Michigan Law Review

Volume 63 | Issue 7

1965

The Federal Securities Act and the Locked-in Stockholder

Neil Flanagin

Member of the Illinois Bar

Follow this and additional works at: <https://repository.law.umich.edu/mlr>

Part of the [Securities Law Commons](#)

Recommended Citation

Neil Flanagin, *The Federal Securities Act and the Locked-in Stockholder*, 63 MICH. L. REV. 1139 (1965).

Available at: <https://repository.law.umich.edu/mlr/vol63/iss7/2>

This Article is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

THE FEDERAL SECURITIES ACT AND THE LOCKED-IN STOCKHOLDER

Neil Flanagin*

THE Securities Act of 1933¹ is generally identified with Securities and Exchange Commission registration and the attendant disclosure for primary and secondary public offerings of securities. Because of the uncertain scope of the registration requirements, however, it has the practical effect of seriously restricting certain security holders² in selling or dealing in their securities. Security holders so restricted may be underwriters themselves or persons considered to be underwriters for the particular transaction. The difficulties arise in determining which security holders are included within this class and which transactions by those parties are affected. It is to these problems that the major portion of this article is devoted.³ But first,

* Member of the Illinois Bar.—Ed.

1. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-77aa (1958), as amended, 15 U.S.C. § 77b (Supp. V, 1964) [hereinafter referred to as the "Securities Act" or the "act"]. References to sections in this and other statutes hereinafter cited are to the original section numbers and not as designated in U.S.C. The rules and regulations under the act are contained in 17 C.F.R. §§ 230.100-656 (1964).

2. Although written from the standpoint of the stockholder since the issue most frequently arises in that context, the same considerations are generally applicable to the holder of any security; for the purposes of this article, no distinction need be made between kinds of securities. For the scope of the definition of "security," see § 2(1) of the act; *Los Angeles Trust Deed & Mortgage Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); *SEC v. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

3. In any proposed sale of securities by an officer, director, or the beneficial owner of more than ten per cent of a class of equity securities, consideration should also be given to the reporting and short-swing liability provisions of §§ 16(a) and 16(b) of the Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-78hh-1, as amended, 15 U.S.C. §§ 78c(a), 78d, 78s (Supp. V, 1964) [hereinafter referred to as the "Exchange Act"] as applicable to listed companies and over-the-counter companies meeting certain minimum standards of assets and public securities distribution. This subject is beyond the scope of this article; it is discussed in 2 LOSS, SECURITIES REGULATION 1037-1132 (2d ed. 1961) [hereinafter cited as Loss], which is a complete and authoritative text on federal securities regulation generally, containing exhaustive citation to authority and secondary materials. See also PRACTICING LAW INSTITUTE, SEC PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 156-82 (1962) [hereinafter cited as P.L.I.].

The various state blue sky laws, also beyond the scope of this article, may be applicable to sales of previously outstanding securities. The securities registration provisions of the Uniform Securities Act, §§ 301-06, require registration of sales of securities by any person unless an exemption is available (as does § 5 of the Federal Securities Act described *infra*), but does not expressly extend to distributions by controlling persons through underwriters. The exemptions contained in § 402 of the Uniform Act exempt many, but not all, secondary distributions. See LOSS & COWETT, BLUE SKY LAW 314-23 (1958). The Uniform Act, with variations, has been adopted in eighteen states (including Michigan, effective January 1, 1965), the District of Columbia, and Puerto Rico. The act and Official Code Comment are reproduced in 1 BLUE SKY L. REP. ¶¶ 4901-49. LOSS & COWETT, *op. cit. supra*, includes the foregoing and the Draftsmen's commentary.

by way of introduction and background, the registration scheme under the Securities Act should be briefly outlined.

I. THE STATUTORY SCHEME OF REGISTRATION AND EXEMPTION

Securities Act registration involves: (1) an expensive and time-consuming process⁴ during which a registration statement is prepared and filed by the issuer with the SEC, examined and commented on by the Commission's staff, amended and completed by the issuer, and, if all goes well, ordered effective by the SEC; (2) disclosure in the registration statement of information concerning the offering and the issuer's financial condition, results of operations, business, property, and management;⁵ (3) the delivery of a prospectus containing most of the information in the registration statement to prospective purchasers of the security;⁶ and (4) the imposition of liabilities upon the issuer, underwriters, directors, and certain officers and experts for material misstatements or omissions in the registration statement and prospectus.⁷

Section 5 of the act requires registration for the sale of any security through the use of the mails or instrumentalities of interstate commerce,⁸ unless one of the exemptions, contained generally in

4. Aside from underwriting commissions or discounts, registration itself can involve substantial expense; this expense is largely fixed and does not increase significantly with the size of the offering. Legal, accounting, and printing costs are the major items of cost and are rarely less than \$30,000 in the aggregate and may run as high as \$100,000. See 1 Loss 370-73. The average interval between a determination of the necessity for registration and the completion of the sale is three months. The interval will normally be longer if the issuer has never before undergone Securities Act registration. The current work load of the SEC will have a bearing on the time lapse. For a discussion of the SEC's examination process and its time lapse, see *id.* at 272-77.

5. See Schedule A to the Securities Act and Form S-1, the general form for Securities Act registration used where none of the other forms (which relate to special types of offerings) are authorized.

6. The registration scheme contemplates a two-step prospectus. A preliminary prospectus, commonly called a "red herring," is distributed to underwriters, brokers, dealers, and potential purchasers after the registration statement has been filed but before it becomes effective. This prospectus must substantially comply with the standards of a final prospectus (but may omit certain information such as the price, underwriting spread, and the identity of the underwriters other than the managing underwriters) and constitutes the only permissible means by which an offering of securities may be made. A final prospectus, including the information omitted from the preliminary prospectus, must be distributed to each purchaser after the registration statement has become effective. The registration statement, which includes the prospectus, other information not included in the prospectus, schedules supporting the financial statements, and exhibits, is on file as a public record at the SEC.

7. Section 11 of the act. Liability for misstatements or omissions may also arise under § 12(2) of the act and rule 10b-5 under the Exchange Act. 17 C.F.R. § 240.10b-5 (1964). See generally 3 Loss 1699-1721, 1763-97.

8. Section 5(c) prohibits making an offer to sell a security before a registration statement has been filed, or while it is subject to a stop order suspending its effectiveness, or while proceedings toward that end are pending. Section 5(a) prohibits the

sections 3 and 4 of the act, is available. For analytical purposes it is most useful to think in terms of the general applicability of section 5, subject only to the federal jurisdictional limitations, unless an exemption is available.

Registration under the act is, in reality, the registration of a transaction in a security and not registration of the security itself. Thus, even though a security was originally issued under an effective registration statement or an applicable exemption, registration or qualification for exemption may again be necessary for a later transaction.⁹ Since there is normally more than one person involved in making the sale and since each participant on the selling side of the transaction is deemed to be making the sale, each must have an exemption for his participation.¹⁰ The burden of establishing the availability of an exemption rests upon the one claiming it.¹¹

The legislative purpose behind the registration requirement was to protect the investing public through the disclosure and liabilities arising from registration for the distribution, but not the trading, of securities. Congress, in focusing its attention on the distribution of securities, drew no distinction between primary distributions by issuers of securities and secondary distributions by controlling interests.¹²

Section 4(1) provides an exemption from these registration requirements for "transactions by any person other than an issuer,¹³ underwriter, or dealer." Although an investor who sells an insubstantial amount of stock is such a person, his broker executing the sale may be included within the term "dealer."¹⁴ However, the broker's participation in such a transaction will normally be ex-

sale or delivery of a security unless a registration statement is in effect. Section 5(b) limits the form of an offer to sell a security to a preliminary prospectus meeting the requirements of § 10 and prohibits delivery of a security after sale unless accompanied or preceded by a final prospectus meeting the requirements of § 10(a). In each case the prohibition or limitation depends on use of the mails or facilities of interstate commerce. All three of these subsections are directed to any person, and not merely an issuer or one acting on behalf of an issuer. The term "prospectus" is defined in § 2(10) to include any written or broadcasted offer to sell a security or any confirmation of a sale, subject to certain limited exceptions. See note 6 *supra* for the distinction between a preliminary prospectus meeting the requirements of § 10(b) and a final prospectus meeting the requirements of § 10(a).

9. This is distinguishable from registration under the Exchange Act, wherein once registered a security retains this status, regardless of whose hands it is in, until action is taken to deregister the security.

10. *Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

11. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

12. H.R. REP. No. 85, 73d Cong., 1st Sess. 13-14 (1933).

13. Section 2(4).

14. Section 2(12).

empt under sections 4(3) or 4(4).¹⁵ However, any transaction involving an underwriter does not come within the section 4(1) exemption.

Section 2(11) defines underwriter as follows:

"any person who has purchased from an issuer with a view to, 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 undertaking¹⁶ As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

Thus, in addition to the requirement that a stockholder register the distribution of any stock as to which he is an underwriter, section 2(11) requires him to register the distribution even if he is not an underwriter if he is a "controlling person" and the transaction involves an underwriter (which would include a broker executing a transaction on his behalf).¹⁷ Consequently, it becomes critical to examine more thoroughly the definitions of "controlling persons" and "underwriters."

II. CONTROLLING PERSONS

A. *The Tests*

Although the Securities Act does not define "control" in concrete terms,¹⁸ two tests have been developed. Rule 405, under the act states:

15. Prior to the Securities Acts Amendments of 1964, Pub. L. 88-467, 78 Stat. 565 (codified in scattered sections of 15 U.S.C.), §§ 4(1), 4(2), 4(3) comprised, respectively, the first, second, and third clauses of § 4(1); section 4(4) was designated § 4(2). Section 4(3) exempts transactions by a dealer except those occurring prior to the expiration of forty days (ninety days in the case of certain issuers) after (1) the first bona fide offering of the security to the public (without registration and in violation), (2) the effective date of a registration statement relating to the security, or (3) the public offering of the security after the effective date of its registration statement, whichever is later, excluding any time during which a stop order is in effect or stop order proceedings are pending, and except for an underwriter's unsold allotment. Section 4(4), which is applicable notwithstanding the forty- or ninety-day period, exempts brokers' transactions executed upon customers' orders on a stock exchange or in the over-the-counter market, but not the solicitation of such orders. The brokers' exemption has been limited by certain rules defining solicitation which would make the exemption unavailable. Both of these exemptions apply only to the broker's or dealer's participation in the sale and not to the customer. The latter must find his own exemption.

16. The omitted portion of § 2(11) and rule 141 under the Securities Act have the effect of excluding from the definition of an underwriter selling group members whose interest is limited to the customary distributors' or sellers' commission.

17. Stockholders selling on behalf of the issuer also come within § 2(11). See note 67 *infra*. The meanings of "purchased" and "distribution," as used in this section, are examined in Part III *infra*.

18. Section 15 extends the liabilities of §§ 11 and 12 to: "Every person who, by

"[T]he term 'control' (including the terms 'controlling,' 'controlled by' and 'under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

While this rule purports to define terms for the purpose of the registration forms, the terms defined are those used in section 2(11) and the rule is given broad application. The second test—whether the person or group is in a position to require the issuer to execute and file a registration statement—has been developed by the courts.¹⁹

Although these tests are the paramount criteria in determining control for the purpose of section 2(11), control should also be considered in the contexts of the Securities Act, Exchange Act,²⁰ Public Utility Holding Company Act of 1935, and Investment Company Act of 1940.²¹ In each of the latter two acts, the control concept

or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12. . . ." Compare the quantitative statutory tests cited in note 22 *infra*.

19. See *SEC v. Micro-Moisture Controls, Inc.*, 148 F. Supp. 558 (S.D.N.Y. 1957) (temporary injunction), 167 F. Supp. 716 (S.D.N.Y. 1958) (permanent injunction), *aff'd sub nom. SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959). This test is entirely rational and consistent with the legislative purpose of the act. Congress imposed the registration and disclosure requirements upon distributions by issuers and those persons who, by reason of their control over issuers, were in a position to cause them to undergo registration. See H.R. REP. NO. 85, *supra* note 12. It was recognized that in many cases substantial amounts of stock were already outstanding in the hands of a dominant stockholder or group and that the protections of the act should (and could without undue restraint on alienation) extend to distributions by these persons as well as by the issuer. Since only an issuer can execute and file a registration statement, Congress could not (without restricting the free alienation of securities) impose both the formal registration requirements and the attendant disclosure concerning the issuer upon persons who were in no position to procure registration. The Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 569-70 (1963), recommends a requirement of limited disclosure of the terms of the offering by brokers making unregistered secondary distributions.

20. Item 8 of the basic registration form, Form S-1, requires disclosure of parents, defined in rule 405 as controlling persons of the issuer. Section 20 of the Exchange Act imposes liability upon controlling persons comparable to that of § 15 of the Securities Act. In addition, the Exchange Act registration forms and reports require disclosure of controlling persons. Item 2 of Form 10 (the basic securities registration form under the Exchange Act), Item 3 of Form 10-K (annual report for issuers under the Exchange Act), Item 1 of Form 8-K (current report for issuers under the Exchange Act). Control is also important in determining the integration of offerings by affiliates to exceed the \$300,000 limit of regulation A under the Securities Act. See rule 254 and *North Country Uranium & Minerals Ltd.*, 37 S.E.C. 608 (1957), a comparable case under the former Regulation D.

21. 49 Stat. 838, as amended, 15 U.S.C. §§ 79-79z-6 (1958) and 54 Stat. 789, as amended, 15 U.S.C. §§ 80a-1 to -52 (1958), as amended, 15 U.S.C. §§ 80a-2, -6, -8, -39 (Supp. V, 1964), respectively.

has a twofold purpose: (1) to determine those persons subject to the act,²² and (2) to regulate or prohibit certain affiliations and transactions between affiliated persons which may lack the characteristics of arms-length dealing.²³ Both of these acts include a concept of "controlling influence," in addition to the concept of control; thus their scope is patently broader.²⁴ The Trust Indenture Act of 1939²⁵ also bars an affiliated person, including one in a control relationship to the issuer or underwriter, from acting as trustee thereunder.²⁶

B. *The Cases*

The control concepts of the various acts differ in accordance with their divergent legislative purposes, and these differences affect the standards for determining control. Nonetheless, precedents under one act will carry significant weight in resolving questions under the others.²⁷ A higher degree of control should be required under section 2(11) than is the case with most of the other control questions.²⁸ Since there are relatively few control cases under section 2(11), and these do not fully define the scope of the term, the other cases must be examined as well, bearing in mind their different purposes and quantitative standards.

22. Sections 2(a)(7), (8), and (11) of the Holding Company Act define such terms as "holding company," "subsidiary company," and "affiliate," for the purposes of determining those persons who are subject to that act, partly in terms of the percentage of outstanding voting securities owned (ten per cent except for "affiliate" where five per cent is the standard), but permit exclusion from these sections by the Commission upon a finding of lack of control. Section 2(a)(9) of the Investment Company Act contains a rebuttable presumption of control based on ownership of more than twenty-five per cent of voting securities. Section 3(b)(2) of the Investment Company Act provides that an issuer who is primarily engaged in an operating as opposed to an investing business through controlled companies may apply for exemption from that act. Section 2.4 of The Illinois Securities Act of 1953, ILL. REV. STAT. ch. 121½, § 137.2-4 (1964), also defines control as including a person or group owning twenty-five per cent of the outstanding voting securities, where no other person owns a larger percentage.

23. Sections 10(b)(1), 12, and 13 of the Holding Company Act; §§ 10 and 17 of the Investment Company Act.

24. Controlling influence has been held to involve something less than control. *Koppers United Co. v. SEC*, 138 F.2d 577, 580-81 (D.C. Cir. 1943); *Detroit Edison Co. v. SEC*, 119 F.2d 730, 739 (6th Cir.), *cert. denied*, 314 U.S. 618 (1941); *Chicago Corp.*, 28 S.E.C. 463 (1948); *Transit Inv. Corp.*, 23 S.E.C. 415 (1946).

25. 53 Stat. 1149, as amended, 15 U.S.C. §§ 77aaa-bbb (1958), as amended, 15 U.S.C. § 77ddd (Supp. V, 1964).

26. Section 310(b)(3), 53 Stat. 1159, 15 U.S.C. § 77jjj(b)(3) (1958). Section 310(b)(5) contains various tests of ineligibility, based on conflict of interests and not expressly on control, in terms of percentages of voting and other securities held.

27. *M. A. Hanna Co.*, 10 S.E.C. 581, 589-90 (1941).

28. The ability to procure Securities Act registration is immaterial in at least two of the three types of control cases: (1) those arising under the disclosure provisions of the Securities Act and the Exchange Act and (2) the control or controlling influence cases under the Holding Company Act and the Investment Company Act. Relations

Control is a question of fact and is determined on a case-by-case basis. It is seldom resolved by reference to a single fact, but by the cumulative effect of all relevant facts. No quantitative rule can be fashioned, and all that can be done is to outline the criteria which have supported findings of control.

1. *Stock Ownership*

a. *Attribution*

The most obvious criterion of control is stock ownership, and it would seem at first glance to be a quantitative one. First, however, there is a question of whose stock should be included in making the determination. The putative control person's ownership furnishes only a starting point; to this should be added stock under his direct control, such as by power of attorney, proxy, contract, or understanding.²⁹ Next, family holdings have to be considered. Although there are no formal attribution rules, stock held by family members, particularly the immediate family, will probably, in the absence of contrary indications, be attributed to him for this purpose.³⁰

A voting trust would not ordinarily insulate the dominant beneficial owners of the deposited stock from a finding of control, particularly where the trustee either acts on the formal directions of the beneficial owners or otherwise is not independent.³¹

b. *Group Ownership*

If the control person is a member of a cohesive group, the entire group may be deemed in control if the relationship of the group members to each other and to the issuer is sufficiently close. The fact that a number of people act in concert to effect a distribution has been recognized as a strong indication of a cohesive control group. In *SEC v. Micro-Moisture Controls, Inc.*,³² a control group

or transactions between an issuer and a person who does not satisfy either the rule 405 or the "ability to procure registration" tests could still lack the characteristics of arms-length dealing (the target of these provisions) and a lower degree of control would be the appropriate standard. However, in the third category—controlling persons' liability under § 15 of the Securities Act and § 20 of the Exchange Act—at least the rule 405 test should govern and the ability to procure registration should be present.

29. *Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1119-21 (1940); *Austin Silver Mining Co.*, 3 S.E.C. 601 (1938); *Canusa Gold Mines, Ltd.*, 2 S.E.C. 548, 555 (1937).

30. In *J. P. Morgan & Co.*, 10 S.E.C. 119 (1941), non-voting stock in an investment banking firm (*Morgan Stanley & Co., Inc.*) held by wives and adult children of officers and directors of *J. P. Morgan* was one of the factors disqualifying that bank, under the Trust Indenture Act, from acting as trustee in offerings in which *Morgan Stanley* acted as underwriter. See also P.L.I. 8-9.

31. *H. M. Byllesby & Co.*, 6 S.E.C. 639, 651 (1940).

32. 148 F. Supp. 558 (S.D.N.Y. 1957) (temporary injunction), 167 F. Supp. 716

of approximately thirty members was found to be making an unlawful distribution without registration. The court held that one of the defendant dealers violated the act in purchasing stock for distribution from two of the control group members holding 1.5 per cent of the outstanding stock.³³ Similarly, a pool or escrow arrangement for stock held by a group has supported a finding of concerted action amounting to control.³⁴

c. Amount Held

Where the stock held by the control person or group exceeds fifty per cent of the total outstanding, a finding of control will normally follow.³⁵ If, as is frequently the case, the amount held is less than fifty per cent, how the balance of the outstanding stock is held must also be considered. If the remaining shares are widely scattered among many small stockholders, a much lower percentage holding by the control person or group would be required for a finding of control.³⁶ It appears that ten per cent of the outstanding stock would easily control many listed companies. Management frequently holds a lower percentage, but its control is based largely on official position and control of the proxy machinery, which in and of themselves are strong positive control factors.³⁷ The firmness of the management's control has been measured in part by the amount of proxies it receives.³⁸ The percentage representation of a person or group at stockholders' meetings is frequently higher than their percentage of the total outstanding stock and this has also been considered a relevant factor.³⁹

(S.D.N.Y. 1958) (permanent injunction), *aff'd sub nom.* SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959).

33. See also S. T. Jackson & Co., Securities Exchange Act Release No. 4459, CCH FED. SEC. L. REP. ¶ 76068 (1950).

34. Thompson Ross Sec. Co., 6 S.E.C. 1111 (1940). In *Landay v. United States*, 108 F.2d 698 (6th Cir. 1939), *cert. denied*, 309 U.S. 681 (1940), a mail fraud and Securities Act prosecution, the court found the defendants, who dominated the corporation through a pooling of stock, to be issuers within § 2(4), without relying on the control concept of § 2(11).

35. Compare *Battery Sec. Corp.*, Securities Exchange Act Release No. 5592, Oct. 25, 1957, in which the president and nominal controlling stockholder was found not to be in control when another person had contributed most of the capital and actually ran the business.

36. *American Gas & Elec. Co. v. SEC*, 134 F.2d 633, 642 (D.C. Cir.), *cert. denied*, 319 U.S. 763 (1943); *Chicago Corp.*, 28 S.E.C. 46 (1948); *Transit Inv. Corp.*, 23 S.E.C. 415, 418-20 (1946); *Automatic Tel. Dialer, Inc.*, 10 S.E.C. 698, 704 (1941).

37. *Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1119-21 (1940).

38. *Id.* at 1120-21.

39. *Chicago Corp.*, 28 S.E.C. 463, 474-77 (1948); *Pacific Gas & Elec. Co.*, 10 S.E.C. 39 (1941), *aff'd*, 127 F.2d 378 (9th Cir. 1942), *aff'd on rehearing by an equally divided court*,

The legislative history of section 2(11) suggests the inverse assumption that anyone disposing of a sufficient quantity of stock to warrant registration ought to be in a position to require it.⁴⁰ However, the quantity of stock to be sold should not, by itself, establish control.⁴¹

d. *Interrelation of Groups*

The existence of a significant block of stock held by others is an important, though not conclusive, factor. Whether it negates control depends on the relationship of the two blocks to each other and to management.⁴² Stockholders at odds with management presumably do not control, and inability to secure board of directors representation is a strong indication of the absence of control.⁴³ However, these facts may be difficult to establish.

If a control person or group shares management with representatives of another group, both may be in a control relationship to the issuer. Cases under the Holding Company and Investment Company Acts recognize that control may rest in more than one person at one time,⁴⁴ although this situation would be more common under the less rigorous tests of these acts. The fact that the non-management block might not prevail in a proxy contest would not negate control, particularly when, because of harmonious relations, the likelihood of such a contest is remote.⁴⁵ The absence of active intervention in management may indicate satisfaction and not the lack of power to intervene.⁴⁶ Since the power to control, as distinguished

139 F.2d 298 (9th Cir. 1943) (per curiam), *aff'd by an equally divided court*, 324 U.S. 826 (1945) (per curiam).

40. H.R. REP. NO. 85, *supra* note 12.

41. H.R. Doc. No. 95, *supra* note 19, at 562-66, discloses several large unregistered secondary distributions through underwriters over the facilities of the New York Stock Exchange, including: General Electric Company \$12,000,000, Bethlehem Steel Corp. \$29,000,000, and Martin Co. \$6,000,000. The absence of registration could only be predicated on a lack of control by the selling stockholders. The size of the offering must, therefore, be considered in relation to the quantity and aggregate market value of the outstanding stock.

42. *Koppers United Co. v. SEC*, 138 F.2d 577, 580-81 (D.C. Cir. 1943); *North Country Uranium & Minerals, Ltd.*, 37 S.E.C. 608, 610-13 (1957); *Chicago Corp.*, 28 S.E.C. 463, 468 (1948).

43. *Detroit Edison Co. v. SEC*, 119 F.2d 730 (6th Cir. 1941); *United States v. Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959); *Allied Chem. & Dye Corp.*, 5 S.E.C. 151 (1939). Inability must be distinguished from abstention. See authorities cited notes 46 and 47 *infra*.

44. *Chicago Corp.*, 28 S.E.C. 463 (1948); *M. A. Hanna Co.*, 10 S.E.C. 581, 586 (1941).

45. *Chicago Corp.*, *supra* note 44, at 474-75. Here the fact that the minority block could prevent corporate action, either by direct vote or by breaking quorum, was considered a factor indicating controlling influence. *Id.* at 471-72, 476-77. This reasoning should not apply to § 2(11), since affirmative control, not negative influence, is the test.

46. *North Am. Co. v. SEC*, 327 U.S. 686, 692 (1946).

from day-to-day management, constitutes control, latent power has been equated to control.⁴⁷

2. Official Position

In the absence of a contrary indication, it is generally assumed that any member of top management is in a control relationship to the issuer. The group concept is pertinent here too, for if the individual in question is a member of a family or other group which includes directors or officers, their positions will have a bearing on his own.⁴⁸ Managements are recognized as being normally harmonious and cohesive,⁴⁹ and it would be unusual for an officer who is among those who make the major corporate decisions not to be a member of the control group. The same conclusion would not necessarily follow with respect to an outside director, particularly one who did not have or represent substantial stockholdings.⁵⁰ For the non-management person or group, board and executive committee representation⁵¹ and historic relationships through personnel ties or the sponsorship and promotion of officers and directors have been given some weight.⁵²

Lack of official position does not itself negate control.⁵³ Likewise,

47. *Detroit Edison Co. v. SEC*, 119 F.2d 730, 739 (6th Cir. 1941); *Chicago Corp.*, 28 S.E.C. 463 (1948); *Walston & Co.*, 7 S.E.C. 937, 950-51 (1940); *Reiter-Foster Oil Corp.*, 6 S.E.C. 1028, 1044-46 (1940).

48. See P.L.I. 8-9, 21. Those closely related to a member of management may be deemed to be under his domination (or he under theirs) and, therefore, within the control group. Of course, if the acts of the relative are in fact the acts of the control person, they will be so regarded.

49. See *Miller v. Hano*, 8 F.R.D. 67 (E.D. Pa. 1947) (management as a group found to be in control); *S. T. Jackson & Co.*, Securities Exchange Act Release No. 4459, CCH FED. SEC. L. REP. ¶ 76068 (1950).

50. In *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959), a case decided under § 16(b) of the Exchange Act, the Court recognized the noncontrolling position of an outside director. His status should depend largely on the degree of participation in the issuer's affairs, such as by membership on key committees of the board of directors.

51. *Koppers United Co. v. SEC*, 138 F.2d 577, 580-81 (D.C. Cir. 1943); *Pacific Gas & Elec. Co. v. SEC*, 127 F.2d 378 (9th Cir. 1942); *Chicago Corp.*, 28 S.E.C. 463 (1948); *M. A. Hanna Co.*, 10 S.E.C. 581, 588 (1941). See note 41 *supra* for cases on inability to secure board representation. Executive committee membership takes on added significance when the directors meet infrequently. *Resources Corp. Int'l*, 7 S.E.C. 689, 716-18 (1940).

52. *North Am. Co. v. SEC*, 327 U.S. 686, 693 (1946); *American Gas & Elec. Co. v. SEC*, 134 F.2d 633, 642 (D.C. Cir. 1943); *Pacific Gas & Elec. Co. v. SEC*, *supra* note 51, all decided under the Holding Company Act. See also *Transit Inv. Corp.*, 23 S.E.C. 415, 418-20 (1946), in which controlling influence, within the Investment Company Act's ban on transactions between affiliates, was found to rest in a bank president and three per cent stockholder who, among other things, had the confidence of substantial stock interests and who, together with his predecessor, had sponsored a majority of the directors.

53. *Nev-tah Oil & Mining Co.*, 38 S.E.C. 497 (1958); *North Country Uranium & Minerals Ltd.*, 37 S.E.C. 608, 610-13 (1957); *Walston & Co.*, 7 S.E.C. 937, 950-51 (1940).

the relinquishment of position does not necessarily indicate loss of control.⁵⁴ In *Transit Investment Corp.*,⁵⁵ the Commission distinguished between position as the source of power and power as the source of position. Applying this distinction to former directors and officers or to the estates of deceased directors and officers, the termination of the official position which was the source of control would mean termination of the control relationship. However, where the position was not the source of power, control would presumably continue.⁵⁶

3. Other Factors

The following factors have also contributed to a finding of control: handling the issuance of securities,⁵⁷ past participation in financing,⁵⁸ a significant financial stake in the issuer (without direct ownership),⁵⁹ speaking for management or handling publicity,⁶⁰ the existence of a management contract or arrangement,⁶¹ or a relationship to the issuer such as that of a major customer, supplier, or creditor.⁶² The historic nature and degree of permanence of these relationships would materially affect their significance.⁶³ An organizer or promoter, who presumably controlled the issuer at the outset, may still be in control at a later date.⁶⁴ The absence of contrary indi-

54. When the Holding Company Act became effective, many holding companies sought to divest themselves of the formal trappings of control over their affiliates. However, the resignation of common directors and officers was found not to establish the cessation of control or controlling influence, since the latent power remained. *American Gas & Elec. Co. v. SEC*, 134 F.2d 633 (D.C. Cir. 1943); *Pacific Gas & Elec. Co. v. SEC*, 127 F.2d 378 (9th Cir. 1942); *Detroit Edison Co. v. SEC*, 119 F.2d 730 (6th Cir. 1941).

55. 23 S.E.C. 415, 420 (1946).

56. This distinction is useful when one or the other of the situations is clearly present; however, there is a large gray area in which the source of control cannot be clearly defined.

57. *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 275 (10th Cir. 1957); *Schamber v. Aaberg*, 186 F. Supp. 52 (D. Colo. 1960); *SEC v. Franklin Atlas Corp.*, 154 F. Supp. 395, 400 (S.D.N.Y. 1957); *Miller v. Hano*, 8 F.R.D. 67 (E.D. Pa. 1947); *Reiter-Foster Oil Corp.*, 6 S.E.C. 1028, 1044-46 (1940).

58. *American Gas & Elec. Co. v. SEC*, 134 F.2d 633 (D.C. Cir. 1943); *Morgan Stanley & Co. v. SEC*, 126 F.2d 325 (2d Cir. 1942); *Detroit Edison Co. v. SEC*, 119 F.2d 730 (6th Cir. 1941); *H. M. Byllesby & Co.*, 6 S.E.C. 639, 652 (1940).

59. *J. P. Morgan & Co.*, 10 S.E.C. 119 (1941); *Walston & Co.*, 7 S.E.C. 937, 950-51 (1940).

60. *SEC v. Franklin Atlas Corp.*, 154 F. Supp. 395 (S.D.N.Y. 1957); *Nev-tah Oil & Mining Co.*, 38 S.E.C. 497 (1958).

61. *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 123 (W.D. Ark. 1949); *M. A. Hanna Co.*, 10 S.E.C. 581, 586 (1941).

62. *Koppers United Co. v. SEC*, 138 F.2d 577, 580-81 (D.C. Cir. 1943); *Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 662-67 (1957).

63. *M. A. Hanna Co.*, 10 S.E.C. 581, 589 (1941), and cases cited in note 58 *supra*.

64. *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 275 (10th Cir. 1957); *North Country Uranium & Minerals, Ltd.*, 37 S.E.C. 608, 610-13 (1957); *Automatic Tel. Dialer*,

cations would permit the inference that control, once present, continued.

Control should follow from evidence of overall domination.⁶⁵ Specific incidents in which the issuer or management has or has not acceded to the wishes of the control person would be relevant, though reliance on an insubstantial amount of disagreement would be misplaced.⁶⁶

III. STATUTORY UNDERWRITERS

The definition of an underwriter in section 2(11) includes, among others, any person who, with a view toward distribution, has purchased from an issuer or control person. The question of whether one comes within this definition most frequently arises in determining the availability of the section 4(1) exemption for a sale of securities received⁶⁷ from the issuer without registration, usually in reliance upon the private offering exemption contained in section 4(2).⁶⁸

Inc., 10 S.E.C. 698, 704 (1941). See also *J. P. Morgan & Co.*, 10 S.E.C. 119 (1941); *M. A. Hanna Co.*, *supra* note 63; cases cited in note 54 *supra*.

65. See, e.g., *Schamber v. Aaberg*, 186 F. Supp. 52 (D. Colo. 1960); *Southeastern Industrial Loan Co.*, 10 S.E.C. 617, 632-33 (1941); *Resources Corp. Int'l*, 7 S.E.C. 689, 716-18 (1940); *Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1119-20 (1940).

66. Under the Holding Company Act, those exercising controlling influence need not always be able to carry their point or make their influence fully effective, *Detroit Edison Co. v. SEC*, 119 F.2d 730 (6th Cir. 1941), so long as the management would probably defer to their wishes on matters of importance. *Koppers United Co. v. SEC*, 138 F.2d 577 (D.C. Cir. 1943). *But cf.* *United States v. Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959). In the Schering Corp.-White Laboratories merger, the SEC acknowledged that rule 133, as then in effect, exempted the exchange of stock in a merger, but it required registration prior to the sale of stock to be received by a trustee who was a director and the largest stockholder of the acquired company. See *Securities Act Release No. 3846*, October 8, 1957, and P.L.I. 10-11. Though he opposed the merger, he was apparently unable to prevent it.

For further discussions of the control concept, see 2 Loss 764-83; Comment, *The Meaning of "Control" in the Protection of Investors*, 60 YALE L.J. 311 (1951). Many of the numerous Holding Company Act control cases are cited in Loss and the above cited comment, as well as in *American Gas & Elec. Co. v. SEC*, 134 F.2d 633, 643 nn. 20, 22 (D.C. Cir. 1943), and *M. A. Hanna Co.*, 10 S.E.C. 581, 589-90, n.13 (1941).

67. Although § 2(11) uses the word "purchased," it is construed in the broadest sense so as to be virtually synonymous with "received." The transfer of securities for any valuable consideration comes within the definition of "sale" in § 2(3). Thus "purchase," which is not separately defined, should be equally broad. Persons selling securities received from the issuer may also come within the other part of the § 2(11) definition as "selling for" the issuer whenever the transfer from the issuer is susceptible to being viewed as transparent. *MacClain v. Bules*, 275 F.2d 431, 436 (8th Cir. 1960); 1 Loss 642; note 94 *infra*.

68. "... transactions by an issuer not involving any public offering." As will be seen, the same question may be present in the sale of stock received from the issuer without registration in reliance upon other exemptions.

A. *Investment Intent Under the Private Offering Exemption*

One of the requisites of the private offering exemption is that the purchase be for investment and not with a view to distribution.⁶⁹ The requirements of this exemption would not be satisfied if the purchaser came within the literal language of section 2(11). By construction, however, only the purchaser who takes with the affirmative intent to hold for investment (rather than with the absence of an intent to distribute) comes within the private offering exemption and is excluded from the definition of an underwriter.

In the Commission's view, an intent to sell (1) after a predetermined event or lapse of time or (2) after an appreciation in value or (3) in the event there is no such appreciation is not an investment intent. The purchaser must be prepared to weather normal investment risks such as changes in the economy and the financial condition, prospects, and even the type of business of the issuer.⁷⁰

Investment intent is to be determined by reference to the time of purchase. Like any intent question, it is determined by inference from the tangible facts, probably the most significant of which is the subsequent sale. Since the seller has the burden of demonstrating investment intent,⁷¹ he must be able to establish that his subsequent sale is consistent with this intent. There are three basic criteria for measuring investment intent and its consistency with a subsequent sale: (1) the seller's circumstances at the time of purchase (whether consistent with a long-term commitment in the stock); (2) the time lapse between the purchase and sale; and (3) the degree to which the seller's circumstances have changed. The question will turn on the combination of inferences to be drawn from these factors.

1. *Circumstances at the Time of Purchase*

A professional, such as a broker or investment banker, will ordinarily not be deemed by the SEC to have taken for investment; investment intent is inconsistent with the occupation of buying, selling, and dealing in securities.⁷² Fiduciaries and institutional investors,

69. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); Securities Act Release No. 4552, Nov. 6, 1962; 72 HARV. L. REV. 784 (1959). There are important conditions to this exemption in addition to taking for investment. See Securities Act Release No. 4552, *supra*, and 1 Loss 653-96.

70. Securities Act Release No. 4552, *supra* note 69; Securities Act Release No. 3825, Aug. 12, 1957 (re The Crowell-Collier Publishing Company); P.L.I. 34-39.

71. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959); Securities Act Release No. 4552, *supra* note 69.

72. *Gilligan, Will & Co. v. SEC*, *supra* note 71; Op. Gen. Counsel, Securities Act

who are obliged constantly to review their portfolios and dispose of investments which are no longer suitable, face the same problem, although to a lesser degree.⁷³

If the purchaser is an officer, director, or employee of the issuer, this relationship would tend to show that he views the investment as a long-term one. On the other hand, if the size of the investment is substantial in relation to the purchaser's net current assets, it may be inconsistent with a long-term commitment since the likelihood of a forced liquidation would be increased; the fact that no particular contingency requiring liquidation is foreseen does not alter the possibility that some such contingency might arise.

2. Holding Period

The SEC recognizes no fixed time period between purchase and sale as establishing an investment intent, although it does acknowledge that lapse of time is an important factor.⁷⁴ Until a few years ago, a one-year rule of thumb had evolved among the securities law bar.⁷⁵ Beginning with the Crowell-Collier Release,⁷⁶ however, the SEC has taken pains to negate any rule of thumb. In the Crowell-Collier Release and the Second Circuit's decision in the related case of *Gilligan, Will & Co. v. SEC*,⁷⁷ a ten-month holding period did not preclude a finding of an intent to distribute. In *United States v. Sherwood*,⁷⁸ the Court stated that the presence there of a two-year holding period was "an insuperable obstacle"⁷⁹ to finding such intent. *Sherwood*, however, was a criminal contempt case in which the Government had the burden of establishing distributive intent beyond reasonable doubt. In the normal case, where the seller has the burden of

Release No. 1862, Dec. 14, 1938. Historically, the Commission has been reluctant to accept investment representations from securities dealers. See Securities Act Release No. 4552, *supra* note 69; Securities Act Release No. 3210, April 9, 1947; 1 Loss 674 n.96; P.L.I. 292-93.

73. See Securities Act Release No. 4552, *supra* note 69, at 4.

74. *Id.* at 3-4.

75. P.L.I. 29-31; Fooshee & McCabe, *Private Placements—Resale of Securities—The Crowell-Collier Case*, 15 Bus. Law. 72, 80 n.18 (1959). The SEC probably invited this rule of thumb. See Op. Gen. Counsel, Securities Act Release No. 285, Jan. 24, 1935, at 3; Securities Act Release No. 1862, *supra* note 72; 1 Loss 668, n.85. See Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 162-63 (1935), indicating that interstate sales by dealers after one year would not ordinarily vitiate the § 3(a)(11) exemption for intrastate offerings; 1 Loss 597. The rule of thumb probably also stemmed from the limitation on the § 4(3) dealers' exemption which was originally one year. See note 15 *supra*.

76. Securities Act Release No. 3825, *supra* note 70. See also Securities Act Release No. 4552, *supra* note 69, at 3; Securities Act Release No. 4248, July 14, 1960, at 6-7, in which the Commission, in its proposed rule 155, declined to adopt any prima facie holding period preceding the sale of underlying securities received upon conversion.

77. 267 F.2d 461 (2d Cir. 1959).

78. 175 F. Supp. 480 (S.D.N.Y. 1959).

79. *Id.* at 483.

establishing his investment intent by a preponderance of the evidence, the *Sherwood* case is of no precedent value.

Notwithstanding the lack of any fixed holding period or of any reliable rule of thumb, the purchaser who gives an investment letter will usually inquire how long he must hold.⁸⁰ Since direct evidence of the seller's intent is rarely available, appearances will form the basis for controlling inferences; the holding period will support or negate an investment intent depending on the other two factors: circumstances at the time of purchase and intervening changes in circumstances. However, the weakness in relying on the holding period lies not in an absence of probative value, because it clearly is probative, but in the tendency to overemphasize it to the exclusion of the other relevant factors. Since it is the most readily ascertainable fact, it is easy to forget that it is only one among several which bear on the question.

If a rule of thumb may be propounded (which is open to serious doubt),⁸¹ the following is advanced. If the holding period is less than two years, the inferences to be drawn from the other two factors must negate a distributive intent in order for the sale to be consummated with reasonable safety; if the holding period is more than two years, the inferences to be drawn from the other two factors must support a distributive intent for the sale to be subject to serious risk.⁸² There will be many cases in which the holding period will have little or no weight.

3. Change of Circumstances

A change of circumstances subsequent to the purchase may permit a sale consistent with an investment intent at the time of purchase. However, several conditions must be met: (1) the change must

80. See text accompanying note 134 *infra*. In 1 Loss 671, the author wonders if, by asking the question, the purchaser has not entertained the fatal thought. See the hypothetical dialogue in Garrett, *Federal Securities Act—An Introduction to Jurisdiction*, 1961 U. ILL. L. F. 267, 293 n.85. Since, under § 2(11), the only relevant intent is that at the time of purchase, a subsequent decision to hold for investment would seem to be irrelevant. The SEC has recognized, however, that the investment versus distribution question is not necessarily determined at the time of initial purchase. See rule 152 and Securities Act Release No. 4248, *supra* note 76.

81. Securities Act Release No. 4248 and other releases cited in note 76 *supra*; Posner, *Developments in Federal Securities Regulation*, 18 Bus. Law. 931, 936 (1963).

82. This amounts to converse rebuttable presumptions based on a two-year holding period when the other factors are inconclusive. The writer can cite no authority for this presumption, since *United States v. Sherwood*, 175 F. Supp. 480 (S.D.N.Y. 1959), is not considered as standing for this proposition. The two-year undertaking in Form S-14 has been cited as evidence that the SEC regards sales after two years as not making the seller an underwriter. See note 145 *infra* and symposium cited therein. However, it is more likely that the SEC, having imposed an obligation to file post-effective amendments, felt constrained to terminate the obligation after a specified period.

not have been reasonably foreseeable at the time of purchase; (2) it must not have been initiated by the seller; (3) it must be outside the scope of normal investment risk;⁸³ and (4) it must bear upon the commitment in the stock and prompt its liquidation. The SEC seems to take the position that the change must render the sale necessary, and not merely desirable or prudent,⁸⁴ although its necessity could indicate an overcommitment inconsistent with an original investment intent, assuming the "foreseeability" that something "unforeseen" may occur. On the other hand, a change of circumstances making a sale desirable but not mandatory may be equally reconcilable with a genuine long-term commitment.

B. Purchasers Under Other Exemptions

To this point, the discussion of statutory underwriters has been limited to persons purchasing from an issuer pursuant to the private offering exemption. The status of underwriter is not limited to this situation; the section 2(11) definition reaches any purchaser from an issuer, regardless of which exemption, if any, is relied upon.⁸⁵

Exemptions from registration are found in sections 3 and 4 of the act and by operation of rule 133.⁸⁶ The statutory arrangement is the source of some confusion as section 3 purports to exempt certain classes of securities while section 4 purports to exempt certain transactions. In fact, the exemptions contained in sections 3(a)(1) for pre-1933 offerings, 3(a)(9) for exchanges with existing security holders, 3(a)(10) for judicially or administratively approved exchanges, and

83. 1 Loss 670-72; P.L.I. 34-39. The Commission seems to be of the view that the change must be in personal circumstances, as opposed to business circumstances such as a merger, change of the issuer's business, or the termination of the purchaser's employment with the issuer. It is arguable that changes in business circumstances are more foreseeable, and thus more within the scope of investment risk, than are changes in personal circumstances. So long as the distinction is not applied arbitrarily, there is no harm in giving it weight. It is unreasonable to require an investor to take subject to any and all changes in business circumstances, some of which may be so dramatic and unforeseeable as to reverse the most genuine investment intent.

84. Securities Act Release No. 4552, *supra* note 69, at 4; 1 Loss 671-72.

85. The purchaser in a registered sale may also be an underwriter upon resale. If so, full compliance with § 5 would require prospectus delivery (which may be a problem if the resale is deferred, see Form S-14 undertaking described *infra* note 145) and the § 11 liabilities would apply to him.

86. There are other exemptions created by rule, but not pertinent to this discussion. Section 3(a) purports to exempt eleven classes of securities, all applicable to sales by an issuer. Sections 3(b) and (c) authorize the Commission to exempt, by rule, issues not exceeding \$300,000 and those by small business investment companies. As stated in Part I *supra*, § 4 consists of four exemptions, only one of which—the private offering exemption—applies to the issuer. Rule 133 (sometimes called the "no sale" rule) has the effect of exempting the issuance of securities in mergers, consolidations, sales of assets, and recapitalizations, if certain conditions are met, by providing that for the purpose of § 5 no sale is deemed to be involved.

3(a)(11) for intrastate offerings are transaction exemptions. They apply only to the issuance or exchange contemplated therein and not to subsequent sales of the securities so issued.⁸⁷ Each of these exemptions is based on the circumstances surrounding the issuance of the security, while the remaining section 3 exemptions are based on the nature of either the issuer or the security.⁸⁸

The rational basis for the exemption disappears after the initial issuance under sections 3(a)(1), (9), (10), and (11), and, when its rational basis disappears, the exemption itself logically falls. If an exemption is construed as representing a determination that the protections of the act are not required in a given case⁸⁹ and if a substitute for the investor protection afforded by registration is found in the nature of the transaction, there is no reason why the exemption should extend to a subsequent distribution. Therefore, the subsequent seller of securities issued under the section 3(a)(1), (9), (10), or (11) exemptions, as well as anyone else participating in the sale, must find his own exemption.⁹⁰

An exchange of securities under section 3(a)(9) or (10) should not alter the status of control persons or those who would be underwriters upon the sale of securities surrendered in the exchange.

87. *W. H. Bell & Co.*, 29 S.E.C. 709, 711-14 (1949); *Ira Haupt & Co.*, 23 S.E.C. 589, 599-600 (1946); *Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1117-18 (1940); Securities Act Release No. 4248, *supra* note 76, at 3-4. See 1 Loss 708-10.

88. The Commission has long acknowledged that the exemptions contained in §§ 3(a)(2) (federal, state, and municipal issues), (3) (short-term notes, drafts, and bills), (4) (securities of non-profit organizations), (5) (certain securities of building and loan, homestead, and savings and loan associations), (6) (securities issued under § 20a of the Interstate Commerce Act), (7) (court approved certificates issued by a receiver or trustee in bankruptcy), and (8) (certain insurance or endowment policies or annuity contracts) are truly exempt securities without regard to the transaction in which they are issued or sold. See *Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1118 (1940); Securities Act Release No. 646 (Class C), Feb. 3, 1936. *But see* Securities Act Release No. 4248, *supra* note 76, at 4-5 regarding convertible securities issued in a Chapter X proceeding and note 89 *infra* regarding §§ 3(a)(6) and (7).

89. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953); *SEC v. American Int'l Sav. & Loan Ass'n*, 199 F. Supp. 341 (D. Md. 1961). This reasoning could be extended to negate the exemption for subsequent sales of securities issued under §§ 3(a)(6) and (7), where a judicial or administrative determination of the fairness of the security and the immediate issuance affords the substitute for registration. The subsequent sale may be on different terms, and the security may have changed in the interim. In the latter case, the rule of *SEC v. Saphier*, 1 SEC Jud. Dec. 291 (S.D.N.Y. 1936) and *Bankers Union Life Co.*, 2 S.E.C. 63 (1937)—that § 3(a)(1) does not apply where there has been a change in the security—could be invoked to terminate the exemption.

90. See *Thompson Ross Sec. Co.*, 6 S.E.C. 1111, 1117-18 (1940), and Securities Act Release No. 646 (Class C), *supra* note 88, regarding § 3(a)(9); *Merger Mines Corp. v. Grismer*, 137 F.2d 335 (9th Cir.), *cert. denied*, 320 U.S. 794 (1943), and compare the unclear opinion in *Shaw v. United States*, 131 F.2d 476, 478 (9th Cir. 1942), regarding § 3(a)(10); authorities cited *supra* note 87 and *infra* note 92 regarding §§ 3(a)(1) and (11). See generally Securities Act Release No. 4248, *supra* note 76. Section 3(a)(1) no longer has any practical significance.

These persons must attempt to come within another exemption for the sale of the securities so received. Whether the purchaser becomes an underwriter upon the sale of securities received in such a transaction depends on whether the sale is part of a distribution.⁹¹

Another approach has been applied to cases arising under the intrastate exemption of section 3(a)(11), which requires that the security be "... part of an issue offered and sold only to persons resident within a single State" This language has been construed to mean that the securities must come to rest in the hands of investors resident within a single state.⁹² The distribution is complete when holders have taken for investment and not with a view to further distribution.

The obvious parallel between the concepts of coming to rest under section 3(a)(11) and being taken for investment under section 4(2) was recognized at an early date by the Commission.⁹³ Although cases involving section 3(a)(11) deal primarily with the availability of the exemption in the first instance, the coming to rest theory is susceptible to the broader application of testing the status (under sections 4 and 2(11)) of a seller of securities received pursuant to other exemptions.

Prior to 1959, rule 133 applied the no sale theory to the issuance of securities in certain mergers, acquisitions, and reorganizations, but was silent on the status of subsequent sales by those receiving the securities. In 1959, the rule was amended to add paragraphs (b) through (f) which impose underwriter status, subject to certain exceptions, on (1) any person who distributes securities issued in the transaction pursuant to any contract or arrangement and on (2) the acquired corporation and controlling persons of the acquired corporation who receive the securities with a view to distribution.⁹⁴

91. Those receiving an insubstantial amount of securities in one of these transactions should not be deemed underwriters or engaged in a distribution, even if they purchase with the intent to resell. As pointed out in 1 Loss 642-43, to hold otherwise would virtually read § 3(a)(9) out of the act since no issuer could ever be certain of the investment intent of all such purchasers. The same would be true for § 3(a)(10). The question may turn, in part, on whether the transaction was essentially public or private. See Securities Act Release No. 4248, *supra* note 76, at 3-5. Although the discussion is of convertible and underlying securities, its rationale could apply to all securities received in such transactions.

92. SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86 (D.N.H. 1958), *aff'd*, 276 F.2d 665 (1st Cir. 1960); Brooklyn Manhattan Transit Corp., 1 S.E.C. 147, 157-63 (1935); Op. Gen. Counsel, Securities Act Release No. 4434, Dec. 6, 1961, at 3. Those participating in a distribution under § 3(a)(11) are underwriters, and the § 4(1) exemption is unavailable should the § 3(a)(11) exemption fail.

93. Brooklyn Manhattan Transit Corp., *supra* note 92; Securities Act Release No. 1459, May 29, 1937. See also Securities Act Release No. 4552, *supra* note 69, at 3.

94. These amendments were prompted by a series of cases in which the old rule had been used as a device for publicly distributing securities without registration

Here the exchange does not alter the status of control persons of the acquired corporation or those who would have been underwriters upon the sale of the securities surrendered. Control persons may make sales within the limits of paragraphs (d) and (e), if unaccompanied by the proscribed selling effort.⁹⁵ Since the amount received in the rule 133 exchange is necessarily in proportion to the amount held in the acquired corporation, purchasers other than control persons and pre-exchange underwriters are unaffected by it and may sell in reliance on section 4(1).⁹⁶

C. Pledgees and Donees

Until the 1960 decision in *SEC v. Guild Films Co.*,⁹⁷ it was commonly assumed that a bona fide pledge of securities did not involve

through effecting a merger followed by a planned distribution of the securities of the surviving corporation by those receiving them in the transaction. *SEC v. Micro-Moisture Controls, Inc.*, 148 F. Supp. 558 (S.D.N.Y. 1957) (temporary injunction), 167 F. Supp. 716 (S.D.N.Y. 1958) (permanent injunction), *aff'd sub nom. SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959); *Great Sweet Grass Oils Ltd.*, 37 S.E.C. 683 (1957), *aff'd*, 256 F.2d 893 (D.C. Cir. 1958) (per curiam); 1 Loss 518-42. It was recognized that the distributing stockholders were mere conduits, and that, although there was no sale by the issuer to them, there was a sale by them to the public on behalf of the issuer. Hence, the sellers came within the other branch of § 2(11) by selling for an issuer, and the sale was not exempt under § 4(1). This result was necessary to close a loophole through which substantial amounts of unregistered securities were being distributed to the public. The amended rule 133 applies underwriter status to, *inter alia*, controlling persons of the acquired corporation who receive the issuer's securities with a view to distribution. 1 Loss 532-33 questions the inconsistency of an underwriter purchasing from the issuer with a view to distribution when the issuer makes no sale. However, the amended rule 133 must be recognized as a pragmatic solution which perhaps does not satisfy technical nicety. Its effect is that, although no sale for the purposes of § 5 occurs, a sale and purchase for the purpose of § 2(11) is involved. As an alternative rationale, "purchased from" in § 2(11) may be read to mean "received from." See discussion of the Schering Corporation-White Laboratories merger, *supra* note 66, for another pre-1959 treatment of the problem. The Uniform Securities Act follows the rule 133 approach by excluding this type of transaction from the definition of sale. See § 401(j)(6)(C). The subsequent resale would be exempt if it qualified for one of the non-issuer exemptions.

95. The purpose of paragraphs (d) and (e) was to equate their positions with that of controlling persons of the acquiring corporation and with their own before the exchange. Securities Act Release No. 4248, *supra* note 76, at 7.

96. Although the Commission is understood to raise no objection to reliance on rule 133 when one stockholder or a group dominates a publicly-held acquired corporation so as to control the vote, framing an acquisition of a closely held corporation under rule 133 to secure the benefit of paragraphs (d) and (e) would seem ill-fated, either because the dictum in *Great Sweet Grass Oils Ltd.*, 37 S.E.C. 683, 691 (1957), that the old rule 133 was not available where the requisite stockholder vote was a mere formality, may have survived the amendments to the rule, or because the purchasers may be deemed underwriters upon even such limited sales.

97. 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960). See also *Skiastron Electronics & Television Corp.*, 40 S.E.C. 236 (1960); 1 Loss 645-51. The sale upon default by a bona fide pledgee is exempt under most blue sky laws. See, *e.g.*, Uniform Securities Act § 402(b)(7).

a sale and that the pledgee would not be deemed an underwriter upon his sale of the collateral after default. In *Guild Films*, stock of a controlling person was pledged and promptly sold upon default of the loan. The lower court based its decision that the sale violated the act on its finding that the pledge was a sham.⁹⁸ In the view of the Second Circuit, however, bona fides is irrelevant under section 2(11) and a pledgee selling stock pledged by a control person after default comes within that section.⁹⁹ Necessarily, the same conclusion would follow for a pledge by the issuer.

Donees of stock from control persons have been deemed underwriters and a distribution by them has been held to require registration when it was reasonably foreseeable by the donor and donee.¹⁰⁰ Likewise, a donee who is the alter ego of or is selling for an issuer or controlling person would be an underwriter.¹⁰¹

D. *The Meaning of "Distribution"*

Heretofore, sales have not been distinguished from distributions, and, as noted above, the legislative purpose of the Securities Act was to apply the registration provisions to the distribution of, but not to trading in, securities.¹⁰² Distribution has been described as "the entire process by which in the course of a public offering a block of securities is dispersed and ultimately comes to rest in the hands of the investing public."¹⁰³ If the transaction in question is but an extension of, or a latter stage in, the original issuance, it is part of the distribution and the seller may be an underwriter.¹⁰⁴ If the distribu-

98. *SEC v. Guild Films Co.*, 178 F. Supp. 418 (S.D.N.Y. 1959).

99. The SEC has supported the *Guild Films* result on two theories: (i) the pledgee takes with an intent to distribute upon the occurrence of a future uncertain event (default) which amounts to an intent to distribute, and (ii) the pledgee must account to the pledgor for the proceeds of the sale after the debt is discharged and is thus selling for the pledgor. Securities Act Release No. 4669, Feb. 17, 1964. On the serious need for the clarification of the status of bona fide pledges, see 1 Loss 650-51; Pierce, *Securities and Exchange Commission v. Guild Films Co. Inc.*, 16 Bus. Law. 603 (1961).

100. Letter of Chief Counsel, Division of Corporation Finance, CCH FED. SEC. L. REP. ¶ 2165.88 (Aug. 8, 1962). In the cases discussed in this letter, the donees were eleemosynary institutions, and a sale of the stock was necessary to accomplish the purpose of the gift. See P.L.I. 32-33.

101. *SEC v. Mono-Kearsarge Consol. Mining Co.*, 167 F. Supp. 248 (D. Utah 1958). See also note 67 *supra*.

102. See H.R. REP. NO. 85, 73d Cong., 1st Sess. 13-14 (1933). See text accompanying note 12 *supra*.

103. *Oklahoma-Texas Trust*, 2 S.E.C. 764, 769 (1937), *aff'd*, 100 F.2d 888 (10th Cir. 1939). See also *Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147, 160 (1935). Both of these cases were decided under § 3(a)(11).

104. *SEC v. Micro-Moisture Controls, Inc.*, 148 F. Supp. 558 (S.D.N.Y. 1957) (temporary injunction), 167 F. Supp. 716 (S.D.N.Y. 1958) (permanent injunction), *aff'd sub nom. SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959). See also authorities cited *supra* note 87.

tion is complete and if the proposed sale is a new and separate transaction, the exemptions of section 4(1) and section 4(3) or 4(4) should be available, respectively, to the seller and his broker, unless the seller is a controlling person of the issuer.

It seems clear that the term distribution is not limited to a single transaction, but may occur in a series of transactions extending over a period of time.¹⁰⁵ The concept of deferred distribution forms the basis for the treatment of privately placed convertible and underlying securities under rule 155.¹⁰⁶ The question is one of intent and purpose, and, if the goal is a distribution, the number of transactions or period of time required to accomplish distribution is irrelevant.

The act and rules do not define distribution in quantitative terms, except in rules 154 and 133(d) and (e). Under these rules, a seller is not deemed to be engaged in a distribution, provided his activities and those of his broker are limited as provided in these rules, if the proposed sale, when added to all sales within the preceding six months, does not exceed one per cent of the issuer's outstanding stock for over-the-counter stocks and the lesser of one per cent of the outstanding stock or the largest weekly volume of trading within any one of the four preceding calendar weeks for listed stocks. Although this test lends itself to broader application, it has not been so applied.¹⁰⁷

The test may represent nothing more than the Commission's estimate of what the market can absorb without resort to the proscribed selling effort, and the essence of distribution is selling effort. This view finds support in the legislative distinction between trading on the one hand and distribution on the other and in the fact that the presence of selling effort would mark a violation of rule 154 even though the quantitative limit were met; the quantitative limit may be exceeded¹⁰⁸ if there is no selling effort. If selling effort is present in a rule 154 transaction, the broker loses his section 4(4) exemption and comes within the terms of section 2(11) as a seller for a control person.

But, if selling effort were the sole criterion, the quantitative test and the exclusion of underwriters in rule 154 would be surplusage.

105. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); *Ira Haupt & Co.*, 23 S.E.C. 589 (1946); Securities Act Release No. 4552, *supra* note 69, at 4-5.

106. See Securities Act Release No. 4248, *supra* note 76.

107. The Commission has stated that it "is not a guide for defining distributions in contexts not covered by the rule." Securities Act Release No. 4669, *supra* note 99, at 2.

108. Under the first sentence of paragraph (b) and the "without limiting the generality of the foregoing" clause in the second sentence.

Likewise, there is no logical reason why an underwriter could not sell within the foregoing limits if there is no selling effort. Before the adoption of rule 154, the Commission recognized the possibility of an unlawful distribution in an active market without selling effort.¹⁰⁹

Distribution involves a public as opposed to a private offering;¹¹⁰ but "distribution" and "public offering" are not synonymous terms. Casual sales under section 4(1) by the normal investor or by the control person within the limits of rule 154 are public offerings, but not distributions.

The issuer, lacking the section 4(1) exemption, is foreclosed from casual selling. The purchaser under the private offering exemption is precluded not only from making a distribution himself, but also from making sales which may be deemed part of a distribution by the issuer.¹¹¹ Those receiving securities under essentially private section 3(a)(9), (10), or (11) transactions or apparent rule 133 transactions would seem to be in the same position.¹¹² The status of substantial purchasers in section 3(a)(9), (10), and (11) public transactions is not entirely clear.¹¹³

A genuine casual sale by such a private purchaser which is not a distribution itself or part of a distribution by his seller should be exempt under section 4(1) because he is not an underwriter upon

109. *Ira Haupt & Co.*, 23 S.E.C. 589, 600-06 (1946).

110. A genuine private offering involves no distribution. However, this term is sharply limited by *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). Under authority quoted with approval by the Court, 346 U.S. at 125 n.11, a public offering could be limited to a small group, even one person, if the class of offerees is not properly restricted. By the same token, one share could be publicly offered to anyone in the world, or to a smaller but still public class, willing to buy it.

111. In this context, "purchased from . . . with a view to . . . distribution" in § 2(11) could include not only an intent by the purchaser to make a distribution, but also an intent to be a part of a distribution by the issuer. The private purchaser from a control person is in the same position. See note 131 *infra*.

112. This result could be reached on several theories: (1) the amount sold may itself amount to a distribution; (2) by analogy to rule 155 (Securities Act Release No. 4248, *supra* note 76, at 3-5); or (3) because they are essentially private placements and should be so treated.

113. They lack a rule of thumb comparable to rule 133(d) and (e). Logically, a § 3(a)(9) exchange should not alter the previous status, and such purchasers should be free to sell in reliance on § 4(1), within the limits of rule 154 if they are control persons, unless they would have been underwriters upon the sale of the securities surrendered. This conclusion finds support by analogy to the non-recognition of a rule 133 exchange for Securities Act purposes, similar to the tax-free reorganization treatment under § 368(a)(1) of the INT. REV. CODE OF 1954 and in Securities Act Release No. 4248, *supra* note 76, at 3-5. However, if the intent to distribute was present at the time of purchase, they come within the letter of § 2(11). The position of substantial purchasers in public § 3(a)(10) transactions who may not have surrendered any securities in the exchange is unclear, although, like substantial purchasers under § 3(a)(11), they appear to be foreclosed from casual sales unless the securities first "come to rest."

such a sale.¹¹⁴ However, since he has no rule of thumb to determine when his sale, standing alone, may be considered a distribution, and the activities of his seller and his fellow private purchasers may be attributed to him, the private purchaser sells at his peril.

Thus the meaning of "distribution" is far from clear. It does require a public offering. For the control person, it seems to connote both a selling effort and a quantity of securities sold. For the potential underwriter selling effort does not seem to be a factor, but, unless distribution means different things when applied to different people, quantity should be a factor even though not limited to the quantity he himself sells. The recognition of the quantitative element of distribution present in other contexts has not been extended to the underwriter.

E. "Hot Stock" v. "Free Stock"

Although a seller's status as a control person is unaffected by which securities he sells, it is generally understood that his status as an underwriter is limited to the particular stock received from the issuer with a view to distribution. Thus a stockholder may be an underwriter as to one block of stock, but not as to another. This distinction receives tacit recognition in rule 154 by the unavailability of that rule to the seller's broker where the control person "is an underwriter in respect of the securities" being sold.¹¹⁵ Since the presumed application of underwriter status upon resale is restricted to the specific stock received from the issuer for investment, a distinction has developed between what is popularly called "free" stock, meaning that as to which the holder is not an underwriter, and "tainted" or "hot" stock, as to which the holder may be an underwriter upon resale.¹¹⁶

114. This question was left open by the Second Circuit in *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959). The SEC rejected the proposal that the rule 133(d) and (e) rule of thumb be applied to private purchasers of convertible securities under rule 155, partially on the ground that rule 133 assumes the existence of an active trading market which is not necessarily present in a private placement. Securities Act Release No. 4248, *supra* note 76, at 7.

115. Rule 154(a)(4).

116. The latter terms are also loosely applied when the holder is a control person, or, in the broadest sense, where a sale may not be made without registration, regardless of the reason. The position of the control person and the underwriter are different, the source of the "taint" in the former case arising from the status of the holder (and applying to all securities held by him) and in the latter from the source of the particular stock (and presumably applying only to that stock). Rule 154 applies to the broker selling for the control person, but not for the underwriter; a lapse of time and change of circumstances, other than his relationship with the issuer, might free stock held by the latter, but not the former. Thus, too much looseness in the use of these terms can lead to confusion. The terms "control" and "investment" stock,

The distinction is supported by a fair reading of section 2(11) and was probably intended. However, section 2(11) is also susceptible to the interpretation that one may be an underwriter without regard to the particular stock to which the intent to distribute relates and that section 4(1) is unavailable in all cases to one who would be an underwriter upon the distribution of any stock held by him. The theory has been advanced that, since stock is fungible, an investment representation ought not to relate to the particular block of stock with respect to which it was given, but rather to the next block sold thereafter up to the amount covered by the investment representation.¹¹⁷ This theory construes the investment representation as applying to an equivalent amount, rather than to the specific stock as to which it was given.

To date, the fungibility theory has not received wide acceptance. There are, however, two Commission decisions which do not limit section 2(11) to the particular block of stock received under an investment representation, but instead hold that a purchaser receiving stock while engaged in a distribution (of, at least to some extent, different stock) is an underwriter.¹¹⁸

In any event, underwriter status should survive changes in the security, such as by stock split or reclassification,¹¹⁹ or by the receipt of a security of a different issuer under rule 133.

Since one who purchases from an issuer or control person with a view to distribution is an underwriter, what then is the status of one who purchases stock as to which his seller is an underwriter? There is nothing illogical in extending underwriter status to one who knowingly takes stock from such a seller intending further distribution.¹²⁰ In *SEC v. Culpepper*¹²¹ judgment was reserved on the status of a purchaser who has no knowledge of the "taint." However,

relating to the control person and underwriter respectively, are more precise, but are also subject to indiscriminate use.

117. P.L.I. 36-37. Presumably the theory would be limited to securities of the same class.

118. *Skiatron Electronics & Television Corp.*, 40 S.E.C. 236, 250 (1960); *Lewisohn Copper Corp.*, 38 S.E.C. 226, 237 (1958). This result is entirely rational where the distributing purchaser could be said to be "selling for" the issuer, and is only slightly less defensible where he is restoring his position in the stock through the private purchase. The Commission is understood to apply this theory to the executive who sells stock to provide funds for the exercise of stock options.

119. Securities Act Release No. 4162, Dec. 2, 1959, pt. 6, announcing the proposed rule 155. The issuance of any new securities involving a sale under § 2(3) would normally be accomplished under § 3(a)(9), if available. See notes 91 and 113 *supra*.

120. Otherwise the purpose of the act could easily be frustrated by running the stock through a nominee. This would amount to a direct sale by the issuer or control person. *MacClain v. Bules*, 275 F.2d 431 (8th Cir. 1960).

121. 270 F.2d 241 (2d Cir. 1959), *affirming* *SEC v. Micro-Moisture Controls, Inc.*, 148 F.Supp. 558 (S.D.N.Y. 1957).

in *United States v. Sherwood*,¹²² the proposition that the "taint" follows stock in successive hands was rejected.¹²³

IV. THE EXTENT TO WHICH CONTROL PERSONS AND UNDERWRITERS ARE LOCKED-IN

Subject to the further development of the fungibility theory or the *Skiatron* and *Lewisohn Copper* cases,¹²⁴ one may be an underwriter as to one block of stock and not as to another. A control person may also be an underwriter as to some, or all, of his stock.¹²⁵ When the control person and underwriter disabilities are both present, the more restrictive one governs. Each is precluded from making a public distribution without registration, although for the underwriter it is the distribution or the intent to make it which causes the preclusion. However, the limitations on the manner in which control persons or underwriters may deal in their stock do not end there.

Casual Sales. Within the limits of rule 154, the control person may effect casual sales through normal brokerage transactions, provided he is not an underwriter as to the stock sold.¹²⁶ In computing the quantitative limits, the amount covered by the sell order is added to all other sales made by or attributed to¹²⁷ the control person within the preceding six months. If this total does not exceed one per cent of the issuer's outstanding stock (for over-the-counter stock) or the lesser of that amount and the largest weekly volume of trading within any one of the four calendar weeks preceding the receipt

122. 175 F. Supp. 480, 483 (S.D.N.Y. 1959).

123. In *Winter v. D. J. & M. Inv. & Constr. Corp.*, 185 F. Supp. 943 (S.D. Cal. 1960), the court declined to fix liability on anyone but the plaintiff's immediate seller, although the facts would allow a finding that each of the successive holders had full knowledge of the "taint," participated in the ultimate distribution, and could have been deemed an underwriter. In 1 Loss 642, the view is expressed that one who knowingly purchases an insubstantial amount of stock from a control person should not be treated as an underwriter, although he may come within § 2(11). See Securities Act Release No. 4248, *supra* note 76, at 5-6, for the treatment of successive holders under rule 155. Section 2(11) contains no express scienter requirement, but it should be implicit; and one who does not know or who is not chargeable with knowledge of the "taint" should not be deemed an underwriter. However, the purchaser of a substantial amount of stock would seem to be under a duty to investigate.

124. *Skiatron Electronics & Television Corp.*, 40 S.E.C. 236 (1960); *Lewisohn Copper Corp.*, 38 S.E.C. 226 (1958).

125. Such as a top executive participating in a stock option or purchase plan, or one joining the control group upon receipt of stock in a private offering.

126. Rule 154 merely defines the broker's exemption of § 4(4), and the seller must find his own exemption. Where he is not an underwriter and the proscribed selling effort is not present, the seller's part in the transaction is exempt under § 4(1). The broker is under an obligation to inquire as to whether the seller is engaged in a distribution or is an underwriter. Securities Act Release No. 4669, *supra* note 99.

127. Sales by persons affiliated with the control person or by their donees may have to be included in determining the availability of the rule. Securities Act Release No. 4669, *id.* at 2-3.

of the sell order by the broker (for listed stock), the sale is not deemed a distribution.¹²⁸

The Commission has stated that rule 154 may not be relied upon to make sales up to its limits in successive six-month periods, as such conduct would be deemed a planned distribution in excess of the rule's limits.¹²⁹ In determining the amount to be matched against the one per cent or weekly volume of trading, all sales within the preceding six months, including both registered and exempt sales, must be counted. Where the weekly volume of trading is controlling, there seems to be nothing to prevent the inclusion of sales on the exchange by the control person during the preceding four weeks, notwithstanding the "bootstrap" benefit derived. In over-the-counter stocks, the one per cent limit may be remarkably generous and not indicative of what the market can absorb in casual trading, when, as is frequently the case, a large portion of the outstanding stock is held by a number of control persons and the public trading market is thin. But the lack of any method of measuring over-the-counter volume seems to require this limit.¹³⁰

Under paragraphs (d) and (e) of rule 133, control persons of the acquired company, who may also have become control persons of the issuer, may take advantage of the "little rule 154" contained in those paragraphs (but not both rule 133 and rule 154 in order to sell twice the amount permitted), notwithstanding the fact that they would otherwise be underwriters upon such sales. There are no restrictions upon the other recipients of stock in a rule 133 transaction. Likewise, there are no restrictions on those receiving insubstantial amounts in essentially public section 3(a)(9) and (10) transactions. Even under the "coming to rest" requirement of section 3(a)(11), casual trading by insubstantial purchasers under this exemption should not be deemed part of the original distribution.

Whether substantial purchasers in these section 3 transactions may make casual sales is unclear, although it may depend in part on whether the transaction was essentially public or private. As in the case of purchasers under the private offering exemption, once they would no longer be deemed underwriters either through passage of

128. Cf. text accompanying note 107 *supra*. The quantitative limits of the rule are safe guidelines. As noted above, if the limits are exceeded by an insubstantial amount, the sale could still be defensible as not amounting to a distribution. See note 108 *supra*.

129. Securities Act Release No. 4669, *supra* note 99, at 4.

130. See rule 154(a), (c), and (d) and Securities Act Release No. 4669, *supra* note 99, at 4-5, for the limitations on the conduct of both the broker and control person in soliciting or inducing purchase orders in anticipation of the sale. Rule 10b-6 under the Exchange Act may be applicable to the sale to preclude purchasing or bidding for the stock by the control person or broker while the sales are being made, even if the quantitative limits of rule 154 are met. Securities Act Release No. 4669, *supra* at 5 n.8.

time or change of circumstances they should be free to make casual sales. Meanwhile, they run the risk that their sales standing alone may be deemed a distribution or a part of the issuer's distribution. There is no safe rule of thumb as in rule 133(d) and (e) or the apparent recognition of a quantitative element in the term "distribution" as applied to insubstantial purchasers in section 3 transactions.

Private Placements. Control persons and underwriters may make private offerings in much the same manner as an issuer,¹³¹ but with one important qualification for the underwriter. Unlike private offerings by issuers or control persons (which are usually judged standing alone), a private offering by an underwriter must be judged in the light of the original offering to him since his sale is deemed but an extension or a part of the original offering. A private offering by an underwriter must be consistent with the exemption claimed by his seller. In effect, the underwriter's offerees will be considered part of the original group of offerees.¹³²

Gifts and Pledges. As noted in Part III, a gift or pledge may be equated to a sale within section 2(11) on several alternate theories. The "selling for" language of that section has been invoked by the Commission as one of the two supports for the *Guild Films* result and may also apply to a gift.¹³³ This language is clearly applicable when the selling donee or pledgee is the alter ego of the donor or pledgor, or when, for other reasons, the gift or pledge is a sham.

The second basis for bringing gifts and pledges within section 2(11) arises when the sale by the donee or pledgee is reasonably contemplated by the parties. Because the Commission views a state of mind which recognizes the possibility of an ultimate sale as an intent to distribute and since the court of appeals in *Guild Films* viewed all pledges as being in contemplation of default, any such transaction by a control person or underwriter in which the possibility of ultimate sale is present carries a degree of risk. Certainly all pledges by such persons are open to question. The obligations of a control person-donor or underwriter-donor, although not entirely clear, are

131. Technically, the exemption for the secondary private offering is not under § 4(2), which applies only to issuers, but under § 4(1); the substance of the exemption, however, is the same. 1 Loss 653 n.43. There have been several recent "swap" or "centennial" type funds prepared to take stock in exchange for their own shares on this basis.

132. If other purchasers in the same private placement are also selling, knowledge of this may be imputed to the particular underwriter and the exemption lost for the entire transaction. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir. 1959), affirming 38 S.E.C. 388, 393 (1958); *Dempsey & Co.*, 38 S.E.C. 371, 376-77 (1958); *Elliott & Co.*, 38 S.E.C. 381, 385 (1958) (all related cases); *Fooshee & McCabe, Private Placements—Resale of Securities—The Crowell-Collier Case*, 15 Bus. Law. 72 (1959).

133. See note 99 *supra* and text accompanying note 101.

probably parallel to those of the private offeror in that such persons must see to it that no disposition by the donee is contemplated.

Customary Restrictions and Procedures in Unregistered Sales. When an issuer intends to rely on the private offering exemption, the custom has developed of obtaining an "investment letter" from the purchaser representing that he is taking the securities for investment and not with a view to distribution.¹³⁴ As an additional precaution, a restrictive legend giving notice of the possible unlawfulness of a sale without registration is frequently placed on the stock certificate and a stop transfer placed against the certificate with the transfer agent.¹³⁵ Once the possible unlawfulness of a sale comes to light, some documentation such as representations of fact, an opinion of counsel, or a "no action letter" will normally be required by either the purchaser, broker, or transfer agent before the sale is executed.¹³⁶

The Chief Counsel of the SEC's Division of Corporation Finance, which administers the Securities Act, will on request furnish interpretative advice on proposed transactions. When such advice is favorable, it is referred to as a "no action letter."¹³⁷ The "no action letter" is, however, a very limited remedy. First, it is not a final determination by the Commission, although as a practical matter the letter would be rescinded in only the most unusual cases; it does not foreclose a private suit under section 12(1) in which the claimed exemption would be open to attack. Second, the "no action letter" procedure is not a fact-finding forum. When a no action request involves factual determinations—which is the case where the question involves the absence of control or the consistency of a sale with an investment intent—the letter will be issued only in the most obvious cases and then only on the basis of the facts as represented. Thus, in these two areas, in which most of the ques-

134. A short form investment letter was condemned in the Crowell-Collier Release, Securities Act Release No. 3825, Aug. 12, 1957. Since that time, a longer form of letter spelling out some of the elements of what SEC regards as a true investment intent has been in vogue. See, e.g., P.L.I. 27-28. The language in this form, to the effect that the purchaser has the right to dispose of his property when and as he sees fit, is open to question. See Advanced Research Associates, Inc., Securities Act Release No. 4630, Aug. 16, 1963, at 10, 19-20; Posner, *Developments in Federal Securities Regulation*, 19 Bus. Law. 593, 596 (1964).

135. Securities Act Release No. 4552, Nov. 6, 1962, at 3; *Symposium—Current Problems of Securities Underwriters and Dealers*, 18 Bus. Law. 27, 85-89, 97 (1962).

136. See Securities Act Release Nos. 3825 & 4552, *supra* notes 134, 135, and Posner, *Developments in Federal Securities Regulation*, 18 Bus. Law. 931, 936-37 (1963), regarding counsel's obligations in giving such opinions.

137. The term stems from the usual conclusion of a favorable letter, that the Division will not recommend any action to the Commission if the proposed transaction is consummated. See P.L.I. 15-18, 126-131, for hypothetical examples.

tions arise, a "no action letter" may be expected only where the legality of the sale is so clear that the letter is not needed.

There are two instances in which a request for such a letter is warranted: when another party to the transaction insists on it, or when the exemption turns on a question of legal interpretation as to which the Commission's position is not clear.

Although the formal restrictions spotlight the question of whether a stockholder is free to sell, the question may be present even where the restrictions are absent. The formalities are only evidence of investment intent and not a substitute for it. Any unregistered disposition by a potential control person or underwriter involves the determination first of status and second of the availability of an exemption. Most often, the consistency of the disposition with an earlier investment intent is an issue. Those connected with a transaction cannot evade their responsibilities to make these difficult, yet necessary, determinations through the "no action letter" procedure.

Registration as a Solution. Frequently, registration will be required to effect a contemplated disposition;¹³⁸ but even registration is not always a satisfactory solution. Registration solely for a secondary offering may raise an ultra vires question.¹³⁹ Only the issuer may undergo registration, and it involves expense and the assumption of certain liabilities. The selling stockholders might, however, reimburse the issuer for all or a portion of the expenses.¹⁴⁰ There may be proposed sales which are large enough to require registration, but too small to justify the expense—which is largely fixed

138. Secondary offerings may be accomplished through regulation A; however, the annual dollar limit is reduced in such cases from \$300,000 to \$100,000. See rule 254(a).

139. A closely held corporation could, however, receive a very real benefit from a registered secondary in the creation of a market for its stock to assist it in future acquisitions or in employee stock purchase or option plans. Purchasers of stock directly from an issuer sometimes obtain commitments to register at their request, particularly in mergers or acquisitions involving the issuance of stock; registration pursuant to such a commitment should also be free from attack as ultra vires. Unanimous stockholder consent is sometimes sought to avoid this question.

140. Indemnity insurance may also be obtained to protect the issuer and others incurring Securities Act liabilities. Until a few years ago, the SEC refused to accelerate the effectiveness of a registration statement, a procedural device which effectively barred a firm commitment underwriting, unless the selling stockholders paid the expense of registration or their proportionate share if the issuer was also registering stock. See 1 Loss 279. Although the Commission no longer takes this position, failure of the selling stockholders to pay their way may raise some blue sky problems. See, e.g., California (where prospectus clearance must be obtained for secondary offerings); Regulation § 357, 1 BLUE SKY L. REP. ¶ 8615 (1963). Registration also involves expenditure of substantial time by personnel of the issuer, for which reimbursement is not feasible.

and does not vary significantly with the size of the offering—regardless of who bears it.¹⁴¹

There are issuers for whom registration would be difficult if not impossible. Although the SEC makes no qualitative appraisal of a security in the course of registration,¹⁴² the disclosure problems of a company in precarious financial condition may be virtually insurmountable.¹⁴³

If registration must be effected, the most satisfactory results are obtained by making a substantial offering through an underwriting group. Participation of professional underwriters, while not a formal prerequisite to registration, will generally mean a more expeditious distribution of the stock and, at the same time, will eliminate some problems in the registration process, which is geared to formal underwritings.¹⁴⁴

The last sentence of section 6(a) of the act provides that a registration statement shall be effective only as to securities intended to be sold. This language is interpreted as precluding registration "for the shelf," that is, registration of a block of stock without any present intent to sell it. Thus the obvious solution for the absence of an exemption—that of registering the stock in question and thereafter being free to sell whenever desired—runs afoul of this provision. But the SEC does not take an inflexible position against shelf registrations¹⁴⁵ and will permit such a registration if coupled with both an undertaking to deregister any stock remaining unsold after some fixed period of time and certain restrictions as to market activity and

141. See note 4 *supra*.

142. This is unlike many blue sky authorities who are authorized or required to make such an appraisal before permitting sales within their jurisdictions or who are authorized to issue a stop order if an offering is inequitable or would tend to work a fraud. See e.g., Uniform Securities Act § 306(a)(E); CAL. CORP. CODE § 25507; Illinois Securities Act of 1953, ILL. REV. STAT. ch. 121½, § 137.5C(4) (Supp. 1964), § 137.11(H) (1960).

143. Form S-1 requires three years' certified profit and loss statements. Forms S-2 and S-3, for certain companies in the development stage meeting specified conditions, contain less rigorous requirements for financial statements. Aside from the financial statements, disclosure problems can be so thorny as to discourage such an issuer from undergoing registration.

144. There are presently two basic types of underwriting arrangements, firm commitment and best efforts. In the former, the underwriters make a firm commitment to purchase the securities from the issuer or selling stockholder, subject to limited outs, and promptly offer the securities to the public. In the latter, the underwriters act as agents for the issuer or selling stockholder, but make no commitment to sell any specified amount of securities.

145. Form S-14 is a type of shelf registration and requires an undertaking by the registrant to file post effective amendments containing a then current prospectus, for a period of twenty-four months after the effective date of the registration statement, prior to a sale by any recipient of the securities covered by the original registration statement who could then be an underwriter. See *Symposium, supra* note 135, at 64-69. The SEC has also permitted other types of shelf registrations for a limited period, in which the prospectus may have to be updated by post effective amendment.

stabilization.¹⁴⁶ Thus, although shelf registration is possible, it is the least satisfactory solution for the locked-in stockholder.

V. CONCLUSION

Clarification is needed both with respect to who is a control person or underwriter and when the status, particularly in the latter case, terminates. This is necessary so that those cases in which the purposes of the act are not served by requiring registration may be eliminated. The harshness of the present statute weighs heaviest on the underwriter, since the control person may avail himself of rule 154. That casual sales by an underwriter should and could be permitted consistently with the purpose of the act seems clear.

If a quantitative element were generally recognized in the term "distribution" as used in section 2(11), those who would be underwriters upon a distribution could make casual sales in reliance on section 4(1). The only remaining task would be to fix the point at which a casual sale ends and a distribution begins. This relief might be achieved by a rule of thumb similar to that contained in rule 154 or by some other refinement of the term "distribution." Selling effort could be controlled as it is in rule 154. If limited to publicly traded stock, the SEC's argument against casual trading by an underwriter¹⁴⁷ evaporates.

In view of the recommendations of the *Special Study*,¹⁴⁸ three categories of transactions might be recognized in addition to existing exemptions: (1) casual sales unaccompanied by special compensation or selling effort, in which no action would be required; (2) distributions, other than by an issuer or control person, in which special compensation or selling effort is involved, requiring the limited disclosure of the terms of the offering recommended by the *Special Study*; and (3) distributions by an issuer or control person, requiring full registration. If the first two categories were limited to publicly traded securities such as those of issuers subject to the Exchange Act reporting requirements, the definitions of control persons and under-

146. Because a shelf registration necessarily involves an offering at a price related to the market price at the time of sale, those participating in such a distribution may not stabilize by over allotment or the entry of bids to support the market during the distribution, as permitted in a formal underwriting within the limits of rules 10b-6 and 10b-7 under the Exchange Act, and they must agree to stay out of the market during the distribution and otherwise to comply with rule 10b-6. See Hazel Bishop, Inc., Securities Act Release No. 4371, June 7, 1961, at 19-20, and Securities Act Release No. 4401, Aug. 3, 1961, regarding the applicability of rule 10b-6 and other problems in an uncontrolled distribution.

147. See note 114 *supra*.

148. Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

writers could be narrowed substantially. Investors would still receive substantially the same protection presently afforded them, but without the unnecessary burden on control persons and underwriters inherent in the present system. This need is heightened by the fact that registration is so frequently an inadequate solution to the investor's plight.

This change would require a quantitative definition of distribution and a delineation of selling effort. However, rule 154 readily lends itself to this application. A more difficult problem would be a redefinition of "underwriter" to exclude all except those who are directly participating in a distribution by the issuer or control person. Although section 2(11) points generally in this direction, the shotgun approach in its interpretation has hit more than the target.

The difference in treatment between publicly traded securities and those which are not publicly traded rests on several grounds. Sales of the former, whether through formal underwriting arrangements or otherwise, are necessarily keyed to an existing market. Similarly, a substantial amount of information, although admittedly not as much or in as accessible form as information contained in a prospectus, is normally available through annual reports to stockholders and financial manuals.¹⁴⁹ The purchaser of the unseasoned security issued by the little known venture is in greatest need of the protections of the act.

Meanwhile, it remains difficult to explain to a client why he cannot make even casual sales of publicly held stock on the open market without registration and prospectus delivery, when the financial press daily reports sales to an undetermined number of purchasers, none of whom received a prospectus. Since it is the purchaser whom the act seeks to protect, the source of his shares should not determine whether he receives these protections, unless the terms of the sale itself depart from usual market transactions.¹⁵⁰

149. This would bring the Securities Act closer to the typical blue sky law, under which listed securities are usually exempt (*e.g.*, Uniform Securities Act § 402(a)(8)), and sales of those listed in financial manuals are exempt transactions if sold either in non-issuer transactions (*e.g.*, Uniform Act § 402(b)(2)) or, subject to certain conditions, by registered dealers (*e.g.*, Illinois Securities Act of 1953 § 4F, ILL. REV. STAT. ch. 121½, § 137.4F (Supp. 1964)).

150. A similar anomaly exists in the dealer's obligation to deliver a prospectus under § 4(3), which seems to depend on the particular shares sold, both during the forty and ninety day periods (see 1 Loss 256-59) and thereafter while he has an unsold allotment.

For another discussion of sales by control persons and statutory underwriters, with particular emphasis on holders of convertible securities and warrants, see Hill, *Rule 154 Under the Securities Act of 1933 and Related Problems—A Proposed Solution*, 20 BUS. LAW. 335 (1965).