Exchange Fund Transactions:

An Advantageous Instrument for Corporate Insiders; A Potential Nightmare for Public Investors

By Jed Wulfekotte

Introduction

Recent investigations into America's "corporate scandalfest"[1] revealed that corporate insiders[2] across the country secretly dumped their stock, causing uninformed shareholders to bear the bulk of the loss as each company sank into bankruptcy. In response, the Securities and Exchange Commission (SEC) tightened disclosure rules and mandated the immediate public disclosure of insider trades. However, by transferring stock into an exchange fund, corporate insiders can still divest corporate shares without alerting investors. An exchange fund is a private company in which shareholders, who own highly appreciated, undiversified stock, contribute a portion of their shares to a common fund. In return, investors receive shares in this fund without incurring immediate taxation on capital gains.[3]

Although exchange funds have always been a topic of controversy due to their tax-deferral benefit, these funds have recently come under fire because they enable executives to divest shares of their companies' stock without disclosing the initial transaction to the public. In September 2004, the *Wall Street Journal* reported that the SEC was investigating dozens of corporate insiders who may have used exchange funds as mechanisms to reduce their respective economic stakes in their companies without alerting investors.[4] Although section 16(a) of the Securities Exchange Act of 1934 requires corporate insiders to report every exchange fund transaction, neither the SEC, nor the courts, require insiders to report the exchange fund transactions as a "sale." According to section 16(a), insiders must file reports with the SEC disclosing any changes in beneficial ownership of their companies' shares. These reports, which are publicly available at SEC offices, permit insiders to label dispositions as either a "sale" or "other." While some executives elect to disclose the initial transaction as a "sale" to avoid the appearance of abuse, most corporate insiders elect to label the initial exchange fund transaction as "other," increasing the odds that analysts and public investors who monitor insider trading will not take notice of the transactions.[5]

In the post-Enron business world, attorneys should encourage, and the SEC should require, corporate insiders to report these transactions as "sales." This requirement would facilitate full disclosure of insider trades and would prevent corporate abuse. The purpose of the disclosure requirements in section 16(a) is to keep public investors informed about purchases and sales which may indicate insiders' private opinions of their corporation's future prospects.[6] This interpretation of SEC reporting requirements emphasizes the purpose of section 16(a), is permissible under the current definition of a "sale," and is consistent with subsequent case law interpreting this definition.

Exchange Funds as a Diversification Mechanism for Concentrated Wealth

Although Congress repeatedly tried to eliminate exchange funds since they emerged in the mid-1960s, corporate insiders have organized these funds to conform to the evolving regulations. In 1966, Congress effectively eliminated exchange funds by abolishing the tax-deferral benefit for individuals who transferred stock into an investment company organized as a corporation.[7] To ensure that this prohibition included exchange funds, Congress defined an "investment company" as any corporation in which more than 80 percent of its assets consisted of readily marketable stocks and securities.[8] Following this legislation, investors attained tax-free diversification by organizing exchange funds as partnerships, which was permissible under the 1966 regulations.[9] Congress responded by redefining the term "investment company," hoping to close the tax-free loophole.[10] However, brokers countered again in the 1990s by offering exchange funds that held at least 20 percent of assets in illiquid securities, thus conforming to the existing

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definition of an “investment company.”[11] In response, the Taxpayer Relief Act of 1997 redefined “investment company” as an entity investing at least 80 percent of its assets in stock or securities.[12] Currently, exchange fund investors organize funds by investing at least 20 percent of fund assets in non-financial investments, such as real estate.

Currently, exchange funds provide a highly advantageous tool for corporate insiders. The primary benefit of investing in an exchange fund is that it enables investors to diversify a single stock, tax-free, until they decide to redeem their share of the fund. Investment banks offer this option to qualified purchasers and to accredited investors, which includes investors with a net worth of at least $5 million dollars (excluding property, furnishings, and automobiles) and with a $200,000 annual income. Due to the benefits of tax-free diversification, most exchange funds are quite large, ranging from 50 to 499 investors who have highly appreciated shares in a single company.

Section 16(a) Disclosure Requirements

Congress intended section 16(a) of the Exchange Act of 1934 to require complete disclosure of securities holdings and transactions of all corporate executives to discourage abuse of insider information. Recently, in response to the Enron debacle, Congress and the SEC tightened the reporting requirements of section 16(a). Prior to these amendments, the SEC required insiders to file Form 4 reports on or before the tenth day of the month following the month in which the transaction occurred. After Congress enacted, and President Bush signed, the Sarbanes-Oxley Act of 2002[13] (Sarbanes-Oxley), insiders must report most exchange fund transactions within two business days of the transaction.[14] Corporate insiders are required to file reports with the SEC that detail any changes in the beneficial ownership of equity securities. Form 4 reports, which are readily available to the public, must label all dispositions that represent a change in beneficial ownership as either a “sale” or “other.”

Transactions labeled as “sales” in Form 4 reports provide public investors with a sense of how an issuer’s securities are likely to perform in the future. Many analysts and investors monitor insider “sales” because these sales are viewed as an indicator of the company’s health. The SEC publishes monthly summaries of section 16(a) reports and many major newspapers routinely publish information gathered from Form 4 reports. A number of private newsletters and services also analyze and report insider sales.

An exchange fund transaction that is reported as “other” may disguise the nature of the transaction and may provide investors with a misleading view of a corporation’s health. Exchange fund investments allow corporate insiders to reduce their economic stake in the corporation by divesting large amounts of company stock. If these transactions are labeled as “other,” as is the standard practice, the transactions will most likely go unnoticed. Subsequent reports, newsletters, and other services that monitor insider sales will not inform the public of these transactions, and thus public investors may have erroneous perceptions of executive confidence in a corporation’s future prospects.

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Exchange Fund Transactions Fit the SEC’s Definition of “Sale”

One way to ensure that corporate insiders provide public investors with an accurate and complete picture of a corporation’s future prospects is to require insiders to disclose each exchange fund transaction as a “sale” in Form 4 reports. Section 2(a)(3) of the Securities Act of 1933 ('33 Act) defines a “sale” as “every contract of sale or disposition of a security or interest in a security, for value.”[15] The statutory definition of a “sale” clearly includes the exchange of securities for cash, but inclusion of other transactions,

such as exchange fund investments, is unclear. Despite the apparent confusion, defining an exchange fund transaction as a "sale" is permissible under the language the '33 Act, and is consistent with case law interpreting the definition.

When insiders relinquish shares to an exchange fund, they are actually exchanging their shares for an interest in the fund. The "disposition of a security or interest in a security" occurs when an insider invests his or her corporate shares, usually consisting of at least one million dollars of corporate stock, into the

fund. Once an insider contributes shares to the fund, the investment may not be retrieved. Exchange funds are extremely illiquid; to receive the tax-deferral benefit, insiders must remain in the fund for at least seven years. Thus, exchange fund transactions satisfy the first element of the SEC's definition of a "sale" because investors clearly dispose of a security, or at minimum, investors dispose of their interest in a security.

Exchange fund investors receive a highly advantageous "value" in return for relinquishing their shares in the fund. Essentially, investors turn shares of a single stock into a diversified portfolio of stocks without accruing capital gains taxation on the investment until they decide to redeem their shares in the fund. By investing in an exchange fund, insiders can eliminate between 70 to 90 percent of the risk that often accompanies investing in a single stock.[16] The only remaining risk is that the market, as a whole, may fall.[17] Despite this risk, the investor is still able to exchange an extremely risky investment for a relatively safe investment that is not dependant upon the success of a single company.[18] Therefore, insiders clearly receive the "value" of a safer investment, satisfying the second part of the definition and leading to the appropriate classification of exchange fund investments as "sales" within the language of the '33 Act.

This interpretation and application of a "sale" is not only permitted by the language of the SEC rules, but also reinforced by case law. Since the '33 Act, courts have generally held that a securities exchange constitutes a "sale" when one investor parts with a security in exchange for another, because the investor gives up the value of the original stock in exchange for the value of the newly acquired security.[19] According to the courts, any change in the rights and obligations of the securities holder, or any amendment to the security, constitutes a "sale."[20]

This Interpretation of a "Sale" Emphasizes the Purpose of Section 16(a)

THE CONCEPT OF A "SALE" should be interpreted broadly to prevent exchange fund investments from being used to side-step securities laws, which are intended to prevent the consequences of these investments. In fact, courts have broadly construed the term "sale" in order to accomplish the objective of certain securities laws.[21] Congress promulgated section 16(a) to publicize insider transactions and to deter the abuse of insider information.[22] Congress also sought to provide public investors with information that might indicate insiders' private opinions of their companies' future prospects.[23]

When Congress enacted the Sarbanes-Oxley amendments, it recognized that existing reporting requirements inadequately fulfilled the purpose of section 16(a). Prior to these amendments, corporate insiders could wait more than a month before publicly disclosing insider transactions.[24] Because of the long delays, these reporting requirements prevented public investors from accurately gauging a corporation's future prospects. The Sarbanes-Oxley amendments tightened disclosure rules by reducing the time corporate insiders have to file Form 4 reports, thus preventing the insiders from withholding information concerning insider sales.[25]

Although Congress aimed to protect shareholders from corporate abuse stemming from insider trading, exchange fund transactions slipped through the cracks of the disclosure requirements. Exchange funds provide corporate insiders with a vehicle for potential abuse because corporate insiders may divest their shares without alerting public investors.[26] This is one of the fundamental actions that the Sarbanes-Oxley amendments sought to prevent by requiring timely reporting. Requiring corporate insiders to report exchange fund transactions as "sales" in Form 4 filings, would prevent insiders from secretly dumping corporate shares and would provide public investors with complete and accurate information.

Implications

IF THE SEC DEFINED AN EXCHANGE FUND TRANSACTION as a "sale," investors would no longer have the option to defer capital gain taxation of their investments. A capital gain represents the difference between the present value of the total future income expected to be generated by the asset (determined at the time of purchase), and the present value of the total future income expected to be generated by the asset (determined at the time of the sale).[27] Currently, the initial transaction is not considered a capital gain because it occurs when an investor relinquishes shares to an exchange fund and therefore is not considered a "sale". However, when investors redeem their share of the fund after seven years, a sale of any stock out of this new portfolio will trigger a capital gain. Therefore, if the SEC defined the initial transaction as a "sale" it would be considered a capital gain – which is immediately taxed.

Although this proposal would eliminate the tax-deferral benefit, investing in exchange funds may still be highly advantageous. Exchange funds might still serve as vehicles to diversify a highly appreciated, undiversified holding. As previously stated, this benefit alone is highly advantageous because investors may hedge a substantial amount of risk that accompanies investing in a single stock. Furthermore, exchange funds provide estate-planning benefits for investors who make gifts to others; in such cases, the gifts would remain illiquid and eventually would consist primarily of securities rather than cash. A gift may reduce the face value of an exchange fund by 15 to 40 percent for tax purposes, provided the gift is made in the first year of the fund's existence. Therefore, even if the tax-deferral benefits are eliminated, exchange funds may still provide investors with substantial benefits through portfolio diversification and estate planning.

Conclusion

RECENTLY, CONGRESS AND THE SEC enacted regulations requiring corporate insiders to publicly disclose purchases and sales of company shares. However, the requirements for disclosing exchange fund transactions under these regulations remains unclear. This ambiguity opens the door for insiders to partake in the very actions which Sarbanes-Oxley aims to prevent. The SEC can shut the door on potential abuse by defining an exchange fund transaction as a "sale." This interpretation is permissible under the SEC's definition of "sale" and is reinforced by case law interpreting the definition. Since 2001, corporate insiders have deceived public investors by disguising information about insider sales. However, investors may protect themselves by utilizing the most powerful weapon the public has against this type of corporate abuse; investors must demand the complete and immediate disclosure of exchange fund transactions.[28] BLB

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ENDNOTES: *Jed Wulfekotte*

1 Allan Sloan, *Martha May have Jaywalked, but Kenny Boy did Worse*, WASH. POST, July 20, 2004, at E03 (stating that Kenneth Lay misled Enron's employees by telling them he had been buying Enron stock, but in reality, he sold it heavily).

2 The term corporate insider refers to a director or officer of an issuer that has a class of equity securities registered under Exchange Act of 1934 § 12, or a person who is the beneficial owner of more than ten percent of an outstanding class of § 12 registered equity securities, who is subject to reporting requirements of § 16(a). 2-8 FEDERAL SECURITIES EXCHANGE ACT OF 1934 § 8.03 n.1 (2004).

3 Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 85 (1997). Exchange funds have a number of other benefits, including the diversification of one's portfolio thereby reducing the risk of loss to the shareholder.

4 Randall Smith, *SEC Looks at How Insiders Use Exchange Funds*, WALL ST. J., Sept. 7, 2004, at A1.

5 *See* Smith, *supra* note 4.

6 *See* FEDERAL SECURITIES EXCHANGE ACT OF 1934, *supra* note 2.

7 Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 203, 80 Stat. 1539, 1577 (codified as I.R.C. § 351 (1994)).

8 *Id.*

9 Catherine L. Heron, *Tax Issues for Certain Unregistered Funds and Other Nontraditional Funds*, 1112 PRAC. LAW INST., CORP. LAW AND PRAC. COURSE HANDBOOK 79, 88 (1999).

10 *Id.*

11 *Id.*

12 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

13 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

14 Securities Exchange Act of 1934, Pub. L. No. 107-204, 116 Stat. 788 §16(a)(2)(C).

15 15 U.S.C. § 77b(a)(3) (2000).

16 Booth, *supra* note 3, at 87.

17 *Id.*

18 *Id.*

19 *See, e.g., In re* No. Natural Gas Co., Exchange Act Release No. 4638 1943, WL 29768, at *3 (Oct. 25, 1943).

20 *See* United States v. New York, New Haven & Harford Railroad Co., 276 F.2d 525 (2d Cir. 1960), *cert. denied* 362 U.S. 961 (1960); *see generally* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 312 (4th ed. 2002).

21 *See In re* American Continental Corp. v. Keating, 49 F.3d 541 (9th Cir. 1995); *see also* United States v. Rudi, 902 F.Supp. 452 (S.D.N.Y. 1995); *see generally* HAZEN, *supra* note 21, at 297.

22 *See* H.R. REP. NO. 1381, at 13 (1934) [hereinafter HOUSE REPORT] (stating that it is difficult to draw a bright line between truly inside information and information that should be known by informed investors).

23 *Id.*

24 *See* FEDERAL SECURITIES EXCHANGE ACT OF 1934, *supra* note 2 (stating that corporate insiders must file Form 4 reports electronically and must publish these reports on their websites by the end of day after they filed the report).

25 *See id.*

26 *See* Smith, *supra* note 4.

27 *See* Yoseph M. Edrey, *What Are Capital Gains and Losses Anyway?*, 24 VA. TAX REV*supra*

28 *See* HOUSE REPORT, *supra* note 23.