering pursuant to the exemption to the out-of-state portion of the business. T. HAZEN, *supra* note 8, at § 4.12. Additionally, the integration doctrine affects the availability of the intrastate exemption and operates to determine whether all of the participants in the securities offering pursuant to the exemption satisfy the exemption's requirements. *Id.*; *see supra* note 96 (discussing integration doctrine).

107. 17 C.F.R. § 230.147 (1986); *see* H. BLOOMENTHAL, *supra* note 48, at § 7.10 (discussing deficiencies of Rule 147); *see also supra* notes 86-91 and accompanying text (discussing requirements of Rule 147).

108. 17 C.F.R. § 230.147(e) (1986).

109. *See* Keller, *supra* note 2, at 157 (indicating practical ineffectiveness of Rule 147 for employee equity incentive plans); *see also* H. BLOOMENTHAL, *supra* note 48, at § 7.10 (discussing deficiencies of Rule 147).

110. *See* H. BLOOMENTHAL, *supra* note 48, at § 7.10 (discussing deficiencies of Rule 147). As with the statutory intrastate exemption of § 3(a)(11) of the 1933 Act, the integration doctrine also applies to offerings under Rule 147. T. HAZEN, *supra* note 8, at § 4.12. The SEC uses the five-factor integration test to determine whether an offering conforms to the residency and conduct requirements of Rule 147. *Id.*; *see supra* note 96 (discussing five-factor integration test); *see also* note 87 and accompanying text (discussing residency and conduct requirements of Rule 147). Rule 147 expressly adopts the five-factor integration test and indicates that any one of the factors can determine the availability of Rule 147 to the corporate issuer in a securities offering. *See* 17 C.F.R. § 230.147 (preliminary note) (expressly adopting SEC's five-factor integration test).

to fall within the "no sale" concept of the 1933 Act.[111] Section 2(3) of the 1933 Act defines a "sale" of securities as a company's disposition for value of a security or grant of interest in a security.[112] Unless a securities transaction represents a sale under the 1933 Act, the Act does not require that the corporate issuer register the securities.[113] While the definition of "sale" under section 2(3) clearly includes a company's issuance of the company's stock for cash consideration, section 2(3) implies that a company's grant of stock to the company's employee without requiring the employee to pay for the security would not constitute a "sale."[114] Thus, a company's grant of stock to an employee would be exempt from the 1933 Act's registration requirements.[115] In fact, the SEC has adopted the view that certain employee stock purchase plans do not constitute a sale of securities under the 1933 Act.[116]

The SEC has instituted a series of guidelines to determine when a company's employee stock plan does not qualify as a sale under the 1933 Act.[117] First, the SEC requires the company to announce the existence of the plan by communicating directly the details of the plan to each of the company's employees.[118] Next, the employer may make payroll deductions for the plan only if the employees participating in the plan have requested the deduction.[119] Finally, the SEC requires the company to pay the expense of the payroll deductions and reasonable brokerage and bookkeeping fees.[120] Any deviation from the above standards could render the securities transaction a sale under the 1933 Act and requires the company to register the

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111. Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1982); *see* 3 H. BLOOMENTHAL, *supra* note 8, at § 2.07[6] (discussing employee stock bonus plan and "no sale" theory of 1933 Act).

112. Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3) (1982).

113. *Id.*

114. Securities Act of 1933 § 2(3), 15 U.S.C. § 77b(3) (1982); *see* 3 H. BLOOMENTHAL, *supra* note 8, at § 2.07[6] (discussing "no sale" concept of 1933 Act). In many equity incentive plans, the recipient employee makes no monetary investment. H. BLOOMENTHAL, *supra* note 8, at § 2.07[6]. Issuing companies, therefore, contend that no sale of securities occurs in the context of employee equity incentive plans. *Id.*; *see supra* notes 10-38 and accompanying text (discussing common equity incentive plans for small companies).

115. H. BLOOMENTHAL, *supra* note 8, at § 2.07[6]; *see supra* note 40 and accompanying text (discussing 1933 Act's registration requirements).

116. Securities Act Release No. 6188 [1980 Transfer Binder] 1 FED. SEC. L. REP ¶ 1945.1 (Feb. 1, 1980). The SEC does not consider stock bonus plans, under which a company awards shares of its stock to employees at no direct cost to the employees, to constitute a sale of securities under the 1933 Act. *Id.* The SEC does not require companies to register the securities that the company grants under a stock bonus plan because employees in almost every instance would decide to participate in the plan if given the opportunity. *Id.* Registration of bonus plans, therefore, would serve no practical purpose. *Id.* The SEC's position concerning employee bonus plans as not constituting a sale of securities applies only to bonus plans that the company makes available to a relatively broad class of employees. *Id.* at n.84.

117. C. HENN & J. ALEXANDER, *supra* note 11, at § 295.

118. *Id.*

119. *Id.*

120. *Id.*

securities offering.[121] Despite the broad guidelines that the SEC has instituted regarding the "no sale" concept, however, the SEC recently has commented that the commission considers stock offerings that a company awards to an employee pursuant to an individual employment arrangement to constitute a sale under the 1933 Act.[122] The SEC seems to include most equity incentive plans in the Commission's determination of individual employment arrangements subject to the registration requirements of the 1933 Act.[123] Thus, the SEC seems to consider the securities offerings that the company grants pursuant to an equity incentive as sales of securities.[124] Given the SEC's recent attitude toward equity incentive plans as constituting sales of securities, therefore, the present availability of the no sale exemption for employee equity incentive plans is uncertain.[125]

Because of the deficiencies of the 1933 Act's registration exemptions and the "no sale" concept that apply to employee equity incentive plans, the SEC should adopt a specific registration exemption for small companies' employee equity incentive plans.[126] To provide a possible framework for this exemption, the SEC should treat equity incentive plans, which are primarily compensatory in nature, differently from other stock purchase plans that companies ordinarily employ to generate additional operating capital.[127] The SEC should adopt a rule to exempt from the registration requirements of the 1933 Act a company's compensatory securities offering to its employees, advisors, and consultants in an aggregate amount up to $5 million.[128] Further, the SEC should tailor the exemption to apply only to companies that are not reporting companies under the 1934 Act and are

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121. *Id.*

122. Securities Act Release No. 6188 [1980 Transfer Binder] FED. SEC. L. REP. (CCH) (Feb. 1, 1980) ¶ 1945.1, n.84.

123. *See id.* (discussing SEC's recent comments concerning securities offerings under individual employment agreements as sales of securities).

124. *Id.*; *see supra* notes 10-38 and accompanying text (discussing common equity incentive plans for small companies).

125. *See* Keller, *supra* note 2, at 157 (discussing availability of 1933 Act's "no sale" concept to small companies instituting employee equity incentive plans).

126. *See* 1986 SEC Government-Business Forum on Small Business Capital Formation 33 (Jan. 1987) [hereinafter 1986 SEC Government-Business Forum] (recommending that SEC adopt employee benefit exemption); *see also* Keller, *supra* note 2, at 157 (recommending that SEC exempt from registration equity incentive plans for small companies); Duke, *supra* note 1, at 1446-48 (recommending that SEC exempt from registration companies' employee stock compensation plans); *supra* notes 10-38 and accompanying text (discussing common equity incentive plans for small companies).

127. *See supra* note 5 and accompanying text (discussing distinction between compensatory stock purchase plans and investment-oriented stock purchase plans).

128. *See* 1986 SEC Government-Business Forum, *supra* note 126, at 33 (discussing proposal for registration exemption for small company's equity incentive plans). The SEC could adopt a registration exemption for small companies' equity incentive plans under the commission's statutory authority to adopt registration exemptions for securities offerings up to $5 million. *See* Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1982) (allowing SEC to adopt registration exemptions for securities issuances of less than $5 million according to commission's discretion).

ineligible to use Form S-8.[129] The SEC should limit the availability of the employee equity exemption to only nonreporting companies to prevent larger companies, which have the ability to absorb registration costs under Form S-8, from circumventing the 1933 Act's registration requirements.[130] By limiting the proposed equity incentive exemption to companies ineligible to use Form S-8, the SEC will help guarantee that only those companies that qualify for the exemption will be able to take advantage of the less stringent disclosure requirements that the exemption will afford.[131] Additionally, by limiting the amount of securities that a company can issue under the proposed exemption to $5 million or less annually, the SEC will help ensure that the proposed exemption will be attractive only to small companies instituting employee equity incentive plans.[132] By imposing limitations on both the types of companies that can take advantage of the exemption and the amount of securities that the eligible companies can issue under the exemption, the SEC successfully could free small companies implementing employee equity incentive plans from the present, burdensome registration requirements under the 1933 Act and guard against potential abuse of the exemption by larger companies.[133]

Currently, in order for a small company to issue securities under an employee equity incentive plan to attract and retain key employees, the company must either register the securities with the SEC or attempt to find an appropriate registration exemption.[134] Because a registered offering is both costly and time consuming, registering stock with the SEC is not the most efficient or practical way to implement an equity incentive plan.[135] Futhermore, the present registration exemptions under the 1933 Act severely limit both the number and types of employees to whom the company may

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129. *See* 1986 SEC Government-Business Forum, *supra* note 126, at 33 (discussing proposal for registration exemption for employee benefit plans); Keller, *supra* note 2, at 157 (recommending that SEC limit availability of employee equity registration exemption); *see also supra* note 46 and accompanying text (discussing reporting companies under 1934 Act); notes 41-47 and accompanying text (discussing Form S-8 and companies entitled to use Form S-8).

130. *See* 1986 SEC Government-Business Forum, *supra* note 126, at 33 (discussing extent and availability of proposed exemption for employee benefit plans).

131. *Id.*; *see* Keller, *supra* note 2, at 157 (recommending that SEC limit availability of employee equity incentive exemption to nonreporting companies under 1934 Act); *see also supra* note 46 and accompanying text (discussing nonreporting companies under 1934 Act).

132. *See* 1986 SEC Government-Business Forum, *supra* note 126, at 33 (recommending that SEC limit aggregate amount of securities that company can offer under proposed employee benefit exemption).

133. *Id.*; *see* Keller, *supra* note 2, at 157 (discussing limitations that SEC should include in adopting equity incentive registration exemption to help guard against larger companies abusing less stringent disclosure requirements).

134. *See supra* notes 40 & 48-91 and accompanying text (discussing 1933 Act's registration requirements and registration exemptions); *see also* notes 10-38 and accompanying text (discussing common equity incentive plans for small companies).

135. *See supra* note 45 and accompanying text (discussing high cost of securities registration); *see also* notes 48-91 and accompanying text (discussing registration requirements of 1933 Act); notes 111-25 (discussing 1933 Act's "no sale" concept).

sell its stock and the total dollar amount of stock that the company may offer its employees under an equity incentive plan.[136] The special, compensatory nature of equity incentive plans suggests that the SEC should permit small companies to issue stock to the companies' employees as a form of compensation without either incurring the high cost of registration or needlessly limiting the offering by dollar amount or number of employees.[137] By adopting a registration exemption for employee equity incentive plans, the SEC significantly will aid small companies in their struggle to attract and compensate key employees while remaining economically competitive.

DAVID B. WILKS

136. *See supra* notes 48-91 and accompanying text (discussing present registration exemptions applicable to small companies' equity incentive plans); notes 92-125 and accompanying text (discussing deficiencies of current registration exemptions and "no sale" concept of 1933 Act).

137. *See supra* note 5 and accompanying text (discussing primarily compensatory nature of equity incentive plans).