

CHAPTER VI.

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CHAPTER VI.

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A. Introduction

This Chapter proposes definitional rules dealing in the main with resales by persons who have purchased securities in so-called “private placements.” The proposed rules are at variance with certain long-standing interpretations of statutory language. The reason is simply stated. In the area of statutory interpretation which is primarily involved, uncertainty and divergence of practice presently prevail to an unacceptable degree. Greater certainty and predictability are essential. They can be obtained, in the Study’s judgment, only under a new interpretative framework more closely attuned to the objectives of the ’33 Act.

Present interpretations are keyed to the necessity of asserting, and then demonstrating, a state of mind on the part of the private purchasers of securities. The test for claiming exemption from the registration requirements is subjective. Did the purchaser possess the requisite “intent”? Can he demonstrate that his intentions were legally correct? It is this emphasis on state of mind which is at the heart of the problem. In lieu thereof, the Study recommends a specific set of objective rules—rules which would inform the

purchaser how long he must hold and how he may sell, irrespective of his state of mind. Similarly informed, the issuer would be in a position to take appropriate precautions against violation of registration requirements.

An essential point should be stressed. The proposed rules are grounded on an informative system of periodic reporting by issuers which are subject to the reporting requirements of Sections 13 or 15(d) of the Act. The present system of periodic reporting needs improvement if it is to furnish an adequate backstop for the proposed rules. Chapter X contains the Study's recommendations for this purpose.

Does the Commission have power to adopt the rules which are here proposed? The Study believes that it has that power, although the question is not free from doubt. The Commission's General Counsel concurs.

First, it is evident that Congress intended that the Commission would utilize its accumulated experience in the formulation of rules necessary to make the statute work. Section 19(a) of the '33 Act provides a broad grant of rule-making power together with specific authority to define accounting, trade, and technical terms. The proposed rules are built upon a careful and detailed definition of the general term "distribution" in Section 2(11), the meaning of which was left to the agency to clarify.

Second, students of the administrative process have, in recent years, stressed the duty of administrative agencies to use their rule-making power to provide specificity and predictability, where possible. A distinguished jurist, Judge Henry J. Friendly of the United States Court of Appeals for the Second Circuit, had this to say:

My thesis is that where the initial standard is . . . general, it is imperative that steps be taken over the years to define and clarify it . . . I do not suggest that this process can be so carried out that all cases can be determined by computers; I do suggest that it ought to be carried to the point of affording a fair degree of predictability . . . in the great majority of cases and of intelligibility in all.^{1/}

School comments:

Where a statute allows wide range for policy choice the agency's failure to define policy may give rise to evil consequences and bring administrative delegation into disrepute. A broad delegation of power is not only a power, it is a summons to create order.^{2/}

In his Administrative Law Treatise, Professor Davis at once compliments and chides the Commission:

Some of the regulatory agencies are too much holding back from the use of their rule-making power. Even the SEC, whose accomplishment in clarifying law through rule-making is outstanding among the agencies, unduly refrains from resort to rule making...^{3/}

^{1/} Friendly, The Federal Administrative Agencies: The Need for Better Definition of Standards 75 Harv. L. Rev. 863, 874 (1962).

^{2/} Jaffe, Judicial Control of Administrative Action 49 (1965).

^{3/} 1 Davis, Administrative Law Treatise §6.13 (Supp. 1965).

Third, one of the benefits of the administrative process is the opportunity it affords to change long-standing interpretations which have ceased to function effectively in light of changing conditions. A recognition of this fact led the President of the New York Stock Exchange to testify in 1934:

Instead of having a fixed rule of law, which can only be changed by an act of Congress . . . , we advocate the power being put in a commission to make these rules and regulations, which if they are wrong, they can immediately change.^{4/}

The same thought has been expressed by Mark Massel, formerly of the Brookings Institution staff:

Policy formulation is a never-ending process. It calls for feedbacks of ideas and information coming from the administration of existing policies. New problems arise that cannot be foreseen when rules are developed. As conditions change, they may require changes in policy.^{5/}

Finally, for reasons more fully set forth in the text which follows, the Study believes that the proposed rules are necessary not only to provide greater predictability, but to give fuller effect to the statutory purpose. “The focus of inquiry,” said the Supreme Court in U. S. v. Ralston Purina Co., “should be on the need of the offerees for the protections afforded by registration”.^{6/} Yet the most casual inquiry into the effects of prevailing interpretative pattern discloses its grave shortcomings in this respect. Sale

^{4/} Hearings on H. R. 7832 and 8720 before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2d Sess. 726 (1934).

^{5/} Massel, The Regulatory Process, 26 Law and Contemp. Probs. 181, 188 (1961).

^{6/} 346 U. S. 119, 127 (1952).

without registration may turn on events wholly unconnected with the needs of investors, and without distinction as to whether (1) the issuer of the securities is providing information concerning its business and financial affairs in regular reports to the Commission, (2) the quantity of securities being sold without registration is massive or modest, and (3) there is, or is not, a heavily compensated selling effort involved. The proposed rules have been designed to do away with such anomalies.

* * * *

The great bulk of interpretative requests and requests for “no action” letters received by the Division of Corporation Finance raises questions which are answered by the rules proposed in this Chapter. These rules, however, employ certain statutory concepts which have never been given precise and definite content. Can more specific definitions be developed to assist in determining when a particular offering of securities is a “public offering”, or when a particular person should be regarded as a “controlling” person?

The Study considered these questions long and seriously. In the areas involved, it was apparent that a substantial lack of specificity was inherent in the workings of the statutory scheme—a degree of generality made mandatory by the almost infinite variety of circumstances encountered in the practical world. Those with whom the Study met generally concurred in this observation.

The distinction between a public and a private offering has acquired a substantial legal gloss over the years. Any attempt to simplify the issue by application of a “numbers test” runs afoul of two important considerations which are essential to the distinction: (1) the integration of separate offerings which are, in essence, parts of the same “issue” of securities, and (2) the effect of subsequent resales by initial purchasers. In the time available to it, the Study found no satisfactory way to reduce these considerations to precise terms. Both are discussed in some detail in the most recent Commission release dealing with the private offering exemption.^{7/} The development of effective techniques for controlling subsequent resales has been the subject of sophisticated commentary reflecting its importance in the statutory scheme.^{8/}

Further efforts to develop a rule generally applicable to the distinction between a private and a public offering may well be productive and should be encouraged.

In one particular area (where “integration” is not a significant factor) a more definite standard, although limited in scope, was thought to be practicable. An issuance of securities for the purpose of acquiring a closely-held going business can reasonably be considered as distinct from issues made for other purposes. Accordingly,

^{7/} See Securities Act Release No. 4552 (November 6, 1962).

^{8/} See Israels, Stop Transfer Procedures and the Securities Act of 1933-Addendum to Uniform Commercial Code – Article 8, 17 Rutgers L. Rev. 158 and Israels, Addendum, 23 Bus. Law, 865 (1968).

Part E of Chapter VII, at pp. 293-4 *infra*, proposes a rule restricted to bona fide business combinations and intended to provide assurance that registration is not required where the offerees are limited to a designated number, assuming that resales of the securities by the original purchasers are also appropriately restricted. The rule would not prevent reliance upon the private offering exemption in instances not expressly covered by its terms.

A holder's right to sell securities publicly without registration may depend on whether or not he is in a control relationship with the issuer. "Control" is not defined in the Act. The generalized definition found in Rule 405 provides little assistance in deciding particular cases. Control of a company may arise from a combination of factors and the significance of most of these may vary from case to case, depending not only on the presence or absence of certain relationships but also upon the particular circumstances of the company and of the persons having an interest in it. The factors which would determine who is in control of General Motors would be far different from the factors which would determine who is in control of a small over-the-counter company; and even among similar companies, each case may present different relationships, corporate structures and managerial pattern.^{9/}

^{9/} The problem of defining "control" in the context of the '34 Act is described in the following passage from the House Committee's report:

It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 26 (1934).

In an effort to provide a modest degree of guidance in this area, however, the Study gave careful consideration to the possibility of a rule which would clarify those conditions under which a person would not be deemed to be “in control,” regardless of the particular circumstances. Such a rule has several disadvantages. First, it is possible that a person might employ it to conceal a control relationship. Accordingly, the net cast by such a rule must necessarily be a very broad one. Second, there is a danger that all persons who have one or more of the relationships enumerated in the rule would, ipso facto, be classified as controlling persons. In fact, however, the existence of one or more of such relationships might be entirely consistent, under particular facts, with an absence of control.

In an effort to minimize this second disadvantage, the Study developed a series of illustrative examples of instances in which a person would not be considered to be in control despite the fact that the rule in question would offer him no safe haven.

The combination of rule and illustrative cases was thought to be of sufficient value to justify its recommendation to the Commission. The details of the Study’s proposal are more fully discussed in Part D of the text which follows, at pp. 245-7.

B. Present doctrine under the '33 Act governing resale of securities purchased in so-called "private offerings" is of uncertain application, creates serious administrative burdens and produces results incompatible with the policy objectives of the Act. A solution consistent with good disclosure policy must be found.

1. The test of "investment intent" for so-called private offerings and its origins.

Two elementary concepts are basic to an understanding of the prevailing wisdom as applied to so-called "private offerings" of securities.

First, the scheme of the '33 Act requires registration of any offer of any non-exempt security made by any person to any other person absent a specific exemption.

Second, in dealing with the registration requirement (as contrasted with the antifraud provisions), the draftsmen of the '33 Act were essentially concerned with offerings to the public rather than with offerings limited to persons who could fend for themselves.^{10/}

^{10/} Landis, The Legislative History of the Securities Act, 28 Geo. Wash. L. Rev. 29, 37 (1959):

"Public offerings" as distinguished from "private offerings" proved to be the answer. The sale of an issue of securities to insurance companies or to a limited group of experienced investors was certainly not a matter of concern to the federal government. The bureaucracy, untrained in these matters as it was, could hardly equal these investors for sophistication, provided only it was their own money that they were spending.

A series of specific exemptions therefore lie at the heart of the '33 Act. One of these (now Section 4(2)) is intended to provide exemption for the issuer of securities engaged in what is essentially a private financing transaction.

The provisions of this specific exemption did not fully answer the draftsmen's problems, however. Suppose that an issuer sells a block of its stock to A, a non-controlling person, who thereafter resells the stock. If the resale is not to the public, an exemption from registration is appropriate; if the resale is to the public, registration ought to be required.

The following drafting technique was adopted:

First, an exemption from registration (now Section 4(1)) was provided for any person "other than an issuer, underwriter or dealer." (A, in the foregoing example, is clearly neither an issuer nor a dealer. He may or may not be an "underwriter;" if not, his transaction is exempt from registration.)

Second, the term "underwriter" was broadly defined in Section 2(11). Under this definition, ordinary investors may become "underwriters" if they act as links in the chain of transmission of securities from issuers (or those who control them) to the public. A key word in Section 2(11) is "distribution". Although not expressly defined, the term "distribution" in Section 2(11) has

always been regarded by the Commission as essentially synonymous with public offering.^{11/} (A, in the foregoing example, is an “underwriter” if his resale is to the public. Being an “underwriter,” he does not come within the terms of the exemption in Section 4(1). No other exemption can apply to his transaction.^{12/} He must register the securities.)

The application of these principles to the real world of investment proved to be no easy task. Both the securities bar and the Commission seized upon a phrase in the broad definition of “underwriter.” That phrase is: “... purchased from an issuer with a view to... distribution”. Thus, any person who purchases a security from an issuer with a view to its subsequent distribution (or public offering) is an “underwriter” and is not entitled to exemption from registration. A corresponding interpretation was given to the issuer’s exemption in Section 4(2). If any of the several persons to whom an issuer sells securities in a private financing transaction happens to purchase the securities “with a view to” their later “distribution”, the issuer’s transaction is one “involving a public offering.” It is therefore not exempt.

^{11/} Loss, Securities Regulation 551 2d ed. (1961); Orrick, Some Interpretative Problems Respecting the Registration Requirements Under the Securities Act, 13 Bus. Law. 369, 370 (1958).

^{12/} For purposes of this analysis, the so-called intra-state exemption of Section 3(a)(11), the small transactions exemption provided by Section 3(b) and the Commission’s Regulation A, and the exemption for officially approved exchanges (Section 3(a)(10), are disregarded.

As a result of this process of interpretation, the Commission and those affected by the '33 Act soon found themselves tied to a wholly subjective test by which to determine when a person is an “underwriter.” Does the person who buys from the issuer or controlling stockholder have the “view” or “intent” of later reselling his securities to the public? How can his true “intention” be accurately determined? It is obviously impossible to peer into his mind. Only two procedures were available, both of doubtful efficacy:

(1) A procedure which involved placing in a written record his own assertion of what was in his mind when he took the securities; and

(2) A procedure which involved looking to his later acts, and the circumstances surrounding them, as evidence of what was in his mind when he took the securities.

The first of these two procedures became settled in practice as the so-called “investment letter.” The purchaser of securities in a private financing signs a statement containing the assertion that he is not taking the securities with a view to their later “distribution”; that, on the contrary, he intends to hold them for “investment.”

The second procedure evolved into the doctrine that a “change of circumstances” is a necessary precondition to the public sale of securities originally purchased under an “investment letter”, unless the length of holding of itself furnishes sufficient evidence of an original “investment intent.”

2. Problems associated with present doctrine and their consequences.

(a) “How long do I have to hold?”

The Commission has indicated that “one evidentiary fact” to be considered in determining whether or not a private purchaser took with the necessary investment intent is the length of time between acquisition of the securities and resale.^{13/}

Will any particular holding period furnish sufficient evidence of investment intent? No definite answer is available. In the language of the Commission’s statement, the weight to be given to the holding period will “vary with the circumstances of each case. Of course, the longer the period of retention, the more persuasive would be the argument that the resale is not at variance with original ‘investment intent’ ...”^{14/}

Other pronouncements on this subject by the Commission and its staff furnish little additional clarification.^{15/} In its opinion

^{13/} Securities Act Release No. 3825 (August 12, 1957).

^{14/} Id.

^{15/} The Commission’s Rule 155, relating to the private placement of convertible securities, provides a special application of the holding period requirement. Under that rule (1) the convertible security may never be sold to the public without registration, regardless of the length of time it has been held, and (2) upon conversion of the convertible security, whenever occurring, a new determination must be made as to whether the person to whom the conversion securities are issued is or is not an “underwriter”; in other words, a new holding period commences at the time of conversion, whenever that act occurs.

in the Crowell-Collier case^{16/}, the Commission observed that "... holding for one year does not afford a statutory basis for an exemption..." Subsequent to Crowell-Collier, former Chairman (then Commissioner) Cohen remarked that a presumption of investment intent might arise after a two-year holding, a statement which has sometimes been referred to as the "Cohen two-year rule." Its author clearly indicated, however, that certain kinds of factual situations would negate any such presumption, despite the period of holding.^{17/} A very recent comment on the subject by an experienced private practitioner is as follows:

...As a practical matter, the shares may . . . be sold in any manner after the lapse of a sufficient amount of time, the period being rather indefinite but probably two to three years. For the record, however, it is official dogma that if stock is acquired for investment, a lapse of time (no matter how long) does not automatically free the stock from restrictions on resale. [Footnote omitted]^{18/}

Members of the Commission's staff have on occasion advised investors who hold privately placed debt securities that the staff would not look with disfavor on a resale after five years. A recent registration statement filed by a closed-end investment

^{16/} Crowell-Collier Publishing Co. Securities Act Release No. 3825, p. 7 (August 12, 1957).

^{17/} SEC Problems of Controlling Stockholders and in Underwritings, 30-31 (Israels, ed., 1962).

^{18/} Schneider, Acquisitions Under the Federal Securities Laws – A Program for Reform, 116 U. Pa. L. Rev. 1323, 1337 (1968).

company stated the registrant's intention to invest largely in securities acquired privately from issuers and controlling stockholders. Under these circumstances the Commission's staff took the position that the registrant is acting as an underwriter irrespective of the period of holding, and the registration statement discloses that no public resales of portfolio securities will be made without registration.^{19/}

(b) What is a sufficient "change of circumstances?"

As noted above, the "change of circumstances" doctrine resulted from the felt need for an affirmative demonstration of an original investment intent. If an investor suffers a "change of circumstances" between his original purchase and his subsequent resale, one can argue on the basis of factual evidence that resale was not contemplated from the very start. But what is a sufficient "change of circumstances" for this purpose?

This has always been a troublesome question.

In the first place, a change that could reasonably have been anticipated at the time of purchase will be of no evidentiary value. Assume, for example, that an investor purchases in a non-public offering shares of a company which later merges into another

^{19/} Fund of Letters, Inc., Registration No. 2-28515 (1968)

company. Even if the specific merger was not in contemplation at the time of the original investment, the Commission's staff has taken the position that a merger is an event reasonably to be anticipated in the life of a company, and hence does not constitute a sufficient "change of circumstances." The stock of the surviving company received as a result of the merger is therefore held subject to the same restrictions as the stock originally purchased in the private offering.

Secondly, it has been held that no change of circumstances occurs where investors anticipate business success only to be disappointed by actual results.^{20/} There is an analogous proposition: neither an advance nor a decline in the market value of the securities purchased can constitute a valid "change of circumstances."^{21/}

Thirdly, the substantiality of the required "change of circumstances" varies directly with the length of time between purchase and sale. The shorter the time, the more drastic the required change. Is there a minimum period, in all events? This is unclear, and

. . . prudent counsel would prefer to see the passage of at least two years as partial basis for his opinion that sale may be made because of a change of circumstances which was not contemplated at the time the security was originally acquired.^{22/}

^{20/} Gilligan, Will & Co. v. SEC. 267 F 2d 461, 468 (2d Cir., 1959) cert. den. 361 U.S. 896.

^{21/} Crowell Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957).

^{22/} When Corporations Go Public, 20, (Israels and Duff, Jr., eds., 1962)

Is it possible for an institution (such as an insurance company) which purchases securities directly from an issuer or from a controlling stockholder to have a “change of circumstances”? Doubts on this score have been expressed by members of the Commission’s staff. Moreover, it has been questioned whether the “change of circumstances” doctrine can have any application to a broker-dealer firm which purchases securities in private transactions, since the essence of such a firm’s business is the purchase and sale of securities.^{23/}

Apart from its uncertainty,^{24/} the “change of circumstances” test, like the holding period requirement, is essentially non-functional in that it bears no relation to the needs of investors for adequate disclosure. Its paradoxical impact may be illustrated as follows: assume that two investors, A and B, acquire shares of a company in a private offering. A takes 50,000 shares, or 10% of the total number of common shares outstanding after completion of the offering. B takes 5000 shares. Some time later, A has a “change of circumstances.” Under the prevailing wisdom, A may now sell all of his 50,000 shares to the public, without registration, in any fashion he pleases. If a substantial selling effort is essential to dispose of the entire block of 50,000 shares, he may pay whatever underwriting commission is needed (or sell to a

^{23/} Where a brokerage firm acquires securities or warrants to purchase securities in connection with the performance of an underwriting function, such securities are part of the public offering and must be registered. Securities Act Release No. 4936, Guide No. 10 (December 9, 1968).

^{24/} Perhaps the best commentary on the uncertain content of the “change

of circumstances” doctrine is found in the mildly sardonic verses of C. Leonard Gorden of the New York bar:

If you buy stock privately,
Enlightened counsel will implore:
Heed the Act of Thirty-Three
Subsection One of Section Four.

Make your purchase for investment.
Have a clear and pure intent.
Do not think about divestment
Till some unforeseen event.

Avoid the Crowell-Collier snare
Be one of few and not of many.
You need not be a millionaire
But don't go in with your last penny . . .

Thereafter, changing factors which
Might make a sale by you exempt
Must be a bad and sudden switch
Which justifies a changed intent.

When you have held two years or more
That sad and unforeseen event
Need not be tragic as before
To justify a new intent!

So put your stock upon the shelf;
Don't question when it will be free.
The very thought defeats itself
With legal logic's subtlety.

With time and troubles, you may get
Advice of counsel or, much better,
Advice to sell that's safer yet –
An SEC “no action” letter.

syndicate of underwriters at whatever discount from the market price is necessary) in order to provide the required selling incentive. The commission (or discount) would remain undisclosed. By his sale, he may even create a public market for the company's shares where none existed before.

By contrast, B, who has had no change of circumstances, may not sell without registration even a few hundred of the shares he had previously purchased.

An obvious question may be asked: in what possible way is A's "change of circumstances" relevant to the needs of public investors, so as to justify the sale of A's entire block of shares without appropriate disclosure?

The easy answer to the question is "none." That answer, however, does not do justice to the effort made by the Commission and its staff over the years to protect public investors through disclosure. Both "change of circumstances" and the holding period requirement arose from the need, deeply felt by the Commission, to find ways of deterring the flow of securities from issuers to the public without registration. It can be persuasively argued that these doctrines were a necessary means to that end in an earlier era. This chapter will examine whether or not there is a better procedure for today.

(c) The dubious magic of “investment letters”.

Mention has been made^{25/} of the established practice of obtaining a so-called “investment letter” from each purchaser in non-public offerings made by issuers and controlling persons. The development of such a practice is understandable, since the subjective intent of the purchaser is crucial to the existence of an exemption. Intent is an elusive thing and all precautions should be taken. What, then, is the effect of an “investment letter”?

The Commission responded to that question in its Crowell-Collier opinion:

An issuer may not establish a claim to an exemption under section 4(1) merely by collecting so-called “investment representations” from a limited group of purchasers if in fact a distribution by such persons occurs.^{26/}

Commenting on this opinion, Mr. David Henkel of the New York bar has remarked:

The Crowell-Collier case made it perfectly clear that the investment letter is not worth the paper it is written on, if in fact it is not lived up to.^{27/}

So long as the present interpretation of Section 2(11) obtains, however, it would be incautious for an issuer to fail to obtain carefully phrased “investment letters” in all private sales. One could argue that the taking of investment letters is mere ritual,

^{25/} P. 163, supra.

^{26/} Securities Act Release 3825, p. 6 (August 12, 1957).

^{27/} When Corporations Go Public 22 (Israels and Duff, eds., 1962).

but failure of an issuer to do so might be deemed to evidence a disregard for the significance of the purchaser's intent with respect to the securities.

The important fact is that the "investment letter" device is of little practical value in furthering a policy which would provide disclosure to the public investor when he needs it.

(d) The peculiar effects of the "fungibility concept".

If there is to be an "investment intent" test for exemption under the '33 Act, the fungibility of securities purchased at different times is essential to its integrity. An example will illustrate the concept:

A purchases 10,000 shares of the common stock of a particular issuer in the trading market. One year later he acquires 10,000 additional shares directly from the same issuer in a non-public transaction. Ten days after the latter transaction, without having experienced any "change of circumstances," A seeks a "no action" letter from the Commission's staff regarding the proposed sale to the public of the 10,000 shares he purchased in the trading market. The "no action" request would be denied. All of the shares now held by A would be deemed to be restricted against public sale.

Assume, however, that A's transactions are reversed. His first purchase is a private placement and his second is in the trading market. It is by no means clear whether the Commission's staff would apply the same theory of fungibility, if, 10 days after his purchase in the market, A were to decide to sell those recently purchased shares.

"Fungibility" also applies, of course, when successive blocks of the same security are purchased in a series of private offerings. A special application of the fungibility doctrine relates to so-called "contingent stock" issued in acquisitions. Assume that company A acquires company B from its 7 shareholders, agreeing to issue 50,000 shares of A's common stock in exchange for the stock of B, and also agreeing that if B's business maintains or achieves certain levels of profitability (and not otherwise) the 7 shareholders of B will be entitled, five years later, to an additional 25,000 shares of A. C, one of the 7 shareholders of B, receives 2,000 shares as his portion of the "contingent" block of 25,000 shares. A month later he decides to sell a portion of the shares acquired by him five years previously. The Commission's staff, in denying no action requests under similar circumstances, takes the position that the receipt of the "contingent" shares starts a new holding period as to all shares of the same class then held by C.

In application, the present “fungibility concept” bears little relationship to the needs of investors for disclosure. It has never been formalized as a Commission rule or interpretative release, and hence introduces an additional element of uncertainty into an already clouded situation. It is essential, however, to prevent evasion of registration requirements under present interpretations of the exemptive provisions. The extent to which such a concept remains a necessary element in a new interpretation of the exemptions will be considered at a later point in this chapter (at pp. 201-02).

(e) The consequences of uncertainty.

Apart from the more obvious difficulties experienced by issuers, investors and brokers as a result of uncertainties in the application of statutory requirements, four consequences of the prevailing interpretation of “investment intent” deserve to be stressed. All are detrimental to the healthy administration of the securities laws:

(1) The existence of vague and imprecise standards (“change of circumstances” and passage of indeterminate amounts of time) have operated through the years to sanction the sale in interstate commerce of large quantities of securities originally issued in non-public transactions.

Such sales have occurred and are occurring irrespective of the availability or non-availability of information concerning the issuers of the securities. The prevailing interpretation of Section 2(11) draws no distinction between issuers furnishing periodic reports to the Commission for the benefit of the public and issuers as to which no information is available.

(2) The Commission's staff is faced with a growing burden in responding to requests for interpretative advice and "no action" letters centered around the question: "when may I sell?" In fact, a large majority of all such requests under the '33 Act pertain to resales following a private offering. It is important that this burden be reduced. To the extent that certainty can be provided, "no action" requests would become unnecessary.

In order to test the possible impact of the new rules which it recommends, the Study made a detailed analysis of approximately 500 written requests for "no action" letters to which the Chief Counsel's office of the Division of Corporation Finance responded during the months of November and December, 1968. It was estimated that had the new rules been in effect during those months, approximately 90% of such requests would have been unnecessary. (A request was regarded, for this purpose, as unnecessary if the question raised is specifically answered in the new rules.)

It would, of course, be overly optimistic to expect a 90% reduction in requests for interpretative advice should the proposed new rules be adopted. It can be expected that questions will be asked about the interpretation of any such new rules. However, the need for “no action” letters arising from uncertainties inherent in present standards should be drastically reduced.

Apart from the mere bulk of requests currently faced by the staff, there is a constant problem in providing reasonably consistent advice. Since the tests with which the staff must work are subjective, its reactions in given situations depend, to a degree at least, on a “feel” of the transaction conveyed by the request for “no action”. Troublesome inconsistency is often the result. Yet that inconsistency, which exists within a relatively compact staff operating under a single director, pales in comparison with the inconsistency in advice given by private counsel as to when and under what circumstances securities sold in private offerings may be resold.

Any lawyer who has practiced in the securities field can recall instances in which several able counselors, viewing an identical set of facts, all reached differing conclusions. An overly conservative counsel may block a transfer of securities which other counsel would consider perfectly within the law, or (on occasion) an issuer of securities may advance

a particularly rigid view of the law in order to prevent a transfer of securities from occurring which it does not wish to see occur for other reasons. Practical problems of this sort are not infrequent.

(3) The lack of objective tests to determine when and how shares issued in a non-public transaction may be offered publicly provides an unfortunate leeway for the unscrupulous. It has been the Commission's experience that unprincipled counsel will often give opinions on the availability of exemption from registration when careful or responsible counsel would not do so. The result of this is to put careful counsel at a marked disadvantage. The client's objective is immediate cash. The pressures are strong, and the temptation to cut the statutory corner is magnified by uncertainty.

(4) Even in flagrant cases of alleged violation of the registration requirements, the Commission's staff faces formidable problems of proof. An intent to distribute must be shown. All of the surrounding circumstances must be developed as bearing on the existence or lack of existence of such intent. The difficulties faced by issuers and issues of securities in coping with subjective tests are paralleled by the difficulties encountered by the Commission's staff in its attempt to enforce the federal law.

3. The search for a solution; the alternatives.

In the Study's judgment, it is essential for the Commission to find a solution to the problems outlined in this portion of the chapter. Such a solution should be sought with appropriate criteria in mind. Three such criteria are suggested:

(1) The present subjective tests associated with the statutory exemptions should be replaced with tests as objective in character as possible. This represents an essential step toward predictability.

(2) Any new interpretations should reflect a greater degree of integration between the disclosure requirements of the '33 Act and the '34 Act. Assuming improvement of '34 Act disclosures, as recommended in this report, it should be possible to permit secondary sales of the securities of reporting companies to take place which would not be permitted under a system to restrictions applicable to secondary sales of all securities.

(3) New interpretations of the exemptive provisions should be consistent with the fundamental aim expressed in the opening phrases of the '33 Act:

to provide full and fair disclosure of the character of the securities sold in interstate and foreign commerce and through the mails and to prevent fraud in sale thereof. . .

Where such full and fair disclosure concerning a particular issuer of securities is unavailable to the public, whether because the issuer has never registered any securities under the '33 Act or because it has never registered a class of securities and placed itself under

obligation to make periodic reports under the '34 Act, the rules of the Commission should inhibit, insofar as practicable, the flow of its securities into the interstate trading markets through secondary sales.

There are a number of alternative procedures, some of which have previously been suggested to the Commission. All have been carefully considered by the Study. Three will be briefly discussed here.

The first would involve retention of the test of “investment intent” for purposes of determining (1) who is an “underwriter,” and (2) when transactions by an issuer “involve” a public offering. An attempt would be made, however, to provide some measure of certainty by expressly permitting resale of privately placed securities in limited brokerage transactions (consistent with the present requirements of Rule 154) after a three-year holding period. In order to prevent the “parking” of securities of dormant companies for three years prior to their public “distribution” under such a rule, it would be provided that the rule applies only if the issuer of the securities has continuously conducted its business during the three-year period with gross revenues during the period exceeding a minimum figure of several hundred thousand dollars.

This suggested approach was rejected by the Study as giving no effect to the availability of information about an issuer and thus failing to meet the policy objectives of the Act.

A second suggested approach would rely principally upon the Commission's power to specify the content of registration statements and prospectuses. Essentially, all public resales of securities (excepting only securities originally purchased in registered public offering or in the trading markets and, possibly, minimal amounts of other securities) would require registration. However, the forms to be used for this purpose would vary from the present Form S-1 (for public resale of the securities of non-reporting companies) to a minimal one-page document to be filed by a reporting issuer whenever a resale occurred of an appropriately limited amount of its securities in ordinary brokerage transactions. (A variant of this approach would expend the availability to individual sellers of the Section 3(b) exemption, but require that an offering circular be used in connection with any sales, however made, in excess of \$50,000 in any one year.)

This suggested approach did not appeal to the Study because of the immense burden of paperwork which it would impose on sellers of securities without clear and corresponding benefits to the public.

A third approach would be constructed around a definition of "distribution" (as that term is used in Section 2(11) of the '33 Act) aimed at reducing '33 Act registration requirements where they do not result in significant benefits to investors and requiring registration where disclosure is not otherwise available. The new

definition would permit limited secondary sales of the stock of reporting companies without registration while restricting secondary public sales (without registration) of the stock of non-reporting companies for a substantial period of years. It would apply both to securities sold on behalf of controlling persons and to securities acquired in private placements. This would end the peculiar anomaly created by the Commission's Rule 154 under which, at present, a controlling stockholder of a corporation may be able to sell without registration securities which he has acquired in the market of the value of several millions of dollars, whereas a subordinate supervisory employee, who purchased 1000 shares one year ago in an unregistered employees' stock purchase plan and who signed an "investment letter" regarding those shares, would be advised that he cannot sell even 100 shares through his broker.^{28/} The tests under the new definition would, insofar as possible, be objective ones.

^{28/} In his article Acquisitions Under the Federal Securities Acts – A Program for Reform, 116 U. Pa. L. Rev. 1323, 1336 n. 45 (1968) Carl Schneider cites the case of a registration statement filed under the '33 Act on behalf of several stockholders of Minnesota Mining and Manufacturing Company who had acquired their shares in what was classified as a private offering. The registration statement covered 29,275 shares, representing 1/20 of 1% of the outstanding common stock. These shareholders could not sell without full registration. But a controlling shareholder of the same company could have sold without registration, within the limits of the Rule 154 definition of "distribution", many times that number of shares.

The third approach was selected by the Study. Its details and practical consequences are discussed in the ensuing section of this chapter.

- C. New rules should be adopted which would (1) distinguish between non-reporting and reporting companies in respect of the public sale of securities, without registration, either by controlling persons or by persons who acquired their securities in non-public transactions, and (2) replace subjective with objective tests to the extent practicable.

The new rules proposed by the Study for this purpose are found in Appendix VI-

1. They are grouped together in a proposed new Article 5 of the General Rules and Regulations under the '33 Act and are designated by number – Rules 161, 162, 163, 164 and 180.

The proposed new Article 5 (entitled “Rules relating to underwriters and non-public offerings under Sections 2(11) and 4(2) of the Act”) collects under one heading all new and existing rules dealing with Sections 2(11) and 4(2).^{29/} This necessitates

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- 29/ Other recommended rules proposed to be included in the new Article 5 are:
- (a) Rule 160, dealing with the meaning of the phrase “directly or indirectly controlling an issuer” in Section 2(11), which is discussed in Part D of this chapter.
 - (b) Rule 181, dealing with the definition of “not involving any public offering” in Section 4(2) in connection with acquisitions of bona fide going businesses, which is discussed in Part E of Chapter VII.

a rearrangement of certain existing rules. The proposed rearrangement is outlined in detail in Appendix VI-2.

In the sections of this chapter which follow, (1) the basic concept of proposed Rules 161-164 are outlined, (2) their practical consequences are dealt with under a series of headings illustrative of typical problem situations, and (3) some implications for the future are briefly explored.

1. Basic concepts of the proposals recommended by the Study.
 - (a) New rules dealing with securities issued in private placements and securities held by controlling persons.
 - (i) Background

Apart from the intrastate exemptions of Section 3(a)(11), the small offerings exemption provided by Section 3(b) and the regulations thereunder, and two exemptions designed primarily for exchanges of securities Sections(3(a)(9) and 3(a)(10)), the exemptions applicable to transactions in securities are found in Section 4 of the Act. Three of these are clearly not available to anyone acting as an “underwriter” of securities. (The fourth, found in Section 4(4), protects only those who act as brokers under certain limited circumstances). For anyone (other than the issuer of the securities or a control person) who seeks to find out whether or not an exemption from registration is available for his sale of

securities, the crucial question is: am I an underwriter?

The investment banking firm which arranges with an issuer (or with a controlling stockholder) for a public sale of securities is, of course, clearly an “underwriter” under Section 2(11). No rules are needed to introduce certainty here; the plain language of the statute is sufficient. Not clear, however (as discussed in the preceding section of this chapter) are the circumstances under which individual investors who are non-professionals in the securities business; and brokers who sell for the accounts of such non-professional investors, become underwriters under the Act.

It is the latter area which is intended to be clarified by the proposed rules, through objective tests to determine when a person of the sort described is an underwriter and when he is not.

The keys to this determination are found in three of the proposed rules:

- (1) Rule 162, which defines the term “distribution;”
- (2) Rule 161, which defines the term “restricted security,” and
- (3) Rule 163, which provides that persons are “underwriters” when they participate in or are connected with a “distribution” of “restricted securities.”

These three rules will be discussed in turn.

(ii) The term “distribution” (Rule 162).

A curious paradox is involved in the use of this term under the prevailing interpretations. It is not found in Section 4(4). However, in an attempt to lend a degree of certainty in the meaning of Section 4(4), the Commission developed a rule (Rule 154) which is built around a definition of “distribution.” The term “distribution” does appear in Section 2(11) of the Act. It is a key word in the meaning of that section, although not defined. Yet under existing interpretations, the definition of “distribution” in Rule 154 has no application in the context of Section 2(11).^{30/} The rule does not allow what is sauce for the goose to be sauce for the gander.

Essentially, the Study recommends that this peculiar state of affairs be reversed. A definition of “distribution” should be introduced in the context of Section 2(11) which will apply both to the sale of securities on behalf of controlling persons and to sales by persons who have purchased their securities in private offerings. This would be accomplished by proposed Rule 162.^{31/} The Study also recommends amendment of Rule 154 to bring its provisions into consonance with Rule 162, as discussed on pp. 220-6, infra.

^{30/} Securities Act Release No. 4818 (Jan. 20, 1966).

^{31/} The proposed definition does not fit other contexts, such as Rules 10b-2 and 10b-6 under the '34 Act.

As observed in the Introduction to this Chapter, in developing a new definition of “distribution” in the context of Section 2(11), the Study focused its inquiry (in the words of Justice Clark) on “... the need of the offerees for the protections afforded by registration.”^{32/} A central question was asked: when securities held by a controlling person are sold, or when securities sold privately by the issuer are resold, under what circumstances do investors need the protection of registration?

It was concluded that a sensible answer to this question could only be found by drawing a distinction between companies which file regular reports on their affairs with the Commission under Sections 13 or 15(d) of the '34 Act (so-called “reporting companies”) and companies which do not. If there has been no full disclosure of a company’s business, earnings and financial condition (or if, despite the fact that the company is reporting company, its reports appear to be defective or out of date), then a sale to the public of that company’s securities ought to be accompanied by the disclosures afforded by '33 Act registration. Conversely, if a company has registered a class of its securities with the Commission under the '34 Act and is maintaining the currency of the information in that original registration statement through up-to-date periodic reports to the Commission, then it ought to be

^{32/} SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1952).

possible to permit secondary sales of its securities to the public without the filing of a '33 Act registration statement except (1) where the quantity of those securities to be sold exceeds an amount which the trading market could normally be expected to absorb within a reasonable period of time, or (2) where, in order to move the securities from private into public hands, arrangements for the solicitation of buying customers, or selling incentives exceeding the commissions paid in ordinary trading transactions, are required.

In other words, the exemptions from '33 Act registration should be interpreted not only in light of the selling effort which can reasonably be anticipated but also in light of the character and extent of the disclosures already made by the issuer of the securities.

If these propositions are correct, then a person who supplies capital to a new venture must do so with full realization that his investment is not liquid in the sense that he can expect to have a free choice of markets. Depending upon the success of the venture—a risk which he must take—he may or may not have a free choice of markets in the future. Unless it becomes practicable to provide the public with adequate disclosure through an appropriate Commission filing, he may well be

limited to private resale, irrespective of any changes that may occur in his circumstances.

On the other hand, if the venture is successful, he can anticipate the likelihood that the company may require additional equity capital. If that capital is obtained through a registered public offering of stock, the company will become a reporting company (unless the amount of new capital to be raised is so small that the offering can be made under Regulation A) and a public market—subject to some limitations—will be open to him. A similar result would, of course, flow from the registration for public sale of securities held by other stockholders of the company. In appropriate circumstances, he might himself utilize the registration process (or the Regulation A exemption) to dispose of all or part of his investment.

Logic would appear to dictate that the foregoing restrictions on public resale of any securities originally taken in a private placement should last indefinitely.^{33/} After long and careful

^{33/} In the context of possible statutory change, such is the view of Milton Cohen:

With respect to issuers other than continuous registrants, on the other hand, the holding period should perhaps be indefinite; that is to say, purchasers in a private placement whose later resales, at any time, amount to a distribution, and thereby turn the issuer into a “public” company, should be deemed underwriters in the present statutory sense, at least for the purpose of attributing their distribution to the issuer itself.

Cohen, “Truth in Securities” Revisited, 79 Harv. L. Rev. 1340, 1404 (1966)

consideration, however, the Study determined that the restrictions should last for a definite period of years, after which the securities would be free of restrictions on resale.^{34/} Perpetual restraints on alienation have been viewed with disfavor and would create difficulties in the administration of the Act. How long should the period of restrictions be? The Study believes that it should be at least 5 years. This is the period used in the draft of Rule 161. The Commission may well determine, however, that a longer period is justified by the primary objective of investor protection.

The new definition of “distribution” in Rule 162 is consistent with the above analysis.

First, non-public transactions are excluded from the term “distribution” and do not require registration of the securities involved.

Second, any public offering of the securities of an issuer which is not subject to appropriate reporting requirements is a “distribution.”

Third, a public offering of the securities of an issuer which is subject to the reporting requirements and is not delinquent in its filings is not a “distribution” (and no registration of the securities is required) if the amounts involved and the method

^{34/} This assumes that the issuer has been a bona fide operating company during the period. A test for this purpose is found in Rule 161, discussed at p. 203, infra.

of sale are consistent with ordinary trading.^{35/}

Objective tests were needed to determine what sales are consistent with ordinary trading. Here, a precedent was available to the Study. The draftsmen of the present version of Rule 154 sought a similar objective. That rule was designed to separate the routine trading transaction from the transaction involving the disposition of a large block of securities by means of extra selling incentives. The Study examined the various parts of Rule 154 and consulted many persons, both within and without the Commission, who had accumulated practical experience with the operation of the rule.

As a result of this examination, the Study reached the conclusion that the general framework of Rule 154 is valid as applied to the securities of reporting companies, at least until the Commission can assess the results of an initial period of experience with improved '34 Act reporting. Following such a period of experience, the Commission would be in a position to

^{35/} It was recommended to the Study that, in advance of all public sales which are excluded by Rule 162 from the definition of "distribution," a statement be required to be filed with the Commission indicating the number of shares to be sold, the name of the broker to be used, and affirming that the seller does not possess any material information about the issuer's affairs which had not been made public. The Study considered the suggestion, and determined for a number of reasons not to recommend that it be adopted. It seemed questionable whether the benefits of such a filing would outweigh the burdens involved. Although the filing might serve as a deterrent to fraud, other means would seem to be better adapted to that function.

determine whether the limits applicable to ordinary trading could be broadened.^{36/} Certain problems exist with the Rule 154 tests, however, which need to be solved. The following paragraphs present the Study's detailed conclusions on the subject of appropriate objective tests of ordinary trading.

(1) Quantity limitations. The quantity limitations of Rule 154^{37/} have been a frequent target of criticism. Some who were consulted by the Study took the position that these limitations are far too generous and permit major dispositions of securities to be made to the investing public with essentially no disclosure. At the opposite end of the spectrum, the view was expressed that there should be no quantity limitations whatever. Still others believed that, for "seasoned" corporations which had been reporting on their affairs to the Commission for a period of years and which met

^{36/} See pp. 244-5, infra.

^{37/} Specifically, "a sale or series of sales of securities which, together with all other sales of securities of the same class by or on behalf of the same person within the preceding 6 months will not exceed approximately 1% of the outstanding shares or units of the security in the case of a security which is traded only otherwise than on a securities exchange and, with respect to a security which is admitted to trading on a securities exchange, the lesser of either 1% of the outstanding securities of the class or the aggregate reported volume of trading during any one week within the preceding 4 calendar weeks." Securities Act Release No. 3525 (December 12, 1954).

certain additional “quality” criteria, the quantity limitation should be increased but not eliminated.

The Study does not believe that, for the present at least, a test based solely upon the absence either of unusual brokerage commission charges or direct solicitation of public customers, with no quantity limitation, could be recommended. During the active market of the last few years, an enormous public appetite has developed from time to time for certain stocks. In such periods, a large percentage of the outstanding stock of a company might easily have been disposed of without selling effort.^{38/} An appropriate quantity limitation will tend, at least, to diminish the temptation to stimulate the public’s appetite in advance of sale which may otherwise exist on the part of those who wish to dispose of a sizable percentage of a company’s outstanding stock. For quantities in excess of the limitations, the requirement of registration will cause the available factual information about the company to be weighed and measured with care.

Assuming that some quantity limitations should be retained, should those now contained in Rule 154 be used? The

^{38/} For an earlier example of such a situation, see Ira Haupt & Company, 23 SEC 589 (1946). During a period of less than six months, the brokerage firm was able to sell 93,000 shares of the stock of Park & Tilford, Inc. (constituting approximately 38% of the then outstanding common stock) on behalf of the controlling interests of that company. Some solicitation of customers’ orders apparently did occur, but only about 4,000 shares were involved.

Study has not been persuaded either by those who should reduce the present limitations or by those who would increase them. Sizable dollar amounts of securities can be sold without registration under the present limitations.^{39/} However, the Study does not consider a quantity limitation based on dollars to be either logical or feasible.

Rule 154 uses the dual test of trading volume and percentage of outstanding shares to measure the quantity of listed securities which may be sold. In periods of heavy volume, the share percentage test would fix the maximum. The Study became interested in determining whether or not the share percentage test was reasonably related to average weekly trading volume. An inquiry (made with the aid of the Commission's computer) disclosed that it was. A total of 2,242 issues of common stock listed on the New York and American Stock Exchanges were studied for the period October 1, 1967 – March 31, 1968 to determine how frequently the share percentage test, as opposed to the trading volume test,^{40/} controlled the maximum quantity of shares which could be sold. The results, averaged

^{39/} For example, common shares of a well-known listed corporation (with approximately 45 million shares outstanding) valued at over 21 million dollars could have been sold under the existing limitations by a controlling person of that corporation at almost any time during the spring of 1968.

^{40/} Only the trading volume on the principal exchange on which the security was listed was used.

for all issues, showed that the trading volume test controlled the quantity 48.6% of the time, whereas the share percentage test controlled the quantity 51.4% of the time. Clearly, under today's conditions at least, a rough but reasonable relationship exists between the two tests, and application of the share percentage test to over-the-counter securities, which is a practical necessity since trading volume figures are as yet not available^{41/}, results in no obvious discrimination between the markets.

Under Rule 154, the quantity which may be sold, measured by the share percentage test, is reduced by the amount of securities sold within the last six months. The Study sees no compelling reason for this reduction, insofar as prior private placements are concerned, and the test in Rule 162 has been modified accordingly. Prior public offerings may stand on a somewhat different footing. Solicitation of buyers is likely to have been widespread during such offerings, and to permit additional quantities to be sold under Rule 162 in close conjunction with such offerings might conflict with the limitations of the rule.

^{41/} The Study is hopeful that when the NASDAQ system developed by the NASD is put into operation, it may be possible to employ a trading volume test as the primary quantity limitation applicable to sales of over-the-counter securities as well as listed securities.

A logical case can be made for separating reporting companies into various categories, depending on size, stability, earnings record, character of market, etc., and applying a different quantity limitation to each category. This subject was carefully considered by the Study, and it was ultimately determined that advantages of such a system were outbalanced by its inherent complexity. The principle of Occam's razor which counsels against the multiplication of categories is not to be forgotten in administrative rule-making. A single, broadly applicable quantity limitation represents a compromise, but it is a compromise necessary, for the present at least, to make the proposed rules administratively workable.

Finally, it was strongly suggested to the Study that the share percentage test should apply only to the floating supply of stock in the market. Several methods for determining an approximate figure for the floating supply were suggested, including subtraction of the securities owned by all officers and directors from securities outstanding. Such subtraction would be done at least once a year. The Study considered this suggestion carefully and determined not to recommend it. The processes of calculation would be complex, and could possibly result in inaccurate data.

(2) Who is a "person?" Rule 154 permits a limited quantity of securities to be sold "on behalf of the same person."

Under existing interpretations, “person” may mean “group”. The Commission had indicated that all sales by members of “a group of closely related persons” are deemed to be sales by any one member of the group.^{42/} The relationship is not limited to ties of blood or family connection. The uncertainties created by this interpretation led to its reexamination by the Study. It is the Study’s recommendation (embodied in Rule 162) that only those members of a carefully defined family group be considered together for purposes of the quantity limitation.

(3) Sales in successive periods. Uncertainty has also arisen under Rule 154 as to whether or not the permitted quantity of securities can be sold on behalf of the same person in successive six-month periods. In 1966, the Commission announced that if any plan exists to effect such sales, they would be deemed to constitute a distribution not exempted by the rule.^{43/} The Study reexamined this limitation (which is of uncertain application in many instances) and decided to recommend that it be dropped. Other limitations of greater functional importance (such as the requirement that the issuer be a reporting company) will govern the public sale of unregistered securities under Rule 162.

^{42/} Securities Act Release No. 4818 (January 20, 1966).

^{43/} Id.

(4) Restrictions on solicitation. Rule 154 prohibits all solicitation of buy orders by the broker excepting only that the broker may make inquiry of other dealers who have recently appeared in the “sheets.” The Study believes that brokers should also be permitted to address inquiries regarding the security to be sold, whether listed or unlisted, to any other bona-fide broker-dealer. Rule 162 so provides.

(5) Appearance of broker in the “sheets”. Rule 154 is presently interpreted to forbid a broker handling an order to remain in the “sheets.”^{44/} The Study has included a provision in Rule 162 which would permit a broker, if he is a bona fide market maker, to remain in the sheets while executing a transaction permitted by the rule.

(6) Limitations on the commission charge. Rule 154 is not available if the broker receives more than “the usual or customary brokerage commission.” This test is obscure, particularly as applied to the over-the-counter market. Rule 162 specifies the commission limits by reference to the minimum commission required by the exchange on which the security is listed and, for over-the-counter securities, by reference to the applicable minimum New York Stock Exchange commission.

^{44/} Id.

The Study conducted an informal survey of broker-dealer firms in various parts of the country, both members and non-members of the principal stock exchanges, to determine what commissions were charged by them in brokerage transactions relating to unlisted securities. The response was that the charge did not exceed the New York Stock Exchange commission, except on rare occasions when a small odd lot was involved—an unlikely event when dealing with control or privately-placed securities. In large transactions, the Study was advised that the commission charge was frequently substantially below the required minimum for a listed security.

It should be noted, of course, that if a broker has an unsolicited customer for the other side of a Rule 162 transaction, it can effect a cross and charge both seller and buyer a commission. ¶The Study reviewed the question whether the exception to “distribution” in Rule 162 should include appropriately limited principal transactions in over-the-counter securities. This would introduce a desirable flexibility if it could be accomplished without detriment to the restriction on selling compensation. To this end, it might be possible to formulate a requirement that the price paid by the dealer to his customer could be no less than a defined inter-dealer bid, minus the minimum commission applicable to the

sale of a like amount of securities on the New York Stock Exchange. It may be easier to achieve such a formulation after the NASDAQ system of the NASD goes on stream. Today, the spreads between wholesale bid and ask prices of some over-the-counter securities are large, and neither the lowest nor the highest independent bid seems to the Study to present a workable standard. Accordingly, until the question has been examined further, it is recommended that the exception for distribution remain limited to agency transactions. This also avoids any lack of coordination between Rule 162 and revised Rule 154 (described at pp. 220-26). A careful broker who is misled by his principal into believing that no distribution is in progress even though the principal is, in fact, engaged in a distribution, can be given protection by a rule under Section 4(4) only if the transaction is an agency transaction.

* * * * *

If the new definition of “distribution” is to be workable both for sales on behalf of controlling persons and sales of privately placed securities, one problem must be solved. The use of ostensible private purchasers as conduits for the sale of securities to the public without registration must be prevented. To solve this problem, a short, mandatory holding period is essential, during which the private purchaser is at risk.^{45/} All who consulted

^{45/} A controlling stockholder who acquired his shares in the trading market is not subject to any holding period.

with the Study on this matter recognized the need for such a holding period, but views as to its appropriate length differed appreciably. Some favored a period of six months. Others strongly believe that the period should be two years. The Study recommends (and has embodied in Rule 162) a period of one year. Such a period should be sufficient for the purpose. During the holding period, a private purchaser may not resell publicly without registration, unless exemption under Regulation A (or any other provision of Section 3) is available. He can, of course, always sell in transactions which are not public offerings, provided such resales are not of such a character as to make the initial sale a public offering.^{46/}

If the quantity limitation is to be meaningful, a similar holding period must apply to the purchaser in a private resale. If it were otherwise, for example, a holder of 5% of the outstanding stock of a company, restricted as to his own sales to 1% in each six month period, could dispose of his entire block simply by selling it to five intermediaries each of whom would immediately be in a position to resell all of his shares to the public.

However, on some occasions, such as transfers involving pledges and gifts, those resulting from death and those resulting from the distribution to beneficiaries on termination of a bona fide trust, a transferee should be permitted to avail himself of the

^{46/} As to the effect of resales of this character, see Gilligan, Will & Co. v. S. E. C. 267 F 2d 461, (2d Cir., 1959) cert. den. 361 U.S. 896.

period during which his transferor held the securities. On other occasions (such as the combination of two bona fide going businesses at the conversion of privately placed convertible securities) where outstanding securities are surrendered in exchange for newly issued securities, a holder of the newly issued securities should be permitted, in the Study's judgment, to make use of the period during which he held the surrendered securities. These special aspects of the holding period requirement are illustrated in the next section of this chapter.

A holding period would be of little effect if a private purchaser could acquire successive blocks of securities at short intervals and intermix such purchases with sales of blocks which had been held for one year. To the limited extent necessary to prevent such a "rolling distribution," a clear and precise provision embodying the concept of fungibility is needed. That provision, found in Rule 162(b), requires that during the applicable holding period, the holder shall not have purchased any additional restricted securities of the same issuer. Purchases of securities of the same class in the open market, and sales, either of restricted or unrestricted securities, should not affect the period of holding. Although serving a necessary purpose, the provision in question can give rise to substantial complexity and possible hardship when applied

in the context of an unregistered, qualified stock option program. The employee granted an option or options by his company may be hard pressed to develop an effective plan to meet both IRS and SEC requirements. Issuers do not seek capital through the exercise of such stock options. Therefore, an exception to the limited fungibility provision appears to be justified for securities privately purchased through the exercise of qualified or restricted stock options. Under Rule 162(c), exercise of such an option will not affect the holding period of shares previously purchased in connection with an option exercise.

(iii) “Restricted security” (Rule 161).

It will be recalled that, under the proposed rules, a person who makes a “distribution” of “restricted securities” is deemed to be an “underwriter.” If a sale is made which clearly comes within the definition of “distribution” but the securities involved are not “restricted securities,” the seller is not an underwriter. Nor is a seller of “restricted securities” an “underwriter” if he stays within the scope of the exceptions to the definition of “distribution.”

The term “restricted security,” defined in Rule 161, means any security acquired directly or indirectly from its

issuer, or from any person in a control relationship with its issuer, in a transaction or chain of transactions none of which was a public offering or public disposition.

Thus, when shares purchased privately are disposed of privately, they remain “restricted securities.” Once sold in a public offering, however, they cease to be “restricted securities.”

As mentioned previously (at pp. 188-9), the Study reached the conclusion that restrictions could not be applied for an indefinite time to the resale of outstanding securities. Accordingly, under Rule 161, “restricted securities” automatically lose that status after a fixed period of years. There is one qualification, however: in order to prevent circumvention of the rule through the employment of shell corporations, it is essential to provide a means of assurance that the issuer of the securities has been an active, going business during the five year period. The test for this purpose recommended by the Study (and embodied in Rule 161) would require annual gross revenues of at least \$250,000 from the conduct of business in the ordinary course during the last 4 of the 5 years.

(iv) Persons deemed to be “underwriters” (Rule 163).

It is the purpose of this rule to remove the emphasis heretofore given to the phrase “. . . has purchased from an issuer with a view to . . .” in Section 2(11) of the '33 Act.

As a substitute for the old emphasis, the rule incorporates a precise definition of the phrases (disjunctively connected to the above-quoted phrase):

. . . or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; . . .

The foregoing phrases are defined together by Rule 163 to include any person who disposes of a “restricted security” in a “distribution.”

Such a person is an underwriter within the meaning of Section 2(11). Of course, the investment banking firm which performs a classic underwriting function in the distribution of securities for an issuer or controlling person is also an underwriter under that section. The definition in Rule 163 (as the language of the rule makes clear) is not exclusive.

The test of Rule 163 is an objective one. Its components, “restricted security” and “distribution” have been defined by other rules. It will not be necessary to prove that a person lacked investment intent in order to find that he is an underwriter of securities if it can be shown that he has disposed of restricted securities in a distribution. Conversely, proof of the purity of one’s intent will no longer be crucial to establishment of a claim for exemption. A person holding securities originally sold by the issuer or a controlling person in a non-public offering need only show (1) that his sales, whenever

occurring, did not amount to “distributions” or (2) that the securities he sold, at the time of sale, were no longer restricted.

Under Rule 163, an effort has been made to relate the test for determining who is an underwriter to the needs of public investors. A holder of restricted securities would no longer be permitted to sell them, irrespective of the manner of sale, the quantity sold, or the availability of information concerning the issuer, on the basis of a claim that he has had a “change of circumstances.”

On the other hand, one who invests in privately placed securities will know in advance what he can and cannot do with his investment. His ability to resell publicly without registration will depend on the availability of information concerning the issuer in the Commission’s public files, and not on some fortuitous change in his own fortunes.

- (v) The effect of transactions not constituting “distributions” under Rule 162 on applicability of the exemption provided by Section 4(2) (Rule 180).

Availability of the exemption of Section 4(2) to an issuer of securities is not determined solely by the character and extent of the initial private group of offerees. The transaction

may “involve” a public offering as a result of resales made by those offerees.^{47/} Rule 180 is designed to prevent loss of the exemption from occurring as the result of any public resale transactions which are excepted from the definition of “distribution” by the provisions of Rule 162(b)(1)(2) and (3).

(vi) The qualified list (Rule 164).

The new definition of “distribution” distinguishes between issuers which have filed an informative registration statement with the Commission and are submitting timely and significant reports under the '34 Act from other issuers of securities.

How is such a separation to be accomplished from a practical standpoint? It is proposed that a list be maintained at the Commission's headquarters and at its principal regional offices to be known as the “Rule 164 Qualified List.” This list would contain the names of all issuers whose securities may be publicly sold without registration in transactions not constituting “distributions” under Rule 162. If deemed desirable, the list could be published and kept up-to-date by frequent published supplements. As recently as two years ago, a sizeable clerical force would have been necessary to maintain an accurate list of the kind

^{47/} Victor and [illegible], Private Offering: Hazards for the Unwary, 45 Va. L. Rev. 869, 871, 879 (1959); Loomis, Enforcement Problems under the Federal Securities Laws, 14 Bus. Law. 665, 669 (1959).

referred to in Rule 164. Today, with the aid of the Commission's Electronic Data Processing Division, it can be accomplished with relative ease.

Another possible method, perhaps administratively easier, would be to maintain a list of those issuers, otherwise obligated to file reports on the appropriate forms, which had been disqualified for delinquency or other reasons specified in Rule 164.

The central policy embodied in the proposed rules is that public resales without registration under the '33 Act should be confined to the securities of those companies which are filing information with the Commission adequate to keep the trading markets reasonably well informed, and immediately available to all interested investors and their advisers through the Commission's microfiche system.

Adequate information is supplied annually by the following categories of companies whose securities are not exempt from registration:

(1) domestic corporations (other than public utility holding companies, certain public utilities and investment companies) with a class of securities listed on a national securities exchange or registered under Section 12(g) of the '34 Act, or subject to Section 15(d) of the '34 Act, which are required to file annual reports on Form 10-K;

(2) North American and Cuban issuers with a class of securities listed on a national securities exchange—the only foreign issuers required to file annual reports with the Commission on Form 10-K.

(3) Public utility holding companies required to file annual reports with the Commission on Form U5-S.

(4) Public utilities regulated by the Federal Power Commission or the Federal Communications Commission, which may file annual reports with the SEC either on Form 10-K or 12-K.^{48/}

(5) Investment companies which are required under the '40 Act to file annual reports with the Commission on Form N-1R and to send certain designated reports to their shareholders.

All of the foregoing categories of companies are required to file quarterly reports on Form 7-Q, 10-Q or N1-Q. (Form 7-Q and 10-Q are proposed by the Study Group in Chapter X to supercede Forms 7-K, 8-K and 9-K).

^{48/} As indicated in Chapter X, the Study suggests a review of Form 12-K to determine whether certain additional information, not now provided by that form, would be of significance to investors.

Requirements consistent with the foregoing are contained in Rule 164(b).^{49/}
Subject to those requirements, an issuer will automatically be placed on the list—

(1) If it has effectively registered a class of securities on a national securities exchange pursuant to Section 12(b) of the '34 Act, or

(2) If it has become subject to the requirements of Section 15(d) of the '34 Act by virtue of having filed a registration statement under the '33 Act which has become effective.

In both of the foregoing instances, it can be reasonably [sic] be assumed that the registration statement filed with the Commission has been circulated to interested persons.

In the case of an issuer which, by virtue of acquiring over 500 shareholders of record and over \$1,000,000 in assets, is required to file a registration statement under Section 12(g) of the '34 Act, there is less assurance that the information in the registration statement will be disseminated with reasonable dispatch. Moreover, a registration statement under Section 12(g) may well become effective (since the process is automatic under

^{49/} Included in the Rule 164 Qualified List would be companies otherwise required to file interim financial information on Form 10-Q but specifically exempted from that obligation by Rules 13a-11 and 15d-11, as proposed to be amended. See pp. 361-3, *infra.*, and Appendices X-5 and X-6.

the statute) before any response has been received to the staff's comments on the disclosures in the registration statement. For these reasons, the effective date of the registration statement is not a propitious time for relaxation of the restrictions on public sale of the issuer's securities effected on behalf of controlling persons or by persons who acquired their securities in private placements. Rule 164 therefore provides for a delay of six months (or such shorter time as the Commission may deem appropriate) after the effective date before such sales may occur. It can be anticipated that the Commission will shorten this period in appropriate cases.

A procedure is provided in Rule 164 which enables the Commission to take action to keep from or to remove from the list the name of any issuer where the circumstances are such that full disclosure concerning the issuer is not available to public investors. The procedure contemplates an opportunity for hearing on the part of any such issuer.

Insurance companies present a special issue. Such companies have a conditional exemption from the registration requirements of Section 12(g) of the '34 Act, provided the following conditions specified in Section 12(g)(2)(G) are met:

- (1) The company is required to and does file an annual statement with the appropriate authority (typically the Insurance Commissioner) of its domiciliary state which conforms to

the standards of the National Association of Insurance Commissioners (“NAIC”) or, in the judgment of the proper state official, substantially conforms thereto. (NAIC has prescribed an annual form for the reporting of detailed financial data by all insurance companies, frequently referred to as the “convention statement.” Early in 1964, and prior to adoption of the Securities Acts Amendments of that year, NAIC also developed and prescribed an annual “Stockholder Information Supplement” to be filed by all domestic stock companies with 100 or more stockholders. The supplement elicits certain information about management and about the shareholdings and share transactions of officers, directors and 10% stockholders. The Study understands that regulations requiring the filing of these forms have been adopted by all states and the District of Columbia.)

(2) The company is subject to proxy regulation by its domiciliary state conforming to that prescribed by NAIC. (Soon after adoption of the ’64 amendments, NAIC prescribed proposed proxy regulations for all domestic stock insurers having over 100 stockholders. It is understood by the Study that such regulations have been adopted in all states and the District of Columbia.)

(3) Short swing trading by officers, directors and 10% stockholders is subject to reporting and profit recovery regulation “substantially in the manner” provided in Section 16

of the '34 Act. (NAIC developed a model “insider trading” statute, and it is understood by the Study that all states and the District of Columbia have adopted such legislation.)

State requirements as to insider trading are expressly inapplicable in the case of insurance companies which have registered a class of securities under Section 12 of the '34 Act. State requirements as to proxy regulation are inapplicable to insurance companies which comply with the Commission's proxy rules. There are at present 11 insurance companies with a class of securities registered under Section 12(b) of the '34 Act. In addition, 25 insurance companies have registered a class of securities under Section 12(g) of that Act, although not required to do so. These 36 companies are subject in all respects to the reporting, proxy and insider trading requirements of the '34 Act. Approximately 227 additional insurance companies are subject to the annual and periodic reporting requirements (but not the proxy rules or insider trading provisions) of the '34 Act under Section 15(d) of that Act, by virtue of a prior registration of securities under the '33 Act.

No accurate figures are available as to the number of publicly-held insurance companies which have obtained exemption from Section 12(g) pursuant to Section 12(g)(2)(G). Based on data furnished to the Study by the NASD, an examination of quotations furnished by the National Quotation Bureau, Inc., and information derived from Best's and Moody's, the Study estimates that there are at least 465 insurance companies with over 100 stockholders and at least 120 insurance companies with over 500 shareholders

which are not subject to either the reporting or proxy requirements of the '34 Act.

The issue as to whether these insurance companies should be placed on the Rule 164 Qualified List involves a number of important factors, among which are the following.

(1) The annual financial information filed by such companies with state authorities (the convention statement) was designed for regulatory purposes and not for the information of investors. It is complex and detailed, and its interpretation requires the skills of a specialized financial analyst.

(2) Although financial statements are required to be sent to shareholders preceding a company's annual meeting, they are designated only by name and (to the Study's knowledge) there are no explicit requirements as to their content.

(3) The annual reporting requirements applicable to such companies do not cover matters of the type proposed to be included in the amended Form 10-K, such as developments and changes in business and types of risks insured.

(4) No interim reports of events of substantial significance to investors (such as are contemplated by present Form 8-K and proposed Form 10-Q) are required to be filed.

(5) No mechanism similar to the microfiche system presently in operation at the Commission's Washington office

(see Chapter IX) is available or in prospect for the ready dissemination to interested persons throughout the country of reports and other information filed with state insurance commissioners.

A further issue is involved which cuts across the insurance company field. Is it feasible and desirable from the standpoint of informing investors for insurance companies to file interim, condensed financial information? All insurance companies required to file reports with the Commission are presently exempt from filing semi-annual financial reports on Form 9-K under Rules 13a-13 and 15d-13. A few states (California, for example) require quarterly financial reports from a broad range of insurance companies subject to their jurisdiction. Others may require such reports from particular companies during a “seasoning” period.

The foregoing factors should be carefully weighed and considered before any change is made in the standards suggested for the Rule 164 Qualified List. The Commission should obtain more complete data concerning the policies of the state insurance commissioners and the practices of unregistered insurance companies in which there is substantial investor interest. Various matters deserve to be more carefully examined, including (1) the practicability of periodic reporting which would more closely approximate that proposed by the Study (in Chapter X), for those insurance companies

wishing to be placed on the List; (2) the possibility of a procedure whereby duplicates of documents filed with state authorities would be made available for purposes of the Commission's microfiche system; and (3) the quality of the disclosures in annual and interim reports sent to the shareholders of insurance companies.

There remains the question whether insurance companies (other than title insurance companies) which are required to file reports with the Commission should continue to have the benefit of an exemption from the filing of any interim financial information. The Study recommends that this exemption be retained temporarily while the feasibility and usefulness of condensed interim financial reporting by insurance companies is explored. See text at note 9, p. 362, infra.

(vii) Expanded availability of Regulation A.

Is Regulation A in conflict with the policy of the new rules? It would provide a limited outlet for the public sale of securities of non-reporting companies, unless its present availability were to be significantly curtailed. The Study does not recommend this. There are countervailing considerations. Regulation A does provide disclosures appropriate to the modest size of the offerings permitted thereunder. The Study sees no reason why it should not be made somewhat more widely available.

Today, use of Regulation A up to the \$300,000 limit by the issuer automatically precludes its use for another year by any control person or holder of privately placed securities. If three individuals have sold a total of \$300,000 worth of securities under Regulation A, the issuer is barred from its use for another year. The Study proposes to change this feature of the Regulation. Any person holding restricted securities which have been outstanding for over one year and who, if he is a control person, has been such for over one year, should be able to sell up to \$100,000 of securities in any one year, irrespective of the use made of the Regulation at any time by the issuer or any other person. Details of this proposal will be found in Chapter VIII.

With the expansion of Regulation A, a combination of outlets will be available to the controlling person or holder of the privately placed securities of a non-reporting company. He can resell in a private transaction which does not violate Ralston Purina standards. Under appropriate circumstances, the exemption provided by Section 3(a)(11) may be available to him.^{50/}

^{50/} It is recognized that this exemption is not always available and, where available, may be difficult to rely upon. See Loomis, Enforcement Problems Under the Federal Securities Laws, 14 Bus. Law. 665, 670-671 (1959); Mulford, Private Placements and Intrastate Offerings of Securities, 13 Bus. Law. 297 (1958). If available, the exemption permits public sales of securities without disclosure, except as the states may act. For example, the California Corporate Securities Law of 1968 authorizes the California Commissioner to establish prospectus requirements for securities not registered under either the '33 Act or '34 Act (Section 25148) and provides for limited continuing disclosures to be required in such cases (Section 25146).

He may be in a position to utilize Regulation A, without regard to what others have done. Finally, if these outlets are insufficient for his purposes, he may be able to obtain '33 Act registration either (1) through his position as a controlling person, or (2) through appropriate contractual arrangements with the issuer, if he is a supplier of private capital.

(viii) Proposed rules to take effect prospectively.

Substantial amounts of securities have been sold and are now held in reliance on existing interpretations associated with the private offering exemption. The Study recognizes that it would be extremely difficult to apply the new rules to such securities held by non-controlling persons. Prospective application of the new rules would mean, of course, that for a short period after their adoption, the old interpretations would continue to govern the resale of certain outstanding securities. There is no reason, however, why holders of such outstanding securities could not rely on the new rules if it would be beneficial from their standpoint to do so. After two or three years, for all practical purposes, only the new rules would be effective.

A different set of considerations applies to outstanding securities held by controlling persons. The proposed revised Rule 154 (see pp. 220-5, infra.) has no application to the securities of non-reporting companies. It is manifestly

impracticable to have two versions of Rule 154 in effect simultaneously, one applying to securities outstanding before the new rules are adopted, and one applying to securities acquired by controlling persons subsequent thereto. Moreover, such a situation, extending into the future for an indeterminate period, would be contrary to the fundamental policy intended to be implemented by the new rules.

Accordingly, the Study recommends that the new rules apply to all resales on behalf of controlling persons, regardless of the date of acquisition by the seller of the securities so sold. The hardship involved is believed to be minimal.

(ix) The inclusion of a “preliminary note” to the proposed rules.

As mentioned previously (at pp. 182-3) it is suggested that the proposed rules (with the exception of the amended Rule 154) be grouped together in a separate article of the General Rules and Regulations adopted under the '33 Act. Article 5 has been used for this purpose in the drafting process.

At the outset of the new Article 5, the Study proposes to include a somewhat expanded preliminary note to explain the scope and purposes of the rules contained in the Article. Certain of the

Commission's rules are presently accompanied by explanatory notes (for example, the Note to Rule 460 under the '33 Act, the introductory Note to Schedule 14A of the Proxy Rules and the Note to Rule 14a-6). This procedure seems particularly appropriate where rules are necessarily lengthy and complex.

The preliminary note to the new rules accomplishes one additional objective. From the onset of its work, the Study has been impressed by the value and effectiveness, in policing an offering made in reliance on the exemption in Section 4(2) of the '33 Act, of a protective legend on certificates evidencing the privately placed securities. Unfortunately, the Study was unable to find a practicable way to require such a legend as a condition of exemption.

Without a conspicuous legend on the certificates, the issuer may be unable to stop transfers of privately placed securities which would destroy the private character of an offering. With such a legend, it can do so and for practical purposes protect the availability of the exemption.^{51/} The use of the legend has recently been referred to by a leading commentator as "an almost

^{51/} Israels, Stop Transfer Procedures and The Securities Act of 1933 – Addendum to Uniform Commercial Code – Article 8, 17 Rutgers L. Rev. 158, reprinted in Selected Articles on Federal Securities Law, 231, 238-240 (American Bar Assn., 1968).

standard pattern of corporate practice.”^{52/} In the Study’s judgment, the Commission should consider the presence or absence of an appropriate legend on certificates evidencing restricted securities a significant indication as to whether or not the circumstances surrounding an offering are consistent with exemption under Section 4(2).

For these reasons, the Study included a paragraph in the preliminary note to Article 5 (1) referring specifically to the necessity for careful precautions on the part of an issuer to see to it that premature resales do not destroy an exemption, and (2) referring to the importance placed by the Commission on the use of an appropriate legend.

(b) Amendment of Rule 154 to modify the definition of “brokers’ transactions” in Section 4(4).

A review of the limited legislative history of Section 4(4) indicates that Congress may well have contemplated the applicability of that exemption only in those limited circumstances (essentially three in number) when (1) the “dealer’s exemption” provided by Section 4(3), usually relied upon by broker-dealers in their

^{52/} Israels, Addendum, 23 Bus. Law. 865 (1968). See also Jennings and Marsh, Securities Regulation, Cases and Materials, 394 (1968); Sommer, Mergers, Consolidations, Sales of Assets—Rule 133, 16 West. Res. L. Rev. 11, 40 (1964) recommends use of a legend on certificates issued to the controlling persons of the acquired company in Rule 133 transactions.

everyday transactions, is not available, and (2) it would constitute a hardship to prevent an owner of securities who is neither an underwriter nor a dealer from disposing of such securities with the assistance of his broker. Under these circumstances, a special exemption is necessary to protect the broker; it is not needed to protect the broker's principal, who obtains exemption under Section 4(1).

To illustrate the first of these three limited circumstances, assume that a corporation's first registration statement became effective two months ago and that the public offering was successfully completed. A, a customer of broker B, purchased some of the securities in the public offering and now wishes to resell them. In the meanwhile, a stop order has been entered by the Commission against further distribution of the securities. B cannot claim exemption under Section 4(3) and therefore cannot sell the securities for A unless he delivers a prospectus to buyers of the security. He is unable to do this because of the stop order. Unless special relief is provided, B will be prevented from acting as broker on behalf of A. It is only fair that relief be afforded; otherwise, the innocent customer would be unable to sell. On the other hand, the relief afforded should be limited. By hypothesis, other members of the public who will buy the securities will not receive a prospectus. It would be contrary to the purposes of the Act to permit the broker to solicit such buyers. Hence the express provisions against solicitation in Section 4(4).

The foregoing fact situation was selected by the House Committee on Banking and Currency to illustrate the operation of Section 4(4):

This exemption also assures an open market for securities at all times, even though a stop order against further distribution of such securities may have been entered. Purchasers, provided they are not dealers, may thus, in the event that a stop order has been entered, cut their losses immediately, if there are losses, by disposing of securities. On the other hand, the entry of a stop order prevents any further distribution of the security.^{53/}

A second situation in which Section 4(3) would not be available (by its own terms) to exempt a broker-dealer from the obligation to deliver a prospectus with each sale of securities, and yet the absence of an exemption might cause severe hardship to innocent customers, exists during the 90 days following commencement of a first registered public offering of those securities.^{54/} If the customer bought securities in the offering which he wishes to resell and the broker cannot obtain a supply of prospectuses, the broker would be unable to act absent a special exemption. The third situation, similar to the second, exists during the first 40 days following an illegal public distribution of securities.

^{53/} H. R. Rep. No. 85, 73 Cong., 1st Sess., 16 (1933).

^{54/} A prospectus must also be delivered at the present time during the first 40 days following the commencement of any registered public offering. The Study proposes that the requirement be removed (see pp. 121-2).

The innocent purchaser of securities in such a distribution should be able to resell; he cannot do so with the aid of his broker unless the broker (who is denied the Section 4(3) exemption under these circumstances) can take advantage of a special exemption. Again, a special exemption for such a situation should be conditioned on no solicitation of buying customers. Section 4(4) so provides.

To repeat, it may not have been contemplated that the special exemption of Section 4(4) for brokers' transactions would be applicable otherwise than in the three situations described. Over the years, however, the scope of the exemption has been extended through a series of changing interpretations, culminating in the present Rule 154.^{55/}

Is an appropriate extension of the scope of the Section 4(4) exemption justifiable?

The Study believes that it is, provided such extension is consistent with the basic policy of the Act to provide public investors with appropriate disclosure. The purpose of the extension should be to protect the careful broker from liability under proper circumstances.

^{55/} The detailed history of these changing interpretations is described by Professor Loss in 1 Securities Regulation 697-706, (2d Ed. 1961). In brief, the Commission at first permitted the exemption to apply to the sale of very sizable quantities of stock held by controlling persons, only to reach a completely contrary result and invalidate the theory on which its former interpretations were based in Ira Haupt & Company, 23 S.E.C. 589 (1946). The opinion in Ira Haupt left the impression that any sale of unregistered securities to the public on behalf of a controlling person might violate the Act. Great uncertainty ensued and there was a demand for clarification. After several proposals and a public hearing the Commission adopted the present version of Rule 154. Securities Act Release 3525 (December 22, 1954).

Under the present Rule 154, if the broker selling for the account of a controlling person is unaware of circumstances indicating that his principal is engaged in making a distribution, the broker escapes liability even though his principal may have violated the '33 Act.^{56/} If, however, the broker sells securities for the account of a shareholder who is, in fact, an underwriter of the securities under Section 2(11), the broker, however innocent, is also an underwriter. No rule exists which grants the broker absolution in such a case. It is the Study's recommendation that Rule 154 be revised to protect a broker under both sets of circumstances if, after reasonable inquiry of his customer, he has no grounds for believing and does not believe that the customer's sale amounts to a "distribution" under Rule 162.

To illustrate, assume that A purchases a block of stock amounting to 5% of the outstanding shares from reporting company C in a non-public transaction. One year later he determines to sell the entire block without seeking registration of the shares. He goes to several brokers for this purpose, falsely representing to each of them that he has sold no other shares of C during the past six months. Broker B, having made appropriate inquiry and having no reason to believe that A is in fact engaged in a distribution,

^{56/} U. S. v. Wolfson, C.C.H. Fed. Sec. L. Rep. (current) para. 92, 328 (C.A.2, December 27, 1968).

sells on his behalf a quantity of shares well within the Rule 162 standards. Today, B would be an underwriter.^{57/} The recommended revision of Rule 154 would provide B with an exemption. On the other hand, the revised Rule 154 would limit the exemption to those cases where the securities being sold to the public without registration are those of reporting companies. Rule 154 is not so limited today. This feature of the present rule is inconsistent with a sound disclosure policy. If the scope of the Section 4(4) exemption is to be extended by interpretation beyond the three situations described above in which there is clear need for a special exemption for brokers' transactions in addition to the dealers' exemption, that extension should not be so broad as to conflict with the interests of public investors.

The Commission has indicated that a broker handling a sale under Rule 154 is obligated to make inquiry into the facts surrounding the proposed sale in order to obtain reasonable assurance that the transaction comes within the scope of the rule.^{58/} This

^{57/} The Commission has expressly stated that neither Rule 154 not [sic] Section 4(4) can be relied upon by the broker under such circumstances. Securities Act Release No. 4818 (January 21, 1966).

^{58/} *Id.* In addition to such inquiry, a careful broker usually obtains a written representation from his customer (the controlling person, in the instance of the present Rule 154) certifying to the absence of any circumstances which might cause the exemption to be unavailable (such as any payments in excess of the brokerage commission, solicitation of orders in anticipation of the transaction, or sale or other securities of the same class which might cause the quantity limitation to be exceeded).

obligations is expressly included in the proposed amended rule. The proposed amended rule also makes clear that the exemption applies only to the broker's part of the transaction. (See Appendix VI-3 for the amended rule).

2. Practical consequences of the Study's proposals.

In the ensuing portion of this chapter, a number of typical practical situations are discussed and the effect of the proposed new rules is indicated. Illustrative examples are given where it appears that they may contribute to an understanding of the proposed new rules.

(a) Sales made on behalf of controlling persons (non-reporting company).

A person who sells securities for a controlling person becomes an "underwriter" if the sale amounts to a "distribution" (Section 2(11)). A private placement is not a distribution (Rule 162). Any sale to the public is a "distribution" except transactions in the securities of reporting companies which are effected within the limitations of Rule 162.^{59/}

Accordingly, a sale of securities on behalf of a controlling person of a non-reporting company may be made without registration of the securities—

^{59/} Hereafter the term "reporting company" refers to a company on the Rule 164 Qualified List. See pp. 206-15, supra.

- (1) if the sale is a private placement, or
- (2) if the sale is within the intrastate exemption of Section 3(a)(11), or
- (3) if the sale is made in accordance with Regulation A or one of the other regulations adopted under the authority of Section 3(b).

Apart from (2) and (3) above, public sales of securities on behalf of controlling persons of non reporting companies may be made only after registration of the securities.

(b) Sales made on behalf of controlling persons (reporting company)

Securities held by a controlling person may be of two kinds: (1) securities acquired in a public distribution of its shares made by the issuer or another controlling person or in the trading markets, and (2) securities acquired directly or indirectly from the issuer or from another controlling person in a non-public transaction or chain of non-public transactions.

Securities in the former category are not within the definition of “restricted security.” Only securities in the latter category come within that definition (Rule 161).

Sales of restricted securities of reporting companies are dealt with in (d) below; the same standards are applicable, whether or not the seller is a controlling person of the issuer.

Non-restricted securities may be sold on behalf of controlling persons of reporting companies, without registration—

- (1) if the sale is a private placement, or
- (2) if the sale is within the intrastate exemption of Section 3(a)(11), or
- (3) if the sale is made in accordance with Regulation A or one of the other regulations adopted under Section 3(b), or
- (4) if the sale meets the requirements of Rule 162(b). Rule 162(b) permits the sale of a limited quantity of securities during any one six-month period in brokerage transactions where no more than the minimum commission is charged.^{60/}

Apart from (2), (3), and (4) above, public sales of non-restricted securities on behalf of controlling persons require registration.

(c) Sales by those who purchased privately (non-reporting company)

Under the proposed rules, a holder of “restricted securities” of a non-reporting company stand on much the same footing as a controlling person of such a company. Both may sell without registration only—

^{60/} The holding period requirement of Rule 162(b) is not applicable when the securities being sold are not “restricted securities.”

- (1) if the sale is a private placement, or
- (2) if the sale is to the public and within the limitations of Section 3(a)(11), or
- (3) if the sale is in accordance with Regulation A or any other applicable regulation adopted under Section 3(b).

Any resale of shares sold by an issuer in reliance upon the exemption from registration in Section 4(2) will, of course, be of concern to the issuer, since it may affect the availability of the exemption. Thus, in the Crowell-Collier case^{61/} shortly after the purported private offering took place, certain of the original purchasers resold a part of their securities. No single resale involved a large number of purchasers, but the original and subsequent purchasers aggregated approximately 115 in number. It was held that a public offering had occurred in violation of Section 5 of the '33 Act. Under the proposed rules, issuers will still find it necessary to take appropriate steps to prevent such an occurrence.

(d) Sales by those who purchased privately (reporting company)

Except in one respect, controlling persons and holders of "restricted securities" of reporting companies are on much the

^{61/} Crowell-Collier Publishing Co., Securities Act Release No. 5825 (August 12, 1957).

same footing. There is a difference between them only if the controlling person acquired his securities in a public offering or in the trading markets. In that case (as indicated in the discussion under (b) above and in footnote 45 on page 199) the securities are not “restricted securities” and the holding period requirement in Rule 162(b) does not apply.

If the securities are “restricted securities”, the holding period required by Rule 162(b) applies whether or not the seller of the security is a controlling person.

Those who hold restricted securities of reporting companies may sell them without registration—

- (1) in a private placement, or
- (2) in transactions exempted by Section 3(a)(11), or
- (3) in sales complying with Regulation A or any other applicable regulation adopted under Section 3(b), or
- (4) after the necessary holding period, in ordinary brokerage transactions involving a limited quantity of securities in any one six month period (Rule 162(b) and (c)).^{62/}

The discussion under (c) above regarding the precautions which must be taken by an issuer which relies on the exemption in

^{62/} It should be noted that “restricted securities” acquired by an underwriter from an issuer or controlling person in connection with services rendered in a registered public offering are deemed to be integrated with the securities publicly offered and must be registered. Securities Act Release No. 4936, Guide 10 (December 9, 1968).

Section 4(2) is also germane here. However, resales in brokerage transactions within the limits of Rule 162(b) (1)(2) and (3) would have no effect upon the issuer's right to claim the exemption (Rule 180).

Under the new rules, there is no need for a "fungibility concept" as pervasive as that which now applies in the area of private offerings. If a person holds securities purchased in the trading markets and securities of the same issuer recently acquired in a private placement, he may resell the former at any time without affecting either the issuer's right to claim the exemption under Section 4(2) or the holding period for the private placement securities. The holding period would be compromised only if during that period he acquired other restricted securities of the same issuer (as outlined more fully on pp. 201-2).

The following examples will illustrate the foregoing aspects of the new rules:

Example one:

Reporting company A, with 4,000,000 shares of common stock outstanding (traded over-the-counter) issues 20,000 shares of its common stock to X and Y, two unrelated businessmen, each of whom take 10,000 shares (the "initial transaction"). X had never previously owned shares of A but Y, three months earlier, had purchased 5,000 shares in the market. Five months after the initial transaction, X purchases an additional 10,000 shares from A's president and controlling stockholder in a private placement. Seven months after the initial transaction, Y sells to a dealer the 5,000 shares he

had acquired ten months earlier. Eleven months after the initial transaction, X acquires 5,000 shares of A in the market. One year after the initial transaction, X and Y decide to sell the shares they purchased in the initial transaction. Y may sell in brokerage transactions as contemplated by Rule 162(b)(3). He has satisfied the holding period requirement of Rule 162(b)(2) by holding his restricted securities for one year, during which he acquired no other restricted securities of A. His sale has no effect upon the ability of A to claim the exemption of Section 4(2) for the initial transaction.

X may not sell any of his shares to the public without registration of compliance with the provisions of Regulation A. His holding period for the 10,000 shares purchased in the initial transaction was interrupted by his purchase of additional restricted shares from A's president. One year after his last acquisition of restricted shares of A, he will be in a position to sell the shares he purchased in the initial transaction. His recent purchase of 5,000 shares of A in the market does not affect such holding period.

Example two:

Company A (in the last example) issues to X, a plant supervisor, a qualified stock option to purchase 2,000 of its common shares, exercisable in equal, cumulative installments during the last 4 years of its 5 year life.

There is no registration statement in effect as to the shares to be issued on exercise of the option. At the mid-point of the second year of the option, X exercises his right to purchase 500 shares. Immediately prior to the end of the fourth year of the option, X exercises as to an additional 500 shares. Shortly after the midpoint of the fifth year of the option, X decides to sell the first block of 500 shares, which he has now held for three years, in order to finance the exercise of the option on the last 1,000 shares.

X may sell the shares in brokerage transactions as contemplated by Rule 162(b)(3). Since the option is qualified, the necessary holding period under Rule 162(b)(2) is not interrupted by X's purchase of additional restricted shares of A on exercise of his option less than one year prior to the sale.

- (e) Recipients [sic] of securities in business combinations where the acquired company is privately owned—herein of “contingent stock”

Assume that company X wishes to acquire company Y (a corporation with 10 shareholders) through a voluntary exchange of securities.^{63/} The new shareholders of company X are in the same position and

^{63/} It is the Study's recommendation in Chapter VII (Business Combinations) that the same principles should apply whether the acquisition is structured as a voluntary exchange of securities, as a statutory merger, or as a sale of assets followed by dissolution of the acquired company.

subject to the same restraints as other purchasers of X's stock in non-public transactions. See (c) and (d) above. The foregoing is, however, subject to two qualifications which are important where the acquiring company is a reporting company:

First qualification: Under Rule 162(c)(2) a special method (discussed in greater detail in Chapter VII at pp. 294-6) is provided for calculating the holding period for shares issued in business combinations. Briefly, if the acquired company satisfies the "going business" requirements of Rule 162(c)(2) each new shareholder may use, for a part or all of the required holding period, the length of time he has held the shares of the acquired company.

An example may be useful to illustrate the application of Rule 162(c)(2) to business combinations:

Reporting company A issues a total of 100,000 shares of its common stock to the shareholders of company B in exchange for all of B's stock. B has ten shareholders, viz., its president, X, who owns 20% of B's stock, his wife (who owns 10%), a trust for his minor child (which owns 10%), the vice president, Y (no relation of X) who owns 40%, and 6 other employees, all unrelated to each other or to X or Y. B has been in operation for several years with gross sales during the past 12 months of approximately \$300,000. Each of B's shareholders, except Z (who acquired 5% of B's stock six months ago), has held his shares of B for more than the past 12 months. None of B's shareholders have previously acquired any shares of A.

A has outstanding a total of 5,000,000 common shares and its shares are traded over-the-counter.

Each of B's shareholders, except Z, may (if permitted to do so under the contract of purchase and sale with A^{64/}) resell all of the shares of A he has received in the exchange in ordinary brokerage transactions of the kind contemplated by Rule 162(b)(3).

Although the shares of A received by the shareholders of B were "restricted securities," the holding period required by Rule 162(c)(2) was satisfied (except in the case of Z) by the periods of time the shares of B had been held prior to the sale. Z will be able to sell his new shares of A in six months time by "tacking" that period to the period during which he previously held his B shares. The holdings of X, his wife, and the trust for his minor child must be considered together under Rule 162(a), but together they do not amount to 1% of the outstanding stock of A. Such holdings, if they were to be combined with the holdings of Y, would exceed 1% of the outstanding stock of A, but X and Y are unrelated and may act independently of each other.

^{64/} Under present standards, if A wishes to obtain pooling of interests accounting treatment for the acquisition of B, the principal stockholders of B will have to retain a major portion of their shares of A for a substantial period.

Second qualification: This qualification is found in the last paragraph of Rule 162(c)(1). To illustrate, assume that in the above example the contract provides that if, in the two years following the transfer of B's stock to A, the business of B achieves certain sales and profit levels, an additional contingent installment of 50,000 shares of A will be paid to the former shareholders of B in consideration of the original transfer to A of the B shares. The condition precedent to this payment is met. Accordingly, two years after the initial transaction, X (who has remained with B under an employment contract executed at the time of the sale) receives 10,000 shares of A. Three weeks later X decides to sell the 20,000 shares of A which he received at the time of the initial transaction together with the 10,000 he has just received. He may do so without registration in ordinary brokerage transactions (as contemplated by Rule 162(b)(3)). The 10,000 contingent shares are deemed to have been "purchased" by him at the time of the initial transaction since no further money or property was paid or payable by him for such shares. (The rule makes it clear that the employment of X is not considered a payment for the contingent shares).

(f) Private placements of convertible securities.

Under present interpretations (1) privately placed immediately convertible securities can never be sold publicly

without registration, and (2) upon conversion of such securities, whenever occurring, the conversion securities cannot be publicly sold unless it is demonstrated that they were acquired at the time of conversion with “investment intent”.

Rule 155, which establishes the foregoing principles, was deemed necessary by the Commission in 1962 to prevent the private placement of convertible senior securities from being employed as a device for the creation of interstate public markets in unregistered common stock. It could be rescinded, in the Study’s opinion, if the proposed new rules are adopted.

As applied to the private placement of convertible securities, the proposed new rules would operate as follows:

Privately placed convertible securities are restricted securities. If a holder of such securities should convert them, the conversion securities would likewise be restricted securities. Restricted securities can be sold only by the several methods outlined in (c) and (d) above. As indicated in (d) above, if the issuer is a reporting company, public sales of restricted securities can take place in ordinary brokerage transactions contemplated by Rule 162(b)(3) after a one-year holding period.

Is it necessary that a new holding period begin when conversion takes place?

A negative answer is given in Rule 162(c)(5) under which the holding period requirement is deemed satisfied if the time during which the seller owned the securities surrendered for conversion,

combined with the time he has held the conversion securities, totals at least one year and the other requirements of Rule 162(c)(5) are met. An example may be helpful to illustrate the foregoing:

Reporting company A (with 1,000,000 outstanding common shares traded over-the-counter) issues its convertible debentures (constituting a new class of securities) to seven persons. X, a purchaser who is unrelated to the others, holds his convertible debentures for one year and then converts them into 10,000 shares of common stock. He can immediately sell the common stock in ordinary brokerage transactions of the kind contemplated by Rule 162(b)(3).

(g) Transfers by gift, or death, or on termination of a bona fide trust

Restricted securities transferred by reason of gift, death, or termination of a bona fide trust remain restricted securities. If the issuer is a reporting company, must the legatee, donee or beneficiary under such circumstances hold the securities for one year before he can sell within the limitations of Rule 162(b)(3)?

Rule 162(c)(3) provides that the legatee, donee or beneficiary can “tack” the period during which the decedent, donor or trustee owned the security; if that period is less than one year, the legatee, donee or beneficiary would have to hold for the balance of a one year period. No holding period at all is required

if the decedent, donor or trustee was a controlling person of the issuer and the securities in question were not restricted securities in his hands.

(h) Pledges of securities.

The so-called Guild Films doctrine^{65/} is currently applied by the Commission to the resale of pledged securities. It consists essentially of two propositions:

(1) A pledgee is considered to stand at least in part in the shoes of the pledgor, and to act at least in part for the pledgor when it sells the collateral;

(2) Accordingly, if the pledgor is a controlling person or a purchaser from the issuer in a private offering, the pledgee can sell the collateral without registration only if an exemption is available to the pledgor which would have permitted the pledgor to sell the same shares without registration.

This doctrine serves a purpose under present interpretations. It is unnecessary under the proposed new rules.

Prior to the advent of the Guild Films doctrine, it was generally believed that a sale of collateral deposited with a bona

^{65/} S.E.C. v. Guild Films Co., Inc., 279 F. 2d 485 (2d Cir. 1960). Cert. denied 364 U.S. 819 (1960).

fide pledgee by a controlling person, or by a person who purchased the securities in a private offering, was exempt under Section 4(1) of the '33 Act, unless the pledgee itself controlled the issuer.^{66/} The concept of bona fides was needed to prevent the pledge transaction from being used (as it was in the Guild Films case) as a mere device to secure the sale of the pledged shares, the pledgor and pledgee both anticipating that the pledgor would default on the loan.

Under the Guild Films doctrine, the bona fides of the pledgee are disregarded. The Study recommends that the concept of the bona fide pledge be revived. As Professor Loss has observed:

The “good faith” test, properly circumscribed, would surely be adequate to take care of evasions like Guild Films or situations where the interest rate of the amount of collateral is so disproportionately high as to raise an inference that the pledgor or pledgee or both looked primarily toward ultimate distribution of the pledged security.^{67/}

Rule 162(c)(4), which deals with the holding period in cases involving pledged securities, treats the bona fide pledgee in the same fashion as any other non-public purchaser of restricted securities, except that he is permitted to “tack” the holding period of the pledgor. If the pledged securities were not restricted

^{66/} 1 Loss, Securities Regulation 645 (2d ed. 1961)

^{67/} Id. at 650.

securities in the hands of the pledgor (as would be true if the pledgor at the time the pledge was made was a controlling person of the issuer and the securities had been acquired by him in the open market), there is no holding period prior to the time the pledgee can sell. The securities transferred to the pledgee in either case, however, are restricted securities in the pledgee's hands, and cannot be sold in a "distribution" without first being registered under the '33 Act. Absent such registration, a pledgee holding restricted securities of a non-reporting company would be limited to the kinds of resale transactions referred to in (c) above. If the securities are those of a reporting company, the pledgee could, in addition, resell them in ordinary brokerage transactions of the kind contemplated by Rule 162(b)(3).

If a pledgee sells restricted securities in a non-public transaction, the purchaser of the securities is permitted under Rule 162(c)(4) to "tack" the holding period of the pledgee and the pledgor.

- (i) Securities acquired by reason of stock dividends, stock splits and recapitalizations.

If a holder of restricted securities received a stock dividend on such securities, if such securities are split, or if such securities are changed or exchanged in a recapitalization, the resulting new shares are likewise restricted securities (Rule 161).

For purposes of the holding period requirement of Rule 162(b)(2), such securities are deemed to have been held for the same period of time and under the same circumstances as the split shares, the shares on which the dividend was paid, or the shares affected by the recapitalization (Rule 162(c)(1)).

Example one:

Reporting company A, with 1,000,000 outstanding common shares traded over-the-counter, sells 10,000 shares of its common stock to its vice president, X, in a non-public transaction. One year later (X not having purchased any other restricted securities of A in the meanwhile and having retained the 10,000 shares), a 25% stock dividend is paid by A on its outstanding common shares. X can immediately resell the 12,000 shares he then holds in ordinary brokerage transactions of the kind contemplated by Rule 162(b)(3).

Example two:

Reporting company A issues 10,000 shares of its 6% cumulative preferred stock, of which there are a total of 1,000,000 shares outstanding traded over-the-counter, to X in a private placement. One year later, pursuant to proceedings taken in accordance with the requirements of the law of the state of incorporation, all such shares are changed into shares of 7% non-cumulative preference stock, subordinated to a new class of cumulative preferred stock. X now wishes to sell his shares.

X can sell in brokerage transactions of the kind contemplated by Rule 162(b)(3). No new holding period began when the recapitalization took place.

(j) Non-reporting company becomes a reporting company.

A person who purchases securities of a non-reporting company in a private offering may, of course, be in a position to resell publicly within the limits of Rule 162(b)(3) as soon as the company registers with the Commission and thereby becomes a reporting company.

Example:

Company A, in order to raise initial equity capital, sells 100,000 shares of its stock to 15 persons. Two years later, having increased its business to the point where additional equity capital is needed, A sells 100,000 additional shares to the public through underwriters, having first registered the shares under the '33 Act. A is now obligated to file reports with the Commission by virtue of Section 15(d) of the '34 Act. X, who purchased 5,000 of the original 100,000 shares, can now sell up to 2,000 of his shares (or 1% of the total outstanding) through his broker in transactions which meet the tests of Rule 162(b)(3).

(k) Restricted securities cease to be restricted.

Under Rule 161, restricted securities cease to be restricted after a period of 5 years, if the issuer has met the gross revenues

test designed to give assurance of an active, going business throughout the period.

Example:

Company A, in the previous example, does not require additional equity capital after the initial private offering and remains closely held. During the first year following the private offering, its gross sales amounted to \$100,000 and, during the second year, to \$150,000. In each subsequent year, gross sales have been in excess of \$250,000. X, a purchaser in the original private offering, is free to sell his shares in any fashion he may choose after the end of the sixth year.

3. Some implications for the future of the proposed rules.

The proposed rules represent the Study's best judgment as to the appropriate next step to take in the evolution of disclosure policy. They move modestly in the direction of greater coordination of '34 Act disclosures with those of the '33 Act, and the recommendation of the Study is conditioned upon improvement in '34 Act reporting—the subject matter of Chapter X. It is possible that they go too far, and it is equally possible that they do not go far enough. Only a period of experience will tell. The rules provide a flexible framework for later modification. In time,

the Commission may wish—

- (1) to increase, or to decrease, the quantity limitation in Rule 162(b)(3) (presently set at 1% of outstanding securities in the case of over-the-counter securities, or the lesser of 1% of outstanding securities or weekly trading volume, in the case of listed securities);
- (2) to reduce, or to increase, the time period (presently six months) during which not more than a specified quantity of securities may be sold in brokerage transactions on behalf of any one offeror; or
- (3) to remove altogether the quantity limitation of Rule 162(b)(3) and rely solely upon restrictions which limit selling compensation and the solicitation of orders from buying customers.

The Study assumes that if the proposed rules are adopted the Commission will review their operation and reexamine their provisions at suitable intervals.

- D. The concept of “control” under Section 2(11) of the ’33 Act should exclude remote relationships. It would be consistent with good policy to clarify this point by rule and appropriate illustrations.

As indicated in the Introduction to this Chapter (at pp. 158-9) the Study considered with care the possibilities for lending greater precision to the concept of “control.” An examination was made

of informal rulings on the issue of control in the files of the Division of Corporation Finance. Although the immense variety of the problems presented makes it highly doubtful whether any precise series of pigeonholes can be developed to contain the “control” concept, a number of issues were raised in which the application of that concept appeared to the Study to be fanciful and unnecessary to a sound disclosure scheme. This observation gave rise to the drafting of a rule (proposed Rule 160, included in Appendix VI-1) providing that a person who possessed none of certain enumerated relationships with the issuer would not be deemed included within the concept.^{68/}

Necessarily, the relationships enumerated are broad ones. They include: a director, an executive officer, an owner of securities possessing 10% or more of the voting power, a designated close relative of one or more of the foregoing, and a creditor who may, at his election, veto those changes in management or important corporate transactions to which he does not expressly consent.

A person whose relationship to a corporation is solely that of a non-executive officer would be outside the concept of

^{68/} The rule might also be applicable in the context of the definition of “affiliate” in Rule 251 of Regulation A. There is some question as to whether it is either necessary or appropriate for such a rule to apply in other contexts of the ’33 and ’34 Acts.

“control” under the proposed rule. The same would be true of the nephew or aunt of the president, for example, or of a person who, although holding just under 10% of the voting power, was otherwise unrelated to the officers, directors of [sic] other shareholders of the company.

The Study was concerned that an inference could arise from such a rule that a person possessing one of the enumerated relationships was necessarily to be deemed in control. No such inference is intended. It appeared to the Study that it might be helpful to provide illustrations of situations involving one or more of the enumerated relationships where control was not deemed to exist. Five such illustrations are given in a note to the proposed rule.